# Sovereign Wealth *Alarm*

**BY STEFAN SCHÖNBERG**

*Will the big sovereign wealth fund surge lead to European protectionism?*

After hedge funds and private equity firms, European policymakers have been eyeing lately another source of foreign capital deemed dangerous for the well-being of their economies: sovereign wealth funds, a loose term to describe state-owned investment pools playing an increasingly significant—and controversial—role in cross-border investment. While assets held by governments in another country's currency are nothing new under the sun, the size of sovereign funds fed by "excess" foreign exchange reserves, accumulated by emerging market economies but not needed for short-term currency stabilization and liquidity management, has increased dramatically over recent years.

The International Monetary Fund estimates that presently such funds have \$2–\$3 trillion under management, and that their total size could reach some \$10 trillion by 2012.

Sovereign wealth funds are a symptom of two phenomena: high oil and other commodity prices, and global macroeconomic imbalances. Both are set to stay for some time. While countries such as Russia and Saudi Arabia, significant exporters of oil and gas, will continue to profit from the rise in com-

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modity prices, non-commodity exporting developing countries running big current account surpluses, like China, are accumulating vast amounts of foreign exchange reserves looking for longer-term investment.

What is giving headaches to European policy-makers is not only that a major proportion of the assets administered by sovereign wealth funds is concentrated in the hands of a small number of countries, mainly China, Russia, Norway, Singapore, and the major oil-exporting countries in the Middle East. There are, above all, misgivings about the ultimate intentions of foreign governments running such funds. Concerns are growing in Europe (and elsewhere among industrial countries) that the purpose of the investments might be to secure control of strategically important industries for political rather than financial gain. Also, the risk of an unwelcome transfer of sensitive technology has been cited if "key industries" in EU countries are being targeted by sovereign wealth funds.

In line with such concerns, European policymakers have demanded legal protection for sensitive industries against takeovers by foreign state-run investment funds. German Chancellor Angela Merkel, for instance, called such funds, worth double- or even triple-digit billions, a "new element" on international capital markets to which appropriate responses were needed. Also other European governments, the European Commission, and the European Central Bank have raised concerns, often diffuse, over the influence of sovereign funds.

However, what may appear a reasonable reaction to the European public, already worried by globalization and alerted by policymakers about the supposed risks involved in the activities of foreign hedge funds ("locusts") and private equity companies ("raiders"), poses in fact a threat of backlash against the financial liberalization of the past decades. Protective measures against sovereign wealth funds also involve difficult issues in practice. On close inspection, it is becoming clear that neither the object to be protected, nor the risks against which protection is sought, nor the identity of the attacker, can be defined on the basis of unambiguous criteria.

### WHO SHOULD BE PROTECTED?

Apart from the defense industry, the usual industries cited as needing protection are energy, telecommunication, ports, information technology and other high-tech industries, and "natural monopolies" such as railways and postal services. However, what may constitute a sensitive ("strategic") industry today may not be regarded as such an industry tomorrow, and vice versa. Also, should all companies operating in these areas be protected or just those beyond a certain size or market share?

In view of these issues, governments tend to prefer non-enumerative definitions of "strategic" industries. The German government, for instance, has just recently presented a draft bill offering the option to the minister of economics of vetoing foreign investments in German

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companies exceeding 25 percent of their capital if such investments "represent a danger to the public order and security." Clearly, such a definition would be opening up broad opportunities for interpretation and arbitrariness. It would also represent a starting point for protectionistic lobbying on the part of industries coming under pressure from foreign investors.

Russia, for its part working for some time on an "investment law" protecting strategic industries, is an example of such risks. The draft law presently under discussion by the Duma lists thirty-nine industries, including such obscure branches as enciphering, industrial fishing, and development and processing of metals with military applicability. If the plan of including the Russian oil and gas industry is also realized, as demanded by interested parties, industries constituting together more than 50 percent of the Russian GDP would be "protected" against foreign investment.

## AGAINST WHICH RISKS SHOULD "STRATEGIC" INDUSTRIES BE PROTECTED?

The empirical evidence available lends little support to worries that state-run investors are investing for political gain at the expense of an appropriate return on their investment. In any case, it would be difficult to substantiate such an objective beforehand. Also, sovereign wealth funds have typically not been buying controlling stakes in strategically important industries. They are mostly engaged in sectors that face plenty of competition and are subject to national antitrust, reporting, and corporate governance requirements.

Contrary to some claims, state-owned investment vehicles, though widely unregulated, do not appear to constitute major new risks for the national or international financial system, either. The International Monetary Fund observes that sovereign funds usually pursue buy-and-hold strategies, have long-term horizons, are little leveraged, and, like other long-term investors, are willing to step in when asset prices fall. These characteristics are likely to exert a stabilizing influence on the financial system. In any case, they contrast quite favorably with the long-standing European preoccupation with short-term, "speculative" capital flows leading, among other things, to proposals for a tax on exchange market transactions.

When European policymakers talk of the "risks" of certain varieties of capital flows, they often rather express unease over the tremendous increase in cross-border asset holdings—sovereign or private—and their lack of control over the corresponding flows. They tend to forget that in a global economy few major companies are owned exclusively domestically, that sovereign wealth funds constitute a welcome source of capital for the corporate sector in industrial countries, that big balance-of-payments surpluses must be recycled, preferably in a long-term, sustained way, and that the international community has urged exporters of non-renewable resources for many years to build up, for less prosperous days, just the sort of funds for which now access limits are being considered.

