

August 20, 2008

**SOVEREIGN WEALTH FUNDS AND NATIONAL SECURITY:  
THE GREAT TRADEOFF**

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This essay has benefitted from the valuable comments of Christian Chavagneux, Eric Helleiner, Eliza Patterson, and Edwin Truman. The research assistance of Heather Arnold and Tabitha Benney is also gratefully acknowledged.

## **ABSTRACT**

One of the most striking financial developments in recent years is the emergence of sovereign wealth funds (SWFs) – large publicly owned investment portfolios, which are growing rapidly in both number and size. In a global environment already roiled by a prolonged credit crisis, SWFs raise tricky and potentially controversial new questions for international financial regulation. One issue of concern to many in host countries is the possibility that some SWFs might be used for overt or tacit political purposes, posing a challenge for global monetary governance: a Great Tradeoff between, on the one hand, the world community’s collective interest in sustaining the openness of capital markets; and on the other hand, the legitimate national security concerns of individual host countries. Can some balance between the two be found that will be both stable and acceptable to all concerned? Individually as well as collectively, recipient countries have begun to address the regulatory challenge directly. To date, however, accomplishments have been slight and have failed to stem a noticeable drift toward financial protectionism. A review of some recent proposals suggests that there is no foolproof solution to the Great Tradeoff. But the potential for controversy could be significantly reduced by a negotiated agreement among host governments addressing three key issues: (1) definitions; (2) risk assessment; and (3) dispute resolution. The most logical venue for such an exercise would be the OECD, building on its already extensive experience with international investment issues.

One of the most striking financial developments in recent years is the emergence of sovereign wealth funds (SWFs) – large publicly owned investment portfolios, which are growing rapidly in both number and size. SWFs effectively make their home governments major players in world capital markets. In a global environment already roiled by a prolonged credit crisis, SWFs raise tricky and potentially controversial new questions for international financial regulation.

One issue of concern to many in host countries (the countries that receive the investments of SWFs) is the possibility that some funds might be used for overt or tacit political purposes. As one source bluntly observes, a number of the governments involved “have a history of mixing politics with business” (Farrell et al. 2008: 18). SWFs could, in effect, become a powerful new arm of foreign policy. Not everyone agrees that the risk is serious. But serious or not, it is evident that *fears* of an instrumental use of SWFs are real. Worse, if unaddressed, those fears could in time provoke a growing wave of “financial protectionism” in recipient economies.

At issue are two competing goals. One is economic: the desire to promote material prosperity by safeguarding opportunities for productive international investment. The other is political: the right and responsibility of every government to defend the nation’s security. A tricky challenge is thus posed for global monetary governance: a Great Tradeoff between, on the one hand, the world community’s collective interest in sustaining the openness of capital markets; and on the other hand, the legitimate national security concerns of individual host countries. Can some balance between the two be found that will be both stable and acceptable to all concerned?

The purpose of this essay is to explore possible answers to this regulatory challenge. Section 1 traces the emergence of SWFs in recent years, setting out the reasons for the fears that their activities have generated. Section 2 then evaluates the responses of host countries, which to date do not appear to have found a satisfactory solution for the Great Tradeoff. Section 3 reviews a variety of reform ideas that have been proposed in recent years, none of which hold much promise in practical political terms, while Section 4 offers some modest suggestions that might move regulatory policy in a desirable direction. Section 5 concludes.

## 1. EMERGENCE

Sovereign wealth funds are not new. Although the term “sovereign wealth fund” was coined only recently (Rozanov 2005), the first recognizable SWF in the modern era actually was established as early as 1953 by Kuwait, followed three years later by the British administration of the Gilbert Islands in Micronesia, now the sovereign state of Kiribati. A few others also came along during the 1970s (Abu Dhabi, Singapore), 1980s (Brunei, Oman), and early 1990s (Botswana, Hong Kong, Malaysia, Norway). It was not until the late 1990s, however, that the fashion really began to catch on. More than two dozen funds have been created since 1998, bringing the current total to about forty. More are expected in years to come.

At end-2007, SWFs were thought to control assets totaling somewhere in the range of \$2-3 trillion dollars and possibly as much as \$3.3 trillion (Maslakovic 2008), a not inconsiderable sum. According to the International Monetary Fund (2008), holdings could soar to \$6-10 trillion by 2013. Other projections run even higher, to as much as \$12 trillion by 2015 (Jen 2007). Numbers like these have led some to identify SWFs as among the most important new “power brokers” in the world economy (Farrell et al. 2007, 2008).

### *The basics*

The basic purpose of a SWF is to manage some portion of the foreign-exchange assets of a national government. In most cases, this means a designated portion of the currency reserves of the country's central bank. Though there is no commonly accepted definition of an SWF, most observers agree that they share at least three elements in common: (1) SWFs are state-owned; (2) they have no significant liabilities; and (3) they are managed separately from the rest of the central bank's reserves (Beck and Fidora 2008: 6).

