Research Article

Sovereign Wealth Funds: An Assessment

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Abstract

High oil prices and impressive economic performance in emerging markets have led to the accumulation of massive financial assets. These nations have created sovereign wealth funds (SWFs) to manage their growing assets. SWFs have provided significant liquidity to American and European financial institutions. The rise of SWFs in number and size has raised concern about their objectives and strategies. This study examines the role these state-owned funds play in the global markets and the efforts to regulate their activities. I argue that capital exporting and importing nations share common interests and reciprocal responsibility in ensuring global financial prosperity.

Policy Implications

- Sovereign wealth funds are currently important players in the international financial system and are projected to become even more influential in the future.
- Sovereign wealth funds investments are driven more by commercial interests and less by political objectives.
- The interests of capital exporting and capital importing nations are not mutually exclusive. Rather, both seek economic prosperity and political stability.
- Too much regulation of sovereign wealth funds' activities is likely to weaken cross-border trade and investment.
- Sovereign wealth funds should gain the confidence of host countries by accepting a high level of transparency.

In the early part of the 2000s, the world witnessed a two-fold dramatic redistribution of global wealth. First, the surge of oil prices (up to July 2008) meant that oil-producing nations accumulated massive revenues. Similarly, emerging markets, particularly China, continued their impressive economic growth. Meanwhile, developed countries, like the United States and some European countries, built up substantial current account deficits. To put it another way, there had been a massive inflow of capital from the latter to the former. Consequently, oil producers and emerging markets emerged as major creditors to the world and to industrialized countries in particular. Second, a substantial share of this new wealth is owned and managed by governments, not by the private sector. This emerging and growing framework is at sharp variance with today's general conception of a market-based global economy and financial system in which decision making is largely in the hands of private agents, principally pursuing commercial interests.

Seeking to invest their excessive foreign exchange reserves, oil producers and emerging markets have established sovereign wealth funds (SWFs). The idea that governments should put some money aside for a rainy day is not new. In 1953 Kuwait founded one of the first funds to invest its oil revenues. Following the surge in oil prices of the 1970s and early 1980s, other producers set up their own funds. Since the late 1990s several oil nations and other commodities exporters in Asia have followed suit. SWFs have emerged as 'symbols of a major global economic and financial rebalancing of power' (Santiso, 2008, p. 1).

This rise in the number and size of SWFs needs to be examined. Although SWF holdings ($2–3 trillion) are still relatively small in comparison with total global financial assets ($190 trillion), they are significant relative to both mature market economies' stock market capitalization ($39.2 trillion) and emerging market economies' debt ($17.8 trillion) (International Working Group of Sovereign Wealth Funds, 2008a, p. 3). About 46 per cent of sovereign assets are held by funds in the Middle East, followed by 29 per cent of assets by Asian funds and the rest held by funds in Russia, Norway and Africa (Deutsche Bank Research, 2008a, p. 4). SWFs are likely to become even more important in the future. The International Monetary Fund (IMF) estimates that foreign assets under management of SWFs could reach $6–10 trillion by 2013 (Allen and Caruana, 2008, p. 6).

The tremendous growth of SWFs and the diversification of their portfolios have attracted heightened attention from markets, policy makers and the media. Indeed, one important element in the changing global economy is the increasing prominence of SWFs from a wide range of home countries. Their rapid expansion, however, has fueled a certain amount of anxiety. They bring benefits to the system, but also raise serious concerns. Since the early 2000s western policy makers and the general public have been surprised by the emergence of financial powerhouses from oil exporters and emerging markets, while these investors have been shocked by the antagonistic reception they have received in the United States and some European countries (i.e. France and Italy).

Generally, most markets welcome foreign investment; however, when the source of this investment is foreign governments, concerns intensify. The role of SWFs in the international financial system has become a major focus of national and international policy because of the potential implications of their massive investments. The list of potential risks includes: (1) governments might mismanage their international investments to their own economic and financial detriment and with negative consequences for the global economic and financial system; (2) SWF investments might be driven by political objectives; (3) suspicion of SWFs might lead to the rise of protectionism in host countries; and (4) the shift from private to public financial assets might contribute to market turmoil and uncertainty (Truman, 2007a, p. 5).

