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FOREIGN INVESTMENT AND SOVEREIGN WEALTH FUNDS

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The amount of money now held by governments around the world both in reserves and through sovereign wealth funds ("SWFs")[1] represents the largest concentration of investment capital the world has ever known. Their sheer size and expected rate of growth raise important issues regarding both the origin of this wealth and how it is to be invested. The origin of these funds rests on two main factors: the global imbalances between debtor nations (like the U.S.) and surplus nations (like China), and the rise of state-owned commodity (oil) funds. As for their uses, these countries have built up sums that dwarf those held by all the hedge funds in the world combined and are set to grow at an unprecedented pace. It is incumbent upon policymakers to not wait, but rather to address this issue now, and to determine what opportunities and threats they present. We should be assessing how best to influence how these funds are utilized and invested. The issues raised involve political, economic, and security considerations.

BACKGROUND

Global Central Bank reserves today total approximately \$5.5 trillion.[2] In addition to these reserves, SWFs are today estimated to have between \$2.5–3 trillion under management.[3]

In the past several months, the Governments of China, Japan, and Russia, among others, have announced the creation of new SWFs with significant re-allocation of present and future reserves to these funds. Independent of reserves, SWFs are conservatively expected to grow to \$12 trillion by 2015—a figure that will roughly equal the entire U.S. GDP.[4]

It is the scale, as well as the nature of the funds' government ownership, that compels analysis of these enormous pools of capital and whether SWFs require new and different standards than those in place today. Existing investments by SWFs, while large by any other standard, have not fundamentally changed the character of the overall market—but the ownership and size of these new funds requires a fresh look.[5]

WHERE DO THESE FUNDS COME FROM?

There are two general types of reserves and SWFs—Commodity Funds and Non-Commodity Funds. Both types are, to some degree, creatures of our own making.

Commodity Funds are established through commodity exports (e.g., oil, gas, minerals, etc.), either owned or taxed by the government. These nations are essentially replacing a real asset in the ground with a financial asset in an account.[6]

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Non-Commodity Funds are typically established through transfers from official foreign exchange reserves. Large balance of payments surpluses have enabled non-commodity exporters (e.g. China) to transfer "excess" foreign exchange reserves to stand-alone investment funds to be managed for higher returns.[7]

At present, Commodity Funds account for some two-thirds of total SWFs. However, by 2015, it is estimated that these two groups will be roughly the same size—at around $6 trillion each, with China's newly created SWF being the single largest SWF.

The continued growth of U.S. and global consumption of oil and gas, as well as other commodities, even at today's higher prices, has led to a significant outflow of U.S. dollars to oil and other commodity-exporting nations forming the first pool of SWFs.

With regard to Asia, the continued appetite of the U.S. to consume more than we produce, combined with one of the world's lowest savings rates, has led the U.S. to rely increasingly on the purchase of U.S. treasuries and other debt instruments by foreign governments and investors to finance our nation and lifestyle. While the overall borrowing position of the U.S. as it relates to the size of the U.S. economy is not out of line with historically accepted ratios, what is unique is that those lending us the money are increasingly not U.S. citizens and entities, but rather governments and central banks of other sovereign nations. In fact, it is believed that non-U.S. official entities now hold well over one-third of all U.S. Treasuries.

Commodity exporting nations and Asian savings have funded our external deficits, kept real interest rates low and boosted asset prices. But it has had other broader consequences as well. Lawrence Summers recently called the significant flow of capital *from* the developing world *to* the industrialized world the "principal irony of today's international financial system." In 2007 alone this flow from "poor" developing nations to the U.S. and other "rich" nations will total well over $500 billion. And yet, this figure will be comfortably exceeded by the continued build-up in reserves and SWFs in these developing countries.[8]

This dramatic shift in capital flows represents a significant sea change in international finance and has a very real impact on the global strategic balance of economic and political power. The scale of this economic shift is beyond any that we have witnessed previously.[9] It is this scale that compels a fresh approach and discussion of ways that the U.S. can positively influence the uses of these enormous funds while protecting our national interests.

