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Nothing to Fear but Fearmongers Themselves: A Look at the Sovereign Wealth Fund Debate

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Introduction

Reliance of the U.S. economy on foreign investment is as old as the Republic itself. So, too, are misgivings about external financing and foreign ownership. But the latest manifestation of the debate over whether, to what degree, and with what stipulations foreigners should be permitted to own U.S. assets presents a new wrinkle. By focusing on a particular subset of foreigners—namely, foreign governments—the current debate is framed in terms that could win support for greater restrictions of foreign investment from those who might otherwise oppose them.

Government-owned investment funds, also known Sovereign Wealth Funds are not new to the international investment scene. Some existing funds were established in the 1950s and 1960s. What is new, however, is that the number of SWFs and the value of assets under their collective management have increased significantly in recent years.

Skepticism about the motives and consequences of increased SWF investment is growing. Perhaps most disconcerting for some U.S. policymakers is that the governments that have been most active in recent SWF investment do not necessarily share America's worldview. At issue is whether SWF investment, which could be used to serve strategic or political objectives, should be subject to greater scrutiny and tighter restrictions than other types of foreign investment.

Despite legitimate concerns about governments accumulating wealth and making investment decisions in the first place, as well as lingering doubts about the motivations behind those investments, changes in foreign investment policy are unnecessary. Current U.S. rules governing banking and investment strike the right balance; they generally welcome foreign investment while being designed to ensure that such transactions do not compromise the integrity of our financial markets or our national security.

The Sovereign Wealth Fund Explosion

The U.S. Department of the Treasury defines sovereign wealth funds as "government investment vehicles funded by foreign exchange assets, which manage those assets separately from official reserves."[1] SWFs are nothing new. Government-owned asset funds financed from currency reserves have existed for more than half a century, pursuing legitimate and rational economic objectives, though not necessarily optimally. Over the years, governments of countries where commodities account for important shares of their economies have established SWFs to hedge against declining commodity prices—hardly a worry today—and to ensure that wealth generated from the extraction and sale of its nonrenewable assets is available to future generations. To date, these funds have exhibited unremarkable behavior—that is, their investment strategies and performances do not appear to have differed markedly from those of private-sector funds.[2]

In recent years, the number of SWFs and the value of assets those funds manage have increased dramatically, due in large part to rising commodity prices and the accumulation of foreign reserves in countries running persistent trade surpluses. Since 2000 the number of funds has roughly doubled to about 40 and the value of assets under SWF management has increased five-fold to a figure approaching $2.5 trillion today.[3] According to projections from the International Monetary Fund and others, SWF assets will increase to about $10 trillion by 2012 and $12 trillion by 2015.[4]

Brewing Concerns about SWF Investment

The rapid growth in SWFs has raised concerns among U.S. and other rich-country policymakers. Skepticism about SWFs reflects, among other things, angst about the implications of wealth accumulation in emerging countries. Among the countries accumulating wealth and establishing new SWFs are China, Russia, and other oil-rich nations, whose views about markets, government accountability, and transparency have not always meshed with those of the West. This has accentuated the political dimension of the issue. A recent front-page article in the *New York Daily News* put it like this:

> America is for sale—and the buyers of some of our most iconic corporate assets are a passel of Mideast oil sheiks, Asian government investment funds and market Marxists.[5]

And with respect to China and other East Asian countries that have run persistent trade surpluses, policymakers are already sensitive to claims that those surpluses are the product of currency manipulation and other alleged "unfair" trade practices. As the United Steelworkers union boss Leo Gerrard put it:

> We've hollowed out our industrial base and run up this massive trade deficit, and now the countries that have built the deficits are coming back to buy up our assets. It's like spitting in your face.[6]

Already worried about falling stock and real estate values, soaring oil and food prices, and the specter of stagflation, Americans are now being told that SWF investment is the fourth horseman of the apocalypse. At a recent House Financial Services Committee hearing on the topic of SWFs, Rep. Paul Kanjorski (D-PA) painted this extreme hypothetical:

> If I were China, I'd put my sovereign funds . . . in the energy field of the United States. I'd buy as many electrical utility companies as I could. And then, at my own desire, rather than send an army over here sometime in the future or an airplane to do damage, I'd just issue the order as the owner of the electrical utility networks in the U.S. to turn off the power. What's going to stop them from doing that?[7]

That scenario reflects the growing concern that SWFs might pursue strategic and political objectives rather than purely economic ones. Not only could foreign purchases of critical infrastructure compromise U.S. national security, but the pursuit of non-economic objectives through investment transactions could adversely affect the ability of markets to price assets correctly and to allocate resources efficiently.

Although nearly entirely lost beneath the hyperbole of his example, there is a trace of merit to Congressman Kanjorski's broader point. The same cannot be said of the xenophobic rantings of the *New York Daily News* article or the economic illiteracy of Leo Gerard. Loss of faith in the ability of financial markets to function properly when major participants in those markets are governments is a thorny issue, and one that concerns Securities and Exchange Commission chairman Christopher Cox.