This study examines the role SWFs play in the international financial system. In the first section I provide a definition of these funds and how they differ from other investment vehicles. This will be followed by a close examination of funds from oil exporting nations. In the third section I analyze the portfolios and targets of SWFs. The main concerns of both host and home countries are discussed in the fourth section. The differences and similarities between European and American efforts to regulate SWFs are highlighted in the fifth section. In the concluding section I discuss the future role of SWFs, particularly in the light of the global economic crisis in the last part of the 2000s. The main argument is that despite serious and legitimate concerns, SWFs are likely to continue to play a positive role in the international financial system. They serve important economic needs in both their home countries and western markets. Rigid regulations are likely to disrupt these mutual interests. Rather, the implementation of a voluntary code of conduct, ideally by all funds, would serve the interests of all parties.

Sovereign wealth fund: a definition

There is no simple, universally accepted definition of SWFs. Researchers at Deutsche Bank define these funds as 'financial vehicles owned by states which hold, manage or administer public funds and invest them in a wide range of assets of various kinds' (Deutsche Bank Research, 2008b, p. 2). Their holdings are derived mainly from excess liquidity in the public sector stemming from government fiscal surpluses or from official reserves at central banks. Two types of SWF can be identified, based on their primary purposes. First, stabilization funds aim to address the intense fluctuation of revenues a country receives from exporting natural resources and/or to balance major changes in foreign exchange conditions. Second, saving or intergenerational funds aim to spread the returns on a country's natural resources across generations.

The United States Department of Treasury defines SWF as a 'government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities' (United States Department of Treasury, 2007, p. 1). The Department of Treasury divides SWF into two categories, based on the source of the foreign exchange assets. First are commodity funds established through commodity exports which serve different purposes, including stabilization of fiscal revenues, intergenerational saving and balance of payment sterilization. Second are noncommodity funds, typically established through transfers of assets from official foreign exchange reserves. Large current account surpluses have enabled noncommodity exporters, particularly in Asia, to transfer excess foreign exchange reserves to stand-alone funds.

The International Monetary Fund defines SWFs as 'special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets' (International Working Group of Sovereign Wealth Funds, 2008a, p. 3). The holdings of the SWFs come from balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses and/or receipts resulting from commodity exports. Analysts at the IMF identify five types of SWF based on their main objective: (1) stabilization funds where the primary objective is to insulate the economy against commodity price swings; (2) savings funds, which aim to benefit future generations; (3) reserve investment corporations, which are established to increase the return on reserves; (4) development funds, which typically support the fund's socioeconomic projects; and (5) contingent pension reserve funds, which provide for contingent pension liabilities on the government's balance sheet (International Monetary Fund, 2008, p. 2).

These definitions suggest that SWFs are a heterogeneous group with multiple purposes. Generally they share a few defining characteristics. They are state-funded long-term investments that accept a higher level of risk in search of higher returns.

Oil funds

The rise of SWFs is closely associated with the rise of oil prices in the early part of the 2000s. The price of a barrel of oil rose from $25.02 in 2002 to $72.39 in 2007 (British Petroleum, 2008, p. 16). This almost tripling of prices led to an unprecedented accumulation of revenues by major oil producers. The total revenues of members of the Organization of Petroleum Exporting Countries (OPEC) rose from $197.2 billion to $674.9 billion during the same time span (Energy Information Administration, 2008, p. 1). This rapid accumulation of massive financial resources created an environment under which major oil producers were not able to absorb the amount of wealth they were generating. Investing abroad was seen as a rational choice to maximize their profits. SWFs were established to pursue these objectives. To put it another way, the tripling of oil prices worked like a tax on consumers around the world. Much of the incremental price that they paid ended up in the investment funds in oil exporting countries. Most of these funds are then recycled out to global financial markets.

In 2006, oil exporting countries became the largest source of net global capital flows in the world, surpassing Asia for the first time since the 1970s (Farrell and Lund, 2008, p. 1). Most SWFs do not disclose information on their holdings and portfolios. Consequently, no comprehensive official figures exist. In 2006 financial assets of major oil producing countries (including the Middle East, Norway, Russia and Venezuela) were estimated to be between $3.4 and $3.8 trillion (Farrell and Lund, 2008, p. 2). Some analysts suggest that even if oil prices were to decline to $30 per barrel, these oil fund assets would still grow at an average rate of 6 per cent annually to reach $4.8 trillion in 2012 (Farrell and Lund, 2007a, p. 12). Almost half of all sovereign assets are held by funds in the Middle East. The region represents the highest concentration of SWF assets worldwide.

