BRIC BY BRIC:
THE EMERGENT REGIME FOR SOVEREIGN WEALTH FUNDS

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ABSTRACT

The rapid growth of sovereign wealth funds highlights apparent shifts in the global distribution of economic power away from OECD economies and towards the BRICSAM economies and energy exporters. The global policy response to SWFs therefore represents an ideal test case to see how well rising powers can interact with existing power structures. Their appearance and behavior have raised policy concerns about their effect on capital markets and the exercise of undue influence over recipient economies. This paper examines the regulatory and geopolitical concerns associated with sovereign wealth funds. It then examines current efforts to establish a global regulatory framework that will accommodate sovereign wealth funds while still alleviating political concerns about their existence.

Introduction

Sovereign wealth funds (SWFs) sit at the intersection of high finance and high politics. Their net worth now exceeds $3 trillion – more than the value of all private equity or hedge funds.[1] SWFs were responsible for 35% of total mergers and acquisitions activity in 2007. Between March 2007 and June 2008, these actors injected $59 billion into western financial institutions, including high-profile equity purchases of Barclays, Citigroup, Credit Suisse, Merrill Lynch, Morgan Stanley, and UBS (Farrell, Lund and Sadan 2008, p. 9-10). Berkshire Hathaway and General Electric are partnering with individual sovereign funds to acquire high-profile firms. In an echo of the Japanese foreign direct investment boom from two decades ago, SWFs have also moved into acquisitions of high-profile real estate. In July 2008, a sovereign wealth fund based in the United Arab Emirates purchased 90% of the Chrysler Building in New York. The Deputy Treasury of the Secretary (Kimmitt 2008, p. 121) wrote in *Foreign Affairs* earlier this year that, "SWFs are already large enough to be systematically significant…. they are likely to grow larger over time, in both absolute and relative terms."

The explosive growth of these funds raises regulatory and geopolitical concerns. Market analysts and regulators (Truman 2007) are concerned about the transparency of these funds. Free market enthusiasts fret about the ideological implications of sovereign wealth funds – and the protectionist backlash they could create (Cox 2007; Markheim 2008). Prominent leaders such as Germany's Angela Merkel and France's Nikolas Sarkozy worry that SWFs now possess bargaining leverage over the economic and political futures of major economies.

Many policy analysts argue that the rise of sovereign wealth funds are symptomatic of shifts in the global distribution of power away from the OECD economies and towards the BRICSAM countries and energy exporters (or, using a different lens, from liberal democratic states to capitalist authoritarian states). A senior economist at the OECD acknowledged that, "What is clear is that at the present moment, [SWFs] certainly have a lot of bargaining power."[2] Brad Setser blogged recently, "One thing is clear: the world's biggest financial powers are no longer the world's large democracies."[3] Jeffrey Garten (2008) concludes that, "the reality [is] that the biggest reservoirs of capital in the future will be in Asia and in Saudi Arabia, Kuwait and the United Arab Emirates, and we should concede the limited ability of the United States or the EU to influence the shape and character of SWFs, given their size, their growing importance to capital markets and the

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[1] These categories are not mutually exclusive; by one estimate (Johnson 2008), sovereign wealth funds account for 10% of private equity investments globally.

[2] Quoted in Thao Hua, "Sovereign wealth funds offer a vigorous defense," *Pensions & Investments*, March 17, 2008.

[3] Brad Setser, "The changing balance of global financial power," August 14, 2008. Accessed at http://blogs.cfr.org/setser/2008/08/14/the-changing-balance-of-global-financial-power/, August 2008.

options they have to invest in their own regions or in other regions, and bypass the United States and Europe if necessary."

At a minimum, the rise of sovereign wealth funds represents a serious challenge to existing global governance structures. Financial analysts have expressed great skepticism about the ability of the international financial institutions to provide meaningful governance on this issue.[4] Truman (2008, p. 3) notes that, "the growth of SWFs reflects a dramatic redistribution of international wealth away from traditional industrial countries like the United States to countries that historically have not been major players in international finance and have had little or no role in shaping the practices, norms, and conventions governing the international financial system." Last year the head of global economic research at Goldman Sachs (O'Neill 2007, p. 237) warned:

> [I]f Western policymakers were to think on a broader scale, the emergence of large SWFs would represent yet another reason why the current organizational structure of the G7, G8, IMF and World Bank needs an urgent overhaul. Just as with misaligned exchange rates, global current account imbalances, high commodity prices, concerns about the environment and global warming, we are highly unlikely to see significant and optimal policies until and unless the institutional structure of world policymaking is changed.

This paper examines the emergent regime to regulate sovereign wealth funds, to see whether and how existing governance structures have coped. The divergence of interests between recipient and host countries suggest that the regulatory outcome could signal whether power has genuinely shifted from established to rising powers. The global policy response to SWFs therefore represents an ideal test case to see whether rising states and established powers can interact within existing power structures.

The international regime for sovereign wealth funds is still in chrysalis. Nevertheless, one can draw some tentative conclusions from examining the governance process to date. First, the established powers in global financial governance – the United States, European Union, and other members of the G-7 – still retain considerable influence in determining global economic governance. Contrary to popular perception, market power resides with the large capital importers, not the large capital exporters. This is consistent with the argument that large consumers have more bargaining leverage than large producers over global regulatory outcomes (Drezner 2007). Second, this market power in global finance is nevertheless in slow decline. This decline will affect the implementation of international agreements over time. Third, changes in the globalization of financial markets pose a challenge for governance structures over time.