For some analysts, such as former Treasury official Edwin Truman (2008a), such an approach is too narrow. Truman prefers a broader definition that would add the international holdings of two other types of funds: governmental pension funds and the funds of subnational governmental units such as the U.S. state of Alaska and the Canadian province of Alberta. Since these types too are publicly owned, he contends, the same issues of motivation arise. But that is a minority view. In practice, neither type is likely to risk returns by investing politically. Pension funds have significant liabilities to worry about, while subnational units like Alaska or Alberta, lacking formal sovereignty, rarely pursue active foreign policies on their own. Most discussion focuses on strictly national agencies that in effect represent an alternative form of investment of a sovereign government's foreign monetary reserves. Exceptions are typically made only for Abu Dhabi and Dubai, component parts of the United Arab Emirates, and for Hong Kong, a specially administered region of China, each of which for these purposes is treated as the equivalent of a state entity.

The new fashion for SWFs is a direct result of the rise of commodity prices and global payments imbalances over the last decade, led of course by the explosion of oil prices. Across the globe, central bank reserves have more than tripled since the late 1990s – particularly in energy-exporting countries and the emerging economies of East Asia. SWFs offer an opportunity to raise the rate of return on a government's foreign-exchange holdings, the bulk of which have traditionally been held in the form of low-paying U.S. Treasury bills or their equivalent (a "revenue" motive). For energy or commodity exporters, they also offer a way to insulate the government's budget and the national economy against volatile price swings (a "stabilization" motive) and to convert nonrenewable export resources into a more diversified portfolio of assets for future generations (a "savings" motive). Kuwait's pioneering Investment Authority was deliberately designed to provide for the day when the Emirate's oil wells run dry. Similarly, Kiribati's Revenue Equalization Reserve Fund was created to invest the revenues from the island nation's phosphate deposits, which have long since been depleted. More recently created SWFs share some or all of these motivations.

In other respects, however, SWFs are remarkably diverse, varying along a number of dimensions. As one observer comments (Roy 2007: 81): "There is no generic sovereign wealth fund model. Each is unique." Funds differ significantly in their level of sophistication and appetite for risk as well as in their style of governance and overall transparency of operation. Some are committed to full disclosure regarding both investment strategies and the size and composition of their portfolios. Others are highly secretive, revealing little.

Most notably, SWFs differ dramatically in size, ranging from under \$1 billion (e.g., Kiribati, Mauritania, Trinidad and Tobago) to as large as an estimated \$875 billion in the case of the Abu Dhabi Investment Authority. Overall, holdings are highly concentrated (Table 1). Most prominent is a group of funds that one source (Lyons 2007) dubs the Super Seven, each with well over \$100 billion of assets: Abu Dhabi, China (\$200 billion), Kuwait (\$265

billion), Norway (\$400 billion), Russia (\$165 billion), and two separate funds of the Government of Singapore (Government of Singapore Investment Corporation and Temasek Holdings, totaling \$490 billion). To the Super Seven should also be added the Saudi Arabian Monetary Authority, with various holdings thought to amount to some \$365 billion, and Hong Kong, whose Exchange Fund Investment Portfolio is estimated to be on the order of \$175 billion. In addition, another four funds – Algeria, Dubai, Libya, and Qatar -- fall in the range of \$50-100 million each. Together, these twelve countries (counting Singapore's two funds as one) account for well over 80 percent of total SWF assets. We might call them the Dirty Dozen.

[Table 1 here]

Put differently, the universe of SWFs is dominated by three classes of countries: seven Arab oil exporters (Abu Dhabi, Algeria, Dubai, Kuwait, Libya, Qatar, Saudi Arabia); two non-Arab oil exporters (Norway, Russia), and three emergent East Asian economies (China, Hong Kong, and Singapore). In any discussion of the regulatory challenge that is posed by the new power brokers, these are the funds that matter most.

### ***The challenge***

From the point of view of host countries, SWFs offer the obvious benefit of access to sizable inflows of capital, which may be useful to supplement domestic savings, finance external deficits, or help stabilize capital markets in moments of stress. Since their time horizons are typically much longer term than most private portfolio managers, SWFs can afford to be more patient in the face of transitory market swings, thus reducing or mitigating the risk of herd behavior that is so often endemic in financial boom-and-bust cycles. A prime case in point was provided in late 2007, following the outbreak of the global credit crisis, when several large SWFs came to the rescue of troubled financial institutions in the United States and elsewhere, including Citicorp, Merrill Lynch, Morgan Stanley, and UBS of Switzerland. In total, SWFs invested over \$60 billion in Western banks and investment firms before the end of 2007. Joked one senior market analyst: “SWF should stand for ‘salvaging withering franchises’” (as quoted by Davis 2007).

But there are plainly risks as well. Precisely because their time horizons are so long, SWFs can also afford to walk away at times just when they may be most needed. Their impact, therefore, could on occasion turn out to be pro-cyclical rather than stabilizing, reinforcing rather than resisting market fluctuations. They certainly cannot always be relied upon to play the role of firemen when flames break out, as the principal SWFs themselves made clear after their dramatic efforts in 2007. In 2008 they flatly turned down most subsequent requests from the likes of Bear Stearns (before its collapse) and Wachovia Bank. One reason was unhappiness with the sizable losses they were suffering as bank stocks continued to tumble. Another was the often negative publicity that their investments generated. “The availability of money from sovereign wealth funds was exceptionally helpful to a limited number of U.S. and other financial institutions around the world,” observed Stephen Schwartzman, founder and head of the private equity firm Blackstone. “But since the spotlight has been put on them, they have pulled back dramatically. They don’t want to be members of a club that doesn’t want them as members. They’ve pretty much withdrawn” (as quoted in the *Financial Times*, 5 June 2008).

