The Foreign Policy Implications of Sovereign Wealth Funds

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Prepared testimony for the Senate Foreign Relations Committee, June 11, 2008

Sovereign wealth funds (SWFs) are government-controlled pools of assets designed to engage primarily in foreign portfolio investment. They are distinct from other sovereign assets – central bank reserves, state-owned enterprises and banks, and government pension funds – because of the emphasis on cross-border equity purchases. Their size, rate of growth, and national origins have raised concerns about whether and how SWF investments impact America's economy and foreign policy. This testimony focuses primarily on the latter

In most respects, the growth of sovereign wealth funds has marginal effects on the contours of U.S. foreign policy. SWFs are, rather, a symptom of other national ailments – persistent macroeconomic imbalances and a failure to diversify America's energy supply. As symptoms go, sovereign wealth funds are relatively benign in their foreign policy effects. Indeed, SWF investment patterns have been less aggressive than the similar wave of Japanese foreign direct investment during the eighties. If anything, these investments demonstrate the ever-increasing interdependence of the Pacific Rim and Middle East with the American economy. There is, however, one foreign policy wrinkle from the rise of sovereign wealth funds. Their growth will significantly impair America's democracy promotion efforts.

BACKGROUND

Sovereign wealth funds are not a recent invention – Kuwait created the first modern one in 1953. Nor are they un-American: the state governments of Alaska and Texas both have sovereign funds designed to manage the revenues that have arisen from their energy booms.

What is new is the size of recently created funds, their anticipated rate of growth, and their countries of origin. Over the past three years, these funds have been growing at a 24% rate. In 2007 these funds invested $48.5 billion globally; in the first three months of this year, they registered more than $24 billion in overseas investments. SWFs have been involved in high-profile equity purchases of high-profile financial institutions, lincluding Blackstone, Credit Suisse, UBS, Merrill Lynch, Morgan Stanley, Visa, and Citibank. The combined heft of sovereign wealth funds is currently estimated to be between $3

trillion and $3.5 trillion. To put this in the proper perspective, this is between one and two percent of global asset markets. Private sector analysts project that by 2015 their total valuation could range in size from $9 trillion to $16 trillion. In 2007, Russia and China created new sovereign wealth funds. Saudi Arabia created one this year, and press reports indicate that Japan and India might create their own funds in the near future.

Two kinds of governments are pumping the most money into sovereign wealth funds: energy exporters and Pacific Rim economies. For the oil exporters, the incentive to create a sovereign wealth fund is two-fold. First, these economies want to create assets that ensure a long-term stream of revenue to cushion themselves against the roller coaster of commodity booms and busts. As many economists have observed, these countries are simply converting assets extracted from the earth into a more liquid form. Second, by focusing on foreign direct investment, these governments are attempting to forestall the Dutch disease of rapidly appreciating currencies. Overseas investment via sovereign wealth funds can accomplish both tasks simultaneously.

Export engines like China are also using sovereign wealth funds to keep their currencies from appreciating too quickly. As of 2007, China had accumulated more than $1.8 trillion in foreign assets in order to prevent the yuan from rising – and therefore keeping Chinese exports competitive in the United States. More than 80% of these assets exist in the form of foreign exchange reserves – safe investments with very low rates of return. As these reserves have accumulated, the Chinese government has been willing to diversify its holdings into higher-risk investments – hence the creation of the China Investment Corporation last year.

THE PATTERN OF SOVEREIGN WEALTH FUND INVESTMENTS

To date, the effects of SWF investment in the United States have been benign. The general consensus among financial analysts is that sovereign wealth funds have taken a long-term, passive approach to their American investments. The bulk of recent SWF investments has been for either non-voting shares or stakes too small to trigger the CFIUS process – somewhat defusing concerns about foreign state control of the U.S. financial sector. A majority of sovereign funds have explicit policies preventing them from acquiring controlling interests, and most of the rest have implicit policies following the same course of action. Compared to the wave of private Japanese foreign direct investment during the 1980s, sovereign investments have been considerably less controlling. They have consciously avoided the purchase of "trophy assets" such as Pebble Beach or Rockefeller Center. The more mature sovereign wealth funds outsource the management of many of their assets to outside managers.