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[4] Rediker and Rediker (2007). See also International Financial Law Review, "Why is IMF meddling with sovereign wealth?" May 2008; Anthony Faiola, "As Global Wealth Spreads, the IMF Recedes," *Washington Post*, May 24, 2008.

This paper is divided into six sections. The next section provides a brief primer on sovereign wealth funds. The third section details the policy concerns that SWFs have raised. Transparency and sovereignty are at the core of these concerns. The fourth section reviews ongoing efforts to establish a global regulatory framework for sovereign wealth funds. The fifth section interprets the governance process to date. The final section concludes with some speculation about the future.

A primer on sovereign wealth funds

There are as almost as many definitions of sovereign wealth fund are there are sovereign wealth funds.[5] I will define them as *government investment vehicles that acquire international financial assets to earn a higher-than-risk-free rate of return*. This definition distinguishes SWFs from central banks that exclusively hold traditional currency reserves,[6] or state-owned enterprises that own or acquire sector-relevant affiliates overseas, or public pension funds that overwhelmingly invest in domestic assets. This definition nevertheless encompasses a variety of government investment vehicles, including stabilization funds and many pension funds.

Sovereign wealth funds are not a recent invention – Kuwait created the first modern fund in 1953, eight years before its independence.[7] Nor are they alien to the advanced industrialized states. Alaska set up a sovereign wealth fund designed to manage the revenues that emanated from energy booms – as has New Mexico and Wyoming.[8] Norway's central bank controls the Government Pension Fund – Global (GPFG), one of the largest sovereign wealth funds in existence. Australia, Canada, New Zealand, Mexico, and South Korea also have funds. In total, the advanced industrialized states hold more than 40% of all SWF international assets (Truman 2008).

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. Randolph (2008) estimates their annual growth rate at 24% over the past five years. The inelastic demand and high price for oil, combined with the persistence of global macroeconomic imbalances, lead many analysts to predict an annual 20 percent growth rate over the next decade (Jen 2007; Setser and Ziemba 2007; Randolph 2008).[9] Private sector analysts project that by 2015 their total valuation could

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[5] Rozanov (2005) first coined the term. For collections and debates of these definitions, see Truman (2008), Balding (2008) and IMF (2008).

[6] It does, however, 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 hold higher-risk investments. In his original definition, Rozanov (2005) observed that central banks that split reserves into separate funds for separate purposes qualified as SWFs.

[7] Hildebrand (2007, p. 2) suggests that the very first sovereign wealth fund was France's *Caisse des Dépots et Consignations* in 1816.

[8] One could also argue that CalPERS also qualifies as a sovereign wealth fund. See Benn Steil, "California's Sovereign Wealth Fund," *Wall Street Journal*, March 7, 2008.

[9] For a dissenting view, see Afnab Das, "SWF growth set to slow," *Financial Times*, July 22, 2008.

range in size from $9 trillion to $16 trillion – or close to four percent of global asset markets (Kern 2007; Jen 2007; Lyons 2007).

Until recently, most sovereign wealth funds were content to keep most of their cross-border investments confined to safe assets – i.e., bonds and index funds. Furthermore, SWFs outsourced investment decisions to external money managers for close to half of their assets.[10] In recent years, however, both trends have been partially reversed. To seek higher rates of return, sovereign wealth funds have shifted from portfolio investments to foreign direct investment. SWF cross-border mergers and acquisitions more than doubled between 2006 and 2007 (Maslakovic 2008). They have also been increasingly attracted to "alternatives" such as hedge funds, derivatives, leveraged buyout firms, and real estate. Sovereign wealth funds are also speculators in commodity futures markets.[11] This affects the political calculus – controlling investments in firms have more political resonance than passive investments in bonds (Drezner 2008a, p. 61; Miracky et al 2008, p. 12). Long-established SWFs have also begun to manage a greater share of their assets in-house (IMF 2008, p. 9). Norway's GPFG, for example has shifted in the past eight years from having external managers handle a majority of its assets to managing a majority of them in-house.

Although the concept of a sovereign wealth fund is not new, close to half of the top forty SWFs have been created since 2000 (Maslakovic 2008). The most prominent sovereign wealth funds come from manufacturing and energy powerhouses in the developing world. The greater Middle East and East Asian economies are responsible for most of the world's large sovereign wealth funds. Looking at the top twenty SWFs as measured by asset size, seven are based in the greater Middle East and nine are based in the Pacific Rim economies. In 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 currently 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 (Fernandez and Eschweiler 2008, p. 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.

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[10] *Pensions & Investments*, "Managers run 44% of sovereign wealth assets," March 7, 2008.
[11] David Cho, "Sovereign Funds Become Big Speculators," *Washington Post*, August 12, 2008.

Export engines like China are also using sovereign wealth funds to keep their currencies fixed to the dollar at a low par value (Dooley, Folkerts-Landau, and Garber 2003; Summers 2006). 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% 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, the Chinese government has debated whether the opportunity cost of holding dollars in such low rate of been willing to diversify its holdings into higher-risk investments – hence the creation of the China Investment Corporation last year (Martin 2008; Cognato 2008; Amadan International 2008).