Another risk arises from the sheer size of SWFs – especially the Dirty Dozen – which could conceivably carry enough weight to move markets on their own. \$3.3 trillion is, as

indicated, a not inconsiderable sum; \$10-12 trillion is obviously a lot more. Some sources downplay the danger, emphasizing that these numbers are still small as compared with the more than \$50 trillion of funds managed by the private asset management industry worldwide (Beck and Fidora 2008: 12) or the more than \$190 trillion in total global financial assets (IMF 2008: 8). But these comparisons do not rule out the possibility that on a more disaggregated basis serious distortions might be generated by large investments in smaller or less liquid sectors.

Yet other risks arise from the secrecy that often shrouds SWF operations, which can create uncertainty and volatility, as numerous observers have suggested (Lyons 2007; IMF 2008; Beck and Fidora 2008). Some analysts also fret about the potential for corruption inherent in the management of such massive sums of money. Until now, as Truman (2008a: 3) insists, all these concerns remain “largely in the realm of the hypothetical.” No one has yet been able to point to a clear case of abuse of power by any SWF. But that is hardly reason to conclude, as Truman (2008b: 3) does, that the only challenge is therefore “to make the world safer for sovereign wealth funds.” Past experience is hardly reassurance that such problems will never materialize in the future.

Even more to the point is the possibility that SWF investments might be deployed strategically in pursuit of geopolitical objectives. In the words of former Treasury Secretary Lawrence Summers (2007): “The logic of the capitalist system depends on shareholders causing companies to act so as to maximize the value of their shares. It is far from obvious that this will over time be the only motivation of governments as shareholders.” SWFs could be used instrumentally to take control of strategically important industries abroad, to extract technology or other proprietary knowledge, or to achieve a degree of direct or indirect influence over host governments. Such possibilities raise legitimate national-security concerns, which in an insecure world cannot be easily discounted. These risks too may “remain for now in the order of fantasy,” as French journalist Christian Chavagneux (2008: 11) suggests. But as he adds:

Like Janus, sovereign funds have a double face. Like the Roman god, they look simultaneously to the East and to the West. It is said that his reign was peaceful and that he was a god of peace. But specialists do not forget to recall that he was also the guardian of the gate of hell. (Chavagneux 2008: 12; translation)

Few foresaw any risk of hell in the early days of SWFs. There seemed little reason to worry about the geopolitical aspirations of a Kuwait or a Kiribati, or even later entrants like Singapore or Norway. Investment behavior appeared to be largely conservative and benign in its objectives, giving grounds for cautious optimism. “There is little evidence of any ulterior foreign policy motives in practice,” proclaimed Robert Kimmitt, Deputy Secretary of the Treasury, as recently as early 2008 (Kimmitt 2008: 124). The Monitor Group, a private consultancy, agreed. “SWFs do not appear to be investing for political motives,” concluded the firm in a lengthy study. “They do not appear to be active in ways that threaten the economic or national security of foreign countries where they invest” (Miracky et al. 2008: 4). Janus seemed to be looking in the right direction.

A turning point was reached, however, when China and Russia joined the game – two countries with unmistakable geopolitical ambitions. In 2007 Beijing formed the China Investment Corporation, with an initial endowment of some \$200 billion, followed just months later by Moscow’s announcement of a pair of new Russian funds with total resources of \$150 billion. Here suddenly were two major powers with pockets deep enough to really

make an impact. And their emergence, in turn, cast new light on the role of the big Arab oil exporters as well, whose strategic interests also could not always be expected to coincide precisely with those of the United States or other Western nations. Should it have been any surprise that political discourse might now begin to take national-security concerns more seriously? Alarm over the new power brokers was rising. In the United States, polls indicated that by ratios ranging between 2 to 1 and 7 to 1, Americans opposed SWF investments in critical sectors of the U.S. economy (Davis 2008).

By 2008 it was becoming clear that the issue had legs. In February 2008 the European Commission (2008) issued a formal statement calling for new scrutiny of SWF operations. European leaders, wrote a former Bundesbank official, had “misgivings about the ultimate intentions of foreign governments running such funds” (Schönberg 2008: 57). And a month later the U.S. House of Representatives announced creation of a bipartisan task force to study the effects of SWFs on America’s economy and national security. As one source (Marchick and Slaughter 2008: 27) notes, “government officials’ rhetoric against sovereign wealth funds has sharpened.” Declared John McConnell, the director of U.S. national intelligence: “Concerns about the financial capabilities of Russia, China, and OPEC countries and the potential use of their market access to exert financial leverage to achieve political ends represents a major national security issue” (U.S. Senate 2008a). Echoed Senator Joe Biden of Delaware, chair of the Senate Foreign Relations Committee: “There is a subtle impact on our conduct of foreign policy when investments in the United States affect powerful groups in which the investments are made, for them to determine and put impact on the Congress and the president to curtail and/or enhance a certain foreign policy action” (U.S. Senate 2008b). A variety of Congressional inquiries have been mounted, and calls for measures to defend against the threat of SWFs have proliferated, coming from, among others, influential senators like Charles Schumer of New York and Evan Bayh of Indiana. The question of regulation plainly is now on the table.

## **2. RESPONSES**

How have governments reacted? To date, responses have been relatively modest. But momentum is obviously building. Individually as well as collectively, host countries are beginning to address the regulatory challenge directly. At issue is the Great Tradeoff. Can legitimate national-security concerns be respected without provoking a wave of financial protectionism?

