Public Footprints in Private Markets
Sovereign Wealth Funds and the World Economy
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Summary: The massive growth of sovereign wealth funds -- pools of capital controlled by governments and invested in private markets abroad -- should not cause alarm. But it does raise legitimate questions for the United States, pointing to the need for new policy principles for both the funds and the countries in which they invest.

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In 1953, eight years before its independence from the United Kingdom, Kuwait established the Kuwait Investment Board to invest its surplus oil revenue. That was perhaps the first-ever "sovereign wealth fund" (SWF), although the term would not exist for another 50 years. SWFs are large pools of capital controlled by a government and invested in private markets abroad. Today, they are growing rapidly in both number and size. Twelve SWFs been established since 2005, and altogether SWFs control roughly $2.5 trillion -- a figure now growing, according to some estimates, by $1 trillion a year.

These developments should not cause alarm, but they do raise legitimate policy questions. Governments should consider the implications of SWFs' growing importance with calm and precision. Many concerns, aired frequently in policy debates and prominently in the media, have been exaggerated, in part because of a lack of understanding of SWFs and other vehicles for sovereign investment. A fuller picture of SWFs' history, purpose, size, growth, and broader systemic implications is needed. Such an understanding, along with a set of clear policy principles for both SWFs and the countries in which they invest, will help preserve openness to foreign investment and promote financial stability worldwide.

THE FOUR SOVEREIGNS

To frame this policy discussion, it is useful to differentiate among four kinds of sovereign investment: international reserves, public pension funds, state-owned enterprises, and SWFs. International reserves, as defined by the International Monetary Fund (IMF), are external assets that are controlled by and readily available to finance ministries and central banks for direct financing of international payment imbalances. Countries typically keep reserves on hand to cushion an export shortfall or to intervene to defend the currency in a financial crisis. Reserves are by definition invested in highly liquid and marketable securities, which usually means highly rated industrialized-country government bonds.

Public pension funds are investment vehicles funded with assets set aside to meet the government's future entitlement obligations to its citizens. Public pension funds differ from SWFs in that they are denominated and funded in the local currency, usually with relatively low exposure to foreign assets. However, it is expected that pension funds will increasingly invest abroad, in some cases using national SWFs to manage their assets.

State-owned enterprises (SOEs) are companies over which the state has significant control, through full, majority, or significant minority ownership. SOEs can themselves undertake foreign investment. This category includes a wide variety of entities, including manufacturing and financial firms.

Finally, SWFs are generally defined as government investment vehicles funded by foreign exchange assets and managed separately from official reserves. SWF managers typically have a higher tolerance for risk and seek higher returns than do official reserve managers.

SWFs generally fall into two categories according to the source of the foreign exchange assets. Commodity SWFs are funded by commodity exports that are either owned or taxed by the government. These funds serve different purposes, including fiscal revenue stabilization, intergenerational saving, and balance-of-payments sterilization (that is, keeping foreign exchange inflows from stoking inflation). Given the current extended rise in commodity prices, many funds initially established for the purposes of fiscal stabilization or balance-of-payments sterilization have evolved into intergenerational savings funds.

Noncommodity SWFs are typically established through transfers of assets from official foreign exchange reserves. Large balance-of-payments surpluses have enabled noncommodity exporters to transfer "excess" foreign exchange reserves to standalone investment funds that can be managed for higher returns. Noncommodity funds often arise from an exchange-rate intervention involving a domestic liquidity increase that has to be absorbed by issuing domestic debt to avoid unwanted inflation. Their net return depends on the difference between the yield earned on investments and the yield paid on domestic debt. The assets of this type of SWF, accordingly, may be thought of more as borrowed money than traditional wealth.

Given that sovereign investment takes these different forms, why has there been so much focus on SWFs alone? First, SWFs appear to be set for rapid and perhaps prolonged growth. Second, SWFs raise issues that also bear on other types of sovereign investment -- financial-market issues, which also relate to international reserves and public pension funds, and investment issues, which also relate to SOEs.

SWFS: THE ISSUES

SWFs have existed in a number of places -- not only Kuwait but also Abu Dhabi and Singapore -- for over 25 years. What is remarkable today is the increase in their number and size. There are now, by some definitions, as many as 40 different SWFs. Estimates of the size of SWFs are hindered by the fact that they are often not transparent, but the IMF approximates that SWF assets are today somewhere between $1.9 trillion and $2.9 trillion. Projections of their future size are also uncertain, as the value of SWFs depends heavily on commodity prices and exchange-rate policies. However, a number of private financial institutions have estimated that SWF assets will reach $10-$15 trillion by 2015.

