

White Whale or Red Herring? – Assessing Sovereign Wealth Funds Daniel W. Drezner

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Glasshouse Forum's Executive Summary

The world became fully aware of sovereign wealth funds when they helped to stabilize the American bank crisis. Many of these state funds represent authoritarian regimes.

Glasshouse Forum asked Professor Daniel W. Drezner at Tufts University to write a report examining the performance of sovereign wealth funds to date, and to place them in relation to the issue in the project "The return of the capitalist-authoritarian great powers". If the hypothesis of the return of the authoritarian great powers is correct, will sovereign wealth funds be playing a part in this development?

In his report "White Whale or Red Herring? – Assessing Sovereign Wealth Funds" Drezner establishes that the apprehensions about sovereign wealth funds have so far proved to be unfounded. As regards corporate governance and market uncertainty, it is difficult to prove significant negative effects from these funds. Attempts to use them for political pressure are impeded by the fact that the dependence between them and Japan, the USA and the EU is mutual. These great economies can to a considerable extent dictate the rules for sovereign wealth funds.

Drezner distinguishes the following possible risks from sovereign wealth funds in the future. They can amplify protectionist tendencies in the OECD countries. A general distrust of foreign investors is intensified by the fact that here it is a question of foreign governments. What is more, they can create problems either by failing disastrously or by being hugely successful. As counterparty surveillance of them is imperfect in authoritarian states, they can commit major errors as regards riskier investments.

Successful sovereign wealth funds can on the other hand contribute to the stability and attraction of authoritarian regimes. They can act as buffers vis-à-vis the vicissitudes of the market economy, mitigate crises and challenge the view that the market is the best allocation of resources. In this way, they can strengthen the position of the authoritarian states as an alternative to the liberal capitalist model.

Defining Sovereign Wealth Funds

There are almost as many definitions of sovereign wealth funds (SWF) as there are sovereign wealth funds.¹ They are defined here as *government investment vehicles that acquire international financial assets to earn a higher-than-risk-free rate of return.*² SWFs have multiple purposes, which can make it difficult to generalize about their intentions and effects. Some funds are designed to smooth out the income volatility of commodity exports, while others are intended to provide an intergenerational wealth transfer, in order to better manage a graying society. Some funds are simply intended to earn a higher rate of return than the holding of foreign exchange reserves, while others are designed to promote economic development. All of them, however, seem to excel at setting policymakers' teeth on edge. Is this tension justified?

Some Background

Sovereign wealth funds are not a recent invention – Kuwait created the first modern fund in 1953, eight years before its independence.³ Nor are they alien to the advanced industrialized states. Norway's central bank controls the second-largest sovereign wealth funds in existence. Within the OECD economies, Australia, Canada, New Zealand, Mexico, South Korea and several American states also have them.

What is new about SWFs is their size, anticipated rate of growth, recent investment trends, and countries of origin. The combined heft of sovereign wealth funds is currently estimated to be between \$3 trillion and \$3.5 trillion – or between one and one and a half percent of global asset markets. They have grown at an annual rate at 24 percent over the past five years. The inelastic demand and high price for oil, combined with the persistence of global macroeconomic imbalances, leads many analysts to predict an annual 20 percent growth rate over the next decade; by 2015 their total valuation could range in size from \$9 trillion to \$16 trillion – or close to four percent of global asset markets.⁴

To seek higher rates of return, in recent years sovereign wealth funds have shifted from bonds and index funds to portfolios with greater risk. SWF cross-border mergers and acquisitions more than doubled between 2006 and 2007.⁵ They have also been attracted to “alternatives” such as hedge funds, derivatives, leveraged buyout firms, and real estate. This summer they have been big players in commodity futures markets in the United States. Long-established SWFs have also begun to manage a greater share of their assets in-house.⁶

Although the concept of a sovereign wealth fund is not new, close to half of the top forty SWFs have been created since 2000.⁷ In

1) The term first appeared in Andrew Rozanov, “Who Holds the Wealth of Nations?”, *Central Banking Journal* 15 (November 2005): 52–57. On the definitional debate, see Edwin Truman, “A Blueprint for Sovereign Wealth Fund Best Practices”, Peterson Institute for International Economics Policy Brief PB08–3, April 2008; Christopher Balding, “A Portfolio Analysis of Sovereign Wealth Funds”, Working paper, Milken Institute, June 2008; International Monetary Fund, “Sovereign Wealth Funds – A Work Agenda”, February 29, 2008.

2) This include institutions like China's State Administration of Foreign Exchange (SAFE), the Hong Kong Monetary Authority (HKMA) and the Saudi Arabian Monetary Authority (SAMA), which do segment some of their holdings into higher-risk investments. In his original definition, Rozanov argued that central banks that split reserves into separate funds for separate purposes qualified as SWFs.