### ***Individual approaches***

Until lately, the danger of new financial protectionism seemed minimal. Indeed the trend, if anything, was going the other way, toward ever greater tolerance for inward foreign investment. In the 1980s and 1990s, financial liberalization was the name of the game in the more advanced economies – the thirty members of the Organization for Economic Cooperation and Development (OECD) – as well as in many emerging economies in East Asia and Latin America. Capital controls seemed on their way out, for foreign direct investment (FDI) as well as for portfolio investments in stocks and bonds.

The trend was clearly evident in data provided by the United Nations Conference on Trade and Development (UNCTAD), which reports annually on all national regulatory changes toward inward FDI. Throughout the 1990s, policy changes were overwhelmingly

favorable to foreign investors. As late as 2000, of the 150 regulatory changes tracked by UNCTAD that year, only three restricted rather than liberalized FDI, a mere two percent of the total. An extensive analysis of investment restrictions published by the OECD in 2003 confirmed that “on the whole the OECD countries are now quite open to foreign direct investment inflows” (Golub 2003: 99).

More recent years, however, have seen a marked reversal, as host governments have become more wary. One catalyst for change was a series of high-profile takeover attempts by foreign corporations, often state-owned or controlled, in key sectors of host economies. Most notorious were two cases in the United States – first, an attempt in 2005 by the government-controlled China National Offshore Oil Company (CNOOC) to purchase Unocal, a U.S. oil producer; and then a year later a bid by Dubai Ports World (DP World), a government-owned entity, to acquire the British-based Peninsula and Oriental Steam Navigation Company (P&O), which had long operated several port facilities in the United States, including the ports of New York and New Jersey. Though both tenders were eventually withdrawn, they did suffice to fan fears about the political implications of FDI. The sudden emergence of SWFs added even more fuel to the fire. By 2005-06, the percentage of new policy actions recorded by UNCTAD that were restrictive rather than liberalizing had risen to some twenty percent of the total each year.

Most countries have long had laws that prohibit or screen foreign investments in the defense sector or other industries deemed essential to national security. What is new is that governments are now fast tightening the rules or extending their coverage to additional sectors, such as “critical infrastructure,” energy, or certain forms of technology. Since 2005 at least eleven major countries, which together receive some two-fifths of all world FDI, have either approved or are seriously considering new laws that would expand governmental oversight over or directly restrict selected types of inward investment (Marchick and Slaughter 2008; General Accounting Office 2008). Most measures have been justified on the basis of defending national security or safeguarding “strategic” industries. Some states have passed legislation to protect “public order” or “economic security”; others have established new national-security review processes, which are usually mandatory if investments reach a certain value threshold or may result in a controlling share of an acquired enterprise. The trend toward liberalization that was so evident a decade ago has clearly now reversed course. In the words of one recent study (Marchick and Slaughter 2008: 3): “A protectionist drift in FDI policy is indeed under way.”

In the United States, as a direct result of the CNOOC and Dubai Ports cases, Congress passed the Foreign Investment and National Security Act (FINSAs) of 2007. The main aim was to update past legislation, including especially the International Emergency Economic Powers Act (IEEPA) of 1977, which over the years had been used by the executive branch for a variety of national-security related actions involving trade and investment. Formally, FINSAs built on the 1988 Exon-Florio amendment to the Defense Production Act of 1950, which had given the executive branch specific authority to block foreign acquisitions that might threaten U.S. national security. The new legislation created a statutory basis for the Committee on Foreign Investment in the United States (CFIUS), an interagency body led by the Treasury Department that been created in 1975 to monitor and review incoming investments. FINSAs also required heightened scrutiny of acquisitions by government-owned entities, mandated the involvement of high-level officials in CFIUS, and required additional reporting to Congress.

Past legislation has also been updated in Canada, France, Germany, and Japan – all members, like the United States, of the Group of Seven advanced economies (G-7) – as well as in several other leading OECD countries. As early as December 2005, France issued a new decree mandating prior authorization for foreign investments in eleven sectors that may affect “national defense interests.” In August 2007, Japan revised its regulation of inward investment to address, in the words of the Ministry of Economy, Trade, and Industry, the “changed security environment surrounding Japan and trends in international investment activity.” In December 2007 the Canadian government issued “clarifications” of its rules on foreign investment for state-owned enterprises under the Investment Canada Act. In February 2008, Australia articulated six principles that will now govern reviews of foreign investments by SWFs and other government-linked entities, as administered by the country’s Foreign Investment Review Board. And in April 2008 Germany passed new legislation authorizing policy makers to pre-examine selected foreign investments, particularly those coming from SWFs. The legislation was actively promoted by Chancellor Angela Merkel, who expressed a fear that SWFs were often driven by “political and other motivations” rather than economic returns. Four months later an even tighter set of restrictions was approved by Merkel’s cabinet, prohibiting acquisitions deemed to pose a threat to “public security or order.”

In no instance has any host country simply declared itself off-limits to SWFs. Policy makers appreciate the benefits that can come with SWF investments; no one wants to kill the goose that lays the golden eggs. But in an insecure world, governments have no choice but to stay attuned to strategic considerations as well. No one wants to leave the state defenseless, either. What responsible authorities are trying to do, therefore, is to recalibrate the Great Tradeoff – to find a new balance between investment openness and national security that will sustain the gains of the former even while fortifying defense of the latter.