## AGAINST WHOM SHOULD STRATEGIC INDUSTRIES BE PROTECTED?

There are sovereign wealth funds, and then there are sovereign wealth funds. Some funds publish information about their assets and liabilities, their management structure, and their investment strategies, while most do not.

One fund, usually applauded by European policymakers on account of its transparency, is the Government Pension Fund of Norway, administering some $320 billion in foreign assets. By mouse click, everybody can get information via Internet on the extent the fund is engaged in more than three thousand foreign companies. In most cases, the fund's share in their capital is below 1 percent, while the maximum share allowed by its statutes is 5 percent.

Nonetheless, the Norwegian fund is not acting as "apolitically" as it may appear. Via its participation in foreign companies, it is fostering such objectives as good corporate governance, environmental protection, and equal gender principles. One of the fund's spectacular moves was its exit from the U.S. supermarket chain Wal-Mart in November 2005, citing accusations that Wal-Mart had violated child labor laws and scuttled efforts by employees to unionize.

Other sovereign wealth funds, above all those domiciling in Russia and Asia, operate in a much murkier way, combining cash richness with rough business practices. Does that mean, however, that they are violating strategic interests of their host countries or withdrawing know-how from European companies?

*Targeting currency manipulation would be a more convincing objective than financial protectionism.*

The difficulties of differentiating between "good" and "bad" money is illustrated by the fact that several sovereign wealth funds have invested part of their money in hedge funds located in the United States and Europe. A prominent example is the multibillion-dollar investment by China Investment Corporation in Blackstone, a U.S. private equity group. In this way, is "bad" Chinese state-owned money transformed into "good" American private capital?

### HOW TO PROTECT SENSITIVE INDUSTRIES?

Concerns about the motives and practices of sovereign wealth funds have led policymakers in a number of OECD countries to consider different proposals. U.S. representatives have proposed that the International Monetary Fund and the World Bank should draw up codes of conduct that would keep politics out of investment decisions and require funds to share information about the composition of their portfolios and their investment strategies. Academics have made various other proposals destined to foster the appropriate institutional arrangements, transparency, accountability, and behavior of sovereign wealth funds.

The European Union, still unsure about whether to outlaw national defenses or to establish them at EU level, is considering whether to allow its members to use some kind of "golden share," held by their governments. Companies would then be shielded from takeovers their governments don't want. But such barriers involve high potential economic costs, particularly for a country, like Germany, which as "world champion in exports" and with outward direct investment exceeding inward investment substantially, has to rely on open markets. With several EU countries trying to protect "national champions" and France having listed eleven "strategic sectors" immune to foreign takeovers, such a move would further raise barriers in the European Union which are already too high.

Germany has proposed that the European Union should introduce a vetting procedure for foreign takeovers, modelled on the U.S. Committee on Foreign Investment, screening and possibly rejecting purchases of American companies by foreigners on national security grounds. But progress on the EU level is slow, hindered by disagreement over procedures and what is relevant for national security, and by the need to get agreement of twenty-seven member states.

Against that background, several EU countries are considering setting up their own rules. By doing so, they are at risk of venturing too far into protectionistic territory. The German draft law, for instance, would protect sensitive industries not only against state-owned investment vehicles but against any acquisition of protected industries by a foreign investor, even if "foreign" means that a non-resident investor owns at least 25 percent of the entity seeking the acquisition.

Protective measures planned by individual EU member countries could also run into conflict with the European Community treaty protecting the freedom of capital movements and the right of foreign investors of acquiring stakes in European companies. Whether such rules would be in accord with World Trade Organization rules is another open question.

### WHAT TO DO?

European countries, like other countries, have legitimate national security interests.

However, any potential move must avoid the impression that European governments, in an arbitrary fashion, pick and choose which country is allowed to invest in what. In order to preempt solo efforts of

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individual EU member countries creating unnecessary and counterproductive barriers, the European Union should take the initiative in favor of a common, non-protectionist approach. As far as national mechanisms for screening sovereign wealth fund investments remain in place, they must be used as a last resort option and only where national security is under threat.

One way of easing fears about the motivations of sovereign wealth funds would be to induce these investment vehicles to become more transparent. The European Union should promote constructive discussions in the relevant international bodies determining which kinds of information about their balance sheets, management structures, investment objectives, portfolio breakdowns, and so forth should be supplied by sovereign wealth funds. The European Union could then put curbs on funds failing to comply with the standards for the publication of such information.

Another way of fostering the acceptability of sovereign wealth fund investment is reciprocity. General curbs to foreign investment could provoke retaliation by other countries and could end up in a protectionist race. A better way would be to tell countries harboring major sovereign wealth funds that they must open their own corporate sector to European investments if they want to invest in Europe.

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Lastly, instead on symptoms, the European Union should concentrate more on the causes of sovereign wealth fund growth. By tying their currencies to the U.S. dollar, major Asian and Middle East countries are preventing the revaluation of their currencies needed for keeping their rising surpluses in check. In this situation, targeting currency manipulation would be a more convincing objective than financial protectionism. ◆