

Sovereign wealth funds and national security: the Great Tradeoff

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One of the most striking financial developments in recent years has been the emergence of sovereign wealth funds (SWFs)—large publicly owned investment portfolios, which until recently were growing rapidly in both number and size. SWFs effectively make their home governments major players in world capital markets, raising tricky and potentially controversial new questions for international financial regulation. For the moment, understandably, the attentions of policy-makers have been deflected elsewhere, to more pressing problems of collapsed housing markets, bank insolvencies and worldwide recession. But the challenges posed by SWFs remain profound and cannot be neglected for long.

A prime issue of concern to many in host countries (the countries that receive the investments of SWFs) is the possibility that some SWFs 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'.¹ SWFs could, in effect, become a powerful new arm of foreign policy. Not everyone agrees that the risk is serious. Many concur with political economist Daniel Drezner, who considers worries about SWFs to be 'overblown'.² However, it is evident that the *fears* of an instrumental use of SWFs are real. Worse, if left unaddressed, those fears could in time provoke a growing wave of 'financial protectionism' in recipient economies. In the words of an earlier analysis in this journal, 'Legitimate caution about SWFs could easily spill over into illegitimate hysteria'.³

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,

* This article has benefited 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.

¹ Diana Farrell, Susan Lund and Koby Sadan, *The new power brokers: gaining clout in turbulent markets* (San Francisco: McKinsey Global Institute, 2008), p. 18.

² Daniel W. Drezner, 'Sovereign wealth funds and the (in)security of global finance', *Journal of International Affairs* 62: 1, Fall–Winter 2008, p. 120.

³ Gawdat Bahgat, 'Sovereign wealth funds: dangers and opportunities', *International Affairs* 84: 6, Nov. 2008, p. 1204.

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 article is to explore possible answers to this regulatory challenge. The first section traces the emergence of SWFs in recent years, setting out the reasons for the fears their activities have generated. The second section evaluates the responses of host countries, which to date do not appear to have found a satisfactory solution for the Great Tradeoff. The third section reviews a variety of reform ideas that have been proposed in recent years, none of which holds much promise in practical political terms. The fourth section offers some modest suggestions that might move regulatory policy in a desirable direction. A final section offers conclusions.

Emergence

Sovereign wealth funds are not new. Although the term 'sovereign wealth fund' was coined only recently,⁴ the first recognizable SWF in the modern era 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 came along during the 1970s (Abu Dhabi, Singapore), 1980s (Brunei, Oman) and early 1990s (Botswana, Hong Kong, Malaysia, Norway). But it was not until the late 1990s that the fashion really began to catch on. More than two dozen funds have been created since 1998, bringing the current total to above 40. More are expected in years to come.

At the end of 2008 SWFs were thought to control assets amounting to something like \$3.9 trillion,⁵ a considerable total. Like most investors, some SWFs lost money in 2008—as much as \$700 billion, according to the *Financial Times*⁶—and may end up losing more in 2009. But overall gains exceeded losses by as much as half a trillion dollars. Moreover, once global economic recovery gets under way, further rapid growth can certainly be expected in the medium term. According to an early analysis by the International Monetary Fund, SWF holdings could soar to between \$6 trillion and \$10 trillion by 2013.⁷ Other projections have run even higher, to as much as \$8–12 trillion by 2015.⁸ Numbers like these have led some to identify SWFs as among the most important new 'power brokers' in the world economy.⁹

⁴ Andrew Rozanov, 'Who holds the wealth of nations?', *Central Banking Journal* 15: 4, May 2005, pp. 52–7.

⁵ Marko Maslakovic, *Sovereign wealth funds 2009* (London: IFSL Research, 2009).

⁶ Lex, 'Sovereign wealth funds', *Financial Times*, 7 Dec. 2008.

⁷ International Monetary Fund, *Sovereign wealth funds: a work agenda* (Washington DC, 2008).