The public policy concerns about sovereign wealth funds

As SWFs have increased their capabilities, policymakers have focused on their intentions in global capital markets and recipient countries.[12] In doing so, analysts raise three core concerns. First, most sovereign wealth funds lack transparency in their objectives and actions. Second, sovereign wealth funds are government actors; their inherent sovereignty causes both market participants and government officials to question their motivations. Third, the uncertainty surrounding SWF intentions could trigger the financial equivalent of the security dilemma in capital markets. Policymakers in recipient countries are concerned that, to alleviate security concerns, they could trigger even greater financial insecurity.

Compared to mutual funds or pension funds, the transparency of most sovereign wealth funds ranges from bad to worse (Lyons 2007; Truman 2008). As Figure 1 demonstrates, there appears to be a correlation between fund size and opacity. The largest sovereign wealth fund, for example, is the Abu Dhabi Investment Authority (ADIA), an institution that has never revealed its fund size, portfolio structure, performance, or investment objectives (Fernandez and Eschweiler 2008, p. 23). Until earlier this year, despite being in existence for more than thirty years, ADIA's official website was confined to a single page containing no financial information.[13]

Not all funds are as opaque as ADIA. Norway's GPFG is quite open about its objectives, ownership structure, and pattern of investment (Velculescu 2008; Truman 2008). There is a general correlation, however, between SWF transparency and the political characteristics of the home country. Beck and Fidora (2008, p. 13) find that transparency is strongly and positively correlated with the country's democratic accountability and the quality of its legal system. Mitchell, Piggott and Kumru (2008) find a strong and positive correlation between a country's political and civil liberties and the quality and

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[12] See Cox (2007), Kimmitt (2008), and Truman (2008) for overviews of the concerns discussed in this section.

[13] Bob David, "U.S. Pushes Sovereign Funds to Open to Outside Scrutiny," *Wall Street Journal*, February 26, 2008. 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.

transparency of its sovereign wealth funds. Not surprisingly, sovereign wealth funds headquartered in the OECD economies are much more transparent than those headquartered in the BRICSAM countries.[14]

Because of a lack of transparency, analysts argue that the unanticipated actions of SWFs could roil financial markets (Kimmitt 2008). Joshua Kurlantzick (2008, p. 65) summarizes the concern voiced by many: "Because of their secretiveness and closed-shop management style, the SWFs could buy up assets across the world without other investors knowing what they are doing, adding massive uncertainty and volatility to financial markets already struggling to understand investments by private equity, hedge funds, and other new actors."[15]

Sovereign wealth funds have responded to this critique by pointing out that peer actors – central banks, hedge funds and private equity – also lack transparency. In recent years, however, these other financial institutions have also faced requests for greater openness. In response, these other financial institutions have begun to move towards more public disclosure. Central banks have moved towards greater transparency in the aftermath of the Asian financial crisis last decade (Geraats 2002; Hoguet, Nugée and Razanov 2008). By 2008, both hedge funds and private equity firms also faced calls from public officials open up their operations to outside observers. This led to follow-on demands to adhere to voluntary codes of conduct.[16] As Edwin Truman recently observed in the *Wall Street Journal*, "The days of cozy undisclosed financial arrangements by large players including hedge and private-equity funds are, and should be, drawing to a close, and that prescription applies to SWFs as well when they invest in international markets."[17]

The second source of concern about sovereign wealth funds is that are, by definition, extensions of the state. They are therefore viewed maximizing their country's strategic interests rather than profit-maximizing actors. Even defenders of sovereign wealth funds as responsible financial actors acknowledge that some SWFs might have strategic objectives in their acquisitions (Fernandez and Eschweiler 2008, p. 6; Miracky et al 2008; Butt et al 2007, p, 75). Lyons (2007) classifies several of the large sovereign wealth funds as having "strategic" investment approaches. The sovereign wealth funds themselves insist that they merely seek to maximize their rate of return. Nevertheless, the perception among financial actors diverges from SWF self-perceptions. A recent survey of global financial institutions revealed that private actors viewed these funds as more likely to seek strategic interests than maximizing their financial returns – even though SWF respondents stressed the latter over the former (Norton Rose 2008).

The sovereign backing of these wealth funds triggers a variety of policy issues. The most obvious concern is whether national governments will use their sovereign wealth

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[14] The correlation coefficient is .64. Transparency data accessed from http://www.swfinstitute.org/research.php, August 2008.
[15] See also Truman (2008);
[16] On hedge funds, see Hedge Fund Working Group 2008) and President's Working Group (2008). On private equity, see Walker Working Group 2007 and Financial Stability Forum (2007).
[17] Edwin Truman, "Do Pick on Sovereign Wealth," *Wall Street Journal*, July 23, 2008.

funds to exercise political leverage over recipient countries. This could happen through the manipulation of domestic interests – i.e., co-opting financial actors eager to do business with SWFs (Miracky et al 2008, p. 28-29).[18] It could happen through the strategic manipulation of assets owned in another country (Luft 2008; Navarro 2008). Finally, leverage could 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."[19] Tonelson (2008) articulates a similar concern: "If, for example, the Chinese government held significant stakes in a large number of big American financial institutions, especially market-makers, and if our nation's current period of financial weakness persists, how willing would Washington be to stand up to Beijing in a Taiwan Straits crisis?"