The problem is that there is no common understanding about how that might be done. As a recent report of the U.S. Government’s General Accounting Office (2008) emphasizes, the approaches of individual countries are highly diverse. There is no agreement on what constitutes “economic security” or how to identify a “strategic” industry. The principles and criteria governing review processes are often quite ambiguous, leaving much to the discretion of public officials. For the international community as a whole, consequently, two serious risks are raised. One is the possibility that governments, in the interest of prudence, may sincerely err on the side of caution, tilting more than necessary in the direction of restriction. The other is that policy makers may be tempted to act opportunistically, using national security as a pretext – a handy excuse for arbitrary acts of protectionism. Uncoordinated individual actions could spawn a proliferation of highly heterogeneous standards, hindering the full integration of financial markets. It could also lead to a collective slide toward a closing of investment opportunities.

### *Collective approaches*

The problem is well understood. Thus even as they have acted individually to defend their separate interests, leading host governments have also explored new collective approaches that might stem the protectionist drift of policy. The key initiative came in June 2007 at the summit meeting of the Group of Eight (G-7 plus Russia) in Heiligendamm, Germany. Any restrictions on SWF investments, the G-8 leaders declared, should be minimized and “only apply to very limited cases that primarily concern national security”

(Group of Eight 2007). Their governments proposed to “work with the OECD and other fora to develop further our common understanding” of the regulatory challenge posed by the new power brokers. Four months later, following strong pressure from the United States and France, the finance ministers and central bank chiefs of the G-7 formally called on the IMF and OECD to take up the issue (Group of Seven 2007). The aim would be to identify “best practices” for all the players involved, in hopes of forestalling misapprehension or mistrust on either side of the market. The process would operate on two parallel tracks. The IMF would develop principles to guide the behavior of SWFs. The OECD would focus on the recipient side.

The task was taken up swiftly by both organizations. Progress, though, has been slight, at least until now. At the IMF the first of a series of meetings of what has come to be named the Sovereign Wealth Fund International Working Group was convened as early as November 2007, bringing together managers of more than two dozen funds, including all the Dirty Dozen. Discussions have focused on how SWFs are structured and governed and how they manage their investments, with particular emphasis on standards for transparency and disclosure. The hope is that by October 2008 agreement can be reached on a first draft of what has come to be called the GAPP (generally accepted principles and practices) – a voluntary code of conduct that will allay host-country fears that SWF operations might be politically motivated.

The path to a GAPP has not been smooth. Some fund-owning governments have expressed considerable resentment at being singled out in this way. They have never done anything to arouse suspicions, they feel. So why should they suffer such intrusion now? Typical were the remarks of the managing director of the Kuwait Investment Authority at the Davos World Economic Forum in February 2008. “The KIA has been operating for fifty five years,” he pointed out, “and has never made a political decision. We look to the bottom line.” At times, the language has been anything but diplomatic. The proposed code of conduct was outright “unfair,” complained the executive vice president of the newly formed China Investment Corporation in March 2008. “We don’t need outsiders to come tell us how we should act.” Some fund managers indicated that they agreed to participate in the GAPP talks only because of a fear of political backlash in the United States and other recipient countries had they refused (Davis 2007).

In an effort to soften resistance, the U.S. Treasury persuaded Abu Dhabi and Singapore, two of the biggest of the Dirty Dozen, to formally disavow “geopolitical goals” in a joint statement with the United States released in March 2008. For its part, Washington agreed that recipient countries “should not erect protectionist barriers” and “should ensure predictable investment frameworks.” Abu Dhabi and Singapore also made commitments to maximum disclosure of investment activities and to strong internal controls, including management of risk in investments. The idea, evidently, was to set an example for other, more reluctant governments. Privately, U.S. officials made clear that they hoped the deal would provide a model for the IMF effort. Despite the precedent, however, negotiations have proved difficult.

Even if agreement on a GAPP can be reached, there will still be room for skepticism over just how much good it will do. Since the code is to be strictly voluntary, how can host governments be sure that it will actually be honored? Optimists argue that SWFs will find it in their interest to abide by the rules for reputational reasons. They will want to keep their good name in order to minimize tensions with the countries where they invest. As Robert Dohner, a U.S. deputy assistant secretary of the Treasury, has put it: “The advantage of a

voluntary code is that funds can distinguish themselves as positive players in the global market by signing on to the best practices” (as quoted in the *Straits Times*, 1 July 2008). Pessimists retort that this is an awfully weak reed on which to rely when it comes to matters of national security. A GAPP may be necessary to meet the regulatory challenge in host countries, but it is hardly likely to be sufficient.

In any event, it is clear from the G-8 ‘s Heiligendamm Declaration that even with SWF commitment to a new code of conduct, an exception would remain on the recipient side for security-related restrictions – a loophole of potentially broad import. That of course is why the OECD was asked to take the lead on a parallel track, to develop a separate code of best practices for host governments. SWFs, as the IMF (2008: 4) acknowledges, have reason to feel that “they are vulnerable to changes in the regulatory climate, and thus have to operate cautiously as change can be costly.” Some countries, such as Singapore, made clear from the start that they anticipated a quid pro quo in return for their acquiescence. If they were expected to submit voluntarily to restraints on their behavior, they felt, they had a right to expect host countries to do the same. What was good for the goose (that lays the golden eggs) should also be good for the gander.