In a recent speech at Harvard University, Cox expressed concern about private interests being at systemic disadvantages because SWFs have access to information that is barred from the public, like government intelligence and state secrets. Markets react to political and diplomatic events; having foreknowledge of an event constitutes an advantage that, if acted upon, could cause investors to lose faith in markets. An asymmetry of information is not the problem; markets deal with that routinely. It is the asymmetry of access to information between market participants that might ultimately dissuade participation in markets, which would be problematic.[8]

Cox also expressed concern that SWFs present conflicts of interest that could impact the SEC's capacity to fulfill some of its functions. The SEC relies on the cooperation of foreign governments to administer its international financial regulation and enforcement efforts. Cox worries that that cooperation might not be forthcoming and that the potential for corruption increases when the proposed investments and activities of foreign governments themselves come under the scrutiny of U.S. authorities.[9]

Oversized Policy Responses

In response to concerns ranging from legitimate to paranoid, U.S. policymakers are considering whether new restrictions of SWFs are warranted. Although no legislation has been introduced yet, several hearings have been held in various U.S. congressional and executive advisory committees on the subject already. At present, the IMF, World Bank, and OECD are reportedly working to draft codes of official conduct for SWFs with guidelines concerning institutional structure, risk management, transparency, and accountability.

For some countries, best practices guidelines will not be enough. The French, who have cultivated a reputation for blocking international transactions to "protect national champion" companies, have identified 11 "strategic sectors" immune to foreign takeovers. Meanwhile, Russia, an emergent SWF investor itself, has drafted a law that, if formalized, would protect 39 different "strategic industries," relegating industries comprising over 50 percent of Russia's GDP off limits to foreign investment.[10]

Certainly, there are voices among U.S. policymakers and within the policy community that would support tighter restrictions or prohibitions of SWF investment, if not all types of foreign investment altogether. With the exception of a couple of token witnesses counseling circumspection in the matter, a recent U.S.-China Economic and Security Commission hearing on the topic was a virtual who's who of trade and investment skeptics. Several witnesses called for strict limits on sovereign investment in U.S. assets, including outright bans on investments in sectors, industries, or assets deemed to be strategic for U.S. economic or military purposes (however amorphous those parameters might be).[11]

Typical was the testimony of Alan Tonelson of the U.S. Business and Industry Council, who draws parallels between the threats to the United States posed by SWFs, Al Qaeda, the Chinese military, and a resurgent Russia, and suggests that it is naïve to count the sheiks in Persian Gulf oil kingdoms as allies. Better to err on the side of caution, which in his estimation means limiting foreign government ownership of any given U.S. entity to 10 percent—because "that seems like a reasonable starting point"—with 1 percent limits coming from any single foreign government.[12]

Tonelson seems unconcerned about the costs of such a blanket prohibition. The shortage of U.S. savings necessitates inflows of foreign capital to finance investment. By restricting large sources of investment a priori, the cost of capital in the United States would be considerably higher. Surely there are better alternatives.

A Little Perspective, Please

The growth of SWFs reflects rational investment portfolio diversification. While there are legitimate concerns about the implications of government ownership of assets, there is something hypocritical about complaints that SWFs might pursue political rather than economic objectives. After all, the value of assets within SWFs is already a reflection of political choices and national policies, such as monetary and fiscal policies, including, notably, a government's decision to spend in excess of its revenue.

For many years, foreign central banks have invested currency reserves conservatively, often in low-yielding U.S. government securities. Over the past few years, as the dollar's decline has accelerated, foreign central banks have been losing money on these investments. In 2007, for example, the yield on 10-year U.S. treasury bills averaged between 4.5 percent and 5 percent. But during 2007, the Chinese renminbi appreciated by 6 percent against the dollar. Accordingly, in terms of its domestic currency, China experienced negative returns on its investments in U.S. debt during 2007.[13] The same was true for nearly all foreign holders of U.S. treasury bills.

The same people who have complained about the need for more rapid appreciation of the Chinese currency now complain about China's diversification into higher-yielding assets, which is necessary to allow that appreciation to happen without the Chinese experiencing huge currency exchange losses.

Furthermore, foreign investment in nongovernment portfolio and physical assets might curtail U.S. government growth by reducing demand for government debt, thereby bidding up the cost of government profligacy. For too long Congress has been able to spend without political consequence by thrusting the costs on future generations. There is an important distinction to draw between investment in the United States that finances current consumption—such as purchases of government bonds—and investment that is likely to produce future income streams—such as purchases of U.S. factories, land, or other productive assets. In that regard, SWF investment is more like an investment and less like a line of credit than the majority of foreign sovereign investment has been thus far.

Most anxiety about SWFs is attributable to their rapid increase in number and size. At nearly $3 trillion (the upper end of current estimates), SWFs are more than twice as large as all of the world's hedge funds combined. But $3 trillion constitutes a tiny sliver of the $190 trillion stock of global financial assets or the $62 trillion managed by private institutional investors.[14] Even with SWF assets projected to quadruple by 2015, global asset values are projected to grow as well, such that the percentages owned by SWFs should not change much. It is highly improbable that the investment decisions of SWFs will "move" U.S. markets.

