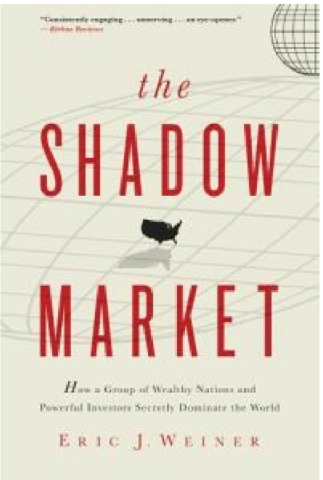

Book The Shadow Market

How a Group of Wealthy Nations and Powerful Investors Secretly Dominate the World

Eric J. Weiner
Scribner, 2010

Recommendation

Journalist Eric J. Weiner exposes the hidden, underreported group of countries and specialized national funds – “the shadow market” – that exerts a huge influence on global and American financial markets, and, indirectly, on US foreign policy. His interpretation of economic forces underpins his case that the US should prepare to play a diminished role in the global economy of the future. He does present a disturbing scenario: Massive public debt held by foreign entities renders the US vulnerable to economic and political manipulation. Weiner clearly believes the US’s future will be very different from its past, but his sometimes hyperbolic tone gives the book a veering-on-xenophobic cast. Nonetheless, *BooksInShort* considers his book an absorbing read for those interested in the new economic factors challenging America’s position in the world.

Take-Aways

- Made up of rich nations and sovereign wealth funds (SWFs), “the shadow market” controls trillions of dollars and operates clandestinely.
- The shadow market countries use economic power to pursue geopolitical agendas that often conflict with US interests.
- While a main US creditor, China has financial links to the Taliban and al-Qaeda.
- The British set up the first SWF in Kuwait in 1953; by 2008, the Kuwait Investment Authority managed $225 billion in assets.
- America’s global influence is waning because foreign investors and governments hold most of its debt.
- The US needs to defend itself against economic warfare and cyberattacks.
- Shadow market participants work through unregulated hedge funds and private equity.
- After the 2008 recession, the US launched a campaign to attract non-US investments.
- The largest ever IPO – $22 billion for a Chinese bank – occurred in 2010, while the West dealt with the collapsing Greek economy.
- The shadow market exemplifies the shift of geopolitical power from West to East.

Summary

What’s Really Going On

Before the 2008 recession began, the US was the world’s economic powerhouse. But as the recession took hold, decimating businesses and draining the capital markets, the US economy desperately needed more cash. In late 2008, the George W. Bush administration sent emissaries from the US Treasury to Kuwait, Saudi Arabia, China, Singapore and Abu Dhabi to request multibillion-dollar capital investments. But these countries rejected the Americans’ entreaties. Already damaged by the failures of Lehman Brothers and Bear Stearns, these nations did not want to assume more US exposure. Without these crucial funds, the US Treasury had no choice but to undertake huge bailout and stimulus programs that incurred massive debt for taxpayers.

> “The march of economic history...is indifferent to your plight or mine.”

The US economy has been weakening for years due to poor fiscal policies combined with excessive consumption and mountains of public debt. Increasing globalization requires capital, which the US can no longer provide, to fund growth. A “shadow market” fills the void. It operates secretly, uses sophisticated investing strategies and, according to projections, will exceed the financial power of the entire West in the near future.

> "The shadow market means that a new global economic force is at play – one that we'll all have to contend with for decades to come."

This shadow financial market has no command center or head office; it is made up of rich nations and investors who operate in unregulated markets and invest through hedge funds, private equity, state-owned corporations and government-run sovereign wealth funds (SWFs). "Petrodollar" states such as Saudi Arabia, Kuwait and Abu Dhabi, as well as China, Japan and South Korea, manage more than $12 trillion in assets. Estimates predict that Persian Gulf- and Asian-owned assets will spike by more than 50% in five years, dwarfing any comparable US gains.

The Shadow Knows

The shadow market developed after World War II, when Britain needed capital to rebuild itself. No longer able to support its overseas territories, Britain chose oil-rich Kuwait in 1953 as the site of the first sovereign wealth fund. Oil revenues in the fund allowed Kuwait to declare independence from the UK in 1961 and it became one of the wealthiest nations per capita on Earth. In 2003, the Kuwait Investment Authority (KIA) adopted a more aggressive strategy based on alternative investments (real estate, hedge funds, new market financing, private equity) to generate higher returns and provide start-up financing to Kuwaiti investment funds. The KIA's success – by 2008 it held $225 billion in assets – has allowed Kuwait to finance the diversification of its economy away from oil dependence.