It is important to point out that this massive oil wealth provides both risks and opportunities. The rise of oil revenues may lead to the so-called 'Dutch disease'. This term refers to the tendency for large resource revenues to appreciate the real exchange rate, which then damages the non-resource-tradable sector. Furthermore, the volatility of oil prices means that the revenue stream is uncertain. The collapse in oil prices since July 2008 has underscored this vulnerability. In the short term the decline in global demand for oil means low prices and diminishing revenues. In the medium to long run, the world economy and demand for energy will grow and the fortune of oil producers is likely to improve.

The international financial crisis has impacted on almost all economies. According to one estimate the market value of the Arabian Peninsula's sovereign funds fell by $350 billion over the course of 2008 (Council on Foreign Relations, 2009, p. 1). This massive loss of assets has ignited intense debates both among creditors in the Gulf and receiving markets in Europe and the United States. In several oil-producing countries some policy makers argue that their SWFs should focus on rescuing domestic economies and address local investments like infrastructure projects. In line with this argument, the Kuwait Investment Authority (KIA) pumped $418 million into Gulf Bank, the country's fourth largest traded lender, after it suffered heavy derivatives trading losses. The KIA also allocated $5.2 billion in a government fund to support the bourse (Critchlow, 2009). Similarly, the Qatar Investment Authority (QIA) raised its stakes in local listed banks to between 10 and 20 per cent to shore up their balance sheets (England, 2009). The orientation of the funds has changed. The onus is now on financing needs at home. Others argue that SWFs should take advantage of opportunities in cheap overseas assets. These overseas investments, however, have become increasingly more conservative, shifting away from the volatile equity markets to fixed-income assets.

On the other hand, in receiving markets policy makers have been divided on how to approach SWFs under the dire economic crisis. Given the current capital scarcity, many American and European firms feel the need to consolidate further their ties to foreign investors and take more steps to attract more investments. Some government officials are concerned that the collapse in market valuations will allow SWFs to acquire important western companies 'on the cheap' (Barysch et al., 2008, p. 11).

To sum up, the international financial crisis has slowed down the rise of SWFs and made them more cautious and selective in their cross-border investments. Nevertheless, these state-controlled vehicles will remain major players in the global economy, with billions of dollars to invest in a variety of markets all over the world.

Traditionally, North American and European companies have been the targets of choice for SWF investments, particularly those in the United States and the United Kingdom. This choice reflects and reinforces close strategic and historic ties between the two sides. Furthermore, western markets have enjoyed a high level of political stability and predictable legal and financial systems. This SWF concentration on investing in western markets, however, has increasingly shifted to emerging markets in Asia, particularly China and India. Several economic and political factors have contributed to this gradual change. In the last two decades emerging markets have enjoyed much higher economic growth rates than American and European economies. Thus, the rates of return on investments in emerging markets have proven very attractive financially. Equally important, due to terrorist attacks in Europe and the United States, some Muslims and Arabs have been victims to stereotyping and travel restrictions. Some western policy makers are suspicious of Muslim and Arab investments. They have called for the issue of new regulations to govern foreign investments. SWF investments in emerging markets face very few, if any, of these hurdles. Finally, the growing privatization of public enterprises in several Middle Eastern countries and the proliferation of Islamic financial institutions have created investment opportunities and attracted capital that would previously have been invested abroad.

SWFs used to invest in safe but low-return Treasury bills. In recent years, this portfolio has dramatically changed. Most SWFs have diversified their holdings and acquired assets in private equity, real estate, hedge funds and commodities. The financial sector in particular has appealed to several SWFs. In aggregate, financial institutions have been the main beneficiaries of SWF investments (Deutsche Bank Research, 2008b, p. 7). Abu Dhabi Investment Authority (ADIA) and the KIA invested in Citigroup and the latter invested in Merrill Lynch. Some SWFs may have hoped that by assisting giant western financial institutions they could dispel some of the concerns that had been publicly expressed about their investment strategies and motivations. Another potential motive could be to gain access to expertise, build up asset management and deepen domestic capital markets.

Several SWFs have expressed interest in investment products that comply with shariah (Islamic law) and the financial institutions that issue them (i.e. Islamic banks). The nascent but fast-growing Islamic finance sector has been an important target for SWF investments. Islamic investment principles prohibit the charging or paying of interest, which is considered a form of usury. Islamic finance represents a small fraction of the global financial services industry. The biggest Islamic banks are in the Persian Gulf – Dubai Islamic Bank, Kuwait Finance House and Saudi Arabia's al-Rajhi Bank. Even there, Islamic assets are outstripped by conventional ones. Islamic banks and financial products are growing in Europe and the United States as well. Given the large and growing Muslim minorities in Europe, several European countries have taken an interest in Islamic finance. The United Kingdom is the headquarters of several Islamic financial institutions. In 2004, the German state of Saxony-Anhalt issued a 100 million euro sovereign Islamic bond.

