In Praise of Foreign Investment

Best practices for the sovereign wealth funds.

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International investment in the United States fuels the U.S. economy by creating well-paid jobs, importing new technology and business methods, and providing healthy competition that fosters innovation, productivity gains, lower prices, and greater variety for consumers. President Bush reiterated the long-standing U.S. commitment to open investment in his May 10, 2007, "Statement on Open Economies," where he affirmed that "[O]ur prosperity and security are founded on our country's openness."

Sovereign wealth funds have attracted significant attention recently, due in large part to their rapid growth in number and size. This growth undoubtedly brings with it implications for the international financial system. However, it is troubling that these developments have also stimulated protectionist pressures that threaten the important open investment policies that allow for greater prosperity throughout the world.

Sovereign wealth funds, as large pools of government-controlled capital invested cross-border in private markets, do raise legitimate policy questions. While greater vigilance is appropriate, it is necessary to ensure a clear understanding of sovereign wealth funds, and consider carefully the implications of their growth, before prescribing a policy response.

WHAT IS A SOVEREIGN WEALTH FUND?

The U.S. Treasury has defined sovereign wealth funds as government investment vehicles funded by foreign exchange assets, and managed separately from official reserves. Sovereign wealth funds generally fall into two categories: commodity funds, which are established through commodity exports, either owned or taxed by the government; and non-commodity funds, which are typically established through transfers of assets from official foreign exchange reserves. Large balance-of-payments surpluses have enabled non-commodity exporting countries to transfer "excess" foreign exchange reserves to stand-alone funds.

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Hank Paulson's Dinner Date with the Sovereign Wealth Funds

The U.S. Treasury Department helped initiate these efforts last October, when Secretary **Henry Paulson** hosted a G7 outreach dinner with finance ministers and heads of sovereign wealth funds from eight countries: China, Kuwait, Norway, Russia, Saudi Arabia, Singapore, South Korea, and the United Arab Emirates. The participants expressed a common interest in maintaining open investment and promoting financial stability.

—R. Kimmitt

It is important to distinguish sovereign wealth funds from other sources of sovereign investment, as many have often confused the activities of sovereign wealth funds with those undertaken by state-owned enterprises or other entities. While there are similarities among these entities, there are some important differences.

■ International reserves are external assets that are readily available to and controlled by finance ministries and central banks for direct financing of international payment imbalances. Reserves are by definition generally invested in highly liquid and marketable securities.

Total sovereign wealth fund assets are only a fraction of the estimated $190 trillion in global financial assets or the roughly $62 trillion managed by private institutional investors.

■ Public pension funds are investment vehicles funded with assets set aside to meet the government's future entitlement obligations to its citizens. They differ from sovereign wealth funds in that they are denominated and funded in local currency, usually with relatively low exposure to foreign assets.

■ State-owned enterprises can be defined as enterprises where the state has significant control, through full, majority, or significant minority ownership. State-owned enterprises may undertake foreign direct investment and occasional portfolio investments, but the majority of state-owned enterprises do not invest abroad.

THE SIZE AND GROWTH OF SOVEREIGN WEALTH FUNDS

While sovereign wealth funds have been around since the 1950s, their recent and rapid growth has created a great deal of interest, and raised some concerns. In 2000, there were about twenty sovereign wealth funds managing total assets of several hundred billion dollars. Twenty new funds have been created since 2000, more than half of them since 2005. Those funds currently manage total assets of between $2 trillion and $3 trillion, and their assets are projected to grow in the range of $10 trillion to $15 trillion by 2015.

Total sovereign wealth fund assets are only a fraction of the estimated $190 trillion in global financial assets or the roughly $62 trillion managed by private institutional investors. But sovereign wealth funds assets are currently larger than the total assets under management by both hedge funds and private equity funds (estimated at $1.5 trillion and $700 billion, respectively).

Sovereign wealth funds are already large enough to be systemically important, and their growth warrants a calibrated and thoughtful response.

