1

Sovereign Wealth Funds and the Global Economy

Five years ago, sovereign wealth funds (SWFs) were so unknown that there was no common term to describe government-owned funds that invested in whole or in part outside their home country. Andrew Rozanov (2005) of State Street Corporation coined the term "sovereign wealth fund" in May 2005. At that time, assets under management of SWFs were about $1.5 trillion. By 2007, they had doubled to $3 trillion and were projected to reach $12 trillion by 2015.[1]

Although SWF assets represented only a tiny fraction of total reported international financial assets of $92 trillion as of 2007, their rapid growth and government control became a source of substantial economic and political anxiety in many countries that were actual or potential recipients of their investments. The SWFs were also a source of considerable controversy in their home countries. The SWFs came to be viewed as "big money," and big money is distrusted, whether in the hands of banks, other private investors, or governments. In the case of SWFs, policymakers and observers in countries receiving their investments raised understandable concerns about the motivations of the governments making the investments. Policymakers in the countries with the SWFs, not inappropriately, focused on the policy responses of countries receiving the actual or potential SWF investments. Concerns were also expressed about the

1. This figure for assets under management by SWFs includes only nonpension SWFs as classified by the definition adopted by the International Working Group on SWFs. Chapter 2 elaborates on the distinction between conventional pension funds and nonpension SWFs and argues that many of the public policy issues that pension funds raise are essentially the same as those raised by pure SWFs.

possible impact of SWF investments on markets and the integrity of the processes governing investment decisions. In this context, conflicts of interest between countries with the SWFs and those receiving their investments are a real possibility.

Anxieties about the threats posed by SWFs were fed by the attempted purchase in 2006 by Dubai Ports World of US ports operated by the Peninsular and Steam Navigation Company and by the prospect of aggressive expansion in Europe by Russia's Gazprom—despite the fact that these are government-owned companies, not SWFs. In some countries, critics also questioned the rationale behind transferring government ownership of a business or activity to the private sector by sales in whole or in part to foreign government-controlled firms or investment funds.

Sovereign wealth funds are symbolic of two major, recent trends in the global political economy: (1) a redistribution of wealth and economic and financial power from the United States, Europe, and other mature industrial economies to countries perceived to be less firmly grounded in similar economic, financial, and political mores; and (2) an increasing role of governments in managing wealth and economic power.

The rapid expansion of SWFs was fueled before 2008 by high and rising prices of natural resources and other commodities and by policies that led to massive accumulations of foreign exchange and financial resources in government coffers. Accelerated transfers from foreign exchange reserves to SWFs, with their more aggressive investment strategies and higher expected returns, were projected to continue to boost the size of SWFs. To a significant degree, this wealth was accumulating under the control of governments that were unfamiliar to citizens of the United States and Western Europe and that, perhaps, were hostile to the interests of those countries. Excluding pension funds, six countries have SWFs with assets of more than $100 billion.[2] Only one country, Norway, is currently a member of the Organization for Economic Cooperation and Development (OECD), the traditional grouping of wealthy nations. Thus, the rise of SWFs is symbolic of the growing disenchantment in the United States and many other mature industrial countries with globalization, which no longer is seen as delivering the dividends that it once did. Globalization is increasingly seen as a lopsided process, and China with its SWF of $300 billion on top of $2.5 trillion in foreign exchange reserves is exhibit A.

The associated fear was that governments would use their SWFs to buy control of large "national champion" firms in key sectors. This dynamic would contribute to the creation of "sharecropper societies" in the West as foreign government investment would pour into industrial countries

2. In order of the estimated size of their SWF assets, the economies are the United Arab Emirates, Norway, Singapore, China, Hong Kong, and Kuwait. Saudi Arabia's international investment holdings often are placed in the same category.

that had lost control over their own affairs.[3] In the United States, if somewhat less so in Europe, there was at best ambivalence and at worst deep suspicion and mistrust of many forms of government investments and economic interventions. These perceptions were illustrated by the delayed, negative reaction to the Troubled Asset Relief Program even after it succeeded in stabilizing the US financial system. In addition, the SWFs were viewed by many as vehicles with which other countries could appropriate sensitive proprietary commercial and technical information and threaten the economic and national security of countries in which they were investing.