Whether these are considered large or small figures depends on the metric used. If one wishes to make SWFs appear large, one can note that the current market capitalization of the S&P 500 is roughly $12 trillion. If one wishes to make them appear small, one can note that $12 trillion is only a fraction of the estimated $190 trillion in total global financial assets. SWFs can also be compared to other investor classes. Once again, if one wishes to make SWFs appear large, one can note that hedge funds manage an estimated $1.5 trillion. If one wishes to make them appear small, one can note that assets managed by mature-market institutional investors (such as pension funds and endowments) are about $53 trillion.

Two points, however, are inescapable regardless of the metric. The first is that SWFs are already large enough to be systemically significant. The second is that they are likely to grow larger over time, in both absolute and relative terms, which calls for a discussion of the issues this growth may raise for the international financial system.

The first issue to consider is whether the formation of SWFs perpetuates undesirable underlying macroeconomic and financial policies. Clearly, it is critical that noncommodity funds, made up of excess reserves accumulated through exchange-rate interventions, not use SWFs as a mechanism simply to accumulate more foreign assets in an effort keep the currency from appreciating. The perpetuation of undesirable underlying policies is less of a concern with commodity funds, since governments are essentially replacing a physical asset in the ground with a financial asset in a bank account to be drawn on by future generations. However, even commodity-exporting countries need to make sure that their SWFs operate within a framework of sound domestic fiscal, monetary, and exchange-rate policies.

Second, since SWFs are an outgrowth of domestic and international economic and financial policies, it makes sense to consider them in terms of their potential impact on financial stability. Here, there is much reason to be reassured. SWFs are in principle long-term investors, which typically do not deviate from their strategic asset allocations in the face of short-term volatility. They are not highly leveraged, and it is difficult to see how they could be forced by regulatory capital requirements or sudden investor withdrawals to liquidate their positions quickly. In this context, SWFs may be considered a force for financial stability -- supplying liquidity to the markets, raising asset prices, and lowering borrowing yields in the countries in which they invest. Still, responsible public policy requires a thorough consideration of the potential impact of SWFs on financial markets. SWFs represent large, concentrated, and often opaque positions in financial markets. A sudden shift by SWFs in illiquid markets can cause price volatility. Further, since many SWFs disclose little of their investment policies, mere rumors of SWF shifts may cause the private sector to react.

The third and perhaps most critical set of issues relates to SWF investment that involves taking active control of private firms. The most obvious consideration is national security. As with any form of foreign investment, countries on the receiving end of SWF investment need to ensure that national security concerns are addressed, without unnecessarily limiting the benefits of an open economy. Such concerns do not stem only from cases in which an SWF gains a formal controlling share of a company; they can also arise when an investor seeks board seats or outsized voting rights -- anything beyond a purely passive investment.

In the United States, balancing open investment with the need to protect national security is done through the Committee on Foreign Investment in the United States. CFIUS is designed to review foreign investments in a manner that preserves national security without creating unnecessary or counterproductive barriers to participation in the U.S. market. The CFIUS process supports open investment by focusing only on those transactions that relate to national security.

Even in the wake of some high-profile controversies -- such as the Chinese national oil company CNOOC's attempted purchase of a U.S. oil company or Dubai Ports World's possible takeover of operations at U.S. ports -- the vast majority of foreign investments reviewed by CFIUS continue to be processed expeditiously and without controversy within a 30-day investigation period. In 2006, there were approximately 10,000 mergers and acquisitions in the United States. Of these, 1,730 were cross-border transactions, and only 113, or roughly 6.5 percent, came before CFIUS. None of these transactions was blocked.

Congress passed a new CFIUS law in the summer of 2007 that mandates additional scrutiny and higher-level clearances for transactions involving foreign government control. However, this additional scrutiny comes in the context of provisions for greater certainty for investors, more accountability from the U.S. administration, and better communication between CFIUS and Congress. It also reinforces the disciplined approach that allows CFIUS to focus its attention on the very small share of cases that raise genuine national security concerns.

There are also non-national-security issues associated with the potential increase in foreign public ownership of private firms. First, the U.S. economy is built on the belief that private firms allocate capital more efficiently than governments. Second, foreign governments could conceivably employ large pools of capital in noncommercially driven ways that are politically sensitive even if they do not have a direct impact on national security. Examples would include investment decisions made to promote a given foreign or social policy. Third, there is the potential for perceived or actual unfair competitive advantages relative to the private sector. For instance, a government could use its intelligence or security services to gather information that is not available to a commercial investor. With a sovereign guarantee, a SWF could also obtain or extend financing (if needed) at interest rates that a commercial investor could not. It is also possible for a SWF to take an indirect approach by channeling foreign exchange through domestic SOEs, which in turn invest abroad.