HOW ARE THESE FUNDS INVESTED?

The migration of large government portfolios from low yielding debt to a more broadly diversified investment portfolio is consistent with prudent investing and should not in and of itself raise concern. Where SWFs are professionally managed on that basis, they should be welcomed and we should be encouraging continued inward investment to the U.S. in all asset classes. The U.S. Treasury has made it a priority to ensure that the United States continues to be the most attractive place in the world to invest—which is especially important given the rise of competing global markets for capital investment.

Secretary Paulson has correctly argued that the flow of funds from SWFs would likely benefit US investors, companies and workers as the increased liquidity and flow of capital will likely result in higher stock and asset prices and lower risk premia, especially of riskier, less liquid assets, while at the same time resulting in continued strong demand for traditional reserve assets. These funds should contribute to continued benign financing conditions, in particular if these SWFs act as long-term buy and hold investors, which would provide additional market stability in times of volatility.[10] Likewise, these funds would not be subject to redemptions by investors in the same way that private funds are.[11] As the Secretary has noted, "the U.S. should welcome foreign investment from SWFs or any direct foreign investment, as it is the highest vote of confidence anyone can pay to our economy by making a direct investment."[12]

But we disagree with those who support a complete laissez-faire approach to SWFs. We believe that it would be imprudent to rely on the benign history of SWFs to assume that we need not protect against potential issues raised by current and future SWFs. This is true both because of the enormous size of funds now available as well as the nature of the governments who control them. Historically, few nations were fearful of the intentions of Norway, United Arab Emirates and Singapore, while many nations are wary of China's and Russia's intentions.

Foreign governments and their SWFs cannot be assumed to always act in a manner consistent with other nations' national interests, but rather should be assumed to act in their own. Self-interest may translate into a singular desire to increase financial return on assets. It may not. There are legitimate worries about SWFs investing in Western financial institutions, high tech and defense companies, and strategic resource companies, both to acquire intellectual and technological skills that are difficult to develop on their own and to control dwindling resources. A balanced perspective on this issue must take into account not only potential security risks, but also over-reactions driven by irrational fear, destructive political hostility and protectionism.[13]

Investors and markets abhor uncertainty. We believe that it is in our interests to establish rules now, so that they are clear at the outset and there are no diplomatic or other misunderstandings later.

As compared with other industrialized nations (the G-7), the U.S. is relatively well regulated in this area. The recent adoption of revised legislation by Committee on Foreign Investment in the United States (CFIUS) and Foreign Investment and National Security Act (FINSA) provides the U.S. Government with a means of protecting national security interests from threats by some unwanted foreign investors on a case by case basis. In addition, general provisions of U.S. securities, antitrust and other similar legislation and regulation afford some protection to investors and acquisition targets from takeover approaches and/or material investments from investors—both foreign and domestic—by requiring disclosure and approvals, as appropriate.[14]

But CFIUS/FINSA and other U.S. legislation were not crafted as a unified means of addressing the rise of foreign government-owned portfolio and foreign direct investment on the scale that now confronts us. To ensure that national interests are fully protected, the U.S. should undertake a comprehensive review of all relevant legislation and regulations to ensure that the existing legislative patchwork is sufficient to address those issues created by SWFs. For example, it is unclear whether SWF investments at a level below that which would trigger CFIUS/FINSA review, but still material enough to exert material influence, is currently considered and addressed.

What is most important is to recognize the opportunity to create a welcoming investment environment while still protecting against national security and other risks. What is also crucial is to recognize that there are limited levers at our disposal to force other governments to act the way we want them to, without scaring away desired investment. The ability to control global markets is beyond the control of any government, even the U.S.[15]

ISSUES RAISED

The broad list of issues and proposed fixes that have been raised regarding SWFs include:

Transparency. Increased disclosure and transparency of asset and currency composition and specific holdings by SWFs would be a benefit to the market and would calm suspicions borne of ignorance. But while increased transparency would alert the market to concentration issues and potential contagion risks, calls to make disclosure a formal pre-requisite to allowing funds to be invested are likely to be ineffective. Strong-armed threats to cut off access to our markets for funds that failed to meet disclosure requirements would likely be counterproductive and ineffective.[16] Instead, we should encourage transparency principally on the basis that any domestic public has the right to know that its government funds and safety net are being managed properly and prudently. Failure to do so will likely result in domestic pressure, which can be far more compelling pressure from the U.S. and other third parties.[17]

U.S. interests remain protected here as an investment from an SWF—or any other entity or fund that rises to a material level—will presumably require disclosure under existing U.S. disclosure obligations.