Symptomatic of interpretations of a rapidly changing world, Gerard Lyons (2007) of Standard and Chartered wrote about the rise of state capitalism in which SWFs would play an active role and Diana Farrell and colleagues (2007) from the McKinsey Global Institute wrote about a broader set of new global financial power brokers, including SWFs. According to these disquieting reports, economic and financial power would no longer rest with the traditional actors in the private sector or their governments that had dominated international finance during the post–World War II era. At the extreme, the perceived threats from SWFs were exaggerated, but those perceptions were illustrative of a distrust of change, particularly when that change is associated with unfamiliar and opaque foreign governments.

Sovereign Wealth Funds and the Global Financial Crisis

In the fall of 2007, as the global financial crisis gained momentum, views about SWFs moderated somewhat. In the fourth quarter of that year and the first quarter of 2008, several SWFs invested substantial amounts in Western financial institutions that were under financial stress. Their actions were motivated by the potential for financial rewards, but they also generated political side benefits: sovereign wealth funds to the rescue! For example, on August 21, 2007, during the month that the financial crisis broke, Steven R. Weisman in the *New York Times* quoted US Treasury Secretary Henry M. Paulson, Jr. as saying: "I'd like nothing more than to get more of that money." Weisman also reported my view that in a future global crisis, and perhaps even during the crisis unfolding at the time, the US Treasury secretary might be wise to place calls to SWF managers as

3. Warren Buffett raised this concern in his letter to his Berkshire Hathaway Company shareholders in 2005, directing it toward the large US fiscal and external deficits at that time (see letter at www.berkshirehathaway.com/letters/2005.html). As described in chapter 3, observers were quick to make the link to a threat from foreign investment and to ignore Buffett's policy prescriptions to reduce fiscal deficits and reign in overspending by the country as a whole.

well as to central bankers and finance ministers around the world in an effort to manage the financial crisis.[4]

The perception of SWFs as saviors of the Western financial system was as exaggerated as that of the SWF as threats that preceded the financial crisis. The new perception was based upon a flawed, partial-equilibrium understanding of SWF investment practices and balance sheets. In managing their portfolios, SWFs may buy government or corporate securities, invest in hedge funds, buy real estate, buy stocks of commodities, or purchase stakes in financial institutions. SWFs have to invest in some asset and generally do not hold substantial proportions of their portfolios in low-yielding cash investments. The particular governments, corporations, hedge funds, real estate developers, commodity producers, or financial institutions benefit financially from the SWFs' investments via access to funds in large volume often for a price. However, other governments and potential recipients of SWF investments, at most, benefit indirectly.[5] To the extent that the SWF disinvests from some assets to make new investments, the issuers of the assets from which the SWF disinvests are net losers. SWFs were not positioned in 2007 to save everyone.

SWF investments in Western financial institutions soured as the financial crisis deepened in the fall of 2008 and winter of 2009. Along with other global investors, SWFs saw reductions in the mark-to-market value of their portfolios on the order of 20 to 30 percent. Their managers were heavily criticized for investment decisions that, with the benefit of hindsight, were seen as unwise. SWFs in 2007 and 2008 proved to be neither an unqualified threat nor an unqualified salvation for anyone involved.

Meanwhile, the SWFs' continued and still-rapid growth raised issues that were not going away. They remained controversial and contentious in North America and Europe, and numerous suggestions were made to regulate SWF investments or refine existing regulations as they applied to such investments by foreign governments.

As researchers and analysts explored the SWF phenomenon, policymakers in North America and Europe discovered that their own countries had SWFs too, often operating at the subnational level, such as Alaska's Permanent Fund, as well as the functional equivalent of SWFs in the form of government pension funds.[6] Both types of governmental investment vehicles diversify their investments globally. Moreover, in the United States, observers are familiar with large government pension funds that use their

4. Steven R. Weisman, "A Fear of Foreign Investments," *New York Times*, August 21, 2007. Weisman became editorial director and public policy fellow at the Peterson Institute for International Economics in July 2008.

5. For example, they may benefit from the stability that a specific SWF investment in one financial institution brings to the financial system as a whole.

6. Policymakers in countries with large foreign exchange reserves, such as Japan, India, and Brazil, also began to think about setting up SWFs. Brazil subsequently has done so.

financial muscle to achieve political objectives, often under the guise of ethical investment policies. Meanwhile, policymakers in non-Western countries with SWFs became concerned that jurisdictions would erect barriers to SWF investments. The associated tensions led to more finger pointing.