⁸ Stephen Jen, *Currencies: how big could sovereign wealth funds be by 2015?* (New York: Morgan Stanley Research Group, 2007); Maslakovic, *Sovereign wealth funds 2009*.

⁹ Diana Farrell, Susan Lund, Eva Gerlemann and Peter Seeburger, *The new power brokers: how oil, Asia, hedge funds, and private equity are shaping global capital markets* (San Francisco: McKinsey Global Institute, 2007); Farrell, Lund and Sadan, *The new power brokers: gaining clout in turbulent markets*.

The basics

The basic purpose of an 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: (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.¹⁰

For some analysts, such as former US Treasury official Edwin Truman, such an approach is too narrow.¹¹ 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 US state of Alaska and the Canadian province of Alberta. Since these types of fund too are publicly owned, he contends, the same issues of motivation arise. But that is questionable. In practice, neither type is likely to jeopardize 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 was a direct result of the rise of commodity prices and global payments imbalances that began in the early 1990s, led by an explosion of oil prices. Across the world, central bank reserves more than tripled after 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 (a 'revenue motive'). Traditionally central bank reserves have been held in the form of low-paying US Treasury bills or their equivalent. For energy or commodity exporters, SWFs also offer a way to insulate the government's budget and the national economy against volatile price swings (a 'stabilization' motive) and to convert non-renewable 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.¹² As one observer comments: 'There is no generic sovereign wealth

¹⁰ Roland Beck and Michael Fidora, *The impact of sovereign wealth funds on global financial markets* (Frankfurt: European Central Bank, 2008), p. 6.

¹¹ Edwin M. Truman, *A blueprint for sovereign wealth fund best practices* (Washington DC: Peterson Institute, 2008).

¹² The diversity of SWFs is well documented by Cornelia Hammer, Peter Kunzel and Iva Petrova, 'Sovereign

fund model. Each is unique.¹³ 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. The dangers of overgeneralization about SWFs are obvious. In the words of economist Paola Subacchi, 'To bundle all of them together risks incompleteness and an over-simplified analysis.'¹⁴

Most notably, SWFs differ dramatically in size, ranging from under \$1 billion (e.g. Kiribati, Mauritania) to as much as an estimated \$875 billion in the case of the Abu Dhabi Investment Authority. In the aggregate holdings are highly concentrated, as can be seen in table 1, which summarizes authoritative estimates for the largest SWFs in late 2008. Most prominent is a group of funds that one source dubs the Super Seven,¹⁵ each with well over \$100 billion of assets: alongside Abu Dhabi, mentioned above, Norway (\$300 billion), Russia (\$225 billion), China (\$200 billion), Kuwait (\$200 billion) and Singapore (two funds totalling \$415 billion). To the Super Seven should also be added the Saudi Arabian Monetary Authority (SAMA), with various holdings thought to amount to at least \$430 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 account for well over 80 per cent of total SWF assets. We might call them the 'dominant dozen'.

Other sources suggest some differences in rank orderings. According to one recent analysis, for instance, Abu Dhabi's portfolio has been vastly overstated and may now actually be smaller than SAMA's.¹⁶ Evidence suggests that SAMA benefited greatly in 2008 from an unusually conservative investment strategy at a time when Abu Dhabi's riskier forays resulted in substantial losses.

No one, however, disputes the overall degree of concentration. In simplest terms, the universe of SWFs may be said to be 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.

wealth funds: current institutional and operational practices', working paper WP/08/254 (Washington: International Monetary Fund, 2008).

¹³ Sudip Roy, 'The new rulers of finance', *Euromoney*, Dec. 2007, p. 81.

¹⁴ Paola Subacchi, 'Asian and Gulf sovereign wealth funds: a tale of two continents', in John Nugée and Paola Subacchi, eds, *The Gulf region: a new hub of global financial power* (London: Royal Institute of International Affairs, 2008), p. 150.

¹⁵ Gerard Lyons, *State capitalism: the rise of sovereign wealth funds* (London: Standard Chartered Bank, 2007).