Indeed, the high-profile purchases of equity stakes have permitted firms like Citibank to recapitalize in the wake of the subprime mortgage crisis. The specter of China's SWF presence has also been exaggerated. While the China Investment Corporation (CIC) has $200 billion to invest, the bulk of its assets have been invested domestically. As of March of this year, CIC's overseas investment total less than $20 billion, though this is

expected to grow. CIC's most notable foreign investment – Blackstone – was made by a subsidiary prior to its takeover.

The comparative advantage of sovereign wealth funds is that they can hold large positions for long stretches of time, weathering short-term panics and downturns (this is a good thing for them – between February 2007 and February 2008, high-profile SWF investments earned a real rate of return of negative ten percent). If these funds are attempting to maximize profits, they would therefore function in a countercyclical manner akin to hedge funds. This kind of investment pattern does not pose a threat to American interests.

OVERALL EFFECTS ON U.S. FOREIGN POLICY

One foreign policy concern is that SWFs are sprouting up primarily in countries not commonly thought of as reliable U.S. allies. Could they would use their stakes to exercise political influence over American firms? Testifying before the U.S.-China Economic and Security Review Commission in February, Alan Tonelson articulated this concern: "If, for example, the Chinese government held significant stakes in a large number of big American financial institutions, especially market-makers, and if our nation's current period of financial weakness persists, how willing would Washington be to stand up to Beijing in a Taiwan Straits crisis?" That same month, Senator Hillary Clinton observed: "You know, you cannot get tough with your banker. You cannot stand up if they have very different interests in the Middle East or in Asia than we do and they basically say, fine, you want us to dump dollars? Do you want us to pull our investments out?"

This fear rests on some tenuous assumptions. First, it presumes that foreign governments will know how to strategically invest so as to maximize foreign policy leverage. This might give governments too much credit. As Kenneth Rogoff pointed out in congressional testimony last year: "Governments have a long tradition of losing massive amounts of money in financial markets. This tradition is not likely to end anytime soon." Second, because of existing U.S. laws and guidelines, it is far from clear whether sovereign wealth funds could exercise malevolent control over firms even if they tried. The Foreign Investment and National Security Act of 2007 already requires heightened scrutiny when a foreign government-controlled entity acquires a controlling stake in a U.S. firm – and the Treasury Department's suggested guidelines suggest that CFIUS will investigate proposed acquisitions below the controlling level. Third, a cursory review of past waves of foreign direct investment reveals that in times of global crisis, what matters is the actual location of physical assets, not the identity of their owner.

Many analysts predict that capital exporters will possess bargaining leverage on regulatory questions. However, the *tâtonnement* process of bargaining currently taking place between home and host countries of sovereign wealth funds suggests that concerns about transparency will be addressed. Last year the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD), in response

to a G-8 request, initiated reviews of best practices for sovereign wealth funds appropriate inward investment regimes for recipient countries. Both international organizations have made reasonable progress in their remits, and experts in both organizations seem unperturbed by their investment patterns to date.

Individual sovereign funds are also adapting to the changed political environment. Two of the largest sovereign wealth funds – Singapore's Government Investment Corporation (GIC) and the Abu Dhabi Investment Authority (ADIA) – agreed to principles of transparency with the U.S. Treasury Department in March of this year. The head of CIC pledged on *60 Minutes* that his fund would match Norway's sovereign wealth fund in transparency. Singaporean officials have made it clear earlier this year that it recognizes the need for greater transparency in its investment plan. GIC's deputy chairman explained, "The greatest danger is if this is not addressed directly, then some form of financial protectionism will arise and barriers will be raised to hinder the flow of funds."

This last quote indicates why American foreign policy does not face significant constraints from SWF investment. The interdependence created by sovereign wealth funds cuts both ways. At present, the United States needs SWF investment to finance its large current account deficit. However, most other asset markets are neither big enough nor open enough to cater to large-scale sovereign wealth investments. Large market jurisdictions – the United States and European Union – should be able to dictate most of the rules and regulations regarding these funds. While the OECD economies – and prominent firms within these jurisdictions – might need SWF investment, it is equally true that capital exporters need America and Europe to keep their jurisdictions open to capital inflows. These two markets remain the only ones deep and liquid enough to absorb inflows in the trillions of dollars. Indeed, the very countries ginning up sovereign wealth funds at the moment are the most protectionist when it comes to foreign direct investment.

