

Sovereign Wealth Funds and Implications for Policy

Testimony

by

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Permit me to start with a few salient observations about Sovereign Wealth Funds (SWFs) before I proceed to policy implications.

Sovereign Wealth Funds

1. Sovereign Wealth Funds are over 50 years old, not an entirely new phenomenon.
2. What is new is their rapid growth and the fact that they have spread almost worldwide, spanning many different countries. There are the so-called “Super Seven” SWFs, each with assets of over \$100 billion. They are in: Singapore (two), Abu Dhabi, Norway, Kuwait, Russia and China.
3. By most estimates, SWFs recently exceeded \$2 trillion already. Some forecast, using current trends, that they could exceed today’s US GNP by the end of 2020. Still, the overall world stock of financial assets is estimated variously in the range of \$165 trillion and up, so that the SWF assets, while “large”, are also “small”.
4. What exactly are they? They represent government-controlled funds. So, typically (but not exclusively) they reflect either (i) monetary authorities’ foreign investments (traditionally, central banks invested their reserves in foreign treasuries, rather than in equity) or (ii) more typically (in areas such as the Middle East) the funds that government entities have earned through exports of oil and other commodities (and which are typically beginning to invest in equity in the US and other rich countries).

Anxiety over SWFs

5. A general anxiety over SWFs has arisen for several reasons. (i) First, we confront the sheer speed at which these funds have increased. The “role reversal” where we have others buy into our banks and businesses instead of being the top dogs ourselves, is a painful reality which makes many of our citizens uncomfortable. (ii) Second, many Western governments (including France and Germany) and their publics are worried about the “non-transparency” of these funds’ investment strategies. With some, we know that they invest here; but we have little clue about their governance and decision criteria in any form or degree whatsoever. So, the fear has grown about their pursuing non-commercial criteria in investing their funds (sometimes referred to as “strategic” investing). In particular, the potential non-commercial aspect of the investment strategy by SWFs, has created a general anxiety that we are laying ourselves open to political exploitation by the governments that own these SWFs. (ii) Third, this fear is particularly likely to arise because the politics of these countries is not one that excludes potential rivalry and even political instability and/or hostility. Thus, in the United States, Chinese and Middle Eastern (SWF) investments have attracted particular opprobrium especially because these are areas where there is feared political instability (the Middle East) or even potential hostility (China and the Middle East). Even in regard to Russian SWFs, the continual Putin-bashing that has afflicted most of the media, and the hostile

and jaundiced coverage of Gazprom, has added to the fear that somehow we are laying ourselves open to exploitation by a Russia that is undemocratic and moving away from us in democracy and from international policy convergence. Again, in regard to China, their equity investments lead to the fear, voiced daily by Lou Dobbs, that China is out to get our technology and to spy on us. He and his likes influence and feed uninformed public opinion on trade, immigration and now China, with hardly any politician daring to take him on frontally: only Senator Obama, to his credit, has denounced him in no uncertain terms while others have had their allies and spokesmen appear on his show without any sense of embarrassment or shame.

6. Let me elaborate on some of these observations; and then turn to the question of how to deal politically with this general anxiety over SWFs.
7. First, it is indeed true that many SWFs have limited or no transparency. The lack of transparency happens to have some correlation with whether the government controlling these funds is democratic or autocratic (i.e. “non-democratic” in one way or another). In the Chart below, my CFR colleague Brad Setser and his Research Associate Arpana Pandey have plotted the form of Government on the vertical axis and the Level of Transparency on the horizontal axis, showing how non-transparency and lack of democratic governance tend to go more or less together. This is not surprising. Democratic governments typically have to meet, in their governance and in their institutions, transparency standards that dictatorships and sheikhdoms do not have to. But because a fair number of such SWF countries are non-

democratic (e.g. UAE and China for sure), the non-transparency makes recipients of these funds afraid that non-commercial “strategic”, political and social factors would prevail in the making of their investments.