¹⁶ Brad Setser and Rachel Ziemba, *GCC sovereign funds: reversal of fortune* (New York: Council on Foreign Relations, 2009).

Table 1: The twelve largest sovereign wealth funds

<i>Country</i>	<i>Fund name</i>	<i>Inception</i>	<i>Assets (US\$bn, end 2008)</i>
Abu Dhabi (United Arab Emirates)	Abu Dhabi Investment Authority	1976	875
Saudi Arabia	Saudi Arabian Monetary Authority	n/a	433
Singapore	(1) Government of Singapore Investment Corporation	1981	330
	(2) Temasek Holdings	1974	85
Norway	Government Pension Fund – Global	1990	301
Russia	(1) National Welfare Fund ^a and (2) Reserve Fund ^a	2008	225.1
Kuwait	Kuwait Investment Authority	1953	202.8
China	China Investment Corporation	2007	200
Hong Kong (China SAR)	Hong Kong Monetary Authority Investment Portfolio	1998	173
Dubai (United Arab Emirates)	Investment Corporation of Dubai	2006	82
Libya	Libyan Investment Authority	2006	65
Qatar	Qatar Investment Authority	2003	60
Algeria	Revenue Regulation Fund	2000	47

n/a not available.

^a Prior to 2008, Russia's two funds were combined in one Stabilization Fund, dating from 2004.

Source: Sovereign Wealth Fund Institute (Jan. 2009).

The challenge

From the point of view of host countries, SWFs offer the obvious benefit of access to sizeable 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 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 behaviour 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 US 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. One senior market analyst joked: 'SWF should stand for "salvaging withering franchises".'¹⁷

But there are plainly risks as well. Precisely because their time horizons are so long, SWFs can also afford to walk away just when they may be most needed. Their impact, therefore, could on occasion turn out to be pro-cyclical rather than

¹⁷ As quoted by Bob Davis, 'Wanted: SWFs' money sans politics', *Wall Street Journal*, 20 Dec. 2007.

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 and Wachovia Bank (both of which ultimately collapsed). One reason was unhappiness with the sizeable losses they were suffering as bank stocks tumbled. Another was the often negative publicity that their investments had generated. 'The availability of money from sovereign wealth funds was exceptionally helpful to a limited number of US 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.'¹⁸ The point was echoed by a senior Chinese official: 'Now, cash is king and as far as possible we will refrain from making investments.'¹⁹ By the end of 2008, as the global financial meltdown intensified, the worry was that SWFs might not just resist new commitments; now they might even begin dumping previous acquisitions.

Another risk arises from the sheer size of SWFs—especially the 'dominant dozen'—in that together they could conceivably carry enough weight to move markets on their own. The current total of \$3.9 trillion is, as indicated, a substantial sum; \$10–12 trillion is obviously a lot more. Some sources downplay the danger, emphasizing that these numbers still represent just a small fraction of total financial assets around the globe.²⁰ But such a comparison does not rule out the possibility that on a more disaggregated basis serious distortions could 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.²¹ Some analysts also fret about the potential for corruption inherent in the management of such massive sums of money. Until now, as Truman rightly insists, all these concerns remain 'largely in the realm of the hypothetical'.²² 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 does, that the only challenge is therefore 'to make the world safer for sovereign wealth funds'.²³ Past experience hardly constitutes reassurance that such problems will never materialize in the future. Even Drezner, otherwise quite sympathetic to SWFs, acknowledges that 'past good behavior is no guarantee of future good behavior'.²⁴

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

¹⁸ As quoted in the *Financial Times*, 5 June 2008.

¹⁹ As quoted by Reuters, 5 Jan. 2009.

²⁰ Beck and Fidora, *Impact*, p. 12; IMF, *Sovereign wealth funds*, p. 8.

²¹ Beck and Fidora, *Impact*; IMF, *Sovereign wealth funds*; Lyons, *State capitalism*.