Beyond political leverage, some recipient countries are concerned that SWFs will tilt the playing field in mergers and acquisitions. These investment vehicles could act to boost "national champions" in global markets (Truman 2008, p. 3). Another concern is the maintenance of a level playing field in financial markets. If sovereign wealth funds are an extension of the state, then they may profit from exploiting other organs of the state – intelligence agencies, central banks, justice ministries – to gain an unfair advantage in acquiring assets (Kimmitt 2008; Cox 2007). In Senate testimony, one SEC official (Tafara 2008) observed, "Governments that control sovereign wealth funds and sovereign businesses, because they are governments, can in some cases control certain economic events, and they may have information advantages over private market participants. Governments routinely are privy to certain types of information that most private investors are not. What if the fund obtains information through its status as a government entity?"

The final policy concern is not about sovereign wealth funds per se, but the political response to them in recipient countries. Public hostility to SWF investment could lead to a protectionist overreaction in the OECD economies. In this decade alone, public hysteria in the United States helped to block Dubai Ports World's acquisition of 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. Mittal's hostile takeover bid for the European conglomerate Arcelor provoked action from four European governments to try to block the merger, even though Mittal is headquartered in Rotterdam (Drezner 2006).

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% to 25%, Americans believed foreign-government investments harmed the U.S.

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[18] 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.
[19] Quoted in Jamil Anderlini, "China fund shuns guns and gambling," *Financial Times*, June 13, 2008.

economy. By 55% to 10%, 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.[20]

Many politicians have begun to respond to this public distrust through hearings and public statements hostile to sovereign wealth funds. 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 implement adverse economic policies (Snyder 1991, p. 41-42). This ties into the question of whether sovereign funds would exercise their leverage over recalcitrant host countries. The co-chairs of the Congressional Working Group on Sovereign Wealth Funds warned in the *Wall Street Journal* that, "Strong arm tactics by our government can be counterproductive given the fact that SWFs can and will take their money elsewhere if the political risk premium for U.S. investment grows too high."[21] The CEO of Blackstone (Schwarzman 2008) warned about the fallout from alienating sovereign wealth funds:

> When capital withdraws, it does so without notice or fanfare. Imagine a private meeting in a room far from the US; a decision is made and billions of dollars that were invested here find a new and more hospitable home. Or billions of dollars that could have been invested here are reallocated to other more benign markets. Sixty years ago, we conducted a painful, expensive and accidental experiment called the Great Depression, with the Smoot Hawley tariffs to teach us the value of free trade. Let us not subject ourselves to another painful lesson in the value of direct investment and the free flow of capital by driving SWFs away.

It should be stressed that many of these concerns are still "in the realm of the hypothetical," as Truman (2008, p. 3) puts it. Based on past behavior, there is little evidence that sovereign wealth funds have acted in any way other than as profit-maximizing actors (Balding 2008; Miracky et al 2008). The general consensus among financial analysts is that sovereign wealth funds have taken a long-term, passive approach to their overseas investments.[22] There have been a few attempts to use sovereign funds as a tool of economic statecraft – though most of these efforts come from funds based in the OECD. These efforts have not yielded any tangible policy concessions, nor have they imposed any actual costs on targeted firms or states (Beck and Fidora 2008; Drezner 2008b). These results are consistent with the general consensus in international relations – threats of economic exit only work under a limited set of circumstances (Knorr 1975; Keohane and Nye 1978; Buzan 1984; Wagner 1988; Kirshner 1995; Drezner 1999; Crescenzi 2003; Steil and Litan 2006).

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[20] Bob Davis, "Americans See Little to Like in Sovereign-Wealth Funds," *Wall Street Journal*, February 21, 2008.
[21] James Moran and Thomas Davis, "Sovereign Good," *Wall Street Journal*, August 6, 2008.
[22] For a dissenting view, see Brad Setser, "Just How Stabilizing?" July 30, 2008. Accessed at http://blogs.cfr.org/setser/2008/07/30/just-how-stabilizing/, August 2008. .

From an international relations perspective, however, these concerns are not surprising. Opaque actors holding billions of dollars in a $200 trillion asset market are inconsequential. Those same actors matter more when they are holding trillions of dollars. Furthermore, a realist approach to the question would argue that past evidence of good behavior is no guarantee of future good behavior (Mearsheimer 2001). Concerns about SWFs are often voiced in *realpolitik* terms. As Garten (2007) observed last year, "who knows what the governments of countries such as China, Russia and Saudi Arabia may look like a decade from now, and what their political motivations might be?" Given the uncertain political alignments between the home countries of significant sovereign wealth funds and the primary recipient countries of cross-border SWF investment to date, it is hardly surprising that recipient countries would want to create governance structures that require sovereign financial actors to signal their intentions.

The emergent regime for SWFs

Momentum for some kind of international regime to address concerns about sovereign wealth funds began in early 2007 (Lowery 2007). The topic was first raised as a global governance question at an April "outreach dinner" between the G-7 finance ministers and officials from Russia, Saudi Arabia, and the UAE; a follow-up dinner was also held in October. Sovereign wealth funds were also discussed at a May meeting of the G-20 to discuss financial stability. By June, Acting Undersecretary of the Treasury for International Affairs Clay Lowery (2007) publicly stated that SWFs raised "broad, strategic issues for the international financial system" and called for the IMF and World Bank to draft best practices to address these issues.

By the fall, the issue had move to the front of the queue of financial governance issues. SWF investments in preeminent financial institutions heightened public anxiety. Policy analysts began proposing concrete regulatory responses (Truman 2007; Rediker and Rediker 2007).[23] At the urging of both the United States and France, the G-7 finance ministers called on the international financial institutions, as well as the OECD, to draft codes of conduct in dealing with sovereign wealth funds (Badian and Harrrington 2008, p. 53).[24] The IFIs were requested to devise a code for the SWFs themselves; the OECD was tasked to design best practices for recipient countries.