8. But remember that even transparency does not ensure that the SWF will not be used to promote non-commercial, non-economic objectives. Thus, the Norwegian SWF proudly refuses to invest in sectors and countries which do not satisfy Norway’s own menu of social responsibility criteria. Is it alright for Norway then to be influencing other countries’ social policies while it would not want other countries to influence (in however limited and paltry a fashion) Norwegian politics? In fact, before outlining my views on what the US needs to handle the anxiety over SWFs, let me proceed to put the SWF question in the context of the US itself using private investment, aid and trade, among other phenomena to advance US political and social objectives.

Public Policy on SWFs: Putting it into Context

9. In deciding on Public Policy to address the anxiety over SWFs especially concerning their possible use of “non-commercial”, “strategic” objectives, it is necessary to put the matter into context. Our own policies on private investment outflows and on trade, for example, are not free from attempts at advancing our political and social, broadly “non-commercial”, agendas. At the same time, there is little evidence that SWFs have been used significantly for “strategic” investments.
10. Thus, we have used Preferential Trade Agreements (PTAs), such as Free

Trade Agreements, to use our political and economic power to compel the smaller countries in one-on-one negotiations, to accept a variety of trade-unrelated, non-commercial objectives, ranging from environmental and Labor agendas to restrictions on the ability to use temporary controls during financial crises.¹ Important developing countries such as Brazil and India, both democracies, reject such PTAs with us, and with Europe, unless they are free from such political and social demands that piggyback on trade negotiations and advance unilaterally defined “non-commercial” objectives reflecting domestic politics and domestic lobbying agendas. I could also cite the deliberate use of trade retaliation under Section 301 of the 1988 Omnibus Trade and Competitiveness Act to impose on others our own unilaterally-defined views as to “unreasonable” practices which reflected our own political and social agendas: a practice that attracted worldwide opprobrium.

11. More importantly, the US has often exercised pressure on private US investors to conform, not to “commercial” criteria, but to national “non-commercial”, “strategic” priorities and objectives. Most tellingly, the 1996 Helms-Burton Act was aimed at extra-territorial demands on foreign firms to advance the objectives of the Cuban embargo (which was operative in any event on US firms). The Act caused an uproar internationally, with the EU and Mexico denouncing the Act and enacting counter-legislation, while the EU threatened to take the matter to the WTO. It is naïve to believe therefore that we allow only strictly commercial objectives to guide the volume and

¹ These issues have been addressed fully in my book, Termites in the Trading System: How Preferential Agreements are Undermining Free Trade, Oxford University Press, July 2008.

direction of our private investment outflows. It would in fact be astonishing if politics were kept out of commerce in this pristine fashion in a constituency- and-lobby-responsive democracy like ours.

13. In fact, even private pension funds have been known to use political and other non-commercial agendas to seduce or intimidate foreign governments into compliance with these agendas, bypassing strictly “commercial” objectives. Thus my colleague at the Council on Foreign Relations, Ben Steil, has written in the Wall Street Journal (March 7,2008) about such political investing by California’s Public Employees’ Retirement System, Calpers which has \$259 billion in assets and “would rank fifth among the world’s SWFs”., and by the California State Teachers’ Retirement System (Calstrs) which has \$169 billion, the two together making California “the second largest SWF in the world, just behind the United Arab Emirates”. Maybe foreign governments and impartial observers are not “anti-American” when they contrast our own behavior with US anxiety over and demands on SWFs abroad.
14. By contrast, as Peter Mandelson (the EU trade commissioner) has written recently in the Wall Street Journal (June 7-8, 2008) that “In my meetings with them, sovereign fund managers have often bridled at being the subject of suspicion. They rightly point out that for more than five decades they have been quietly investing the proceeds of oil and gas wealth for future generations without raising the slightest concern. Some have standards of transparency that are exemplary.”