Response to Sovereign Wealth Funds

As is appropriate and desirable when international controversies emerge, responsible policymakers sought multilateral solutions and, to that end, the involvement of multilateral institutions—the International Monetary Fund (IMF), World Bank, and OECD. Outside observers, including myself, suggested the development of a voluntary code of conduct or set of standards or best practices for SWFs.[7]

This suggestion was initially resisted by officials of some of the countries that would be affected. They argued that hedge funds, private equity firms, and other large pools of capital were not subject to international standards. The arguments from the countries with SWFs were somewhat undercut by the fact that authorities in the United States, United Kingdom, and other jurisdictions were moving at the same time to promote the establishment of standards or codes of conduct for such private investment vehicles. Standards were emerging for all the big money players.

Some also argued that the public sector should set a strong example for the private sector in demonstrating accountability and transparency. The fact that this argument took time to catch on reflected the reality that the many countries that are home to SWFs have diverse and differing political and cultural histories. Their funds were established to serve a wide range of economic and financial policy objectives derived from their own unique circumstances. They did not from the start perceive themselves as part of a coherent group, let alone one that could benefit from self-regulation. Moreover, the countries that were home to SWFs were legitimately seeking a quid pro quo in the form of a commitment from countries receiving their investments not to subject SWF investments to special restrictions or higher standards.

In October 2007, the Peterson Institute for International Economics released my prototype of an international standard for SWF accountability and transparency in the form of an SWF scoreboard.[8] In April 2008, my refined and updated SWF scoreboard was released in the form of a

7. Edwin M. Truman, "What Should the Fund's Role Be Now?" Remarks at the Bretton Woods Committee 2007 Annual Meeting, June 12, 2007, available at www.piie.com (accessed on July 12, 2010).

8. See Edwin M. Truman, "Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States," testimony before the US Senate Committee on Banking, Housing, and Urban Affairs, November 14, 2007.

blueprint for SWF best practices (Truman 2008a). The blueprint was designed to prod and inform the multilateral, collaborative project that became the International Working Group of Sovereign Wealth Funds (known as the IWG), which was about to be established under the aegis of the IMF. The first meeting of the IWG was on May 1, 2008.

The IWG completed its work in September 2008 and the result of its effort was a set of Generally Accepted Principles and Practices of SWFs (known as the Santiago Principles or the GAPP). The release of the Santiago Principles in October 2008 was drowned out by the cascading crescendos of the global economic and financial crisis.

In parallel with the IMF-facilitated process, during 2007–08 many of the countries that are recipients of SWF investments, as well as those that are home to SWFs, met under the aegis of the OECD to reexamine the issues raised by international investments by governments or government-controlled entities. This examination concluded that there was no case for establishing a new, separate regulatory framework for SWF investments. Members of the OECD in effect recommitted themselves to the existing framework of OECD codes and declarations governing foreign government investments. Nevertheless, over the past several years the authorities in a number of OECD countries, including the United States, have implemented, and in a few cases established for the first time, regimes governing foreign investments in their countries that, in their practical application, raise the potential bar for such investments. Countries with SWFs are justified in their concern that the quid pro quo for greater accountability and transparency by SWFs has not been delivered.

All the multilateral activity addressed, but hardly dispensed with, the SWF challenge. The funds continue to raise a host of economic, financial, and political issues, which is why they are both fascinating and contentious, attracting observers and scholars in many disciplines and with many different perspectives. Everyone has an opinion and gets into the act.

Structure of the Book

This volume is designed to describe the state of play for SWFs as of mid-2010. It pulls together the insights and information I have gathered since late 2006, when I expanded my research interests from patterns of reserve diversification to other closely related forms of international financial investment by governments.

Chapter 2 provides background information on SWFs and their many different origins, objectives, and investment strategies. I examine prospects for the continued expansion of SWFs and conclude that these funds will continue to expand, although probably not at the pace of the 2002–07 period, which was more than 30 percent per year. SWFs are part of the international financial system and are here to stay.