Unfortunately, progress on the OECD track has been even less impressive. The Paris-based “rich countries club” seemed a logical venue for an effort on the recipient side, since until now its members collectively have attracted the vast majority of SWF investments. Moreover, the organization’s Investment Committee was already in the midst of a major project on “Freedom of Investment, National Security, and ‘Strategic Industries,’” which had been started in May 2006. A new look at recipient-country policies toward SWFs could easily be folded into that ongoing activity. But after less than half a year of deliberations, the Investment Committee produced a brief interim report in April 2008 that managed to do little more than ratify the status quo (OECD 2008b). A final report is due in the spring of 2009 but is not expected to differ greatly in tone.

The OECD has long maintained a series of “investment instruments” for its membership, including most importantly a Code of Liberalization of Capital Movements dating back to the organization’s origins in 1961, which is designed to establish basic principles to guide recipient country behavior. Amended and extended over the years, these principles commit member states to “fair” treatment of foreign investors, including foreign governmental entities. They also provide for “peer review” of existing policies, a process of face-to-face discussions by members that OECD officials consider reasonably effective in promoting compliance with standing norms. According to the interim report, the organization’s instruments are more than adequate to cope with the challenge of investments from SWFs. No new laws or regulations are needed. The existing principles already provide “the required guidance” for member countries and could easily be extended to “adhering governments” outside the OECD. In the words of Angel Gurría, OECD Secretary-General: “What we’re discovering is that we don’t have to apply too many original measures. We have a bunch of codes and guidelines that we have approved over the years which, if applied today, could perfectly well be the context in which these investments should be received” (as quoted by Reuters, 25 March 2008). The Investment Committee’s conclusions were “welcomed” by OECD ministers in a Ministerial Declaration in June 2008 (OECD 2008a)..

In reality, however, the OECD’s response seems surprisingly complacent. Under its investment instruments, recipient countries have always had the right to take actions they consider necessary to protect national security (OECD 2007: Article 3). But since no definitions have ever been offered for such key terms as “public order” or “essential security

interests,” host governments remain free to attach any meaning they wish. The best the interim report could do was to urge states to use their national-security exception “with restraint.” The loophole “should not be a general escape clause from their commitments to open investment policies” (OECD 2008b: 4). But why should we believe that governments will seriously heed such hortatory rhetoric?

In principle, deviations from the principle of “fair treatment” are supposed to expose governments to the opprobrium of the OECD’s peer-review process. In practice, however, the organization’s procedures do not extend to the national-security exception. No provision is made for challenges to restrictions proposed on behalf of a state’s defense interests; members are not even able to question such decisions *ex post*. With apprehensions growing over the potential for mischief by SWFs, therefore, the status quo does not in fact seem adequate to slow down the protectionist drift of policy.

In short, the regulatory challenge remains unresolved. Governments have yet to find an effective solution for the Great Tradeoff.

### 3. MIRAGES

Not surprisingly, given the urgency of the issue, numerous ideas for reform have already surfaced from a variety of sources. Not many, however, are destined to gain traction in practical political terms. Most are like a mirage in the desert, alluring only until they are approached up close.

One idea, for example, is to create an entirely new global organization – a World Investment Organization (WIO) – to act as the ultimate regulatory authority for SWFs. In the words of *The Economist* (5 July 2008), the purpose of a WIO would be “to set basic rules and better track the huge and complex flow of cash that now wash around” from the operations of the Dirty Dozen and other funds. The approach has an obvious appeal. We have long since accepted the need for regulation of financial markets at the national level. Why not do the same at the global level? In a world of sovereign states, however, there clearly are limits to how much power policy makers would be prepared to delegate to any supranational agency. Is it really plausible to think that fund-owning governments, with the billions of dollars at their disposal, would so easily accept the *diktat* of an international bureaucracy?

A related idea, in lieu of a new organization, is to assign the problem to one of the already existing global institutions in hopes of finding a mutually acceptable multilateral solution. Some observers highlight a possible role for the World Trade Organization (WTO) in this regard. As one source puts it, “there is a bargain to be struck between countries with SWFs, which want secure and liberal access for their capital, and capital-importing countries that have concerns about the objectives and operations of SWFs. The WTO is the natural place to strike this bargain” (Mattoo and Subramanian 2008: 1). A multilateral negotiation at the WTO would lessen the risk of uncoordinated unilateral actions by individual countries. Moreover, there is already legal precedent for a WTO role in two of the organization’s existing agreements -- the General Agreement on Trade in Services (GATS) and the Trade-Related Investment Measures (TRIMs) agreement. Both, dating from 1995, cover selected forms of FDI.

Again, however, there is a question of plausibility. Anyone familiar with the experience of the WTO in the long-running Doha Round of trade talks, which proved extraordinarily cumbersome and appears ultimately to have failed, would be entitled to a certain degree of skepticism. The most likely outcome of a global approach through the

WTO would be agreement at the level of the lowest common denominator: a set of general principles not much less ambiguous than what we have now. The chances of achieving anything any more meaningful would be small.