SWFs have also invested in automotive, aerospace, metals, mining and energy firms (Ziemba, 2008, p. 9). Most of these investments are riskier but are expected to yield higher returns. It is important to point out that SWFs have learned to avoid high-profile investment in the strategic sector. In 1987 the KIA bought more than 20 per cent of British Petroleum (BP), at that time recently privatized. The UK Monopolies and Mergers Commission decided that this large share would constrain BP from acting competitively. As a result, the KIA reduced its shareholding to 9.9 per cent.

To sum up, SWFs have diversified portfolios and pursued different strategies to manage their assets. Their investment choices have significant impact on the economic well-being of their population and financial markets around the world. A sensible management of SWFs' huge assets is in everyone's interest. The future of SWF investments will be shaped largely by the volatility of oil prices, investment strategies and how recipient markets react to them. The rise of state funds has provoked anxieties.

The argument for and against SWF investments

The rise of SWFs in global financial markets in the early 2000s and the projected significant role they are likely to play in the foreseeable future have ignited an intense debate about their impact on the economies of home countries, recipient nations and the international financial system. Proponents of SWFs argue that these state funds contribute to economic development in their home countries (OECD, 2009). The funds have long-term investment horizons, high tolerance for risk and generally have no commercial liabilities; therefore they are well placed to withstand market pressures in times of crisis, contribute to stabilizing financial markets (Almunia, 2008, p. 2) and provide new sources of liquidity for global capital markets. In addition to these financial benefits, proponents argue, SWFs consolidate peaceful relations between nations by facilitating interdependence between home and recipient countries (Behrendt, 2008, p. 2). As one observer put it, 'investment across borders binds us together by creating actors with much to lose from political tension' (Kay, 2008).

Despite these real and potential advantages of SWFs, the fact that they are owned and managed by governments, not private entities, raises a number of serious concerns. First, they may be driven less by commercial interests and more by strategic considerations. They may seek to acquire certain technology or target certain sensitive sectors (such as energy or defense). Large cross-border holdings in official hands are at sharp variance with today's general conception of a market-based global economy and financial system in which decision making is largely in the hands of numerous private agents pursuing commercial objectives (Truman, 2007b, p. 1). Second, policy makers in Europe and the United States are not only concerned that the SWFs' investments are state owned and state managed, but also that most of these SWFs originate in countries that largely do not adhere to western ideals of democracy and the free market. In other words, there is a lack of reciprocity. The sets of values under which western governments and markets operate are different from those held by the owners of SWFs. Tables 1, 2 and 3 compare the United States and the United Kingdom (as the largest recipients of SWFs investments) with the major state owners of these funds. The figures illustrate the disparity between most

Table 1. Political freedom scores

Country	Political rights	Civil liberties	Freedom rating
China	7	6	Not free
Libya	7	7	Not free
Saudi Arabia	7	6	Not free
Algeria	6	5	Not free
Iran	6	6	Not free
Qatar	6	5	Not free
Russia	6	5	Not free
United Arab Emirates	6	5	Not free
Singapore	5	4	Partly free
Kuwait	4	4	Partly free
Norway	1	1	Free
United Kingdom	1	1	Free
United States	1	1	Free

Note: The lower these scores are, the better a country is performing to protect rights.
Source: Freedom House, 2008, pp. 6–11.

Table 2. Economic freedom scores

Country	Economic Freedom score
Singapore	87.1
United States	80.7
United Kingdom	79.0
Norway	70.2
Qatar	65.8
Kuwait	65.6
United Arab Emirates	64.7
Saudi Arabia	64.3
Algeria	56.6
China	53.2
Russia	50.8
Iran	44.6
Libya	43.5

Note: The higher these scores are, the better a country is performing on economic freedoms.
Source: Heritage Foundation, Index of Economic Freedom, 2009, pp. 1–4.

Table 3. Corruption Perception scores

Country	CPI Score
Singapore	9.2
Norway	7.9
United Kingdom	7.7
United States	7.3
Qatar	6.5
United Arab Emirates	5.9
Kuwait	4.3
China	3.6
Saudi Arabia	3.5
Algeria	3.2
Libya	2.6
Iran	2.3
Russia	2.1

Note: The higher these scores are, the better a country is performing to combat corruption.
Source: Transparency International, Corruption Perceptions Index 2008, pp. 3–7.