3) Some suggest that the very first sovereign wealth fund was France's *Caisse des Dépôts et Consignations* in 1816.

4) The estimates in this paragraph come from Stephen Jen, “How Big Could Sovereign Wealth Funds be by 2015?”, Morgan Stanley Research Global, May 3rd, 2007; Steffen Kern, “Sovereign wealth funds – state investments on the rise”, Deutsche Bank Research, September 10th, 2007; Gerald Lyons, “State Capitalism: the Rise of Sovereign Wealth Funds”, Standard Chartered, October 2007; Brad Setser and Rachel Ziemba, “Understanding the New Financial Superpower – the Management of GCC Official Foreign Assets”, RGE Monitor, December 2007; Jen Randolph, *Sovereign Wealth Fund Tracker*. Global Insight, April 2008. For a dissenting view, see Afnab Das, “SWF growth set to slow”, *Financial Times*, July 22, 2008.

5) Marko Maslakovic, “Sovereign Wealth Funds 2008”, International Financial Services, London, April 2008.

6) IMF, “Sovereign Wealth Funds – A Work Agenda”, p. 9.

7) Maslakovic, “Sovereign Wealth Funds 2008”.

the past two years, Saudi Arabia, Russia and China created large sovereign wealth funds. Press reports indicate that Brazil and Nigeria will create new funds in the near future. Two kinds of governments are pumping money into sovereign wealth funds: commodity exporters and countries running fiscal and trade surpluses. Commodity-exporting countries hold approximately two-thirds of total SWF assets.⁸ For the oil exporters, the incentive to create a sovereign wealth fund is three-fold. First, these economies want to create assets that ensure a long-term stream of revenue to cushion themselves against the roller coaster of commodity booms and busts. As many economists have observed, these countries are simply converting assets extracted from the earth into a more liquid form. Second, many of these governments are trying to build up reserve funds for the day when all of the oil is extracted from below ground. Third, by focusing on foreign investments, these governments are attempting to forestall the Dutch disease of rapidly appreciating currencies. Overseas investment via sovereign wealth funds can accomplish all of these tasks.

Export engines are also using sovereign wealth funds to keep their currencies fixed at a low par value.⁹ As of 2007, China had accumulated more than \$1.8 trillion in foreign assets in order to prevent the renminbi from appreciating too rapidly. This keeps Chinese exports competitive in the United States. More than 80 percent of these assets exist in the form of foreign exchange reserves – i.e., safe investments with very low rates of return. As these reserves have accumulated, so have the opportunity costs of amassing dollars in such low-yield investments. According to some estimates, the cost is close to \$100 billion a year.¹⁰ This explains the creation of the China Investment Corporation in 2007, as well as the State Administration of Foreign Exchange's recent equity purchases.¹¹

Sources of Concern

The criticisms of sovereign wealth funds are myriad and many. They can be boiled down to a few key concerns – their effects on individual firms, capital markets, and national polities.

At the firm level, several commentators argue that SWF investments could weaken corporate governance.¹² As sovereign wealth funds shift their portfolios away from risk-averse assets into greater equity investments, the cost of equity capital would be artificially lowered. This could reduce the fiscal discipline for corporations seeking capital. Furthermore, over the past year corporate CEOs have sought out SWF investment when they have faced a crisis. In return for taking large equity stakes, sovereign investors might reciprocate by protecting the management of poorly run companies. Related to this last point, if sovereign wealth funds buy large stakes but explicitly refrain from being “active” investors because of concerns about political blowback, then a powerful monitor of corporate performance could be curtailed.

At the market level, the mix of transparency and sovereignty issues raises multiple concerns. Compared to mutual funds or pension funds, the transparency of most sovereign wealth funds ranges from bad to worse.¹³ The largest sovereign wealth fund, for example, is the Abu Dhabi Investment Authority (ADIA). An institution that

8) David Fernandez and Bernhard Eschweiler, “Sovereign Wealth Funds: A Bottom-Up Primer”, JP Morgan Research, June 2008, p. 8.

9) Michael Dooley, David Folkerts-Landau and Peter Garber, “An Essay on the Revived Bretton Woods System”, NBER Working Paper No. W9971, September 2003; Lawrence Summers, “Reflections on Global Account Imbalances and Emerging Markets Reserve Accumulation”, L.K. Jha Memorial Lecture, Reserve Bank of India, Mumbai, March 24, 2006.

10) Lawrence Summers, “Reflections on Global Account Imbalances and Emerging Markets Reserve Accumulation”.

11) Michael Cognato, “China Investment Corporation: Threat or Opportunity?” *NBR Analysis* 19 (June 2008): 9–36; Amadan International, “The Creation of the China Investment Corporation”, January 2008.

12) Lawrence Summers, “Funds that shake capitalist logic”, *Financial Times*, July 29, 2007; John Plender, “An unseen risk in sovereign funds”, *Financial Times*, June 21, 2007.

