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SOVEREIGN WEALTH FUNDS AND INTERNATIONAL POLITICAL ECONOMY

Global Finance Series

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To my parents

Preface

Over the past few years, the study of state–owned investment funds known as sovereign wealth funds (SWFs), with their diversified and international portfolios, has gained momentum. Interestingly, though many of these SWFs have existed for several decades, separately from the national or official reserves, their ventures and operations have only recently become an object of interest to other states. This political scrutiny of sovereign wealth funds' foreign investment, much of it stemming from political debates in the United States concerning the attempts by foreign entities to acquire stakes in US entities in 2005 and 2006, has centered on a question that has attracted considerable attention, especially in the United States and, to a lesser extent, Europe: Do SWFs pose a threat to recipient countries with respect to sovereignty, national security, or financial stability?

Although this question has been frequently raised, it did not represent the best approach to achieving an understanding of the underlying motives of these funds. In order to best understand the agenda and decision–making processes of SWFs and thereby be in a better position to predict their behavior, we should instead focus on the more fundamental questions of why SWFs were created in the first place, what their various goals are, and how the owner states balance these goals.

Another problem in the relatively new literature on SWFs has been that, oftentimes, researchers and analysts in both the economic and political camps have grouped all states that own SWFs into a single set and treated them as a whole, with little or no consideration given to their various individual traits. As the case studies in this book will show, owner states of SWFs are often diverse in regard to their political and economic structure, and, thus, their funds' agenda. Additionally, a SWF may pursue multiple goals simultaneously, and its agenda may be modified as the state's priorities or the environment in which it is functioning change.

The ultimate questions one might ask are, why have states established sovereign funds and what do investor states seek to accomplish? Through their portfolio diversification and international investment, SWFs may pursue varying goals, such as meeting future public pension obligations, insulating the domestic economy from international market volatility, and achieving a more efficient management of national financial assets.

By providing a systematic methodology for a micro–level study of SWFs that views these funds within a larger economic and political context, this book addresses shortcomings in the existing literature. The juxtaposition of economic and political perspectives allows us to study these funds from two important angles, while the examination of each fund independently sheds light on the distinctive characteristics of each fund.

Recognizing the varying characteristics and, therefore, the varying agendas, of SWFs, as well as the diversity of the systems of political economy among the owner states, has an important implication for both economic and political policy making: decision–making processes based solely on either political or economic considerations are often inefficient since they often fail to account for important benefits of SWF investments. The politically–based decisions discount the potential economic benefits that a SWF investment may have on the host economy. For instance, SWFs can provide long–term liquidity when short–term liquidity is tight and markets are contracting. SWFs can also contribute to greater market efficiency and lower volatility by diversifying the global investor base. At the same time, policy prescriptions based solely on financial grounds can overlook the potential political implications of SWF investments.

Fortunately, there is a whole host of literature in international political economy in which one can study the SWFs objectives. There are a number of schools of thought on the question of why a sovereign state would choose to establish a fund and engage in portfolio management and international investment. This book employs three alternative theoretical perspectives, drawn from major political economic theories, to explain the goals investor states may pursue through their SWFs.

The book also addresses shortcomings in the literature by proposing a systematic methodology for the micro–level study of these funds and subsequently applying it to four major SWFs. This research reveals that the dominant conception, which is that investor states are in pursuit of political power over other states, is unjustified. The assertion that SWFs are primarily used for balance of payments corrections is equally unsound. None of the funds were shown to have been used in order to exert political power over another state and none provided funding only to correct the balance of payments. Some states act as economic agents or entrepreneurs in order to increase the value of their assets. For others, accumulating the resources required for domestic compensation is the immediate goal.

We should also be aware that investments by SWFs create interdependencies between the investor and the recipient states. A critical and yet hardly–discussed issue is that vulnerabilities exist on both sides of these interdependent relationships. This means investor states, too, are exposed to various risks.

The idea of this book came to me at the height of the political debates over the motivations of sovereign wealth funds. Having a background in both international economics and political economy, I was troubled by the fact that the conclusions reached by the decision–makers were often based on political ideology rather than an impartial and holistic cost–benefit analysis. On many occasions, as the politicians argued heatedly, essential points were missed: that a purely political approach with respect to SWFs' international investments—an inherently economic activity—is misguided, and that the potential negative impacts on (or costs to) the recipient states should be reviewed in close conjunction with the potential economic benefits of SWF investments.