Which way for US Policy on SWFs

15. But US policymakers cannot ignore the anxiety in the body politic, no matter how unjustified it may be. This became obvious during the uproar during February-March 2006 over the proposed purchase, after approval by the Committee on Foreign Investment in the United States (CFIUS), by DPW, owned by the government of Dubai, of 6 major US seaports and takeover of management of 16 other lesser seaports. Dubai is an ally or a satellite, depending on your political viewpoint; but it is certainly not a hostile or unstable government. But the political uproar was quite enormous, accompanied by Congressional hearings and widespread condemnation. My own view was that this fuss was entirely irrational. But, once the security issue had been raised, with sabotage feared from the Middle East, it made no sense to persist with it. Suppose that the sale had been approved despite the political tsunami. And then some sabotage had happened at one of the 6 ports (as is always possible). That would then have killed the possibility of a more enlightened policy in this regard.
16. To handle the politics of the issue, therefore, it is necessary now to develop a short list of sensitive sectors where “enhanced scrutiny” is exercised over inflows of funds, whether private or SWF, leaving all other sectors with free entry. The French do it and more for their “national champions” (which include, believe it or not, Dannon which produces yoghurt). But we can be more sensible. Bipartisan involvement of Congressional leadership on particularly sensitive investments (like seaport and airports) would also preempt later political surprises and embarrassments with political fallout in

terms of our image abroad as champions of an open world regime on trade and investment. Indeed, we must recognize, and not compromise on, our openness which has been so rewarding to us (including to our workers as much empirical work shows that the pressure on our worker's wages cannot be attributed to trade and indeed some studies, such as mine, provide evidence that trade openness may actually have moderated the fall in real wages resulting from acute and repeated labor-saving technical change).

17. Do we also need an international, voluntary Code of Conduct on SWFs?

This is the current thinking.

Mandelson states that the IMF is interested in masterminding such a Code but that SWFs are suspicious of the IMF. We merely need to recall that, unlike the WTO which had an open and fiercely contested election where the Brazilian candidate was a close front-runner who lost to Pascal Lamy, the choice of the IMF Managing Director was basically regarded as a European prerogative. The newly emerging countries were denied the place, with the Europeans saying: next time, not now. It was reminiscent of the famous remark of St. Augustine in his bacchanalian youth: "Dear God, grant me chastity but not yet".

The OECD also wants to embark on formulating such a Code. But its credentials are also weak: except for Mexico and South Korea, it is a club of the rich countries who represent the countries receiving SWF funds, not the countries that own them. Unfortunately for the OECD, its attempt at formulating a Code on Multinationals revealed the flaw of such

unbalanced representation. Its attempted code on multinationals failed because it contained mainly the rights of multinationals, and virtually nothing on their obligations (e.g. Corporate Social Responsibility) or on the rights of the receiving countries. The Code should have been a tripod with all three legs; instead it had only one leg and the stool collapsed as critiques multiplied.

But, leaving aside the question of who oversees the formulation of a Code, do we really need one? My view is that the problems currently about the SWFs will iron themselves out as both the SWF-investing countries and the investment-receiving countries have incentives to arrive at a workable solution without a bureaucratic Code having to be formulated, with all the attendant compromises that leave behind much dissatisfaction. First, the SWF owners have little incentive to get themselves shut out of desired investment outlets. So, they will surely hire Wall Street firms like Goldman Sachs to do their investing, for example: I heard a Chinese high official say precisely this when the SWF matter was raised at a small meeting I recently attended in Florence. [I might add that rewarding Goldman Sachs with a juicy contract would not counter in the US eyes the fear that the Chinese SWFs are going to be used for non-commercial purposes; it would also have the added advantage of pleasing Treasury Secretary Paulson!]

As for the US and other rich countries, the enhanced influx of SWFs is, at least as of now, a matter of high priority. Where would Citigroup be

without SWF infusion? Indeed, the competition for SWF funds is likely to be sufficiently intense for the US and others to not create too many obstacles, and to put in place just a few procedures (such as the one recommended above for “enhanced scrutiny”) to shield their political flank, in the way of the SWF investments.

Hence, the need for a Code seems to be negligible; it is really a red herring.

CHART:

SWF: Relationship between transparency and form of government