13) Sovereign wealth funds protest that, compared with private equity firms and hedge funds, they are being treated unfairly. This overlooks recent efforts (the Walker Report and the Large Report; the Financial Stability Forum's work on highly-leveraged institutions) to force these investment vehicles into greater transparency.

has been in existence for more than thirty years but has yet to reveal its fund size, portfolio structure, performance, or investment objectives. Until earlier this year ADIA's official website was confined to a single page containing no financial information.¹⁴

The lack of transparency is problematic when combined with their size and the fact that SWFs are, by definition, extensions of the state. They are, therefore, viewed as maximizing their country's long-term strategic interests rather than as profit-maximizing actors. The funds themselves have repeatedly insisted that they merely seek to maximize their rate of return. Nevertheless, the perception among financial actors diverges from the self-perception of SWFs. A recent survey of global financial institutions revealed that private actors viewed sovereign funds as more likely to seek strategic interests than maximize their financial returns – even though SWF respondents stressed the latter over the former.¹⁵

Without a clear read on the intentions of sovereign wealth funds, their actions could roil financial markets. Analysts are concerned that sovereign wealth funds will act to boost “national champions” in global markets.¹⁶ Regulators are worried about keeping a level playing field in financial markets. In theory, sovereign wealth funds could profit from exploiting other organs of the state – intelligence agencies, central banks, justice ministries – to gain an unfair advantage in mergers and acquisitions.¹⁷

The political effects of sovereign wealth funds in both home and host countries are the source of considerable anxiety. Within home countries, the paramount concern is that sovereign funds increase the chances of corruption and crowd out businesses independent of the state. Within host countries, SWF investment decisions have caused political and financial turmoil in both Iceland and Thailand.¹⁸ The most obvious geopolitical concern is whether national governments will use their sovereign wealth funds to exercise political leverage over recipient countries. This could happen directly through the ownership and control of strategic sectors or critical infrastructure.¹⁹ It could also happen more subtly, through the co-optation of domestic interests – i.e. financial actors eager to do business with SWFs and lobby politicians on their behalf.²⁰ Leverage could also be exercised through the threat of investment

withdrawal. Indeed, the president of the Chinese Investment Corporation warned the *Financial Times* this year that, “there are more than 200 countries in the world. And, fortunately, there are many countries who are happy with us.”²¹

The Empirical Record²²

How valid are these concerns? The corporate governance issue might have some traction. On the one hand, the stock price of a firm

14) Fernandez and Eschweiler, “Sovereign Wealth Funds: A Bottom-Up Primer”, p. 23; Bob David, “U.S. Pushes Sovereign Funds to Open to Outside Scrutiny”, *Wall Street Journal*, February 26, 2008. For more on ADIA, see also Landon Thomas Jr., “Cash-Rich, Publicity-Shy, Abu Dhabi Fund Draws Scrutiny”, *New York Times*, February 28, 2008; Emily Thornton and Stanley Reed, “Inside the Abu Dhabi Investment Authority”, *Business Week*, June 6, 2008.

15) “Sovereign Wealth Funds and the Global Private Equity Landscape”, Norton Rose, June 2008. Accessed at <http://www.nortonrose.com/knowledge/publications/2008/pub15287.aspx?page=all&clang=en-gb>

16) Edwin M. Truman, “A Blueprint for Sovereign Wealth Fund Best Practices”, p. 3; Joshua Kurlantzick, “A Fistful of Dinars”, *Democracy* 8 (Spring 2008): 59–71.

17) Ethiopis Tafara, “Testimony Concerning the Regulatory Framework for Sovereign Investments”, Presented at the U.S. Senate Committee on Banking, Housing and Urban Affairs, April 24, 2008.

18) “Asset-backed insecurity”, *Economist*, January 17, 2008.

19) Gal Luft, “Selling Out: Sovereign Wealth Funds and Economic Security”, *The American Interest* 3 (July/August): 53–56.

20) Andy Mukherjee, “Sovereign Wealth Funds a Boon for Asset Managers”, Bloomberg News, October 23, 2007; Chris Larson, “Managers Eye Asian SWF Billions”, *Financial Times*, August 3, 2008.

21) Quoted in Jamil Anderlini, “China fund shuns guns and gambling”, *Financial Times*, June 13, 2008.