SWF owners (with the exception of Norway and Singapore) on one side and recipient countries (the United Kingdom and the United States) on the other.

Third, very few SWFs publish information about their assets, management and investment strategies. This lack of transparency reinforces recipients' suspicion and concern (Farrell and Lund, 2007b, p. 38) and promotes a culture of corruption. Transparency can be defined in terms of: (a) clarity of roles and responsibilities; (b) public availability of information; (c) open budget preparation, execution and reporting; and (d) assurances of integrity (International Monetary Fund, 2005, p. 8). Three areas of transparency can be distinguished: governance structure (i.e. who owns and manages the funds and what are the procedures for auditing and supervision?); investment objectives (i.e. what are the goals and the time horizon to pursue them?); and investment strategy and implementation (i.e. what is the size of the fund, asset composition, risk limits and returns?) (Skancke, 2008, p. 6). A high degree of transparency would establish and maintain public support on how oil revenues are invested. It would also alleviate political suspicion in recipient countries and contribute to stable international financial markets.

Transparency and accountability practices for funds differ across oil-producing countries and emerging markets. There is no uniform public disclosure of the assets, strategies and governance of SWFs. While most funds reveal very little information, Norway is leading the way in disclosure. Indeed, western officials have often cited Norway's Government Pension Fund-Global as a model for other SWFs to follow. Kristin Halvorsen, Norway's Minister of Finance, explains the philosophical guide of the country's fund:

> A high degree of transparency is essential to be able to build and maintain support for the government's management of the petroleum wealth, which entails running large budget surpluses and building up substantial and very visible financial assets in order to meet large unfunded pension liabilities in years to come (Halvorsen, 2008, p. 2).

Norway's model of high level of transparency and openness, however, is unlikely to be followed by others. The approach to disclosure of oil funds' assets and investments often mirrors general attitudes to public sector transparency. As Halvorsen emphasized, 'Our transparency is very connected to the transparency of Norwegian society. It is a part of our tradition that other countries do not have' (Dougherty and Bennhold, 2008).

A country's Corruption Perceptions Index (CPI) score indicates the degree of public sector corruption as perceived by businesspeople and country analysts, and ranges between 10 (highly clean) and 0 (highly corrupt).

In closing this section, four conclusions need to be highlighted. First, the more transparent the resources flowing to the public sector, the more difficult it may be to misuse them. In other words, more transparency leads to less corruption. Second, the need for increased transparency has to be balanced against legitimate business interests. In any firm there are certain aspects of management that, based on pure business consideration, are not made public. Thus, there is a need to strike a balance between the public's right to know and legitimate management practices. Third, it is likely that sovereign investors will make progress towards more transparency, but this progress will be gradual and incomplete. Its pace will vary among countries and it will not eliminate recipient countries' concerns about their security (Roller and Veron, 2008, p. 6). Fourth, transparency runs both ways; recipient markets' call for openness should be balanced by disclosure of information on any restrictions or discriminatory actions on SWF investments in Europe and the United States.

Against this background, SWF owners have worked with the United States and European governments as well as with the International Monetary Fund to reach a consensus on a mutually accepted set of regulations that would ensure the continuing flow of foreign investment to global markets without subjecting SWFs to unfair restrictions.

Regulations

In the early part of the 2000s SWFs injected billions of dollars into some of the world's biggest investment banks and provided vital liquidity for world financial markets. The growing visibility of state investments from oil producers and emerging markets has heightened a sense of anxiety among policy makers and the general public in several western countries. Will these recently acquired stocks in major US and European companies by Middle Eastern and Asian investors be transformed into economic and political leverage?

Two important caveats should be taken into consideration regarding this rising anxiety. First, to date there is no evidence that SWFs pursue any political objectives. Rather, all indicators suggest that their investments are largely driven by commercial interests. Second, SWFs do not operate in a legal vacuum. Almost every country in the world already has a comprehensive regime that regulates the entry of foreign capital and investment into the domestic economy. These regimes include quantitative and qualitative limitations on foreign investments, vetting mechanisms for foreign capital, restrictions on foreign ownership of land and assets in certain sectors, and discriminatory rules in competition policy and taxation.

In addition to these regulations adopted by individual countries, there have been collective efforts by a number of states to establish guidelines to govern foreign capital. Top officials from major industrial countries have sought to reach a consensus on rules to govern investments by SWFs. In October 2007, finance ministers from Britain, France, Germany, Italy, Canada, Japan and the United States met in Washington, DC and confirmed their agreement that cross-border investment was generally a major contributor to robust global growth (Weisman, 2007). Concerned about these state-owned investments, the finance ministers asked the IMF and the Organization for Economic Cooperation and Development (OECD) to participate in setting rules of conduct for SWFs.