SOVEREIGN WEALTH FUND CONCERNS

As large pools of government capital invested in private markets, sovereign wealth funds raise several important issues. First, do they perpetuate undesirable underlying macroeconomic policies? Countries should not use these funds as a mechanism to accumulate more foreign assets to avoid exchange rate appreciation. Second, what is the potential impact of these funds on financial stability? Sovereign wealth funds are in principle long-term, stable investors who can provide liquidity to markets. However,

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they also represent large, concentrated—and often non-transparent—positions in financial markets. Third, are sovereign wealth fund investment decisions made on commercial grounds consistent with free-market principles?

Finally, do investment decisions by sovereign wealth funds have national security implications? The Committee on Foreign Investment in the United States (CFIUS), which is chaired by the Secretary of the Treasury, reviews foreign direct investments into the United States that may raise genuine national security considerations. It conducts its reviews in a manner that both safeguards national security and reinforces the U.S. commitment to open investment.

POLICY CONSIDERATIONS

The Department of the Treasury has been leading an effort with other U.S. agencies and our international counterparts to develop an appropriate policy response that addresses both financial stability issues and works to maintain an open investment climate. In this vein, we have considered two sets of principles: one for sovereign wealth funds and another for recipient countries of sovereign wealth fund investment.

Sovereign wealth funds should invest commercially, not politically. They should convey institutional integrity through transparent investment policies, strong risk management systems, governance structures, internal controls, and respect for host-country rules. They should compete fairly with the private sector by complying with regulatory and disclosure requirements.

Countries that receive sovereign wealth fund investment should avoid protectionism. They should uphold fair and transparent investment frameworks that do not direct sovereign wealth funds on how to invest their money and that treat investors equally. Countries' investment policies and processes, especially those involving national security considerations, should be predictable and nondiscriminatory, and the rules should be publicly disclosed.

The principle of reciprocity—reciprocal openness to investment—is not among the principles above, despite the fact that many countries with sovereign wealth funds are themselves far too closed to foreign investment. We in the United States believe it is in our interest to be open to market-driven investments even if other countries are not. However, the reality is that public support for open investment policies is in part a function of a broader political context in which reciprocity is an important factor.

BEST PRACTICES

Taking the principles above into consideration, the United States has suggested that two sets of voluntary best practices be developed. The International Monetary Fund, with support from the World Bank, is well positioned to develop voluntary best practices with the sovereign wealth funds, by building on its existing best practices for foreign exchange reserve management. And the Organisation for Economic Co-operation and Development, based on its extensive work on promoting open investment regimes, is well positioned to identify best practices for countries that receive foreign government-controlled investment.

It is imperative to have a policy discussion now to combat rising protectionism.

These best practices would provide guidance, help demonstrate to critics that sovereign wealth funds can continue to be responsible, constructive participants in global markets, and reduce any potential systemic risk.

The U.S. Treasury Department helped initiate these efforts last October, when Secretary Henry Paulson hosted a G7 outreach dinner with finance ministers and heads of sovereign wealth funds from eight countries: China, Kuwait, Norway, Russia, Saudi Arabia, Singapore, South Korea, and the United Arab Emirates. The participants expressed a common interest in maintaining open investment and promoting financial stability. The International Monetary Fund's work is currently underway, and they envision a release of their best practices this fall. The Organisation for Economic Co-operation and Development, meanwhile, is proceeding well with its own work to provide guidance on inward investment policy for countries that receive sovereign wealth fund investment.

The increase in sovereign wealth fund cross-border investment is projected to continue, as sustained high commodity prices and accumulation of official reserves continue to fuel sovereign wealth fund growth. Given that, it is imperative to have a policy discussion now to combat rising protectionism and ensure continued global financial stability.

So far, it appears that sovereign wealth funds are seeking to generate higher investment returns without generating political controversy. If sovereign wealth funds continue on this path, investing on a commercial—not political—basis, the United States and other countries will continue to benefit from keeping their borders open to sovereign wealth fund investment. ◆