22) A cautionary note: the aforementioned lack of transparency makes it difficult to systematically evaluate the validity of these policy concerns. Focusing exclusively on the more transparent sovereign funds (Norway's Government Pension Fund – Global, for example) on high-profile transactions (CIC's investment in Blackstone) could lead to erroneous generalizations.

increases significantly immediately following the announcement of SWF investment.²³ On the other hand, a recent econometric study examined 53 SWF equity purchases from 1989 to 2008 and found that, on average, two year abnormal returns amounted to -4.1 percent.²⁴ This is consistent with the performance of these funds in their high-profile investments in the financial sector. The McKinsey Global Institute estimates that as of July 2008, SWFs had lost \$14 billion from these investments.²⁵ Two years is still a relatively short time period, however. There might also be another reason for these outcomes: governments are not the savviest of investors. Sovereign wealth funds in Nigeria and Ecuador have gone bust in the past. As Kenneth Rogoff pointed out in congressional testimony last year: “Governments have a long tradition of losing massive amounts of money in financial markets. This tradition is not likely to end any time soon.”²⁶

Ironically, though the source of most policy concerns emanates from the OECD economies, there is little hard evidence for any of these concerns bearing out. There are few reported instances of sovereign wealth funds succeeding in cross-border market transactions because of assistance from other government agencies.²⁷ If anything, the effect might cut in the opposite direction; private actors benefit from their association with a sovereign wealth fund when acting in the SWF’s home market. It is possible, for example, that Blackstone has had preferred access to the Chinese market following CIC’s investment in that private equity firm. In the time since CIC’s investment, Blackstone purchased a 20 percent stake in a state-owned Chinese chemical manufacturer, as well as a high-end commercial building in downtown Shanghai. They have announced plans to set up a Beijing office to facilitate even more transactions, relying on CIC for assistance within China. Blackstone’s successes have occurred while other private equity firms have encountered fierce resistance to similar kinds of investment.²⁸

The argument that SWFs exacerbate market uncertainty also appears to lack empirical foundation. Theoretically, the comparative advantage of sovereign wealth funds is that they can hold large positions for long stretches of time, weathering short-term panics and downturns. Sovereign wealth funds would therefore be expected

to function in a countercyclical, stabilizing manner – as their investments in the financial sector earlier this year suggest. Furthermore, in contrast to their private sector counterparts, SWFs traditionally have not been highly leveraged. Their equity investments to date have been focused in regions and sectors where they have local knowledge. The general consensus among financial analysts is that sovereign wealth funds have taken a long-term, passive approach to their overseas investments.²⁹ The bulk of recent SWF equity investments has been for either non-voting shares or stakes too small to warrant corporate control.

The strategic concerns about sovereign wealth funds also rest on dubious empirical and theoretical grounds. Financial analysts identify the primary “strategic” goal of SWFs as acquiring expertise or technology that can facilitate economic development in the home country. Many of these investments complement the home country’s

23) Jason Kotter and Ugur Lel, “Friends or Foes? The Stock Price Impact of Sovereign Wealth Fund Investments and the Price of Keeping Secrets”, Federal Reserve International Finance Discussion Paper number 940, August 2008.

24) Veljko Fotak, Bernardo Bortolotti, and William Megginson, “The Financial Impact of Sovereign Wealth Fund Investments in Listed Companies”, Working paper, June 2008.

25) Diana Farrell, Susan Lind and Koby Sadan, “The New Power Brokers: Gaining Clout in Turbulent Markets”, McKinsey Global Institute, July 2008, p. 9.

26) Kenneth Rogoff, “Foreign Holdings of U.S. Debt: Is Our Economy Vulnerable?”, Testimony prepared for U.S. House of Representatives Committee on the Budget, June 26, 2007. See also Anders Åslund, “The Truth about Sovereign Wealth Funds”, Foreignpolicy.com, December 2007. Accessed at http://www.foreignpolicy.com/story/cms.php?story_id=4056, February 2008.

27) It would seem intuitively obvious that sovereign wealth funds would have a decided advantage in acquiring firms within their own home country.

28) Tony Munroe and George Chen, “Blackstone Group opening Beijing rep office”, Reuters, August 4, 2008; Shams Butt, Anil Shivdasani, Carsten Stendevad and Ann Wyman, 2007. “Sovereign Wealth Funds: A Growing Global Force in Corporate Finance”, *Journal of Applied Corporate Finance* 19 (Winter): 73–83.

29) For a dissent, see Brad Setser, “Just How Stabilizing?” July 30, 2008. Accessed at <http://blogs.cfr.org/setser/2008/07/30/just-how-stabilizing/>

pre-existing comparative advantage.³⁰ Arab SWFs, for example, are more likely to acquire equity stakes in the energy sector; Singapore's Temasek has been more likely to acquire port facilities. A recent Monitor Group study examined 785 SWF equity purchases from 2000 to the present.³¹ They found that investments in strategic sectors – transportation, defense, aerospace, and high technology – comprised less than one percent of the value of all purchases. Even expanding the definition to include energy and utilities, less than five percent of all sovereign wealth fund acquisitions were for controlling interests in strategic sectors in OECD markets.³²