The United States

In general, the United States welcomes foreign investment, including from SWFs, viewing it as a useful means to strengthen the economy, improve productivity, create jobs and spur healthy competition. According to the Department of Treasury, foreign investment supports nearly 10 million US jobs directly or indirectly, 13 per cent of research and development spending and 19 per cent of exports, and pays 30 per cent higher compensation than the US average (US Department of Treasury, 2007, p. 3).

Traditionally, SWFs have invested in US Treasury bills. According to Ben Bernanke, Federal Reserve chairman, in 2008 about a third of emergency funding for financial institutions came from Asian and Arab SWFs (Woertz, 2008). However, the decline of the US dollar in the greater part of the 2000s has prompted SWFs to shift part of their investments into buying stakes in companies. Some of the high-profile deals include Abu Dhabi's acquisition of a $7.5 billion stake in Citigroup, Kuwait's capital injection into Merrill Lynch and China's purchase of part of the Blackstone Group. This increasing visibility has ignited public demand for more scrutiny. Given the severe and deep-rooted financial crisis and the growing need for foreign investment, the challenge facing US officials is how to alleviate public skepticism while encouraging SWFs to keep investing. In order to reach such a compromise, Washington has pursued a twofold strategy: issuing new laws and amending existing ones to further scrutinize foreign investment; and working with SWFs to endorse guidelines on best practices.

In May 1975 President Gerald Ford issued an executive order 11858 – Foreign Investment in the United States, creating the Committee on Foreign Investments in the United States (CFIUS). The CFIUS, an interagency committee chaired by the Secretary of Treasury, seeks to serve US investment policy through thorough reviews that protect national security while maintaining the credibility of open investment policy and preserving the confidence of foreign investors in the United States and of American investors abroad that they will not be subject to retaliatory discrimination.

In 2007 the Congress passed a new law – Foreign Investment and National Security Act (FINSA), Public Law 110-49 that mandates additional scrutiny and higher-level clearances for transactions involving foreign government control. FINSA extends the range of transactions open to CFIUS review, expands the definition of national security so as to include transactions involving critical infrastructure, energy assets and critical technology, increases Congressional oversight and enables CFIUS to reopen a reviewed transaction if mitigation measures are materially breached. This additional scrutiny comes in the context of provisions for greater certainty for investors, more accountability from the US administration and better communication between CFIUS and Congress (Kimmitt, 2008, p. 116).

In March 2008 the United States Department of Treasury reached an agreement on principles for SWF investment with the governments of Singapore and Abu Dhabi and their respective funds, Government Investment Corporation and Abu Dhabi Investment Authority. The two sides endorsed reciprocal policy principles for SWFs and for the receiving countries.

The European Union

The free movement of capital between individual European countries and between them and third parties was a core principle in the creation of the European Union. The European Community Treaty clearly spells out the policy on foreign investment. Article 56 states: 'All restrictions on the movement of capital between member states and between member states and third countries shall be prohibited'. Under exceptional circumstances the European Council 'may take safeguard measures for a period not exceeding six months'. Meanwhile, member states maintain the right to restrict foreign investment 'on ground of public policy or public security' (European Union, 2009).

Unlike the United States, there is no agency responsible for the vetting of investments at the EU level. Instead, European leaders have sought to engage in a cooperative dialogue with SWFs and their sponsor states. The goal of such dialogue is to ensure greater clarity and insight into the governance of SWFs and to deliver a higher level of transparency on their activities and investments. If this low-key approach of devising a voluntary code proved ineffective, José Manuel Barroso warned, the EU would draft laws that could block investments from the funds (Dougherty and Castle, 2008).

In February 2008 the European Commission issued a Communication highlighting the main themes of Europe's stance on SWFs. The Communication was approved at a summit of the EU leaders the following month. The European leaders confirmed their view that the generally long-term strategic outlook of SWFs can contribute to stability in the international financial system. They also underscored that SWFs do not operate in a legal vacuum. In Europe, between the EU and the member state level, there exists a comprehensive regime to regulate the establishment and the actions of foreign investors, which covers SWFs in exactly the same way as any other investor. As soon as they invest in European assets, SWFs have to 'comply with the same EU and national economic and social legislation that any other investors have to respect' (European Commission, 2008, p. 4).