The home countries of sovereign wealth funds reacted coolly to the G-7 pronouncement. An early draft of the G-7 statement explicitly demanded that SWFs should not invest with political motivations in mind, but G-7 officials were worried that this would upset Russia, China and Saudi Arabia.[25] A month later, developing country representatives at the G-20 Finance Ministers were wary about the G-7 request for standards. The G-20

[23] Intriguingly, many of these analysts had reversed course by 2008, warning against excessive action; see Garten (2008), as well as Rediker and Rediker (2008).
[24] See Statement of G-7 Finance Ministers, Washington, DC, October 19, 2007, at http://www.g8.utoronto.ca/finance/fm071019.htm (accessed August 2008).
[25] Steven Weisman, "Rules Urged To Govern Investing By Nations," *New York Times*, October 20, 2007. See also Sean O'Grady, "G7 compromises over calls to reform sovereign wealth funds," *The Independent*, October 20, 2007.

communiqué praised the virtues of SWFs and then merely stated that they "noted the work" of the IFIs, without any positive affirmation.[26] At the Davos Economic Forum in January 2008, SWF representatives across the board rejected criticisms of their activities. Muhammad Al-Jasser, the vice governor of the Saudi Arabian Monetary Agency, complained, "it's like the sovereign wealth funds are guilty until proven innocent." Some SWF representatives began to highlight their financial bargaining power. At one point, Norway's finance minister Kristin Halvorsen said, "It seems you don't like us, but you need our money."[27]

The OECD process to develop recipient country guidelines generated few ripples or complaints by participants. In response to the emergence of state-owned enterprises like Gazprom and Dubai Pots World, the OECD was already trying to clarify rules on security restrictions to FDI through its "Freedom of Investment" initiative (OECD 2007). The guidelines for sovereign wealth funds borrowed from and paralleled those efforts. Prior to meeting with sovereign wealth fund officials, OECD Secretary General Angel Gurría explicitly stated, "There should not be any regulation or code applied that unduly restricts the freedom of investment, because we would be doing ourselves a disservice."[28]

Following open consultation with sovereign wealth funds, the organization's Investment Committee issued a report (OECD 2008, p. 3) in which it concluded that, "the OECD's existing investment instruments already contain fundamental principles for recipient country policies needed for the required guidance." Those principles included non-discrimination, transparency, and progressive liberalization. After the report was released, Gurría wrote, "Sovereign wealth funds, welcome! OECD markets are open for your investments.… national security should not be a cover for protectionism, and OECD countries have agreed to use the security argument with restraint."[29]

Both member countries and sovereign wealth funds greeted the OECD report favorably.[30] However, the report also linked the response of OECD members to the willingness of sovereign wealth funds adhere to more stringent standards (OECD 2008, p. 6):

> Although the OECD work focuses on host country policies, observance by SWFs of high standards of transparency, risk management, disclosure and accountability can affect the political and policy environment in which recipient countries act. In particular, observance of high standards by

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[26] See statement of G-20 Finance Ministers meeting,, Kleinmond, South Africa, November 18, 2007, at http://www.g8.utoronto.ca/g20/g20-071118.html (accessed August 2008).

[27] Al-Jasser quoted in Natsuko Waki and Clara Ferreira-Marques, "Wealth funds bristle at rich country wariness," Reuters, January 24, 2008; Halverson quoted in Daniel Gross, "SWF seeks loving American Man," *Slate*, January 24, 2008.

[28] Associated Press, "OECD head says sovereign wealth curbs unneeded, no political moves seen," March 25, 2008.

[29] Angel Gurría, "Sovereign wealth funds an opportunity, not a threat," *Guardian*, April 9, 2008.

[30] Steve Schifferes, "Lifting the lid on sovereign wealth funds," BBC News, June 3, 2008; OECD, "OECD Members adopt declaration on sovereign wealth funds," June 6, 2008, accessed at http://www.oecd.org/document/29/0,3343,en_2649_34887_40790173_1_1_1_34529562,00.html, August 2008. Indeed, the Chair's Summary praised the "rapidity" with which the OECD report had been written and accepted.

> investors should positively influence how recipient countries implement their OECD obligations and OECD's policy recommendations when they design and implement policies to address national security concerns while maintaining their commitment to open markets.

This was consistent with prior OECD calls for transparency in sovereign wealth funds (OECD 2007, p. 40).

The IMF effort was a more contentious process. The initial steps were unremarkable. The Fund's director of research wrote in September 2007 that he saw no need for "dramatic action" in response to SWFs (Johnson 2007). By November, initial consultations began with a "very successful" first meeting, according to the head of the IMF working group on the issue.[31] The Fund asked representatives from Singapore, Norway and Abu Dhabi to develop benchmarks for best practices.[32] As the global credit crunch deepened, however, IMF officials reported pushback from some SWF officials at the very idea of voluntary best practices. Beyond the public complaints aired at Davos in January, officials expressed their opposition directly to Fund officials involved in drafting a work agenda.[33]

The IMF (2008) issued a paper at the end of February to establish a working agenda. The paper concurred with SWFs that many of the stated concerns for sovereign wealth funds were exaggerated. It also argued, however, that there were valid regulatory concerns with regard to financial stability and transparency, justifying IMF involvement. For a work agenda, the IMF proposed an International Working Group (IWG) to draft a set of best practices by August in the hopes of receiving approval at the Bank/Fund meetings in October. The paper called for applying preexisting Fund standards to focus on governance and institutional arrangements.