As for bargaining leverage, the complex interdependence created by sovereign wealth funds cuts both ways. To be sure, the United States needs SWF investment to finance its large current account deficit. However, most other asset markets are neither big enough nor open enough to cater to large-scale sovereign wealth investments. Large market jurisdictions – the Japan, United States and European Union – should be able to dictate most of the rules and regulations regarding these funds.³³ While some OECD economies might need SWF investment, it is equally true that capital exporters need America and Europe to keep their jurisdictions open to inflows. These markets remain the only ones deep enough and liquid enough to absorb inflows in the trillions of dollars. Indeed, the very countries that are bulking up their sovereign wealth funds at the moment are the most protectionist when it comes to inward investment.³⁴

Taking a step back, while sovereign wealth funds certainly warrant greater surveillance, these concerns should not be overstated. Perhaps the most interesting trend is among the commentators on sovereign wealth funds. Many of them were much warier about SWFs in 2007; this year, they are much more concerned about western governments overreacting to these funds with rampant investor protectionism.³⁵

While the bulk of SWF external investment has been directed at the OECD economies, these funds have not ignored the developing world.³⁶ According to the Monitor study, two-thirds of all deals have been made in the non-OECD area. The pattern of SWF investment and behavior changes in these regions. Sovereign wealth funds

have been more willing to purchase controlling stakes in firms in the developing world. There are also a few more instances of home countries using SWFs to exercise political leverage in the developing world. In the United States, CalPERS decided to divest its holding in firms doing business in Sudan. The recent Divest Terror campaign has been designed to use state pension funds to pressure European firms into divestiture from Iran. Earlier this year, Muammar Khaddafi threatened to withdraw Libyan SWF investment from African nations resistant to his idea of strengthening the African Union. He said, “This money is invested by Libya in Africa not to be given to Africans for free, but for a return to Libyans.”³⁷

There is no evidence, however, that any of these attempts to exercise leverage have had any policy effect. Furthermore, a recent European Central Bank paper examined stock prices after Norway's SWF strengthened its ethical guidelines for investment and an-

30) Though not all – Abu Dhabi's Mubdala, for example, has targeted high technology and aviation services. In December 2007 they purchased an 8 percent stake in AMD, a U.S. semiconductor firm.

31) William Miracky, Davis Dyer, Drosten Fisher, Tony Goldner, Loic Lagarde and Vicente Piedrahita, “Assessing the Risks: The Behaviors of Sovereign Wealth Funds in the Global Economy”, Monitor Group, June 2008.

32) Furthermore, this five percent is all the result of Singapore's Temasek purchased four energy and utility firms in OECD countries – one in Australia, one in the United Kingdom and two in South Korea.

33) Daniel W. Drezner, *All Politics Is Global: Explaining International Regulatory Regimes* (Princeton: Princeton University Press, 2008).

34) Takeshi Koyama and Stephen Golub, “OECD's FDI Restrictiveness Index: Revision and Extension to More Economies”, OECD Working Paper on International Investment 2006/4, December 2006; Rachel Ziemba “Responses to Sovereign Wealth Funds: Are ‘Draconian’ Measures on the Way?”, RGE Monitor, November 2007; U.S. Government Accountability Office, *Laws and Policies Regulating Foreign Investment in 10 Countries*, GAO-08-320, February 2008.

35) For example, compare Jeffrey Garten, “We need rules for sovereign funds”, *Financial Times*, August 8, 2007, with Garten, “Keep Your Rich Rivals Close”, *Newsweek*, August 9, 2008.

36) Singapore's Temasek in particular specializes in developing world investments.

37) Reuters, “Libya's Gaddafi says may pull Africa investments”, January 30, 2008.

nounced that it would divest from firms like Wal-Mart and United Technologies. They found no significant effect on firm performance or rate of return.³⁸ These results are consistent with the general consensus in international relations – threats of economic exit only work under a limited set of circumstances.³⁹

Are Authoritarian SWFs Different from Democratic Ones?

One would expect sovereign wealth funds based in authoritarian countries to have two advantages over SWFs based in democratic countries. First, consistent with their regime type, authoritarian SWFs would be expected to be less transparent. Second, because authoritarian societies are better able to suppress dissent, they should be able to make investments that might be unpopular in the short-term but yield much greater long-term rewards.