In that case, why not turn to the IMF? Michael Bordo and Harold James, two noted economic historians, have suggested looking back to the original rationale for the Fund as an agent of financial stabilization. The IMF was always intended to play a key role in the management of global reserves. At one time, that meant lending to countries with payments deficits, a function that has been greatly diminished by the resurrection of international financial markets as an alternative source of liquidity. In today's world of massive global imbalances, by contrast, it might mean taking a more active part in the investment of reserve surpluses, thus reducing the risk of politically motivated operations. Fund-owning governments would in effect become passive investors. Active management of their foreign holdings would be delegated to the IMF, which could thus reinvigorate its leadership role in systemic stabilization. In the words of Bordo and James (2008: 3), the IMF "would be in a powerful position to take bets against speculators. The stabilizing action would ultimately benefit both the world economy and the interests of the owners of the reserve assets."

But is this approach any more plausible? Can we really imagine fund-owning countries voluntarily agreeing to hand over control of a large part of their national patrimony to a gaggle of international civil servants, no matter how well trained? The scenario defies everything we know about the political sensitivities of the various governments involved.

The same objection also casts doubt on a similar idea backed *inter alia* by Evan Bayh (2008), which would also encourage fund-owning governments to be passive investors, but without the intermediation of the IMF. SWFs would agree to channel all their billions directly into outlets that while remaining profitable, would eliminate any possibility of direct influence or control. One way to do this would be to create a kind of "global fund" for SWF investments, composed of the indexes of all the countries that are part of the international financial system. Another would be to persuade fund managers to limit their investments solely to existing index instruments, such as the Standard and Poor 500, Dow Jones Wilshire Global Total Market Index, and the like. Either way, even the appearance of geopolitical motivation would be eliminated, thus reassuring host governments. As one source suggests: "Channeling the activities of SWFs into widely diversified country funds offers diversification gains to investors, while minimizing the exposure of a given country to strategic 'cherry picking'" (Aizenman and Glick 2007: 3).

That too, however, is difficult to imagine. Short of a gun held to their head, fund-owning governments are bound to resist such a radical constraint on their sovereign discretion. Moreover, there is also the question of who would hold the gun. To make the approach work, the biggest host countries would have to act together, jointly closing their markets to all but the most passive investments. Otherwise, SWFs might be able to use tactics of "divide and conquer" to gain access for more active acquisitions. Successful collective action by the key recipients would not seem a plausible scenario, either.

A final idea, proposed by economist Adam Posen (2007), is to concentrate on who does the investing rather than, as at present, on the motivations that may or may not underlie specific investments. In most host countries today, review processes tend to focus on the nature of individual investments. Is there a threat to national security? Is the industry or sector "strategic?" Is the possibility of influence or control genuine? For Posen, such questions are inherently subjective and ultimately impossible to answer definitively – a "fruitless pursuit," in his words. A better alternative, he suggests, would be to ask where the

investment comes from: an “investor-based regime,” as he puts it, rather than an “investment target-based regime.” Is the SWF owned by a friendly country? An ally? A democracy? With this approach, there would be no need at all for a review process screening individual investments.

But would host governments really want to get into the business of making such invidious distinctions among states? Diplomatic feathers might be ruffled only slightly if an individual investment is rejected. But it is not difficult to imagine how much more serious a rupture could result from labeling a whole country, say China or Russia, as unwelcome. The price is apt to be higher than most host governments are willing to contemplate.

#### 4. A MODEST PROPOSAL

In short, there is no foolproof solution. But that does not mean that improvements are impossible. As the old adage suggests, we should not let the perfect be the enemy of the good. Scope exists for moving regulatory policy in a desirable direction if we keep our ambitions modest. The aim is to minimize, to the extent possible, the risk that host countries will restrict SWF investments either excessively or arbitrarily.

##### *Three key issues*

Most realistic, in my view, would be a negotiated agreement among host governments aimed directly at the central problem for the Great Tradeoff: the diversity of approaches by individual countries, which fosters ambiguity and uncertainty. The most logical venue for such an exercise would seem to be the OECD, building on its already existing “Freedom of Investment” (FOI) project. Negotiations should focus on three key issues: (1) definitions; (2) risk assessment; and (3) dispute resolution. Advances on these three issues would go a long way toward narrowing the scope for wasteful quarrels.

1. **Definitions.** First, it is necessary to agree on the meaning of such critical terms as “public order” or “economic security.” What exactly is a “strategic” industry? What precisely do we mean by “essential” defense interests? The lack of consensus on these matters, both in individual national legislation and in the OECD’s investment instruments, is a natural recipe for discord. The more these terms are carefully clarified, the less likely it is that SWFs will hazard investments that may be seen as dangerously “political.”

2. **Risk assessment.** Second, an equally serious effort should be made to formalize the risk-assessment criteria used in national-security review processes when screening specific investments. At the moment, procedures in most host countries are anything but transparent. Little public guidance is offered regarding the factors that go into decisions or how they are weighed and evaluated. Indeed, in many cases it is not clear whether any formal calculus is used at all. The wide latitude that is provided for the discretion of decision makers is an open invitation to politicize the process, exacerbating the risk of excessive or arbitrary restrictions. Once again, a little increase of clarity could go a long way toward reducing the chance of discord.