The biggest issue was transparency on a variety of dimensions. The report argued that if sovereign wealth funds were more explicit about their objectives, organizational structure, and investment portfolio, it would assuage anxieties about their cross-border investments. The paper (IMF 2008, p. 26) acknowledged that transparency on the last point was, "likely to generate considerable discussion." Sovereign fund officials argued that there were sound financial reasons for keeping their portfolio composition a secret.

The advanced industrialized states also took steps outside of the OECD/IMF/G7 process. Australia and the European Union issued their own voluntary guidelines for a code of conduct. The content of the EU's voluntary guidelines mirrored the IMF work agenda, stressing governance, accountability and transparency. While the guidelines were voluntary, the President of the European Commission stated that legislation was still a

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[31] Quoted in David Francis, "Will Sovereign Wealth Funds rule the world?" *Christian Science Monitor*, November 26, 2007.
[32] John Burton, "IMF urges action on sovereign wealth," *Financial Times*, January 24, 2008.
[33] Steven Weisman, "Sovereign wealth funds resist IMF attempts to draft code of conduct," *International Herald-Tribune*, February 9, 2008.

possibility, warning, "we cannot allow non-European funds to be run in an opaque manner or used as an implement of geopolitical strategy."[34]

The United States began formulating guidelines in response to the 2007 Foreign Investment and National Security Act (FINSA), which passed in response to the Dubai Ports World fiasco. FINSA toughened the national security review process investments by foreign government investment vehicles, which include SWFs. At the same time, the Treasury Department also worked on gaining SWF acceptance of a voluntary code of conduct. Treasury representatives consulted with SWF host officials at the Davos Forum.[35] Secretary Henry Paulson met with more than thirty SWF representatives in the first quarter of 2008. As a way of signaling the desired outcome of the IMF process, the United States persuaded ADIA and GIC to jointly issue a set of policy principles regarding SWFs and recipient countries. These included commitments to governance and transparency standards, as well as a pledge to use commercial and not political criteria in determining investments.[36] This was significant for two reasons. First, ADIA and GIC ranked near the bottom of transparency scores on sovereign wealth funds (Truman 2008). Their commitment to these principles signaled a clear change of tack. Second, combined with sovereign wealth funds headquartered in the OECD, the G-7 members had *de facto* or *de jure* commitments to transparency from sovereign wealth funds controlling more than half of all SWF assets – including the three largest funds. .

The other sovereign wealth funds responded to these steps on two parallel tracks. They continued to resist any effort to craft a set of best practices within the IMF process. Russia and China in particular expressed skepticism about the IMF work agenda even before the Board of Governors approved it. The first meetings in of the IWG in April made little headway. In June, EU Trade Commissioner Peter Mandelson (2008) characterized the IWG negotiations as "prickly." In the spring, individual sovereign wealth fund officials were surprisingly outspoken in arguing against any code of conduct. In April, the managing director of the Kuwait Investment Authority (Al Sa'ad 2008) said, "Recipient countries are placing handcuffs on Sovereign Wealth Funds in the form of regulations, termed in the best tradition of George Orwell's Newspeak, by calling them code of conduct or principles of operations or best practices…. there should be limits placed on transparency. Complete transparency would raise more questions than answers." That same month Gao Xiqing, the president of the Chinese Investment Corporation, told *60 Minutes* that an IMF code would "only hurt feelings" and characterized the idea as "politically stupid." In June he was more blunt, characterizing the process as "political bullshit."[37]

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[34] Statement by José Manuel Barroso, February 25, 2008; Tony Barber, "Brussels pushes wealth funds to sign code," *Financial Times*, February 27, 2008.
[35] Gillian Tett, "SWFs face growing U.S. pressure," *Financial Times*, January 23, 2008.
[36] Davis, "U.S. Pushes Sovereign Funds to Open to Outside Scrutiny." Policy principles accessed at http://treas.gov/press/releases/hp881.htm, August 2008.
[37] *60 Minutes* transcript accessed at http://www.cbsnews.com/stories/2008/04/04/60minutes/printable3993933.shtml, August 2008; Jamil Anderlini, "China fund shuns guns and gambling," *Financial Times*, June 13, 2008.

Outside the IMF process, however, sovereign wealth funds demonstrated receptivity to greater openness. In the same *60 Minutes* interview, Gao pledged that CIC would be as transparent as Norway's sovereign wealth fund. This was part of a concerted effort by the CIC to tell media outlets that CIC's sole concern was maximizing its rate of return on overseas investments. Skeptics like Edwin Truman acknowledged that in response to public pressure, sovereign wealth funds had taken steps towards greater transparency.[38] Fernandez and Eschweiler (2008, p. 6) observe that newly created SWFs are actually more transparent than older funds.

