

Who's Afraid of Sovereign Wealth Funds?

Even as central banks around the world shore up financial institutions battered by the US sub-prime mortgage crisis, a debate has begun about the longer-term consequences of the crisis and what it means for the global financial system.

One of the lesser known aspects of this debate is the role of Sovereign Wealth Funds (SWFs) in rescuing troubled banks, and the implications for foreign investment policy in industrialized countries.

Sovereign wealth funds are government-owned investment vehicles that are funded by foreign exchange assets. The IMF estimates that foreign assets held by sovereign governments include US\$5.6 trillion of international reserves and between US\$1.9-2.9 trillion in SWF-type arrangements.

Since the crisis broke in August 2007, SWFs have placed as much as USD\$45B in equity to help repair the crippled balance sheets of many global banks. These deals include investments in Citigroup by the Abu Dhabi Investment Authority and the Government of Singapore Investment Corporation (GIC), worth \$7.5B and \$6.88B respectively; investments in Merrill Lynch by Singapore's Temasek Holdings, the Korean Investment Corporation, and the Kuwait Investment Authority, worth approximately US\$10B combined; and bailouts in December of Morgan Stanley by the China Investment Corporation (US\$5B) and of UBS AG by GIC (\$9.8B).

One would have expected that the provision of long-term capital to distressed financial institutions at a time of economic slowdown would be a cause for celebration in the centers of global capitalism. On the contrary, these deals have been received with much angst. The US is leading the way with calls from politicians of all stripes for special limits and controls on SWFs and on state-owned enterprise investment in general.

Canada is not exactly a hotbed for foreign state-led investment, but in December 2007, Industry Minister Jim Prentice introduced additional criteria for the review of foreign state-owned enterprises (SOEs) investing in Canada. The new criteria will look at the corporate governance practices of SOEs and whether these entities will operate on a "non-commercial" basis. Minister Prentice has also promised a set of rules for the review of foreign investors on "national security" grounds.

But if transparency and good corporate governance are to be the standards for foreign investment in Canada, why should these principles apply differently to state-owned and non-state owned companies? And if they don't apply differently, why make the distinction?

The specter of "non-commercial" or "strategic" investments by foreign governments has a superficial plausibility to it, but applying these concepts to the review of specific investment proposals is a much trickier proposition. Is corporate social responsibility a "non-commercial" practice? Will business decisions that don't maximize shareholder value in the short term be considered "strategic" and therefore deemed offside? In any case, if it were possible to define these unacceptable business practices, surely they would apply to state-owned and non state-owned entities alike? There is a vast body of domestic regulation that is already in place to deal with anti-competitive behavior.

It is hard to avoid a suspicion that the recent concern around SWFs and state-owned enterprise investment has to do with the source of funds and the fact that these monies are controlled by regimes considered to be unsavoury. In the case of China, there is the added (but unspoken) concern that the People's Republic is a rising global power that has the potential to challenge American influence.

The idea of foreign state-owned investment poses a special ideological challenge for economic liberals who, on the one hand, argue for free trade and open investment policies, across borders and who, on the other hand, are reflexively against state ownership of productive resources. According to this logic, if it is bad economics for Ottawa to nationalize a Canadian business icon, wouldn't the same acquisition by a foreign state-owned enterprise be just as unpalatable?

This logic is not so simple from the investor's perspective. In Beijing, for example, there is a view that the West has for decades lectured China about the merits of open markets, including the need for free capital movements. The People's Republic has responded with a program of progressive economic liberalization over the past 25 years, including accession to the WTO under terms that were more stringent than for any previous new developing country member. That industrialized countries would now impose special restrictions on Chinese state-owned enterprise and SWF investment seems hypocritical at best.

The success of Asian economies over the years was never about just the invisible hand. The state has played a strategic role in shaping and cajoling economic development in many Asian countries – for better or worse -- and SWFs are a natural and legitimate extension of that role. They are also a product of export-led growth in Asia that has not only provided North American consumers with cheap manufactured goods, but also the (low-cost) financing of American consumption. SWFs are simply a different way of recycling current account surpluses and, in effect, putting capital to work.

SWFs would clearly inspire confidence in host countries if they were more transparent and had stronger corporate governance. It is in their interest to work with international bodies, such as the IMF and OECD, to develop a code of conduct that conforms to the norms of institutional investment. Governments, in turn, should resist singling out SWFs for special scrutiny under domestic foreign investment review laws. At a time when risk capital is scarce, the world needs more SWF investment, not less.

Debra Steger is Professor of Law at the University of Ottawa, and Yuen Pau Woo is President and co-CEO of the Asia Pacific Foundation of Canada.