In the course of this research I have accumulated many debts. My largest intellectual debt is owed to David C. Earnest and Kurt Taylor Gaubatz for their comments and insights from both the economics and political science worlds. I am also thankful to Simon Serfaty, whose advice solidified my decision to go ahead with this topic and Larry Filer for his valuable comments. I am grateful to the participants at the 2009 International Studies Association–South Conference, where an early draft of this book was recognized as one of the best papers. I received many helpful suggestions and a great deal of encouragement for publishing my work.

Additionally, I would like to thank Nick Wilson for his superb editing skills and feedback on the original draft, and the editors and reviewers at Ashgate Publishing for their comments and support. I am also indebted to Svetoslav Georgiev for reading and editing the entire manuscript, his participation in critical discussions that we had all through the course of the research, and above all his patience and constant support. Finally, I am grateful to my parents for their encouragement. Needless to say, any errors that may remain are my own.

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Chapter 1
Introduction

In late 2005 and early 2006, Sovereign Wealth Funds (SWFs)—some of which had been in existence since the 1950s—fell under the media spotlight for the first time. Policy makers in the states that were recipients of SWFs' investments became concerned about the underlying motivation of these funds, mainly because politicians and academics understood neither the fundamental reasons for the creation of SWFs nor the functioning of SWFs. A major concern for many recipient states of sovereign money was the "possibility that some SWFs might be used for overt or tacit political purposes."[1] To assess the validity of recipient states' concerns with respect to SWFs' investments, we first need to study how investor states employ these funds.

While there is no universally accepted definition of a Sovereign Wealth Fund, various financial institutions, government agencies, and international organizations have provided definitions that generally share three main characteristics: ownership by sovereign governments, management of portfolios other than official national reserves, and involvement in overseas investments. The definition of SWFs in this book combines all three of these characteristics but also incorporates an additional criterion—the absence of a monetary or fiscal regulatory function. That means that, for instance, Saudi Arabia Monetary Authority (SAMA) is excluded from the SWF pool since it performs a function similar to that of a central bank.

In the United States and some European countries, the political scrutiny of SWFs' overseas investments over the past few years was intensified due to the lack of information about these funds. More importantly, the politicians' mindset, which had been influenced by major historical events, was not open to the idea of government–owned funds making overseas investments. The dominant realist view that the state's main goal is the pursuit of power, and the resulting presumption that any investment by sovereign states is a means to exert political influence over the recipient state, resulted in the rejection of foreign ownership or the withdrawal of foreign investment proposals in the United States.

Interestingly, there was very little interest in SWFs and their investments until a Chinese government–owned company placed a bid to buy an American oil company in 2005, and later a government–owned company from the United Arab Emirates acquired a British company whose assets included six port facilities in the United States. In August 2005, the China National Offshore Oil Corporation (CNOOC) abandoned its initial $18.5 billion cash bid—a more attractive proposal than

1 Benjamin J. Cohen, "Sovereign Wealth Funds and National Security: The Great Tradeoff," *International Affairs* 85, no. 4 (2009): 713.

Chevron's—for Unocal when it was faced with political opposition in the United States Congress while the proposal was still under the review by the Committee on Foreign Investment in the United States (CFIUS). Dubai Ports World (DP World), which had acquired Peninsular and Oriental Steam Navigation Company (P&O), was also made to sell the port facilities to a United States–controlled firm under the pressure of widespread and intense congressional opposition, despite prior approval of the ownership change by the CFIUS.[2]

What these entities shared in their relationship with the United States was general skepticism and disapproval by the American policy makers. China, with its massive balance of payments surplus, artificially weak exchange rate, and various political issues, receives extra attention and scrutiny, as do the states in the Middle East for their oil and gas policies, positions with regard to regional conflicts, and their potential ties to the events of 9/11. Consequently, the investment by these states has been excessively politicized. The political controversy over foreign investment by Chinese and Emirati entities in 2005 and 2006 soon evolved into a major presumption among policy makers in the United States. National security rhetoric was used for the purpose of opposing investments by states of which the politicians did not approve. The presumption, subsequently, shifted the attention to SWFs that had been managing states' assets for decades without causing any concerns.

