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Sovereign wealth funds: much ado about some money

by
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The first sovereign wealth fund (SWF) was established by Kuwait in 1953,[1] and was followed by many others from 1973-4, after the first oil crisis.[2] Since then, each major jump in oil and gas prices increased the number and size of SWFs; after 2000, countries with large trade surpluses also began to establish SWFs. By April 2009, SWFs had grown to $3-5 trillion of assets under management,[3] invested mostly in high quality bonds. Equity investments have been a much smaller part of their portfolio and began to grow only in the 1990s. This trend has since accelerated with at least 698 documented equity investments between June 2005 and March 2009.[4]

These investments brought SWFs not only increased attention, but also their name, adopted by the *Financial Times* in May 2007.[5] This has been unfortunate and misleading. The term has endowed SWFs with a special and even threatening aura, even though, under international law, they do not enjoy sovereign immunity, as they are just state-owned entities, along with government-owned airlines, banks, shipping companies, etc. We have a long history of national and international jurisprudence for dealing with these, but, since reality is rarely a bar to fashion, the term is here to stay.

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[1] Bernardo Bortoletti, Veljko Fotak, William L. Meggison, William F. Miracky, "Sovereign Wealth Fund Investment Patterns and Performance," MSS Draft, 13 July 2009, p.39, 49. (Hereafter: BFMM).

[2] Singapore, was the exception to this rule; it established in Temasek Holdings in 1974, and the Government of Singapore Investment Corporation in 1981.

[3] BFMM, p. 37, listing 32 funds that meet Monitor-FEEM standards, with $1,831 mn in assets, while *UNCTAD*'s *World Investment Report* (United Nations: New York and Geneva, 2008), p. 20 reported $5 bn as a headline number, but also noted $3 bn+ as a credible estimate.

[4] BRFMM, p. 1.

[5] Ibid, p. 50.

The recent large investments by SWFs in troubled financial institutions brought these funds unprecedented publicity, and the increased attention of the governments of host countries and of IFIs. The former were interested mainly in the economic and security implications of SWFs' investments, while the latter, and the OECD in particular, seem concerned that SWFs might face restrictions by host countries of the kind that many of the SWFs' home countries have been applying against foreign investors.[6]

How important in fact are the SWFs? Of course, 3-5 trillion dollars is a lot of money, but it is only a small part of the investment universe. This universe includes external sovereign debt of $55 trillion, equities of at least $40 trillion, plus even more in real estate, artificial financial instruments, precious metals, commodity trading instruments, and so on and on. SWFs are actually one of the smaller players, just above hedge funds. By way of comparison, pension funds, mutual funds and insurance funds ***each*** have approximately US$20-23 trillion of assets.

Paradoxically, SWFs are least important with regards to foreign direct investment (FDI), defined by the IMF as equity investments that exceed 10% of the target company's voting shares. Annual FDI flows in the past 10 years have ranged between US$600 billion to a record US$2 trillion in 2007. Meanwhile, the FDI from SWFs amounted to only US$10 billion in 2007: 0.2% of their total assets, and 0.6% of the FDI flows that year.[7]

Clearly, the attention and concern generated by SWFs has been disproportionate to their systemic importance, and especially so regarding FDI. The reasons? SWFs are good copy for the media because most are from distant countries with dictatorial or authoritarian regimes, they are at least vaguely mysterious, and many of their transactions are genuinely newsworthy. The media's focus has in turn generated hype and political attention, and much of what we are witnessing now is similar to the spectacles of the late 1970s about Arab equity investments in the United States and Western Europe.

The attention by governments has been partly a response to public and political pressures, but their concern about national security should not be underestimated. All foreign investment has been subject to national security considerations for a long time. SWFs are instruments of state, mostly of states with at best delicate relations with NATO member countries, and several belong to potential adversaries with a long history of extensive and effective espionage. SWFs are not the best vehicle for information gathering, influencing host countries, and for various economic and commercial mischief, and this is why national security related reviews cover all foreign investments.

In the coming years, SWFs will grow in number and size, probably in an international arena more turbulent than now, and SWFs will continue to favor the major advanced economies. Although SWFs are unlikely to become a significant source of FDI, their importance in other equity investments may well increase along the lines of their recent acquisitions of up to 9.99%

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[6] See, e.g., OECD, "Sovereign wealth funds and recipient country policies: report by the OECD Investment Committee" (Paris: Organisation of Economic Co-operation and Development, 2008).

[7] UNCTAD, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge* (Geneva: UNCTAD, 2008), p. 20.

of several major financial institutions. Consequently, host governments will continue to be obliged to follow a fine line between the demands of national security, balanced against the desirability of increased capital inflows, and the goodwill of countries needed for the attainment of foreign policy objectives.

This may well require a review process for SWFs that goes beyond the existing review mechanisms, and may even have informal aspects. Host countries will need to differentiate SWFs by their nationality and by their relationship with the host countries. Therefore, decision-making will need the direct involvement of the diplomatic, military and intelligence communities while still acting within the time frame required by investors. All this may seem daunting, but the United States and the United Kingdom in particular have immense experience in dealing with foreign investment since the First World War. These experiences and *modus operandi* are readily transferable to existing or new monitoring entities. It remains to be seen whether SWFs will become a source of conflict or of responsible capital, but judging from past experience, a sensible and sensitive review process should serve well both the SWFs and the host countries as long as they are both aiming at a seamless and quiet settlement of actual and potential disagreements. After all, business is business, and host countries and SWFs have already established an agreeable symbiotic relationship.

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The Vale Columbia Center on Sustainable International Investment (VCC), led by Dr. Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

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