²² Truman, *Blueprint*, p. 3.

²³ Edwin M. Truman, 'Do sovereign wealth funds pose a risk to the United States?', remarks at the American Enterprise Institute, 25 Feb. 2008, p. 3.

²⁴ Drezner, 'Sovereign wealth funds', p. 124.

US Treasury Secretary Lawrence Summers (now a White House adviser to President Barack Obama): '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.'²⁵ SWFs could be used instrumentally to seek control of strategically important industries, to extract technology or other proprietary knowledge, or to achieve a degree of direct or indirect influence over host governments. Such possibilities raise legitimate concerns about national security, 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 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.'²⁶

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 of later entrants like Singapore or Norway. Investment behaviour 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, then US Deputy Secretary of the Treasury, as recently as early 2008.²⁷ 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.'²⁸ Janus seemed to be looking in the right direction.

A turning point was reached, however, when China and Russia—two countries with unmistakable geopolitical ambitions—joined the game. In 2007 Beijing formed the China Investment Corporation, with an initial endowment of some \$200 billion. Just months later Moscow announced that its Stabilization Fund, first created in 2004, was to be split into two separate entities, a Reserve Fund and a National Welfare Fund, starting with total resources of \$150 billion. Both funds were now expected to invest more aggressively on global markets. Here suddenly were two major powers with pockets deep enough to make a real impact. And their emergence, in turn, cast new light on the role of the big Arab oil exporters, whose strategic interests also could not always be expected to coincide precisely with those of the US 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 US, polls indicated

²⁵ Lawrence Summers, 'Funds that shake capitalist logic', *Financial Times*, 29 July 2007. For a similar line of argument, see Brad W. Setser, *Sovereign wealth and sovereign power* (New York: Council on Foreign Relations, 2008).

²⁶ Christian Chavagneux, 'Le double visage des fonds souverains', *Alternatives Économiques*, no. 266, Feb. 2008, pp. 11–12.

²⁷ Robert M. Kimmitt, 'Public footprints in private markets: sovereign wealth funds and the world economy', *Foreign Affairs* 87: 1, Jan.–Feb. 2008, p. 124.

²⁸ William Miracky, Davis Dyer, Drost Fisher, Tony Goldner, Loic Lagarde and Victor Piedrahita, *Assessing the risks: the behavior of sovereign wealth funds in the global economy* (Cambridge, MA: Monitor Group, 2008), p. 4.

that Americans opposed SWF investments in critical sectors of the US economy by ratios ranging between 2:1 and 7:1.²⁹

By 2008 it was becoming clear that concerns were persistent, and spreading. In February 2008 the European Commission issued a formal statement calling for new scrutiny of SWF operations. European leaders, wrote a former Bundesbank official, now had 'misgivings about the ultimate intentions of foreign governments running such funds'.³⁰ And a month later the US House of Representatives announced the creation of a bipartisan task force to study the effects of SWFs on America's economy and national security. As a source noted at the time, 'government officials' rhetoric against sovereign wealth funds has sharpened'.³¹ John McConnell, then director of US national intelligence, declared: '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.'³² His anxiety was echoed by Joe Biden, chair of the Senate Foreign Relations Committee (and now Vice-President): '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.'³³ A variety of congressional inquiries were mounted, and calls for measures to defend against the threat of SWFs proliferated, coming from, among others, influential senators such as Charles Schumer of New York and Evan Bayh of Indiana. The question of regulation plainly was now on the table.

Responses

How have governments reacted to the increasing prominence of, and perceived potential threat posed by, SWFs? To date, responses have been relatively modest. But momentum is building. Individually as well as collectively, host countries are addressing 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 the early years of the present decade, the danger of new financial protectionism seemed minimal. Indeed, the trend was if anything in the opposite direction, towards ever greater tolerance for inward foreign investment. In the 1980s and 1990s

²⁹ Bob Davis, 'Americans see little to like in sovereign wealth funds', *Wall Street Journal*, 21 Feb. 2008.