> "As the US debt load has skyrocketed, the concept of mutually assured destruction has become the central economic metaphor for America's financial dilemma."

But the wealthy nations of the shadow market also use their economic power to pursue their own geopolitical agendas. For example, take China, which owns 10% of Morgan Stanley as well as holding $2 trillion worth of US currency and bonds: Chinese-made weapons have turned up in Taliban and al-Qaeda possession, pointing to China's "financial relationships" with "enemies of the West." Rich countries like Qatar and Dubai have complex relationships with pariah states such as Iran, and they serve as financial hubs for transferring money to terrorist groups.

> "The sheer size of [US] national debt – and the fact that it's largely held by many of our global rivals – has reduced our potential geopolitical influence, because we really are controlled by the countries that have invested in us."

Since 2007, foreign investors and governments have held most of the US's debt, a development that potentially constrains America's global influence, especially when some of the lending nations are US rivals. America's dependence on nonresident financing sources led Michael McConnell, the former director of US national intelligence, to point out in 2008 that one of the greatest threats against the US is that of "the financial capabilities of Russia, China and the OPEC countries" to impose their political aims. Some military and intelligence officials have even called for preparations for economic warfare. For example, US government simulations show that if China were just to rejigger its portfolio of Treasury bonds to shorten maturities from 90 to 60 days, it would wreak havoc in US markets.

The Mexican Mess

The "tequila crisis" of 1995 revealed the fragile and interconnected nature of the global financial system. The rapid collapse of the Mexican peso in what former secretary of the Treasury Robert Rubin termed "the first real financial crisis of the 21st century" spread investor panic throughout developing nations' economies, threatening their stability as well as businesses and jobs in countries – like the US – that trade with the developing world. Rubin convinced President Bill Clinton to support Mexico with $20 billion in loan guarantees, while the International Monetary Fund added another $18 billion. America then had the liquidity and sway to intervene in a foreign country to safeguard its own financial interests. The efforts stabilized Mexico's economy and provided important lessons to other countries with "aspirations for increased geopolitical influence": that financial clout could override military capacity and that a fiscally weakened US wouldn't be able to exercise the same authority it had wielded during the tequila crisis.

Shhh...Follow the (Secret) Money

While foreign governments may control huge amounts of capital, not all are savvy investors. As a result, they are buying that expertise by investing in established private equity investment firms and hedge funds, while also setting up their own funds in conjunction with top-name managers. The migration of leading investment talent to SWFs emerged as a major hiring trend in 2009 and is expected to continue, according to management employment specialist Heidricks & Struggles.

> "In many ways, we're now living in the global, free-market capitalist society our bankers and financiers always dreamed of."

Shadow market operators take particular interest in private equity firms and hedge funds: These firms negotiate their investments in confidence, using borrowed money to engage in activities ranging from venture capital to leveraged buyouts. In 2009, China's chief SWF, the China Investment Corporation, invested $500 million in a fund operated by the Blackstone Group.

> "For all the financial frustrations surrounding the rise of economic power of wealthy oil states in the Persian Gulf, it's the geopolitical implications that are truly frightening."

While these investments differ, their common denominator is secrecy. Neither hedge funds nor private equity firms have to disclose their activities. They are exempt from the US Securities and Exchange Commission's oversight through their use of SEC Rule 144A, which permits "qualified institutional" investors (those with more than $100 million in market holdings) to transact among themselves without registration and with few legal requirements. This privacy is one reason Rule 144A transactions have raised more money each year since 2006 than funds raised in initial public offerings (IPOs), and it's also why individual investors hold only 30% of all securities traded in the US; large institutions own and trade the rest in secret.

Declaring Economic Independence

A 2008 Ernst & Young report projected that the BRIC nations will contribute 40% of the world's economic growth until 2020, while the US will only add 14%. At the first ever "BRIC summit" in 2009, Brazil, Russia, India and China met "to declare their economic independence from the US and the European countries that have long dominated the global financial system." While the BRIC nations form a loose federation, their statement highlights "the tectonic shift" in shared global economic responsibility from the G7 (Western nations) to the G8 (plus Russia) to the G20 ("19 industrial and emerging-market countries plus the European Union"). A concrete example of this change occurred in July 2010, when the biggest ever IPO – $22 billion for the Agricultural Bank of China – launched while the Greek financial crisis preoccupied Europe and the US.

> "The uncontrollable power of oil wealth is shifting geopolitical power across the world in ways we're only beginning to understand."