Best Practices/Code of Conduct. One suggestion raised by the current administration and recently endorsed by IMF Managing Director-designate Dominique Strauss-Kahn was to call for the IMF to draw up a code of best practices under which SWFs would operate. While well-intentioned, there is little leverage that can be brought to bear on SWFs if they decline to adopt this code of conduct. Rather, nations must be convinced that the establishment and adoption of a new code of conduct would be in their own best interests to do so—allowing them to maximize returns and maintain disciplined and prudent investing standards consistent with their fiduciary duties to their populace.

In addition to the IMF, we believe that the U.S. should take a more active role in this area and offer our country's own financial expertise to help establish structures, rules and procedures to those now creating the SWFs that will be so important in the future.

For example, the U.S. Government operates the Thrift Savings Plan ("TSP") with $225 billion under management,[18] the State of California boasts the largest U.S. public pension fund, the California Public Employees Retirement System ("CALPERS")—a state-run investment fund with more than $245 billion in assets and Alaska boasts its own Permanent Reserve Fund with $40 billion under management. Although these differ from foreign owned SWFs in many fundamental ways, these funds nevertheless have had to grapple with the same balance between a desire for high returns on assets and a desire to advance an activist political and ideological agenda.[19] Their experiences could be offered in a non-threatening way to governments in the process of establishing or reforming their SWFs as part of our diplomatic efforts. This use of creative financial statecraft has been sorely lacking in recent years.

Reciprocity. Some argue that SWFs should be prohibited from purchasing stakes in U.S. companies unless private U.S. investors are free to make similar purchases in China, the Gulf, and in any other country with a large SWF.[20] We disagree. Among other concerns, there are countries that arguably meet this standard whose investments may nevertheless cause us concern, and similarly, there are those countries that have made significant investments in the U.S. over the past decades but that do not meet this standard, and whose investment capital would presumably be shunned under this argument.[21]

Moreover, any call for outright reciprocity fails to recognize that in a world of large deficits and large surpluses, the flow of capital intrinsically lacks full reciprocity. Surplus countries by definition are building up claims on the rest of the world which need to be re-circulated.[22]

Limits on exercise of control. While remaining strong proponents of open markets, decrying protectionism and stressing the need to attract capital to our markets, we nevertheless, believe that there is one area of risk that needs to be considered. This involves the issue of how to deal with investments made by SWFs and other government-owned vehicles that fall below the trigger for CFIUS/FINSA review—"mergers, acquisitions, and takeovers"—but that still rise to a level where significant influence could be exercised. Given the nature of public markets and of the broad and diffuse shareholding structures of most public companies, shareholders with seemingly small ownership percentages (as low as 1 percent) can, in fact, exercise influence disproportionate to their shareholding. Hedge funds, corporate raiders and activist shareholders regularly act in this fashion.

We believe that it would be difficult, if not impossible, for FINSA/CFIUS implementing regulations to comprehensively protect U.S. interests, as well as those of other stakeholders, in the instance where an SWF takes an investment position less than that of "control", but where such shareholding presents that opportunity for enormous "mischief".

This issue arises primarily because FINSA/CFIUS is intended to address issues raised by non-U.S. entities that seek to obtain outright control over a U.S. target. SWFs, by contrast, are likely to engage in market-based purchases of less than controlling positions. Nevertheless, we believe that it is naïve to assume that all SWFs, unlike other investment vehicles, will be driven purely by above-board motives, or even primarily, by financial interests. In this regard, SWFs represent a unique risk. As an example, while FINSA/CFIUS would clearly apply should Russia's Gazprom seek to acquire control over a U.S. energy company, it is less certain that there is any existing mechanism to review or restrict a purchase by a Russian or Chinese Government SWF in a material, but non-controlling, investment in the same company.