The problem is that protectionist policies in the recipient states—which may result from the politicization of foreign governments' investment—can trigger counter measures by investor states. Once their entry into the market of a potential recipient state is blocked, the investor states may decide to retaliate by blocking the entry of companies or capital flows from the protectionist states. In the end, the retributory actions by both investor and recipient states could undermine the long–fought–for global economic openness and put the foundation of the "free markets" at risk.

Decision–making processes, based solely on a political rationale, are not efficient. In other words, politically–based decisions discount the importance of potential economic benefits. In the case of states that are recipients of SWF investments, the potential gain from the inflow of foreign investment is often times overlooked. This is not to say that investment by sovereign states should be viewed in exactly the same way as investment by private entities; however, it should be considered with more objectivity. To be sure, dealing with SWFs and their investments is more complicated than dealing with private investors for two reasons. First, ownership by the governments makes it difficult to readily apply conventional economic theories to SWFs' investments. In other words, private sector economics may not be a suitable framework for the study of SWFs. Second,

2 Gary Clyde Hufbauer, Yee Wong, and Ketki Sheth, *US–China Trade Disputes: Rising Tide, Rising Stakes*, Policy Analyses in International Economics 78 (Peterson Institute for International Economics, 2006).

the economic nature of the investment itself makes the application of political or international relations theories to these funds more difficult.

The point—often missed in the heated debates among politicians—is that a purely political approach alone is misguided. Potential negative impacts on (or costs to) the recipient states should be reviewed in close conjunction with the potential economic benefits of SWF investments. The point is that in this kind of interdependent relationship, recipient states do not necessarily lose. SWFs can provide long term liquidity when short term liquidity is tight and markets are contracting. SWFs could also contribute to greater market efficiency and lower volatility by diversifying the global investor base.[3]

Investor states have various perspectives with respect to their sovereign funds. The opportunity cost of holding official reserves or excess capital in risk–free or fixed–income assets is continuously increasing, not only because of global inflation and downward pressures on the dollar—the unit of account for the majority of investor states—but also because of uncertainties such as the risk of natural disasters, conflicts, wars, and market turmoil. To reiterate, viewing the capital inflow from investor states—which has been mostly in the form of portfolio investment rather than direct investment—through a highly political lens can limit both our understanding of the true nature and purpose of the SWFs, as well as potential gains (economic and otherwise) from sovereign investments.

Another important issue is that the SWFs are not identical, i.e., their characteristics vary widely. As this book will show, the national system of political economy of the investor states influences the SWFs' motives and purposes. The multiplicity of forms and motives will be discussed in further details, but for now suffice it to say that the existence of such diversity among SWFs makes the application of a single policy ineffective. Policy prescriptions based on general—and perhaps inaccurate—assumptions about investor states can lead to over– and under–estimation of various risks.

In order to address these complications, an original and innovative theoretical approach, one that brings a new perspective to the political economy literature, is needed. This book presents a methodology for a micro–level analysis of SWFs, and proposes ways to distinguish the various motives of the investor states. In this book, I propose an answer to the question of whether recipient states should be concerned about the investments by SWFs. I have observed that the investment decisions and strategies of the four cases of SWFs examined here are based on certain fundamental yet uncomplicated principles other than the pursuit of power. The current research refutes the two mainstream conceptions of SWFs: (1) the policy makers' belief that these funds are a means of economic statecraft or foreign policy tool, aimed at exerting power over another state, and (2) the view of some economists that the role of these funds is limited to the correction of balance of payments deficit or monetary imbalances.

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3 "Sovereign Wealth Funds–a Work Agenda," (International Monetary Fund, 2008), 12-3.

In fact, all of the investor states examined in this book (Norway, United Arab Emirates, Singapore and the Russian Federation) had a balance of payments surplus during most of the life of their funds. In addition to that, there was no evidence indicating that the investor states had ever used their funds in order to exercise power over any of the states in which they had made investments. Even in the case of the fund of Norway, whose investment decisions are often guided by a set of non–commercial guidelines, the targets were corporations, rather than the recipient states directly. Norway has certainly communicated its intentions to foreign states (e.g., Burma), but has done so without attempting to directly influence the government in the recipient state. This is what I call "benign economic statecraft."