³⁰ Stefan Schönberg, 'Sovereign wealth alarm', *The International Economy* 22: 1, Winter 2008, p. 57.

³¹ David M. Marchick and Matthew J. Slaughter, *Global FDI policy: correcting a protectionist drift* (New York: Council on Foreign Relations, 2008), p. 27.

³² United States Senate, *Current and projected national security threats*, hearings before the Senate Select Committee on Intelligence (Washington DC, 2008).

³³ United States Senate, *Sovereign wealth funds: foreign policy consequences in an era of new money*, hearings before the Senate Foreign Relations Committee (Washington DC, 2008).

financial liberalization was the name of the game in the more advanced economies—the 30 members of the 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.

This 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 relating to inward FDI. Throughout the 1990s, policy changes were overwhelmingly favourable 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 2 per cent 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’.³⁴

More recent years, however, have seen a marked reversal of this trend, 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 state-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 US oil producer; and then a year later a bid by DP World, a government-owned entity, to acquire the British-based P&O, which had long operated several port facilities in the United States, including the ports of New York and New Jersey. Both tenders were eventually withdrawn, though not before they had fanned fears about the political implications of FDI. The sudden emergence of SWFs added even more fuel to the fire. By 2005/2006, the percentage of new policy actions recorded by UNCTAD that were restrictive rather than liberalizing had risen to some 20 per cent of the annual total.

Most countries have long had laws that prohibit or screen foreign investments in the defence 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.³⁵ Most such 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 the acquisition of a controlling share of an enterprise. The trend towards liberalization that was so evident a decade ago has clearly now reversed course. In

³⁴ Stephen S. Golub, *Measures of restrictions on inward foreign direct investment for OECD countries*, OECD Economic Studies 36, 2003, p. 99.

³⁵ US Government General Accountability Office, *Foreign investment: laws and policies regulating foreign investment in ten countries* (Washington DC, 2008); Marchick and Slaughter, *Global FDI policy*.

the words of one recent study: 'A protectionist drift in FDI policy is indeed under way.'³⁶

In the United States, as a direct result of the CNOOC and Dubai Ports cases, Congress passed the Foreign Investment and National Security Act (FINSA) in 2007. The main aim was to update past legislation, notably the International Emergency Economic Powers Act 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, FINSA 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 US national security. The new legislation created a statutory basis for the Committee on Foreign Investment in the United States, an interagency body led by the Treasury Department that had been created in 1975 to monitor and review incoming investments. FINSA 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.

Legislation has also been updated in Canada, France, Germany and Japan—all members, like the United States, of the Group of Seven advanced economies (G7)—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 defence 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 henceforth 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 must stay attuned to strategic considerations as well. No one wants to leave the state defenceless. 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 defence of the latter.

³⁶ Marchick and Slaughter, *Global FDI policy*, p. 3.

The problem is that there is no common understanding about how that might be done. As a recent report of the US government's General Accountability Office emphasizes, the approaches of individual countries are highly diverse.³⁷ 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. This lack of consensus raises two serious risks for the international community as a whole. One is the possibility that governments, in the interests of prudence, may sincerely err on the side of caution, tilting more than necessary in the direction of restriction. The other is that in the midst of a global economic crisis policy-makers may be tempted to act opportunistically, using national security as a pretext for arbitrary acts of protectionism. Uncoordinated individual actions could spawn a proliferation of highly heterogeneous standards, eroding the integration of financial markets. They could also lead to a collective slide towards 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 (G7 plus Russia) in Heiligendamm, Germany. Any restrictions on SWF investments, the G8 leaders declared, should be minimized and 'only apply to very limited cases that primarily concern national security'.³⁸ 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 US and France, the finance ministers and central bank chiefs of the G7 formally called on the IMF and OECD to take up the issue.³⁹ The aim was to identify 'best practices' for all the players involved, in the hope of forestalling misapprehension or mistrust on either side of the market. The process was to operate on two parallel tracks. The IMF would develop principles to guide the behaviour of SWFs, while the OECD would focus on the recipient side.