FIRST, DO NO HARM

How should the United States and other recipient countries of SWF investments respond to their increased importance? First, they should take care to do no harm. They should recognize that SWFs have not caused significant financial-market disruption and that the overwhelming majority of SWF investments do not involve partial or complete control of firms. And even for investments that do involve control, there is little evidence of any ulterior foreign policy motives in practice.

Recipient countries should also maintain their unequivocal support for international investment. President George W. Bush reaffirmed this long-standing U.S. policy in his "Statement on Open Economies" on May 10, 2007, the first such statement in 16 years. The benefits of market-driven free investment flows are many. There are static gains as U.S. businesses are able to expand by tapping international capital. From a macroeconomic perspective, investment inflows help finance the country's current account deficit. There are also important dynamic gains from the resulting business competition. Prices of goods and services decrease, their availability and variety increase, and the productivity and efficiency of domestic businesses rise.

The U.S. economy benefits significantly from inward and outward foreign direct investment. U.S.-headquartered multinational companies that invest abroad have contributed strongly to overall productivity growth in the United States and thus to rising U.S. living standards. U.S. multinationals accounted for over half of U.S. productivity growth between 1977 and 2000 and for half of the increase in U.S. productivity growth between 1995 and 2000. During this five-year period, productivity at U.S. multinationals surged, growing six percent annually.

Research also shows that foreign-owned firms in the United States employ 4.5 percent of the work force and account for 5.7 percent of output, 19 percent of U.S. exports, 13 percent of research-and-development spending, and 10 percent of all U.S. investment in plant and equipment. These firms also pay more than 30 percent higher compensation (wages and benefits) on average than do their counterparts in the rest of the U.S. economy. And 30 percent of these jobs are in manufacturing, compared with fewer than 10 percent of all U.S. jobs.

The biggest threat to the benefits of foreign direct investment would be a slide toward investment protectionism. As Treasury Secretary Henry Paulson has noted, protectionism, in both investment and trade, would undermine U.S. growth and job creation. And this is not just a U.S. concern: there is also rising protectionism in Europe and other industrialized countries and in emerging markets. Often this investment protectionism is masked by claims of national security concerns or driven by individual firms that might lose out in a given deal.

PRINCIPLES FOR A POLICY RESPONSE

One clear conclusion that arises from this discussion is that the benefits of SWF investments to the recipient countries depend on the extent to which the behavior of SWFs is economically driven. If these investments are economically, rather than politically, driven, recipient countries have a strong interest in providing an open, transparent, and predictable framework for SWF investment.

Clearly, both the countries in which SWFs invest and SWFs themselves have certain responsibilities. Policy principles are needed for both sides. The U.S. government is now intensifying direct bilateral outreach efforts with both countries that have SWFs and countries that receive their investment.

Countries receiving SWF investment should follow four basic principles. First, avoid protectionism. Countries should not erect counterproductive barriers to investment, regardless of whether the investor holds a controlling interest in national firms. Second, uphold fair and transparent investment frameworks. Investment policies and processes, especially those involving national security considerations, should be public, clearly articulated, predictable, and nondiscriminatory. Third, within those frameworks, respect investor decisions. Having laid out the ground rules, recipient countries should not tell SWFs how to invest their money. Decisions on how to allocate investments across countries and asset classes are for the funds' managers alone, particularly given the potential for losses as well as gains. Finally, treat investors equally. Tax and regulatory policies should not discriminate between foreign and domestic entities.

The principle of reciprocity -- that is, reciprocal openness to investment -- is not on this list despite the fact that many countries with SWFs are themselves far too closed to foreign investment. This is because it is in the United States' interest to be open to market-driven investments -- from both private and sovereign entities -- even if other countries are not. Still, that is not to say that reciprocity is not considered at all: the reality is that investment policy decisions are made in a broader political context in which reciprocity, as well as the protection of intellectual and physical property, is taken into account.

SWFs, meanwhile, should follow five policy principles of their own. First, invest commercially, not politically. SWF investment decisions should be based solely on economic grounds, rather than political or foreign policy considerations. SWFs should make this statement a formal part of their basic investment management policies. Second, convey world-class institutional integrity. SWFs should be transparent about their investment policies and have strong risk-management systems, governance structures, and internal controls. Although not highly leveraged and, in principle, long-term investors, SWFs can represent large, concentrated, and opaque positions and thus may cause worries of systemic risk. Third, compete fairly with the private sector. SWFs should be careful not to be seen as having an unfair advantage in competing with the private sector for transactions, including by financing acquisitions at below-market rates. Fourth, promote international financial stability. As public-sector entities seeking to benefit from healthy global markets, SWFs have a strong stake in and responsibility for international financial stability. During times of market stress, SWFs should be committed to communicating effectively with the official sector to address financial-market issues. Finally, respect host-country rules. SWFs should comply with and be subject to all applicable regulatory and disclosure requirements of the countries in which they invest.