States like United Arab Emirates and Singapore are far too small, and at the same time, preoccupied with their internal concerns, one being increasing the value of their assets. SWFs in these countries have acted mainly as an entrepreneurial arm of the state. On the other hand, various internal centers of power in Russia struggle to get access to the fund's assets. The main thrust of this book is that there are alternative political economic theories that suggest a more meaningful explanation for the creation, evolution, and functioning of SWFs than the pure economic or realist perspectives.

This book makes a number of important arguments. First, SWFs' management and operations reflect—to borrow Gilpin's term—the national system of political economy[4] as well as the political mindset of the leadership, which have been shaped by historical events. The multiplicity of political economic systems suggests a variety of SWF motives and purposes. Therefore, the one–size–fits–all approach to policy making with respect to these funds is not appropriate. In practice, as the study shows, the only time SWFs tend to show a similar behavior is at times of financial crisis, or severe economic contraction. The recent global financial crisis and economic downturn in countries around the world provided an excellent opportunity for testing this hypothesis, where its timing and extent of impact with respect to the various states was consistent.

Second, the management and operation of SWFs are not a static percept but a dynamic process; learning and adjustment are natural and inevitable. States also undergo changes over time as a result of changes in modes of production, demography, political system, technological advancements, and global forces. All these mean investor states and their sovereign funds have to be studied longitudinally.

And lastly, the lack of transparency is certainly an important issue, and a legitimate source of concern for the recipient states, but the level of transparency

4 Gilpin argues that the role of domestic economies and the differences among them determine the international economic affairs. Therefore, the differences among national systems of political economies have significant implications for the global economy. For more information see Robert Gilpin, *Global Political Economy of International Relations* (Princeton: Princeton University Press, 1987).

should not become the sole or primary basis on which policy makers assess the funds. The assumption that the level of transparency can serve as an indicator of the real agenda of a SWF is superficial, naïve, and most importantly, logically flawed.[5] A fully transparent SWF may include non–commercial principles in its investment decision making processes, as is the case with the Norwegian fund. A lack of transparency simply means that we do not know enough about these funds. This book attempts to fill this gap by providing a systematic typology of SWFs and an in–depth analysis of selected funds.

The study of SWFs at this junction in time is important as we are now on the verge of a new era of increased state intervention in the economy. On the one hand, states "have asserted their authority in global finance not as regulator but as major investors in the markets."[6] On the other hand—specifically after the recent crisis—they have taken over a number of large companies; as it is said:

> Today big government is back with a vengeance: not just as a brute fact, but as a vigorous ideology … The world is seeing the rise of a new economic hybrid—what might be termed "state capitalism" … The most interesting arguments over the next few years will weigh government failure against market failure.[7]

Interestingly, history is repeating itself. In the late 1960s, the expansion of multi–national companies (MNCs) raised concerns among both politicians and academics that the rise of the new global actors would undermine nation–states.[8] Today, policy makers' minds are occupied with the same fundamental concerns—the loss of sovereign power. The study of SWFs requires a "paradigm shift" in our approach to the study of international political economy.

This book provides information, analysis, and a research methodology that is of benefit to academia and policy makers alike. For the academic world, this research proposes a systematic methodology for a longitudinal study of SWFs. By drawing upon major international political economic theories, this book provides a much broader view of the functioning of SWFs. It emphasizes the need for more specific policies on both the international and domestic scales.

There are also several messages for policy makers at the national and international level. On the national level, they need to be more open to and receptive of emerging state capitalism. Policy makers can, in fact, influence the

5 For more information see Manda Shemirani, "Sovereign Wealth Funds: The False Promise of Transparency," *Infinity Journal* 1, no. 5 (2009).

6 Eric Helleiner, "The Geopolitics of Sovereign Wealth Funds: An Introduction," *Geopolitics* 14, no. 2 (2009).

7 "Leviathan Stirs Again; the Growth of the State," *The Economist*, 23 January 2010.

8 Scholars like Raymond Vernon (1971) and George Ball (1967) strongly believed that MNCs would undermine the states' sovereignty or would create conflict with state's goals.