As a consequence of this concern, we recommend consideration of restrictions on the voting (but not economic) rights of SWFs and other government-owned investment vehicles in U.S. public companies above a certain threshold. These restrictions would apply in those instances where an SWF or other government owned entity acquired a shareholding below that which would trigger a FINSA/CFIUS review. The threshold would need to be set at a level that would not discourage legitimate financial investments made in pursuit of higher returns, but sufficient to ensure that these funds do not exercise undue influence. Under this proposal, SWF investment above this threshold would not be prohibited, but rather would compel either the purchase of non-voting shares or require that voting rights be exercised by an independent US trustee.

This approach may engender arguments that it discriminates against SWFs relative to other investment and hedge fund investors. This is clearly true. But it is also explained on the basis of security and other considerations that would be absent were the investor not an arm of a foreign government.

Among the issues identified in taking this approach is that SWFs may feel that this restriction is unfair and may discourage an investment where they may otherwise have done so, thus making the U.S. a less attractive destination for their investment capital. In fact, we believe that the certainty of a specific threshold at which this voting limitation would apply would be more likely to attract investors than a general, but non-specific broadening of CFIUS/FINSA. Were the latter to be the case, it is likely that investments would be more severely discouraged, as it is not likely that an SWF would make an investment that required prior permission over an extended period of review. In fact, telegraphing the market would go against a strategy of maximizing return. Furthermore, should the SWF decline to file voluntarily and later be found to be in violation of FINSA/CFIUS, the risk to the SWF would be far greater than simply the loss of voting rights.

Another issue raised is the possibility that other nations may seek to impose similar restrictions on US Government or state controlled funds, such as CALPERS, which seek to influence investee companies in areas of corporate governance and the like. This is a risk. But, while CALPERS may believe that its intentions are worthy, it would be hypocritical to argue that U.S. SWFs or their state equivalents should be free to try to influence international investments to serve political goals, but that other countries should not be free to do the same here.

RECOMMENDATIONS

We believe that a prudent position would include:

1. Comprehensive review of existing U.S. legislation (CFIUS, Antitrust, Securities, etc.) to ensure that the rise of SWFs will not result in an unforeseen situation where national interests and those of U.S. investors and companies are somehow compromised.
2. Call for increased voluntary transparency and disclosure so as to inform both the international market and the foreign state's domestic public (whose funds are being invested) of the basis on which these funds are being invested.
3. Support calls for the IMF to establish a code of best practice for SWFs but further make available to the governments of China, Russia, and other nations in the process of establishing or reforming SWFs the most successful U.S. public fund managers so that we can export our best practices and lessons learned on how to balance the need to drive returns and responsibilities driven by their relationship with the state.
4. Engage in an "Invest in America" marketing program around the world. Rather than fearing global investment, we must be aggressively competing for it, while making clear the advantages of investing in the U.S., as well as providing certainty about the "rules of the game."
5. Consider the possibility of allowing—even encouraging—the purchase of shares or other securities by foreign government-owned funds in public companies, but applying specific restrictions on the exercise of control or voting rights in those securities above a to-be-determined threshold. In those instances where outright control is sought, this would presumably be covered under provisions of existing law, including FINSA/CFIUS.

POSTSCRIPT

The enormous growth of reserves and SWFs and the resulting concerns about foreign investment from the rising economic power of developing nations is an inevitable consequence of globalization and third world development. The overall trend toward rising global GDP (albeit with a declining U.S. share of global GDP) should be viewed as a positive development bringing hundreds of millions of people around the world out of poverty and into the global market and financial system. It needs to be managed, not resisted. We should view this as an opportunity. But newly wealthy nations will also have financial and political power associated with that wealth that may not always be exercised to our liking. We must ensure that this wealth is not used in any way to compromise our national interests—which include complex economic, political, and security considerations.