3. **Appeals.** In the end, of course, no amount of clarification or formalization can be counted on to eliminate the risk of discord altogether. At the national level, that is why we have civil courts: to resolve disputes that may arise over the interpretation of contractual terms or the quality of decisions. And even in relations among sovereign states the right of appeal has been recognized, at least in the realm of foreign trade, in the dispute-settlement

procedures of the WTO. So why not establish some form of appeals process for SWFs as well, as an adjunct of the WTO or OECD or as an independent body? SWFs should be given an opportunity to ask for an independent review if they feel they have been treated unfairly. Even if the appeals process were only advisory rather than compulsory, it would go a long way toward reassuring fund-owning governments that there need not be a continued drift toward financial protectionism in the countries where they hope to invest.

### *Possible objections*

Objections are possible, of course. For example, is it realistic to think that we could ever establish truly unambiguous definitions or risk criteria for assessing SWF acquisitions? Posen (2007) is by no means alone in highlighting the subjectivities inherent in any investment target-based regime. Not only are the core concepts involved, by their very nature, obscure. Worse, policy makers actually like the flexibility that is given them by a certain amount of artful obfuscation. So why should we even try going down this road? In effect, though, this is a counsel for resigned inaction, which amounts to an abdication of responsibility. Though the challenge is daunting, it need not necessarily prove a “fruitless pursuit.” Just because a task is difficult should not become an excuse for not even trying.

Or think about the idea of an appeals process. Why should we believe that fund-owning governments would accept an arrangement whose terms were negotiated without their participation? To point out that an independent review procedure would presumably reduce the risk of a protectionist drift in host countries might not be enough to persuade them of its legitimacy. More likely, they would insist on having some input as well, in terms of both design and implementation. The OECD has attempted to pre-empt objections to its FOI project by including a sizable number of non-member governments in the Investment Committee’s discussions, including many that own SWFs. Certainly the same could be done as well for any attempt to negotiate the terms of an appeals process.

Perhaps most critically, one might question the choice of the OECD as the venue for such a negotiation. Why should we believe that the OECD could do a better job at this than, say, the WTO? The organization’s record of achievement on investment issues, after all, is not all that bright. Many still remember the OECD’s painful experience back in the 1990s when it undertook to sponsor negotiation of a Multilateral Agreement on Investment (MAI) – an initiative intended to develop systematic and consistent rules for host-country treatment of FDI, which ended in 1998 in ignominious failure. For years thereafter the subject was avoided like the plague at the OECD’s Paris headquarters; and even now, with memories of the MAI still lingering, the organization seems reluctant to stick its neck out too far. Should we not be skeptical about OECD efficacy, too?

Admittedly, there is no guarantee that any sort of effective agreement could actually be reached under the OECD’s auspices. But the odds are certainly better than with the MAI, which was ultimately brought down by a broad-based coalition of non-governmental organizations and social movements (Kobrin 1998). With the MAI, OECD governments were attempting to codify rules that, it was expected, would eventually apply to all nations hosting FDI, including many in the developing world that were not even members of the rich countries club. The perceived unrepresentativeness of the negotiation ultimately proved to be a fatal flaw. In the current context, by contrast, any new rules would apply mainly to OECD countries themselves. Moreover, there is clearly more commonality of interest among the thirty members of the rich countries club than there is at more global institutions like the

WTO. Negotiations at the OECD, therefore, would be far less cumbersome, with a correspondingly higher chance of meaningful success. And a sense of legitimacy would certainly be enhanced if, as in the FOI project, a number of interested non-members could be included in the deliberations in some capacity.

## **5. CONCLUSION**

SWFs pose a dramatic challenge for global monetary governance. The question is: Can some balance be found between the world community's collective interest in sustaining the openness of capital markets and the legitimate national security concerns of host countries? Individually as well as collectively, recipient countries have begun to address the regulatory challenge directly. To date, however, accomplishments have been slight and have failed to stem a noticeable drift toward financial protectionism. A review of some recent proposals suggests that there is no foolproof solution to the Great Tradeoff. But the potential for controversy could be significantly reduced by a negotiated agreement among host governments addressing three key issues: (1) definitions; (2) risk assessment; and (3) dispute resolution. The most logical venue for such an exercise would be the OECD, building on its already extensive experience with international investment issues.

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**TABLE 1**

**TWELVE LARGEST SOVEREIGN WEALTH FUNDS (“DIRTY DOZEN”)**  
(billions of U.S. dollars, mid-2008)

<u>Country</u>	<u>Fund Name</u>	<u>Inception</u>	<u>Assets</u>
Abu Dhabi (United Arab Emirates)	Abu Dhabi Investment Authority	1976	\$875
Norway	Government Pension Fund - Global	1990	\$396.5
Saudi Arabia	Saudi Arabian Monetary Authority	n/a	\$365.2
Singapore	(1) Government of Singapore Investment Corporation	1981	\$330
	(2) Temasek Holdings	1974	\$159
Kuwait	Kuwait Investment Authority	1953	\$264.4
China	China Investment Corporation	2007	\$200
Hong Kong (China S.A.R.)	Hong Kong Monetary Authority Investment Portfolio	1998	\$173
Russia	National Welfare Fund	2008	\$162.5
Dubai (United Arab Emirates)	Investment Corporation of Dubai	2006	\$82
Qatar	Qatar Investment Authority	2003	\$60
Libya	Libyan Investment Authority	2006	\$50
Algeria	Revenue Regulation Fund	2000	\$47

n/a Not available

Source: Sovereign Wealth Fund Institute