These principles are all predicated on the fact that SWF asset accumulation is appropriate in the first place. Still, the underlying macroeconomic policies creating the resources for SWFs should be under constant review to see that they, too, remain appropriate -- both for the countries with SWFs and the international financial system.

It is also worth addressing the frequently made comparison between the transparency of hedge funds and the transparency of SWFs. Transparency is very important in both cases, but each requires a different approach. Unlike SWFs, hedge funds are private-sector entities. Disclosure is important to foster market discipline, which helps to mitigate systemic risk. The key avenues for hedge-fund transparency are between hedge funds and their investors, between hedge funds and their counterparties and creditors, and among counterparties, creditors, and their regulators. These issues are being addressed through the development of voluntary best practices by private-sector groups on both sides of the Atlantic.

This framework for market discipline to mitigate systemic risk does not apply to SWFs. SWFs are public-sector entities managing public funds, and profit maximization may not be considered the primary objective. Investor discipline depends on citizens and the government, rather than savvy institutional investors. SWFs' counterparties thus may not exercise market discipline, by limiting exposures or tightening financing terms, because they assume a sovereign guarantee will assure full payment. Public disclosure is therefore appropriate for SWFs to mitigate systemic risk.

A STRUCTURAL SHIFT

The U.S. Treasury Department has played a leadership role within the U.S. government in seeking better understanding of, and communication with, SWFs. The President's Working Group on Financial Markets, which brings together key U.S. financial regulators and other members of the U.S. government under Secretary Paulson's chairmanship, has initiated a review of SWFs. The Treasury Department has also undertaken regular outreach and discussion with SWFs and market participants to better understand trends and monitor sovereign investments and acquisitions, and it has initiated in-depth analysis and regular reporting to Congress.

The Treasury Department believes that the principles outlined above can inform the development of two sets of voluntary multilateral best practices to provide an improved framework for SWFs and the recipients of their investment. The wide variety of experience and investment strategies among SWFs, combined with the wide diversity of regimes for regulating inward investment, underscores the need for broadly discussed and accepted best practices.

First, the Organization for Economic Cooperation and Development could identify best practices for countries that receive foreign government-controlled investment, including from SWFs. Recipient countries have a responsibility to maintain openness, and the OECD has a long history of promoting open investment regimes.

Second, the IMF, assisted by the World Bank, could draft a set of best practices for SWFs, building on existing best practices for the management of foreign exchange reserves. These best practices could cover the overall objectives and principles of SWFs, their institutional arrangements, their risk-management frameworks, and their transparency and accountability -- including public disclosure. These would provide guidance to new funds seeking to make sound decisions on how to structure themselves, mitigate any potential systemic risk, and help demonstrate to critics that SWFs will continue to be constructive, responsible participants in the international financial system. Even long-standing SWFs are aware that the increase in the number and size of these funds has, rightly or wrongly, raised reputational issues for them all.

To initiate high-level discussion of the impact of SWFs, Secretary Paulson hosted an outreach dinner at the Treasury Department in October 2007 with the finance ministers of the G-7 (the group of highly industrialized countries); the heads of the IMF, the OECD, and the World Bank; and finance ministers and heads of SWFs from eight countries: China, Kuwait, Norway, Russia, Saudi Arabia, Singapore, South Korea, and the United Arab Emirates. There was a shared realization of a common interest in maintaining open investment and promoting financial stability. The following day, the International Monetary and Financial Committee -- a ministerial-level committee whose members represent all 185 IMF member countries -- tasked the IMF with identifying best practices for SWFs. The OECD, meanwhile, is accelerating its own work on developing best practices for recipient countries' investment regimes.

It is hard to escape the conclusion that the ongoing increase in SWF cross-border investment represents a potential structural shift in the global economy. It is incumbent on economic policymakers in all countries to consider fully the implications of this shift and how to respond. The evidence so far suggests that SWFs are seeking to generate higher investment returns without generating political controversy. Although it is imperative that the U.S. government remain vigilant, so long as SWF activities are consistent with free and fair competition based on agreed best practices, keeping the United States' doors open to investment from SWFs will continue to promote growth and prosperity, both at home and abroad.