Welcome Investment and Let Our Laws Work

The proliferation of SWFs is not a threat to the United States but an affront to citizens in countries where large amounts of wealth and too many investment and other economic decisions are controlled by the state. When governments get wealthier, their capacity to exert firmer control over their citizens and to marginalize civil society grows. It remains the firm hope of liberal-minded people that economic growth continues to lead to increased civil and political liberties and a diminution of the role of government, as it has in the past. That that process has been agonizingly slow in some countries is a fact of economic life that we should not attempt to mitigate through trade or investment policy.

Instead, we should welcome all foreign investment that complies with out laws. We have to ensure that any policies we adopt in response to SWFs and in the name of preventing market distortions don't themselves cause market distortions. Blanket prohibitions or rigid controls on investment from foreign sovereigns are likely to cause resources to be allocated inefficiently.

If SWF investment is significantly curtailed in the United States and in other rich countries, where most of the world's assets are parked, it is more likely that those funds will seek out investment opportunities in other markets that are less capitalized. The total value of assets in Latin American stock markets, for example, is estimated to be about $4 trillion. The $1 to $2 trillion in new wealth projected to be added to SWFs annually through 2015 could certainly have a major impact on markets that are less capitalized, like Latin America's and Africa's, where, presumably, the United States has security interests as well.

A heavy-handed response to SWF growth also could spark a tit-for-tat trade and investment war. U.S. policymakers should be aware of the stakes. For example, in 2005 the U.S. parents of U.S. multinational companies exported $456 billion in goods to foreign markets, but their foreign subsidiaries sold nearly $3 trillion of goods abroad that year. U.S. multinationals serve foreign markets primarily through host country affiliate sales.[15]

Whether controlling or passive, direct or portfolio, sovereign or private, foreign investment in the United States should be welcomed with the presumption that it will be mutually beneficial. Its presence reduces the cost of capital to businesses and the cost of credit to consumers, whose investment and consumption decisions drive the economy.

But foreign investments should be vetted to ensure that any risks to national security posed by such investments are minimal and that proposed investments that do present legitimate national security risks are blocked or restructured. The interagency Committee on Foreign Investment in the United States, whose procedures for reviewing proposed foreign investments were just revamped by the Foreign Investment and National Security Act of 2007 (FINSA), has the tools and authority to do just that. And where ownership of U.S. financial institutions is concerned, a host of banking laws exists to ensure that our financial system remains safe.

The one extra assurance that will reduce risk even further below tolerable levels without repelling investment is voluntary transparency. If SWFs are forthcoming about their investment strategies, their portfolio allocations, and their governance, and they are made aware that the consequences of false representations or insider trading would result in severe penalties and future restrictions, there should be no problems. If SWFs refuse to disclose, there should be an adverse presumption that leads to investment restrictions.

Finally, to allay some of the deeper fears, like those roused by Representative Kanjorski's depiction, foreigners would never be able to turn off the power in the United States. The first stopgap would be CFIUS, which would not allow foreigners to obtain potentially dangerous levels of ownership in U.S. utilities. Second, the operation of utilities and other assets in the United States are subject to U.S. laws and, ultimately, to U.S. actions to mitigate the problems associated with nefarious aims.

We should welcome foreign investment, in whatever form it comes, without a priori exclusions. Our laws are already well-suited to identify and discipline bad actors, when necessary.

Notes

1. David H. McCormick, Undersecretary for International Affairs, U.S. Department of the Treasury, Testimony Before the U.S. House of Representatives, Committee on Financial Services, March 5, 2008.
2. Stefan Schonberg,, "Sovereign Wealth Alarm," *The International Economy*, Winter 2008, p. 58.
3. McCormick Testimony. Many sources cite current SWF asset values between $2 and $3 trillion.
4. Ibid. Many sources cite projected growth of SWF asset values to between $10 and $15 trillion by 2015.
5. Douglas Feiden, "American Corporations Selling Chunks to Economic Powerhouses," *New York Daily News*, January 16, 2008.
6. Peter Goodman and Louise Story, "Overseas Investors Buy Aggressively in U.S.," *New York Times*, January 20, 2008.
7. Congressman Paul Kanjorski, Comments During Hearing in the U.S. House of Representatives, Committee on Financial Services, March 5, 2008.
8. Christopher Cox, "The Role of Government in Markets," Speech before the John F. Kennedy School of Government, Harvard University, October 24, 2007.
9. Ibid.
10. Schonberg, p. 58.
11. Peter Navarro, Professor of Business, University of California-Irvine, Testimony before the U.S. China Security Commission, February 7, 2008.
12. Alan Tonelson, Research Fellow, U.S. Business and Industry Council, Testimony before the U.S.-China Security Commission, February 7, 2008.
13. Congressional Research Service, *CRS Report for Congress*, "China's Sovereign Wealth Fund," January 22, 2008, p. 16.
14. McCormick Testimony.
15. Matthew J. Slaughter, Associate Dean and Professor of International Economics, Tuck School of Business, Dartmouth University, Testimony Before the U.S. House of Representatives, Committee on Financial Services, March 5, 2008.

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