Despite resistance to the IMF process, the members of the G-7 continued to push the issue. In the bilateral Strategic Economic Dialogue in June, Paulson indicated to his Chinese counterparts that a successful IMF process would help keep barriers to investment relatively low in the United States and Europe.[39] SWF host countries increasingly understood the linkage between accepting a code of conduct and access to OECD markets. The IMF process also received encouragement in the G-8 communiqué in Toyako in early July – which meant Russia had publicly signed onto the idea of the IMF code of conduct.[40]

These G-7 efforts appeared to yield progress. The July IWG working session was more constructive than the previous session in drafting Generally Accepted Principles and Practices (GAPP).[41] Agreement was reached on the institutional and governance issues, leaving transparency as the remaining sticking point.[42] The goal of codifying the GAPP by the October meetings of the Bank and Fund were epeated. IMF officials have continued to voice uncertainty about whether this target date will be met, however.[43]

Interpretations of the emergent regime

As of this writing, it appears that the system has worked better than expected. Contrary to perceptions about the bargaining power of sovereign wealth funds, the established great powers of global financial governance have gotten their way. The most important sovereign wealth funds have agreed in principle to greater transparency. The IMF and G-7 remained the policy drivers on this issue. Despite the extreme reluctance of key BRICSAM countries, a code of conduct looks likely to emerge from the current process.

There are two competing explanations for this turn of events. One possibility is that the governance process will produce a "sham standards" outcome in which principles are vaguely articulated but not codified or implemented. Back in February, one official

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[38] Bruce Stokes, "New Moves on Wealth Funds," *National Journal*, March 15, 2008, p. 54.
[39] Transcript of U.S. Delegation Press Conference at the Fourth Meeting of the U.S. China Strategic Economic Dialogue, June 18, 2008. Accessed at http://www.treas.gov/press/releases/hp1048.htm, August 2008.
[40] See G-8 communiqué on the world economy at http://www.g8.utoronto.ca/summit/2008hokkaido/2008-economy.html, accessed August 2008.
[41] See press release at http://www.iwg-swf.org/pr.htm, accessed August 2008.
[42] John Jannarone, "Sovereign Wealth Group Aims to Improve Transparency," Dow Jones, July 10, 2008.
[43] "Sovereign funds may not agree to code of conduct," Reuters, July 28, 2008.

involved in the IMF negotiations predicted the GAPP would be, "toothless and devoid of anything other than motherhood and apple pie."[44] The IWG's characterization of the proposed code of conduct was as follows: "a voluntary document, which the members of the IWG support and either adhere to, or aspire to implement." That does not sound like a terribly stringent standard. It is unclear whether the tripartite agreement between the United States, GIC and ADIA will have any affect. Despite the agreement and other public pledges, there was little observed change in their transparency scores.[45] Russia's leaders have gone so far as to claim that they do not have a sovereign wealth fund.[46]

One could also argue that the OECD's guidelines for recipient countries already resembles a sham standard. Despite repeated affirmations by the OECD and its officials to keep member countries receptive to FDI, the trend at the national level has moved in the reverse direction. Germany, which has been particularly exercised about this issue, has drafted a FINSA-style law that would violate EU legislation.[47] Marchick and Slaughter (2008) examine the inward FDI policies of eight OECD members and found a drift towards investor protectionism. Countries are expanding the scope of national security exceptions to inward FDI, moving beyond the traditional defense industries to include other "critical infrastructure" sectors. The definition of critical infrastructure can vary widely, however: in France, it includes gambling and gaming. Marchick and Slaughter explicitly attribute this expansion of protection to the rise of state-owned enterprises and sovereign wealth funds engaging in cross-border mergers and acquisitions.

If OECD and IMF guidelines are promulgated but honored only in the breach, then the outcome is a hypocritical regime in which sham standards are created (Drezner 2007, p. 81-85). Sham standards are politically useful to both emerging and established states. They create path dependencies in governance institutions that can cast a shadow over future governance efforts (North 1990; Raustiala and Victor 2004). They also permit governments to claim the *de jure* existence of global governance, even in the absence of effective enforcement. These standards act to relieve or redirect any domestic or civil society pressure for more significant global regulations. This fits the distribution of domestic interests on this issue. Both public opinion and legislative sentiment across OECD economies have been in favor of more protectionism, while foreign policy, finance ministry and regulatory agency officials have preferred much more modest measures (Cox 2007; Kimmitt 2008).

The other possibility is that the codes of conduct eventually generate wide acceptance. The depth of the opposition from some sovereign wealth funds suggests that they interpreted the IMF's involvement as a significant policy step. This might be because the standards proposed by the OECD and IMF would be relatively easy to observe by private

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[44] Quoted in Weisman, "Sovereign wealth funds resist IMF attempts to draft code of conduct,"
[45] Based on comparing first quarter and second quarter scores on the Linaburg-Maduell Transparency Index, available at http://www.swfinstitute.org/research/transparencyindex.php.
[46] Deborah Solomon, "Paulson to Putin: You Say Potato, I Say Sovereign Wealth Fund," *Wall Street Journal* online, June 30, 2008.
[47] Bertrand Benoit, "Germany warned of clash on 'Cfius' plan," *Financial Times*, August 5, 2008.

and public sector officials. The preferences of capital importers matter more than capital exporters, and the principal markets for inward investment remain the OECD economies. In this kind of standards situation, agreement by the largest markets can trigger a cascade effect of cooperation by other market participants (Simmons 2001; Drezner 2007, chapter five). The United States and European Union articulated very similar preferences over SWF standards in early 2008. This similarity of views, combined with the divergent preferences of most SWF home countries, suggests a club standards outcome (Drezner 2007, pp. 75-79). The combined market size of a great power concert will induce most recalcitrant states into shifting their standards.