Organization for Economic Cooperation and Development (OECD)

OECD officials have expressed their support for SWF investments and their confidence that the guidelines, those already in place and newly negotiated ones, would further strengthen cooperation between the two sides. According to Angel Gurria, OECD Secretary-General, SWFs have much to offer. 'Their recent injections of capital into several OECD financial institutions were stabilizing. They help to recycle savings internationally and generally have a good track record as long-term investors' (Gurria, 2008a, p. 2). Javier Santiso, Director and Chief Development Economist, echoes the same sentiment: 'Far from being a threat to the OECD financial system, SWFs could be allies in the struggle to stimulate development and support donors as development finance partners' (Santiso, 2008, p. 1).

For a long time the OECD has engaged in multilateral negotiations to forge a consensus on comprehensive guidelines to regulate foreign investment. These guidelines are laid down in two documents: the OECD Code of Liberalization of Capital Movements, adopted in 1961, and the OECD Declaration on International Investment and Multinational Enterprises of 1976, as revised in 2000.

The OECD Code of Liberalization of Capital Movements underscores the need for a consultative process where 'understanding and persuasion have greater weight than pressure and negotiation' (OECD, 2003, p. 3). The Code's main principles include: (a) standstill: members accepted that they may not introduce new barriers; (b) rollback: liberalization is the principal objective even if members may achieve it gradually through abolishing restrictions over time and according to their individual situation; (c) nondiscrimination: where restrictions exist, they must be applied to everybody in the same way; and (d) transparency: information on the barriers to capital movements should be complete, up to date, comprehensible and accessible to everyone (OECD, 2003, pp. 5–7).

The OECD Declaration on International Investment and Multinational Enterprises has periodically been reviewed (1979, 1982, 1984, 1991 and 2000). It contains four interrelated elements: the guidelines for multinational enterprises provide voluntary principles and standards for responsible business conduct addressed to multinational enterprises; the national treatment instrument sets out member countries' commitment to accord to foreign-controlled enterprises operating in their territories treatment no less favorable than that accorded to domestic enterprises in like situations; an instrument on international investment incentives and disincentives provides for efforts among member countries to improve cooperation on measures affecting international direct investment; and an instrument on conflicting requirements calls on member countries to avoid or minimize conflicting requirements imposed on multinational enterprises by governments of different countries (OECD, 2000, p. 20).

The Code of Liberalization of Capital Movements and the Declaration on International Investment and Multinational Enterprises illustrate that the OECD has played a leading role in articulating a policy on the free movement of capital. Not surprisingly, finance ministers of the Group of Seven (G7) called on the OECD to develop guidance for recipient countries' policies toward investments from SWFs. Follow-up on this mandate has been undertaken as part of the Investment Committee's project on 'Freedom of Investment, National Security and Strategic Industries' and has benefited from the participation of non-OECD countries. The Freedom of Investment project involves the 30 OECD members, the European Commission and other partners including Brazil, China, India, Russia and South Africa. Governments that have SWFs were invited. The project is independent from, but complements, efforts carried out by the IMF to develop voluntary best practices for SWFs (OECD Investment Committee, 2008, p. 3). Participants in the freedom of investment project agreed on a number of principles to safeguard national security without creating a hostile environment for foreign investment. These principles include nondiscrimination, transparency/predictability, regulatory proportionality and accountability.

In June 2008 the OECD Ministerial Council adopted the Declaration on SWFs and Recipient Country Policies. The ministers welcomed the benefits that SWFs bring to home and host countries and agreed that protectionist barriers to foreign investment would hamper growth. They expressed their support for the work at the IMF on voluntary best practices for SWFs as an essential contribution and welcomed the continuing cooperation between the OECD and the IMF (OECD, 2008, p. 4). They also noted that home countries of SWFs and the funds themselves can enhance confidence by taking steps to strengthen transparency and governance (Gurria, 2008b, p. 1).

International Monetary Fund

Recognizing the growing importance of SWFs and the role of the IMF in monitoring the health of its member countries' economies and the global financial system, the IMF's ministerial guidance body – the International Monetary and Financial Committee – called on the Fund to engage in a dialogue with all concerned parties to arrive at a voluntary set of best practices in the management of SWFs. The IMF had developed similar guidelines in the past, particularly in the areas of fiscal transparency and foreign exchange reserves management. In response, the International Working Group (IWG) was established in April 2008. Its goal was to identify and draft a set of generally accepted principles and practices (GAPP) that properly reflect SWF investment practices and objectives. With the direct input of SWFs via the IWG, the GAPP aimed to promote a clear understanding of the institutional framework, governance and investment operations of SWFs that continue to support the maintenance of an open and stable investment climate globally (International Working Group of Sovereign Wealth Funds, 2008b, p. 2).