Sovereign wealth funds are unlikely to disrupt the functioning of the American economy. They are symptom of other problems. U.S. consumption is keeping energy prices high. A low U.S. savings rate, combined with the foreign manipulation of exchange rates, has allowed some Pacific Rim economies to inflate their current account surpluses. Those are the macroeconomic forces that are causing foreign governments to expand their sovereign wealth funds. Addressing those problems sooner, rather than later, will go a long way towards eliminating sovereign wealth funds as a political hot potato. Improving the savings rate of Americans, for example, would help to reduce the large current account deficit that is fueling the growth of sovereign wealth funds in the Pacific Rim. Reducing energy demand would also reduce the growth of sovereign wealth funds among energy exporters – though such a reduction would be partially offset by rising demand around the globe. Recent trends suggest that market forces are moving in the preferred direction. In recent years the Chinese renminbi has appreciated by 20% against the dollar. High prices will likely contribute to greater conservation efforts and reduced energy demand.

EFFECTS ON DEMOCRACY PROMOTION

The biggest effect of sovereign wealth funds on American foreign policy is their effect on democracy promotion efforts. These funds impact U.S. foreign policy in this area on several dimensions. SWFs aid and abet in the persistence of "rentier states" – governments that do not need their citizens to raise revenue. Democratization is a much more difficult policy for the United States to pursue when the target government is sitting on trillions of dollars in assets to buy off discontented domestic groups. Authoritarian governments in the Middle East and East Asia will be more capable of riding out downturns that would otherwise have threatened their regimes.

More generally, the growth of China's sovereign wealth fund belies the notion that as China grows richer it will become more democratic. Embedded within America's current national security strategy is the assumption that as China integrates itself into the global economy, it will face a growing demand from its own people to follow the path of East Asia's many modern democracies, adding political freedom to economic freedom. If the Chinese government can blunt pressures towards democratization through its financial muscle, then the United States will need to recalculate its long-term approach towards Beijing.

More perversely, the growth of sovereign wealth funds, combined with rising nationalism and anti-Americanism in capital exporting countries, would give the United States even less reason to *want* democratic transitions in these parts of the globe. Consider the effect of a populist or fundamentalist revolution taking over in Saudi Arabia or the Gulf emirates. Rampant anti-Americanism among the Arab populace could encourage a new government to purposefully sell off SWF investments in the United States in order to induce a financial panic. While such moves would also be economically costly to these countries, such actions are not inconceivable in the early stages of a revolutionary government.

Even if China or the Persian Gulf emirates were to democratize more gradually, one could easily envisage nationalist parliaments using their SWFs to constrain U.S. actions. Sovereign funds in democratic societies are more likely to inject political conditionality into their capital markets. In the United States, for example, interest groups have been eager to use America's financial muscle to alter the behavior of foreign actors in Sudan and Iran. There would be no reason to expect other democratic, capital-rich countries to behave differently.

Looking at the long term, sovereign wealth funds are one component of an alternative development path, suggests a possible rival to liberal free-market democracy. In state-led development societies, governments could use sovereign wealth funds, state-owned enterprises and banks, national oil companies, extensive regulation, and other measures to accelerate economic development, buy off dissent and promote technology transfer. If this model proves sustainable over the long run – and this is a big if – it could emerge as a viable challenger to the liberal democratic path taken by the advanced industrialized states. More countries might think of sovereign wealth funds as a signal of being a

"successful" country. One could then envision the proliferation of such funds – even in situations in which there is no economic rationale for its creation. This would have corrosive effects on America's soft power. It would be an open question whether the rest of the world would look at the democratic development model as one to emulate. Crudely put, far fewer countries would want what America wants.

In conclusion, sovereign wealth funds have made headlines over the past year because of high-profile purchases of prominent firms. As long as global macroeconomic imbalances and demand for traditional hydrocarbon fuels continue to persist, SWFs are projected to grow at an accelerated rate over the next decade. Sovereign funds have, to date, played a constructive role in injecting liquidity into the global economy during the current period of uncertainty. There is little reason to believe that, on their own, sovereign wealth funds will exercise any significant constraint on most dimensions of U.S. foreign policy. Over the long term, the trouble with sovereign wealth funds is not that they will fail, but that they will succeed – in which case they pose a challenge to American national interests.