There is indeed a strong relationship between SWF transparency and the political characteristics of the home country. SWF transparency is closely and positively correlated with the home country's rule of law and democratic accountability. Multivariate tests also find a strong and positive correlation between a country's political and civil liberties and the quality and transparency of its sovereign wealth funds.⁴⁰ Not surprisingly, sovereign wealth funds headquartered in the OECD economies are much more transparent than those headquartered in the developing world.⁴¹

There is less evidence, however, that authoritarian regimes are better able to look at the long term in their investment strategies. The recent experiences of Russia and China are revealing in this regard. The China Investment Corporation (CIC) has received considerable domestic flak for its investment in Blackstone, after that firm's stock value plummeted by 40 percent. CIC's performance has exacerbated tensions between China's finance ministry and its central bank over the management of foreign reserves. A few months after that investment Lou Jiwei, the head of CIC, did worse than expected in Central Committee elections. Indeed, the way CIC is financed actually forces the fund to try to maximize its short-term rate of return.⁴² Similarly, Russia's central bank received withering

domestic criticism when it was revealed that it held over \$100 billion in Fannie Mae and Freddie Mac. In response, the bank cut its exposure by forty percent – but to do this it sold low.⁴³

Authoritarian countries might not have elections, but they must still cope with bureaucratic rivalries and domestic discontent. Furthermore, while there are sound policy reasons for these countries to set up SWFs, they must still cope with the political incongruity of investing billions of government dollars in the developed world while tolerating significant pockets of domestic poverty.⁴⁴ In many ways, therefore, authoritarian politics can be even more limiting than democratic politics in hampering long-term planning.

Scenarios for the Future

How will sovereign wealth funds affect the future? The answer depends upon whether their ostensible investing advantages are real

38) Roland Beck and Michael Fidora, "The Impact of Sovereign Wealth Funds on Global Financial Markets", European Central Bank Occasional Paper Series no. 91, July 2008.

39) See, for example, Jonathan Kirshner, *Currencies and Coercion* (Princeton: Princeton University Press, 1995); Daniel W. Drezner, *The Sanctions Paradox* (Cambridge: Cambridge University Press, 1999); Mark Crescenzi, "Economic Exit, Interdependence, and Conflict", *Journal of Politics* 65 (August 2003): 809–832; Benn Steil and Robert Litan, *Financial Statecraft* (New Haven: Yale University Press, 2006).

40) Beck and Michael Fidora, "The Impact of Sovereign Wealth Funds on Global Financial Markets"; Olivia Mitchell, John Piggott and Cagri Kumru, "Managing Public Investment Funds: Best Practices and New Challenges", NBER Working Paper 14078, June 2008.

41) The correlation coefficient is .64. Transparency data accessed from <http://www.swfinstitute.org/research.php>, August 2008.

42) Because it was funded through bond sales rather than the transfer of foreign exchange reserves, CIC needs to pay interest to its creditors beginning early next year. See the sources cited in fn. 11.

43) Reuters, "Media mudslinging scares Russian oil wealth managers", August 1, 2008.

44) Heidi Crebo-Rediker and Douglas Rediker, "Watching Sovereign Wealth", *Wall Street Journal*, February 28, 2008.

or illusory. Without claiming clairvoyance, here are four possible scenarios:

1) **The Rosy Scenario:** Part of the policy concern about sovereign wealth funds is that every private sector analysis has them growing at a near-20 percent clip over the next five years. There are several mechanisms by which this growth rate tapers off.

First, consider that the drivers behind the phenomenal growth in sovereign wealth funds are global macroeconomic imbalances and the rising price of oil. Both trends can easily reverse themselves. The response to \$140 barrel oil in the United States suggests that, over time, importing states will find ways to reduce and diversify their consumption. This would both lower the price and quantity demanded of oil. Similarly, if personal consumption rises in the Pacific Rim economies, then the source of current account surpluses in that region will begin to dry up.

Second, as of the time of writing an IMF-sponsored working group is close to developing a voluntary code of conduct for sovereign wealth funds that would encourage greater transparency.⁴⁵ Newly created SWFs are already more transparent than older funds, and earlier this year two of the largest funds (ADIA and GIC) pledged to be more transparent to the United States.⁴⁶ Greater transparency could create two pressures on the home countries of SWFs. First, as previously noted, it could generate greater domestic pressure to deploy those resources in the domestic economy. Second, the code of conduct could act as a transmission mechanism through which good governance practices permeate more authoritarian polities.

2) **The Status Quo Scenario:** This scenario assumes that home countries continue to accumulate reserves, but at a slower pace, and that sovereign wealth funds move along the learning curve in coping with the politics of investment in the OECD economies.

This would lead to a bifurcated outcome. In the OECD economies, sovereign wealth funds would continue to make non-controlling equity investments. SWF purchases would primarily be passive, low-profile, and in non-strategic sectors. In part this is

because the funds themselves would want to avoid political landmines. In part this is because the OECD economies themselves are rapidly developing and expanding of CFIUS/FINSA procedures to safeguard strategic sectors and critical infrastructure.⁴⁷

The same would not be true, however, in the non-OECD economies. During this calendar year, a number of funds have announced their intentions to increase their investments in East Asia and other emerging markets.⁴⁸ These include funds based in Kuwait, Dubai, Qatar, and Norway. The CEO of Dubai International Capital explained, “The world is changing fast. When we think about where the real growth will be in the years ahead, we are very much looking to Asia.”⁴⁹ This would be consistent with SWFs trying to increase their rate of return from exposure to greater risk.⁵⁰ The fall in the value of the dollar, and the deepening of the housing market crisis, has exacerbated this investment trend.⁵¹

The more sovereign wealth funds bypass OECD markets, the more “go-it-alone” power they possess.⁵² In the long run, the more

45) See press release at <http://www.iwg-swf.org/pr.htm>, accessed August 2008.