The task was taken up swiftly by both organizations. Achievements, however, have been slight. At the IMF, the first of a series of meetings of what came to be named the International Working Group of Sovereign Wealth Funds was convened as early as November 2007, bringing together managers of more than two dozen funds, including all the 'dominant dozen'. Discussions focused on how SWFs are structured and how they manage their investments, with particular emphasis

³⁷ US General Accountability Office, *Foreign investment*.

³⁸ G8 summit declaration, 'Growth and responsibility in the world economy' (Heiligendamm, Germany, 7 June 2007).

³⁹ G7, 'Statement of the G7 finance ministers and central bank governors' (Washington DC, 29 Oct. 2007).

on standards for transparency and disclosure. Less than a year later, following a meeting in Santiago, Chile, agreement was reached on a set of 24 general principles for SWF governance—a voluntary code of conduct intended to allay host-country fears that future investment practices might be politically motivated. The so-called ‘Santiago Principles’ were formally presented to a ministerial meeting held in conjunction with the IMF’s annual meeting in October 2008.⁴⁰

The path to agreement was not smooth. Some fund-owning governments expressed considerable resentment at being singled out in this way. They had never done anything to arouse suspicions, they felt. So why should they suffer such intrusion now? Typical were the remarks of the managing director of the Kuwait Investment Authority (KIA) 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 was 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 had agreed to participate in the IWG talks only because of a fear of political backlash in the US and other recipient countries had they refused.⁴¹

In an effort to soften resistance, the US Treasury persuaded Abu Dhabi and Singapore, two of the biggest of the SWF holders, to formally disavow ‘geopolitical goals’ in a joint statement with the US 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, US officials made clear that they hoped the deal would provide a model for the IMF effort. Despite the precedent, however, negotiations proved difficult.

Even with agreement on the Santiago Principles, there remains room for scepticism over just how much good they will do. Since the code is to be strictly voluntary, how can host governments be sure that it will actually be honoured? 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, then a US deputy assistant secretary of the Treasury, 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.’⁴² Pessimists retort that this is an awfully weak reed on which to rely when it comes to matters of national security. The Santiago Principles may be necessary to meet the regulatory challenge in host countries, but they are hardly likely to be sufficient.

⁴⁰ International Working Group of Sovereign Wealth Funds, *Sovereign wealth funds: generally accepted principles and practices—‘Santiago principles’* (Washington DC, Oct. 2008).

⁴¹ Davis, ‘Wanted’.

⁴² As quoted in the *Straits Times*, 1 July 2008.

In any event, it is clear from the G8'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 potentially very wide loophole. 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 has acknowledged, 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'.⁴³ 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 behaviour, 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, achievements on the OECD track have been even less impressive than those on the IMF side. 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 and could easily incorporate a new look at recipient-country policies towards SWFs. 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.⁴⁴ A final 'tranche' of the report was adopted by OECD members in October 2008 but added even less substance.

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 behaviour. 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 OECD 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.'⁴⁵

⁴³ IMF, *Sovereign wealth funds*, p. 4.

⁴⁴ Organization for Economic Cooperation and Development, *Sovereign wealth funds and recipient country policies* (Paris, 4 April 2008).

⁴⁵ As quoted by Reuters, 25 March 2008.

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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.⁴⁶ 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 to them any meaning they wish. The best the 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'.⁴⁷ But why should we believe that governments will seriously heed such hortatory devices?

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 review procedures do not extend to the national security exception. No provision is made for challenges to restrictions proposed on behalf of a state's defence interests; members are not even able to question such decisions after the event. 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.