China invests worldwide with both economic and diplomatic ends in mind. Wielding billions of dollars, it has funded infrastructure development in India and Southeast Asia, extended credit to Argentina and made unconditional "concessional loans" to African nations. China's interest in securing access to Iran's oil explains why China routinely opposes measures against Iran's nuclear program (although China gave its tacit approval to new UN sanctions against Iran in 2010). China aggressively seeks US technology, both in the open marketplace and through corporate espionage. US prosecutors have brought numerous cases against, and secured convictions of, individuals engaged in procuring classified technology, as well as in carrying out organized hacking and cyberspying efforts on behalf of the Chinese.

The Shadow Market in Action

When the shadow market acts, it exerts its tremendous power through complex and sometimes obscure methods. For example, when a bomb blew Pan Am flight 103 out of the sky over Lockerbie, Scotland, on Dec. 21, 1988, killing 270 people, investigators traced the terrorist act back to Libyan intelligence. Eventually, Scottish authorities convicted Libyan intelligence official Abdel Basset Ali al-Megrahi of the crime and sentenced him to life imprisonment in the UK.

> "The only real way for the countries of the West to play the shadow market was to open their markets, engage the wealthy nations diplomatically and economically, and let the cash flow."

But the Libyans wanted him back. British officials also wanted its energy corporations to get access to Libya's natural gas and oil. Thus began a long-secret courtship involving banks, oil companies, and Libyan and UK diplomats. The cozy relationship worked. Despite protests from the US, in August 2009 the UK released an ailing Megrahi and returned him to Libya where he received a hero's welcome. At about the same time, 150 UK firms opened new operations in Libya or received lucrative business contracts from the Libyans. And, in a neat exchange, Libya's SWF, the Libyan Investment Authority, invested "hundreds of millions of dollars" in the UK.

> "What European countries are most concerned about is their obvious loss of influence in the global arena."

But not all SWFs operate in nefarious ways. Norway's SWF, the Government Pension Fund Global, is unique in its approach: It follows a transparent, socially conscious investment program based on the "Santiago Principles" of fair and free trade. Its investment platform stresses shareholder rights and nonfinancial issues such as child labor, water management and climate change. Its managers are subject to scrutiny by an ethics committee. But the SWF doesn't hesitate to take political stands on issues about which the Norwegian government feels strongly. For example, to send a message criticizing "Israel's policies toward the Palestinians," the fund disinvested in an Israeli company that provides observation equipment on the West Bank.

Shifting Currents

As the shadow market expands, Europe's relative economic and political importance diminishes. In 2004, almost a third of global trade came from the 16 euro zone countries; by 2008, the EU's share had dropped to 28%. As the recession of 2008 deepened, Europe's economy declined, aggravated by problems in Greece, Spain and Ireland.

> "At its core, the emergence of the shadow market is the story of geopolitical power shifting from West to East."

Ironically, Britain failed to set aside its own oil revenues into a dedicated SWF when it discovered oil reserves in the 1970s. Instead, the money disappeared into government spending programs. In 2009, UK officials started asking SWFs to invest in British government-owned banks and assets. In contrast, France started a $28 billion SWF in 2008 with the stated purpose of investing only in French companies as a means of protecting them from takeovers by non-French investors. Germany took another tack: There, the government enacted legislation that would allow it to examine any proposal by a non-EU organization "to buy 25% or more of a German company." The announcement angered Middle Eastern-based SWFs, so, under EU pressure, the Germans tempered the plan to permit investments that did not directly "threaten" state interests.

> "We can argue over whether the development of the shadow market is good or bad...but that misses the bigger picture of what's going on."

The US faces similar issues with non-US investors buying into domestic companies. In 2009, Chinese firms bought more assets in the US than American companies purchased in China. Given the enormous pools of overseas funds, US corporations will increasingly look abroad to raise needed capital. After the 2008 recession crippled American industry, the US Commerce Department launched its "Invest in America" campaign to attract foreign investors. The campaign is working. Cash-rich countries like South Korea, Saudi Arabia and India are investing in the US to gain access to the huge American market. Wisconsin boasts a shopping center built with Chinese investors' capital, and Georgia houses a Chinese soy sauce factory.

> "The shadow market simply is. It's a force in the world that we all have to deal with."

All this is part of a change in political and economic supremacy moving from West to East. Experts predict that between 2020 and 2030, China will surpass the US as the world's biggest economy; by 2050, India's gross domestic product will equal America's GDP. The US and the West may control less of their economic future, but the shadow market is here to stay.

About the Author

Barron's and *Kiplinger's* named **Eric J. Weiner**'s first book, *What Goes Up,* one of the best books of 2005. Formerly with Dow Jones Newswires, he has written for *The Wall Street Journal, The Los Angeles Times* and *The Boston Globe.*