46) David G. Fernandez and Bernhard Eschweiler, “Sovereign Wealth Funds: A Bottom-Up Primer”, p. 6; Bob Davis, “U.S. Pushes Sovereign Funds to Open to Outside Scrutiny”. Policy principles accessed at <http://treas.gov/press/releases/hp881.htm>, August 2008.

47) David Marchick and Matthew Slaughter, “Global FDI Policy: Correcting a Protectionist Drift”, Council on Foreign Relations Special Report No. 34, June 2008.

48) Reuters, “Kuwait’s KIA looking at Asian Investment”, July 17, 2008; Gulf Daily News, “Sovereign wealth funds boosting Mideast IPOs”, July 11, 2008.

49) Quoted in William Pesek, “Chrysler Building May be Aberration”, Bloomberg, July 23, 2008.

50) Roland Beck and Michael Fidora, “The Impact of Sovereign Wealth Funds on Global Financial Markets”, European Central Bank Occasional Paper Series No. 91, July 2008; IMF, “Sovereign Wealth Funds – A Work Agenda”, February 29, 2008.

51) Henny Sender, “Sovereign funds cut exposure to weak dollar”, Financial Times, July 16, 2008; Steven Johnson and Gertrude Cavez-Dreyfuss, “Asia may benefit as sovereign funds shun dollar”, Reuters, July 18, 2008.

52) Lloyd Gruber, *Ruling the World: Power Politics and the Rise of Supranational Institutions* (Princeton: Princeton University Press, 2000).

sovereign wealth funds diversify away from Western markets, the less they need to adhere to Western rules.⁵³ Efforts to promote democracy and Washington consensus-style economic policies would therefore wane in their effectiveness. SWFs aid and abet in the persistence of “rentier states” – governments that do not need their citizens to raise revenue.⁵⁴ Democratization is a much more difficult policy for the Western powers to pursue when target governments are sitting on trillions of dollars in assets to buy off discontented domestic groups. Short of revolutions, authoritarian governments in the Middle East and East Asia will be more capable of riding out downturns that would otherwise have threatened their regimes.⁵⁵

3) **The Blowback Scenario:** Public hostility to SWF investment could lead to a protectionist overreaction in the OECD economies. In this decade alone, public hysteria helped to block Dubai Ports World’s acquisition of American port facilities, as well as CNOOC’s attempt to acquire Unocal. The United States is hardly unique in this sentiment among the advanced industrialized states. Japanese hostility to inward foreign investment is long-established. The European Union has had to deal with its member states blocking takeovers of utilities by other member states. Other companies, like Gazprom and Mittal, have faced even greater levels of hostility.⁵⁶

Sovereign wealth funds exacerbate suspicions of foreign investment, because the investors are foreign governments. For example, a February 2008 poll by Public Strategies shows that Americans are overwhelmingly opposed to SWF investments. By 49 percent to 25 percent, Americans believed foreign-government investments harmed the U.S. economy. By 55 percent to 10 percent, Americans believed these investments harmed U.S. national security. Opposition was particularly pronounced to investments in high-tech or financial firms – and investments by SWFs headquartered in the Middle East or East Asia.⁵⁷

Many politicians have begun to respond to this public distrust through hearings, statements and regulations hostile to sovereign investments. Given this type of public climate, it is possible that a blowback scenario could take place. Politicians could find themselves trapped by their public rhetoric, and implementing adverse

economic policies. If that were to happen while financial markets remain jittery, the effect would be profound.

4) **The Worst Case Scenario:** Sovereign wealth funds can cause serious trouble in one of two ways: they can be wildly successful or wildly unsuccessful.

Sovereign wealth funds could fail spectacularly as they move into riskier investments. There is an economic rationale for SWFs to absorb riskier portfolios – the question is whether they will go too far. There are reports that sovereign wealth funds are increasingly big speculators in commodity futures markets.⁵⁸ Sovereign funds based in Bahrain and Dubai have begun to leverage themselves in order to make bigger overseas acquisitions.⁵⁹ Historically, investments in the developing world are more prone to booms and busts.

As Alan Greenspan has pointed out, the strongest check

53) Naazneen Barma, Ely Ratner and Steven Weber, “A World without the West”, *The National Interest* 90 (July/August 2007): 23–30.