The decision by GIC and ADIA to comply with U.S. requests for transparency is consistent with this argument. It appears these funds agreed to the voluntary principles as a way of preventing further strictures on cross-border investment. GIC's deputy chairman explained, "The greatest danger is if this is not addressed directly, then some form of financial protectionism will arise and barriers will be raised to hinder the flow of funds."[48] A few days before the policy principles were articulated, Abu Dhabi's director of international affairs wrote an open letter to the *Wall Street Journal* stressing the importance of an open investment climate.[49] In August, an Arab League affiliate issued a report urging acceptance of a code of conduct, arguing that it would alleviate Western pressure to reduce restrict SWF activity.[50] Survey evidence also indicates that sovereign wealth fund managers believed there was a linkage between agreeing to a code of conduct and warding off investment protectionism (Norton Rose 2008).

The SWF threat of withdrawal from OECD markets is largely a hollow one in the short term. While the OECD economies – and prominent firms within these jurisdictions – might need SWF investment, it is equally true that capital exporters need America and Europe to keep their jurisdictions open to capital inflows. 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 – remain the only ones deep and liquid enough to absorb inflows in the trillions of dollars. As Johnson (2007) points out, the total value of all traded securities in Latin America, Africa and the Middle East is less than $8 trillion. Sovereign wealth funds cannot invest sizeable amounts of their portfolios in emerging markets without incurring excessive risk. Furthermore, the very countries that are bulking up their sovereign wealth funds at the moment are the most protectionist when it comes to inward foreign investment (Koyama and Golob 2006; Ziemba 2007; Schönberg 2008; Government Accountability Office 2008).

A warning note

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[48] Peter Thal Larsen and Martin Dickson, "Singapore Fund Pledges Greater Transparency," *Financial Times*, January 27, 2008.
[49] Yousef al Otaiba, "Our Sovereign Wealth Plans," *Wall Street Journal*, March 19, 2008.
[50] Nadim Kawach, "SWFs still face risk of Western curbs," Emirates Business 24/7, August 1, 2008. The Inter-Arab Investment Guarantee Corporation issued the report.

The emergent regime on sovereign wealth funds suggest that the established powers and institutions in global financial governance are "not dead yet," to quote Monty Python.[51] On the financial dimension, the rise of the BRICSAM countries would not appear to presage a serious disruption in the global political economy. The home countries of sovereign wealth funds have not balanced or organized against the G-7 effort to create a regime to govern their behavior.

The emergent regime lends some credence to John Ikenberry's (2008) argument that existing global governance structures can accommodate the rise of the non-West. Three notes of caution should be sounded, however. First, the creation of this emergent regime rests on traditional source of power – namely, market size. The challenge for global financial governance will be what happens once other countries develop capital markets equal in size to the OECD economies (Drezner 2008b).

Second, while sovereign wealth funds cannot radically withdraw their assets from OECD markets, they can shift their portfolios over time. During this calendar year, a number of sizeable funds have announced intentions to increase their investments in East Asia and other emerging markets.[52] 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."[53] As economists point out, this trend would be consistent with these funds trying to increase their rate of return from exposure to greater risk (Beck and Fidora 2008; IMF 2008). The fall in the value of the dollar, and the deepening of the housing market crisis, has exacerbated this investment trend. Both Russia and China have pledged to diversify their holdings away from the United States.[54]

The more that sovereign wealth funds bypass OECD markets, the more "go-it-alone" power that they possess (Gruber 2000). Indeed, as Barma, Ratner and Weber (2007) point out, non-OECD economies are developing ever-greater economic linkages that do not rely upon the advanced industrialized states. The G-7/OECD/IMF/IWG process might matter in the short run. In the long run, the more that sovereign wealth funds diversify away from Western markets, the less they need to adhere to Western rules.

There is final, more sobering consideration. Changes in policy, technology and the distribution of power are shifting the cooperation game in finance to more closely resemble the cooperation game in security studies. The emergence of sovereign wealth funds needs to be considered in the context of other changes in the global political economy. As Lipson (1984) pointed out 25 years ago, a key explanatory factor for higher levels of cooperation in the global economy was the absence of tight coupling. Historically, the effect of a powerful actor defecting from the rules of the game does not

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[51] http://www.youtube.com/watch?v=grbSQ6O6kbs.

[52] Reuters, "Kuwait's KIA looking at Asian Investment," July 17, 2008; Gulf Daily News, "Sovereign wealth funds boosting Mideast IPOs," July 11, 2008;

[53] Quoted in William Pesek, "Chrysler Building May be Aberration," Bloomberg, July 23, 2008.

[54] 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; Reuters, "Media mudslinging scares Russian oil wealth managers," Reuters, August 1, 2008; "China Sovereign Fund Spreads the Wealth," Forbes.com, July 9, 2008.

usually have a dramatic and immediate effect in international economics. The globalization of financial markets, combined with the re-emergence of powerful state actors, changes this equation. As Summers (2006) points out, there are geopolitical concerns that come with the "financial balance of terror" created by current macroeconomic imbalances.

The shifting of government assets from central banks to sovereign wealth funds and state-owned enterprises exacerbates these concerns. Transparency measures cannot completely erase concerns about the capabilities and intentions of powerful sovereign actors (Garten 2007; Truman 2008; Miracky et al 2008, p. 49). These concerns, combined with the tight coupling of today's financial markets, will cause the incentive structures in global finance to more closely resemble those of international security. This does not mean that the financial equivalent of World War III will take place. It does mean, however, that policymakers must be increasingly cognizant of that contingency.

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FIGURE 1

CHARACTERISTICS OF SOVEREIGN WEALTH FUNDS