Chapter 3 examines five broad areas of principal concern about SWFs: (1) mismanagement of investments by SWFs to the economic and financial detriment of the country with the fund; (2) pursuit of political objectives, economic power objectives, or both together, via SWFs; (3) exacerbation of financial protectionism inspired by SWFs; (4) the potential for financial market turmoil and uncertainty associated with SWF activities; and (5) conflicts of interest between countries with SWFs and countries in which they invest. Some argue that these are largely hypothetical concerns and unsubstantiated. However, fear of the unknown is still fear.

Chapter 4 reviews a range of possible policy responses to SWF investments by the authorities of the countries receiving their investments. These responses include (1) a comprehensive regulatory regime covering all aspects of SWF activities; (2) prohibitions on specific SWF investments, as, for example, in certain industries or sectors; (3) limitations on SWF investment activities such as voting their shares; and (4) reciprocal arrangements with the country of origin of an SWF investment. I conclude that none of these approaches is likely to be effective in dealing with the issues described in chapter 3, and each would be economically costly to implement. Thus, I argue that an approach to increase the accountability and transparency of SWFs and their government owners is preferable in the absence of strong evidence that tighter measures are required.

Against this backdrop, chapter 5 provides an updated and slightly revised SWF scoreboard with coverage expanded to 53 nonpension and pension SWFs. The objective is not only to describe the rationale behind the elements of the scoreboard as it has evolved, but also to demonstrate two key points. First, not all SWFs are alike in their accountability and transparency or in their lack thereof. Second, since I first presented the scoreboard in 2007, the scores of the SWFs have increased, in some cases substantially. To some extent (I have been assured) the attention given to the SWF scoreboard has enhanced incentives to improve the accountability and transparency of individual SWFs. This recorded progress is a strong argument in favor of the scoreboard approach to promoting SWF best practices. The scoreboard approach also helps to address each of the five broad concerns outlined in chapter 3 and summarized above.

The Santiago Principles are an agreed-upon and voluntary international application of the SWF scoreboard approach. They are a significant first step toward establishing and implementing a responsible response to concerns raised by SWFs via increasing their accountability and transparency. The specific application of the SWF scoreboard approach was the result of a negotiation that necessarily involved compromises. Chapter 6 examines the Santiago Principles using the SWF scoreboard as a yardstick. Three tests are applied. First, was there broad participation by the countries with large SWFs? The answer is yes, with a few prominent exceptions. Second, do the Santiago Principles cover most of the elements in the scoreboard? The answer is a qualified yes. In particular, the Santiago Principles fall short in not systematically recommending public disclosure to demonstrate implementation by each fund. Third, are the SWFs already implementing the Santiago Principles? The answer is that to date the record of implementation of the principles as a scaled-down mechanism for accountability and transparency is as diverse as that recorded on the full SWF scoreboard. The Santiago Principles are the start, not the end, of enhanced SWF accountability and transparency.

Chapter 7 looks at the investment policies, procedures, and practices of countries that receive SWF investments and the review of those policies conducted in 2007–08 under the aegis of the OECD. The good news is that the OECD exercise did not result in a formal tightening of the existing framework applied by OECD members to SWF investments. The OECD members agreed that no special regime for SWF investments is required because those investments are (rightly) seen as not inherently different from other government-owned or controlled investment vehicles. The bad news is that the OECD countries did not address how to strengthen their current codes, procedures, and practices to reinforce their openness to foreign investments, including by governments and their SWFs. Instead, and partly as a consequence of the rise of SWFs, we have seen a tangible increase in financial protectionism in OECD countries in recent years via a tightening of laws, standards, and procedures.

Chapter 8 concludes and looks to the future. SWFs are here to stay. As a result of the Santiago Principles and other parallel efforts at education such as the SWF scoreboard that I have featured in my research, a substantial amount of distrust surrounding SWFs has been defused. Unfortunately, reciprocal actions by host countries to SWF investments have been less than impressive.

On the basis of my analysis, I make four broad recommendations. First, countries with SWFs should promote adherence to and implementation of the Santiago Principles and the progressive improvement of the quality and content of those principles. Second, recipient countries should take reciprocal steps to monitor more closely incipient financial protectionism put in place in recent years with a view to rolling it back. Third, to prevent regulatory and institutional arbitrage, governments should step up their collaborative efforts in order to improve other accountability and transparency standards, such as those on the management of foreign exchange reserves, and to collect more comprehensive data on all cross-border government investments. Fourth, the long-term goal should be a comprehensive, internationally agreed-upon framework governing all types of cross-border investments by governments.