54) Hazem Beblawi and Giacomo Luciani, eds., *The Rentier State* (London: Routledge, 1987).

55) The prospect of revolution raises another problem. The growth of sovereign wealth funds, combined with anti-Americanism in capital exporting countries, would give the United States in particular even less reason to want democratic transitions in these parts of the globe. Consider the effect of a populist or fundamentalist revolution taking over in Saudi Arabia or the Gulf emirates. Rampant anti-Americanism among the Arab populace could encourage a new government to purposefully sell off SWF investments in the United States in order to induce a financial panic. While such moves would also be economically costly to these countries, such actions are not inconceivable in the early stages of a revolutionary government. See, on this point, Stephen Walt, *Revolution and War* (Ithaca: Cornell University Press, 1996).

56) Daniel W. Drezner, “So, You Want to Buy a Strategic American Company...” *Slate*, February 28, 2006.

57) Bob Davis, “Americans See Little to Like in Sovereign-Wealth Funds,” *Wall Street Journal*, February 21, 2008.

58) David Cho, “Sovereign Funds Become Big Speculators”, *Washington Post*, August 12, 2008.

59) Duncan Kerr, “Arab Sovereign-Wealth Funds Dip a Toe in the Debt Pool”, <http://blogs.wsj.com/deals/2008/08/13/arab-sovereign-wealth-funds-dip-a-toe-in-the-debt-pool/>, accessed August 15, 2008.

against financial misbehavior is “counterparty surveillance” – the incentive of investors to make sure that their investment funds are acting prudently and profitably.⁶⁰ The trouble with sovereign wealth funds is that, in most cases, there is no counterparty surveillance. In the best-case scenario, like Norway, democratically-elected parliaments must approve changes in investment strategies. This kind of oversight is consistent with the spirit of counterparty surveillance. In places like Russia and China, however, the lack of transparency, oversight and accountability is much more problematic.

On the other hand, what if sovereign wealth funds prove to be wildly successful? The idea that the state can beat the market at its own game would pose a serious challenge to the ideas that underlie the western economic order. The dominant theme of the past three decades of global economic history has been a retreat of the state from the commanding heights of the economy.⁶¹ Through privatization, liberalization and/or deregulation, governments have until recently accepted the idea that markets represent the most efficient form of resource allocation. This is of a piece with Francis Fukuyama’s “end of history” thesis – the idea that no universally viable challenger to liberal capitalist democracy will emerge as an alternative mode of domestic governance.⁶²

In capitalist-authoritarian societies, governments could use sovereign wealth funds, state-owned enterprises, development banks, national monopolies, and extensive regulation to accelerate economic development, buy off dissent and promote technology transfer. Azar Gat has written about how authoritarian states can co-exist with capitalism.⁶³ SWFs buttress Gat’s argument, because they are a means through which authoritarian regimes can guard against the vicissitudes of the free market. As the Asian financial crisis demonstrated a decade ago, market shocks can fell authoritarian governments. Sovereign funds, combined with ever increasing foreign reserves, can halt crises before they topple the power structure.

If this model proves sustainable over the long run – remember, this is a big if – it could emerge as a viable challenger to the liberal democratic path taken by the advanced industrialized states. More countries could think of sovereign wealth funds as one signal of

being a “successful” country. Suddenly, the authoritarian developmental state, armed with a sovereign wealth fund, would look like the “right” way to develop.

This kind of emulation would have corrosive effects on both the global economy and the soft power of the West. Sociologists have discussed the tendency of states to engage in “institutional isomorphism”, mimetically copying the practices of successful states.⁶⁴ This copying is not always successful – indeed, these same sociologists conclude that it leads to dysfunctional policy outcomes. If sovereign wealth funds were perceived by the majority of countries in the world as one signal of being a “successful” country, then one could envision the proliferation of such funds – even in situations in which there is no economic rationale for their creation. Politically, it would be an open question whether the rest of the world would look at the democratic development model as one to emulate. Crudely put, far fewer countries would want what the advanced industrialized states want.

60) Alan Greenspan, *The Age of Turbulence* (New York: Penguin, 2007).

61) Daniel Yergin and Joseph Stanislaw, *The Commanding Heights* (New York: Simon and Schuster, 1997); Jeffrey Frieden, *Global Capitalism* (New York: W.W. Norton, 2006).

62) Francis Fukuyama, *The End of History and the Last Man* (New York: Free Press, 1992).

63) See Azar Gat, “The Return of Authoritarian Great Powers”, *Foreign Affairs* 86 (July/August 2007): 59–69.

64) John Meyer and Brian Rowan, “Institutionalized Organizations: Formal Structure as Myth and Ceremony”, *American Journal of Sociology* 83 (September 1977): 340–363; Paul Dimaggio and Walter Powell, “The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields”, *American Sociological Review* 48 (April 1983): 147–160.

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