ENDNOTES

[1] SWFs are government-owned investment funds intended to diversify foreign exchange assets and earn higher returns than reserves (which are generally invested in high grade fixed income securities, in particular U.S. Treasuries) by investing in a broad range of asset classes, including longer-term government bonds, agency and asset-backed securities, corporate bonds, equities, commodities, real estate, derivatives, alternative investments, and foreign direct investment. SWFs are not new. Kuwait established its first SWF as early as 1960, and the UAE created the Abu Dhabi Investment Authority ("ADIA"), the largest SWF, in 1976.

[2] As of September 2007, the largest holders of such reserves are:

China: $1.3 trillion
Japan: $900 billion
Russia: $330 billion
Korea: $245 billion
India: $192 billion

[3] While the size of SWFs is difficult to determine with certainty, the largest SWFs include:

ADIA: up to $875 billion
Singapore: up to $440 billion
Norway: $320 billion
Kuwait: $250 billion
Russia: $127.5 billion

[4] Stephen Jen, Morgan Stanley, May 3, 2007.

[5] To put this in perspective, at present, collectively the Gulf states (Kuwait, Qatar, Abu Dhabi, and Dubai) have over $1 billion a week to invest. Combined with Saudi Arabia's reserves, the Gulf states are adding around $120 billion annually from oil revenues. China however, needs to invest $2 billion every working day. Its portfolio is currently doubling every two years or so, from $500 billion in late 2004 rising to over $1 trillion by the end of 2006 and expected to reach $2 trillion by 2008. Even if China takes policy actions to slow the growth of its current account surplus and Chinese foreign asset growth stabilizes at around $500 billion a year, its portfolio will continue to grow from $2 trillion in 2008 to $4 trillion in 2012—even without any capital gains from investment. That is enormous and of a different scale than anything we have seen before. <u>See</u>, Brad Setser, *RGE Monitor*, July 30, 2007.

[6] With the recent rise in commodity prices globally, and the limited nature of these commodities and revenues, many Governments created SWFs to serve as savings funds for future generations. If commodity prices remain high, these governments are likely to accumulate foreign assets going forward even after the implementation of sensible domestic fixed investment plans. These funds are considered a prudent way of protecting against a world where these commodities have run out, prices decline or, in the case of oil, where alternative energy takes hold and oil is no longer as important to the U.S. and global economy as it is today. U.S. Treasury, Clay Lowery, June 21, 2007.

[7] Non-Commodity Fund assets often derive from exchange rate intervention. These funds' net return will depend on the difference between the yield they earn on their investments and the yield they pay on their sterilization debt. So they may be thought of more as "borrowed funds" than traditional "wealth." The extent of asset accumulation in Non-Commodity Funds will depend heavily on how successful these countries are in shifting to increased exchange rate flexibility. <u>See</u>, Lowery, June 21, 2007.

[8] Lawrence Summers, *Financial Times*, July 31, 2007.

[9] In 2006 the net issuance of the most traditional reserve assets—U.S. Treasuries, U.S. Agencies, Euro area Government securities and U.K. Treasuries—totaled $461 billion. That means that even if reserve and Sovereign Wealth Fund managers had purchased **all** 2006 net issuance of these traditional reserve assets, the U.S. Treasury estimates that they would still have had some $720 billion left over. See, Lowery, June 21, 2007.

[10] A recent estimate quantified the potential gross capital inflows over the next five years from SWFs to global equities at $1 trillion and $ 1.5 trillion to global debt markets, rising to $3.1 trillion and $4.6 trillion respectively over the next decade. Steffen Kern, Deutsche Bank, September 10, 2007.

[11] However, one analyst recently noted that we must acknowledge increased market risk of contagion should SWFs act in a herd-like fashion and become overly concentrated in any given sectors or regions. Kern, Deutsche Bank, September 10, 2007.

[12] Press Conference by Secretary Paulson August 2, 2007.