The IWG held three meetings in Washington, DC, Singapore and Santiago (Chile), respectively, and in October 2008 it issued a list of 24 generally accepted principles and practices, also known as Santiago Principles. The GAPP covers three key areas: (a) legal framework, objectives and coordination with macroeconomic policies; (b) institutional framework and governance structure; and (c) investment and risk management framework. The list highlights the need for clear and publicly disclosed policies, rules, procedures in relations to the SWFs' general approach to funding (principle 4); the accountability framework for the SWFs' operations should be clearly defined in the relevant legislation, charter and other constitutive documents (principle 10); dealing with third parties should be based on economic and financial grounds and follow clear rules and procedures (principle 14); and SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate (principle 15). It is important to underscore that the IMF does not have the authority to enforce these principles. Rather, the funds themselves are likely to set up some kind of loose oversight arrangement.

Sovereign wealth funds' response

Officials from SWF states have frequently expressed their strong frustration and disappointment at the recipient countries' attempts to regulate their activities and the political backlash they face in Europe and the United States. They point out, with good cause, that they are helping to stabilize Western financial markets with their investments and that their capital is welcome in times of trouble but 'frowned upon when less urgently needed' (Khalaf, 2008). An official in the Saudi Arabian Monetary Agency sums up the sentiment: 'It is like the SWFs are guilty until proven innocent' (Cha, 2008). Specifically, SWF executives warn against four potential trends: their business record, discrimination, protectionism and oil prices.

First, SWF executives argue that a close examination of their track records demonstrates their abstention from political interference and that their investments are exclusively driven by commercial interests. They challenge politicians in the US and Europe to name a single investment that was made for political reasons. In short, they claim, fears of SWFs are unjustified. Second, SWFs argue against rigid regulations that would restrict their activities. Given that private equity and hedge funds have attracted less attention and are under few restrictions, SWFs accuse western governments of singling them out.

Third, SWFs are concerned that the tight scrutiny of their activities could fuel sentiments of economic nationalism and trigger protectionist measures against the free flow of foreign capital. Such a scenario would have disastrous consequences for the global economy and the financial international system. Fourth, if investments from oil-related SWFs in international financial markets are restricted, the relative attractiveness of saving in the form of keeping oil underground would increase. To put it another way, faced with limited investment opportunities, oil producers could find it more profitable to cut their production. Such a scenario would push prices higher and add pressure on global energy and financial markets.

Conclusions: the way forward

In closing, three questions need to be addressed: what impact do SWFs have on their own home countries? On recipient markets? And on the global system? An accurate evaluation of SWF activities suffers from several shortcomings. The number of government funds, though growing, is still small. Most SWFs were created in the last decade and the majority of them do not disclose information on their management and strategies. This suggests that any generalization on the role SWFs play in their home countries would be ambivalent. They can improve or worsen the management of public assets. What is clear is that SWFs should be well integrated in a broader sound fiscal policy.

For the recipient markets, the experience in the recent financial turmoil suggests that SWFs have had a stabilizing impact through the substantial injections of billions of dollars into several large banks and financial institutions by Asian and Middle Eastern government funds. Furthermore, it is hard to find any case where SWFs have abused their power and sought political interference in host countries. Indeed, it seems that the anxiety in Europe and the United States owes less to reality than to a mix of secrecy and suspicion.

Foreign investment, including from SWFs, seems to have a positive role in the international system both economically and politically. It contributes to recycling international financial assets, improved technology, intensifying competition and generating jobs, among other things. Strategically, the free flow of trade and capital reinforces bonds of mutual dependence or financial interdependence between capital importing and exporting nations. This means that all parties share stakes in global economic prosperity and political stability. In other words, when China, Russia and Kuwait invest in Europe, Japan and the United States the chances for a peaceful resolution of international conflicts are higher than the chances of using military force. Mutual economic interdependence makes going to war more costly.

In the foreseeable future, how SWFs choose to allocate their assets will have a significant impact on job creation, fiscal policy and the overall economic development both in their home countries and in the recipient ones as well as on the global financial system. These choices hold both opportunities and risks. It is in all parties' interests to reach a consensus on constructive approaches to ensure the free flow of capital and to alleviate concerns over transparency and political intervention.

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