Mirages

Not surprisingly, given the urgency of the issue, numerous ideas for reform have already surfaced from a variety of sources. Few if any, however, are destined to gain any degree of 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*, the purpose of a WIO would be 'to set basic rules and better track the huge and complex flows of cash that now wash around' from the operations of these funds.⁴⁸ 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 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 the hope of finding a mutually acceptable multilateral solution. Some observers highlight a possible role for the WTO in this regard. As one source puts it, 'there is a bargain to be struck between countries with

⁴⁶ OECD, *OECD code of liberalisation of capital movements 2007* (Paris, 2007), art. 3.

⁴⁷ OECD, *Sovereign wealth funds*, p. 4.

⁴⁸ *The Economist*, 5 July 2008.

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.⁴⁹ A multilateral negotiation at the WTO would lessen the risk of uncoordinated unilateral actions by individual countries. Moreover, there is already a legal precedent for a WTO role in two of the organization's existing agreements—the General Agreement on Trade in Services and the Trade-Related Investment Measures 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 degree of scepticism. 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 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, 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.'⁵⁰

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 by, among others, Evan Bayh, which would also encourage fund-owning governments to be passive investors, but without the intermediation of the IMF.⁵¹ SWFs would agree to channel all their billions directly into outlets that, while remaining profitable,

⁴⁹ Aaditya Mattoo and Arvind Subramanian, *Currency undervaluation and sovereign wealth funds: a new role for the World Trade Organization* (Washington: Peterson Institute, 2008), p. 1. See also Aaditya Mattoo and Arvind Subramanian, 'From Doha to the next Bretton Woods', *Foreign Affairs* 88: 1, Jan.–Feb. 2009, pp. 21–2.

⁵⁰ Michael Bordo and Harold James, 'The IMF as reserve manager', 28 June 2008, www.VoxEU.org, accessed 18 May 2009.

⁵¹ Evan Bayh, 'Time for sovereign wealth rules', *Wall Street Journal*, 13 Feb. 2008.

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 investment 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".'⁵²

That too, however, is difficult to imagine. Fund-owning governments are bound to resist such a radical constraint on their sovereign discretion. So who is going to overcome that resistance? 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 seems no more plausible.

A final idea, proposed by economist Adam Posen, is to concentrate on who does the investing rather than, as at present, on the motivations that may or may not underlie specific investments.⁵³ 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 labelling a whole country, say China or Russia, as unwelcome. The price is likely to be higher than most host governments are willing to contemplate.

A modest proposal

In short, there is no foolproof solution. But that does not mean that improvements in the current situation 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,

⁵² Joshua Aizenman and Reuven Glick, 'Sovereign wealth funds: stumbling blocks or stepping stones to financial globalization?', *Federal Reserve Bank of San Francisco Economic Letter* 2007/2008, Dec. 2007, p. 3.

⁵³ Adam Posen, 'Who, not what, matters for investment barriers', *Welt am Sonntag*, 4 Nov. 2007.

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 towards 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' defence interests? The lack of consensus on these matters, both in individual national legislation and in the OECD's investment instruments, is itself a recipe for discord. The more carefully these terms are 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 in clarity could go a long way towards reducing the chance of discord.
- 3 *Dispute resolution.* 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—third—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 was only advisory rather than compulsory, it would go a long way towards reassuring fund-owning governments that there need not be a continued drift towards financial protectionism in the countries where they hope to invest.

Possible objections

Objections may be made to these proposals, 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 is by no means alone in highlighting the subjectivities inherent in any regime based on investment targets. 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 to counsel resigned inaction, which amounts to an abdication of responsibility. Though the challenge is daunting, it need not necessarily prove a 'fruitless pursuit'. The fact that 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 sizeable number of non-member governments in the Investment Committee's discussions, including many that own SWFs. Certainly the same could be done 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 sceptical 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.⁵⁴ 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

⁵⁴ Stephen J. Kobrin, 'The MAI and the clash of globalizations', *Foreign Policy*, no. 112, Autumn 1998, pp. 97–109.

to OECD countries themselves. Moreover, there is clearly more commonality of interest among the 30 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 genuine 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 some capacity in the deliberations.

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 towards 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.