[13] The U.S. Treasury has been a strong advocate on this issue, recognizing that these political risks exist and that protectionism and over-reaction would be counterproductive. They have issued a statement on this issue recognizing that we must avoid an "upsurge in destructive protectionism."

[14] See, Steffen Kern, Deutsche Bank, September 10, 2007 for a good discussion of various countries' foreign control mechanisms.

[15] In fact, protectionist pressure against, for example, Chinese investment into U.S. equities could result in China threatening to reduce its participation in purchases of U.S. Treasuries. While stopping short of the so-called "nuclear option" of dumping U.S. dollars, contrary to political arguments, this would not be as disastrous for the Chinese as it would for the U.S. , which could be faced with higher interest rates, a weaker dollar and the potential for broader market based disruption.

[16] Arguments against mandatory disclosure include:

Any call for mandatory transparency by SWFs at a meaningful level runs the risk that disclosure of specific portfolio holdings on this scale would provide private market players the opportunity to front-run these funds and thus potentially compromise the very financial returns we are arguing should be the primary motivation of an SWF. Moreover, disclosure can be misleading and can provide a false sense of security. For example, many disclosure advocates point to Norway's publicly disclosed SWF portfolio as a model of best practice. But, even Norway does not disclose its derivative positions, leaving every opportunity for disclosure to be compliant with "best practice," while still being misleading and incomplete. Perhaps most important, we have little leverage to insist on such disclosure on a mandatory basis. For example, large existing SWFs including those from Singapore (GIC) and the Gulf funds (ADIA) do not consistently disclose their asset composition, let alone more details about the country and currency mix of their portfolio. Were transparency to be required from these funds, would the U.S. really tell ADIA and the GIC that they must sell existing positions for failure to disclose more than they do now, and also more than competing sources of capital, namely hedge funds? Such forced sales would be enormously damaging to our markets, would cost existing investors and companies dearly and could lead to the further decline of the U.S. as the pre-eminent global capital market. See, Brad Setser, *RGE Monitor*, July 30, 2007.

[17] It is noteworthy that China's $3 billion investment in Blackstone this summer was disclosed as part of the U.S. IPO filing process and garnered worldwide (and domestic Chinese) attention. Just weeks after it was made, its investment had lost 40 percent of its value—over $1 billion. Disclosure of this position has led to outrage by the Chinese public, which has expressed anger through news stories, editorials, and blogs—all taking the fund to task for squandering the people's hard earned funds. It is very likely that the current market downturn and global volatility will ensure that fund managers, especially those who do not get handsomely paid to take risk (as do

hedge fund managers), will be more prone to react to pressure from domestic sources rather than from international threats.

[18] In fact, the TSP itself has approximately $23 billion of U.S. government pension funds invested outside of the U.S. in holdings that mirror the MSCI EAFE index. These include holdings in the U.K., France, Japan, Switzerland, Germany, and scores of others.

[19] In fact, CALPERS recently toned down its attempt to apply political criteria (albeit criteria that the U.S. would argue were well-intentioned) to international investments in favor of a more return oriented focus.

[20] In the case of China, any call for opening its capital account to portfolio inflows necessarily raises more complicated trade and currency valuation issues. It is not our purpose here to address these issues, but we do take note that China cannot open up its markets to inward investment so long as it is intervening to hold down its domestic currency. Without appreciation of its currency, increased inward investment into China would result in even larger capital inflows, which would just means faster reserve growth—and ultimately, an even bigger Chinese SWF. Brad Setser, *RGE Monitor*, July 30, 2007.

[21] That is, while Norway and Singapore could potentially meet this standard, it is arguable that Russia does as well, and it would be ill-advised to allow Russia to take ownership of U.S. strategic assets. Similarly, the Gulf States do not meet this standard, but it would not be in our interests to tell them to take their money elsewhere. There are also issues of degree in terms of what constitutes an "open and reciprocal" market. For example, Gazprom has a large and wide domestic and international investor base and it is listed and publicly traded on global stock markets. But it is clearly controlled by the Russian State and used for political purposes.

[22] See, Brad Setser, *RGE Monitor*, July 30, 2007.