Sovereign Investment

CONCERNS AND POLICY REACTIONS

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Foreword

THIS VOLUME ON *Sovereign Investment: Concern and Policy Reactions* brings together many of the world's leading specialists on global financial markets to analyze the investment dynamics of sovereign wealth funds (SWFs) and state-owned enterprises (SOEs) from the emerging markets. The studies are consistently insightful, thorough, and up-to-date. They cover the nature, size, and motivations of the largest sovereign investors, the financial and macroeconomic implications of sovereign investment flow, and the legal, policy, and regulatory issues that are raised by this special class of investors. As an enormous added bonus, many chapters include detailed and carefully collected original data on SWFs and SOEs that will be of enormous value to researchers and policy-makers.

The subject matter of sovereign investment is fascinating and timely. Investments by sovereign entities such as SWFs and SOEs (as well as other entities such as state-owned pension funds) inevitably reflect both political and economic considerations, raising important and subtle issues of market behavior, political motivations, and even national security. The emerging-market SWFs and outward-investing SOEs have quickly become important and controversial players in global capital markets. Their public profile has soared in recent years. Several SWFs made investments in major Wall Street firms in the midst of the 2008 financial crisis, thereby playing a visible and controversial role in the rescue of several major firms, also often incurring large losses along the way. Around the same time, several SOEs from the Middle East and Asia became embroiled in public controversies when they sought to invest in ports, oil companies, and other sensitive sectors in the United States and Europe. Opponents of these deals charged that the deals would imperil the national security of the receiving countries. Proponents of the deals charged that the opposition was nothing more than disreputable, and possibly illegal "investment protectionism."

While such high profile and controversial deals thrust SWFs and SOEs into the public spotlight, the growth, scale, and importance of sovereign investments by emerging markets reflects several deeper trends in the global economy. The first and most fundamental is the dramatic rise in global significance of the emerging economies themselves. As the BRICS (Brazil, Russia, India, China, South Africa) have grown significantly as a share of the world economy, rising from a combined fifteen percent in 1992 to twenty-six percent in 2010, their enterprises have entered the Fortune 500 list, becoming some of the world's largest economies. In 2010, Chinese companies took three of the top ten spots on the list, compared with none in 1980.

Second, the very rapid growth of the world economy in the years leading up to the financial crisis, and the still rapid though lower growth since 2009, has caused a major and persisting rise in primary commodity prices, including hydrocarbons (oil and gas), coal, minerals such as iron and copper, and agricultural products. The result has been soaring profits of the natural-resource economies, and soaring budget revenues for the host countries, especially Brazil, Russia, and the Middle East oil states. These large earnings in turn have filled the coffers of SWFs and have fueled the investment plans of SOEs.

Third, as a matter of macroeconomic policy, several of the resource-rich countries created SWFs or other sovereign investment vehicles to manage the earnings of the primary-resource sectors. The choice to adopt specialized investment funds is relatively new. Before the advent of SWFs, the government's earnings would generally have accrued directly to the national budget and the Central Bank's foreign exchange reserves. These, in turn, would typically have been invested very conservatively in U.S. and European treasury bills and bank balances, rather than in equity and still less in direct investments with ownership control. The motivations for creating SWFs have varied across countries and over time, and include: increased transparency of oil earnings, a desire to use the specialized funds to support macroeconomic control and long-term saving, higher yields on more aggressive portfolios, industrial policies, and strategic objectives to own foreign claims in banking, commodities, high-tech, or other sectors. The bottom line has been stunning, with SWFs quickly amassing several trillion U.S. dollars in their portfolios (as documented in this volume).

Fourth, the global push toward more liberalized international-investment regimes opened the way for both SWFs and SOEs to become more deeply involved as diversified investors in the high-income economies. Ironically, the initial push for global capital market liberalization came from the high-income countries, who aimed to invest in each other and in the developing economies. In the 1980s and 1990s, almost all observers supposed that investments would flow overwhelmingly from the rich to the developing countries. The reality has been different, and hence the present volume.

Fifth, and finally, the very low saving rates in the U.S. during the past twenty years led U.S. policy-makers and business leaders to encourage capital inflows from the increasingly cash-rich emerging economies of China and the Middle East. The U.S.

aggressively courted foreign investors, especially in 2006–2008 when Wall Street banks needed urgently to raise capital in the midst of financial market upheaval. Even though U.S. businesses courted these investments, the psychological impact on the U.S. public was dramatic. Suddenly, foreign investors, from developing countries no less, seemed to be gaining control over key sectors, including finance, energy, and even ports.

The analytical and policy issues raised by sovereign investments are consistently fascinating, cutting to the heart of modern political economy. What are the main motivations of SWFs and outward-investing SOEs: commercial, political, or even strategic (i.e., to win control of sectors vital to the national security of the outward and host countries)? How significant are these investments in terms of transferring corporate control to outside investors, a phenomenon that is typical perhaps in many countries but is relatively novel in the U.S.? Are these investments of macroeconomic significance in moderating global financial shocks? How should the international financial system honor the free flow of cross-border investments while addressing legitimate concerns about national security that some investments might raise? These issues are treated in their full complexity throughout the present volume.

Importantly, several chapters provide a detailed look at the fast evolving legal and regulatory frameworks governing SWFs and outward-investing SOEs. The analyses of the Committee on Foreign Investment in the United States (CFIUS), the evolving EU institutions, the OECD "Freedom on Investment" Roundtables, and the new IMF voluntary Santiago Principles, are all superb and extremely valuable and up-to-date. They show vividly the complex and subtle balancing of political, economic, financial, and security considerations in the evolving legal framework.

All of these issues of course reflect and illuminate the deepest geopolitical changes of our time: the rise of China, the relative decline of the United States and Europe and the growing scramble for strategic resources. The implications of these trends are of course vast, and the issues regarding sovereign investments offer a window in the larger geopolitical issues as well. The authors of this volume do a masterful job of describing the complexity of the issues and illuminating the deep changes underway in the world economy.

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