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Are SWFs Welcome Now?

by
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Until the end of 2007, western media, governments and regulators often seemed more concerned about protecting domestic firms from investments by sovereign wealth funds (SWFs) than about attracting capital inflows. Politicians in many countries called for the regulation of sovereign foreign investments at that time, when SWF investments were growing rapidly. In fact, during 2006 and 2007, countries that introduced at least one regulatory change (many of them related to such investments) making the investment climate less welcoming for multinational enterprises accounted for 40% of all FDI inflows.[1]

In early 2008, attitudes began to change, as SWFs temporarily rescued the western banking system by purchasing approximately $60 billion of new equity issued by U.S. and European banks. As the financial crisis deepened, western financial firms displayed an ever increasing appetite for foreign capital. At the same time, sources of the latter dried up rapidly, with a decrease in total FDI in 2008 of around 15%. Investment in OECD countries by SWFs declined throughout 2008, totaling $37 billion during the first quarter, $9 billion during the second and $8 billion during the third.[2] A handful of factors brought about this decline. Low commodity prices and the underperformance of previous investments led to a shrinking asset and funding base even as a renewed emphasis on more conservative asset classes and domestic investments dramatically reduced the proportion of assets invested in foreign equity.

The ongoing need for capital by the western financial system, coupled with the sudden drop in foreign investments by SWFs, is leading to a dramatic shift in attitudes. Rather than discouraging SWF capital inflows, Western governments and firms are actively seeking sovereign direct

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[1] Karl P. Sauvant, "Driving and countervailing forces: a rebalancing of national FDI policies," in Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy 2008-2009* (New York: Oxford University Press, 2009), pp. 239-240.

[2] William Miracky et al. "Sovereign wealth fund investment behavior: analysis of sovereign wealth fund transactions during Q3 2008," Monitor Company Group Publications (2008).

investment, and public calls for opening financial markets to SWFs now abound.[3] Whereas observers once feared an excessive push toward the regulation of foreign investment and a consequent stifling of FDI inflows into OECD countries, these fears have been allayed in part by the adoption of the Santiago Principles by both the major SWFs and the principal Western nations that now seek SWF capital.

Today, we are again facing the risk of overreaction, but in the opposite direction: security concerns, certainly overplayed in the past, are being sidelined. Yet, previous calls for protectionism and current appeals to open markets completely both lack the support of empirical evidence, as very little is known about the impact of SWF investments on target firms and recipient economies. Accordingly, we believe that the most important step for governments is to promote the analysis of SWF investments and their impact on target firms, with the goal of developing the body of knowledge necessary for the formulation of the proper regulatory response. In doing so, we recommend the following guiding principles:

- *The burden of proof should fall on those calling for restricting access to national markets*. While we recognize the need for further investigation, we note that, despite over a half-century of SWF activity, there are no examples of politically charged or otherwise detrimental (to recipient economies) SWF investments. At the same time, the benefits associated with long-term, stable investments are obvious.
- *Beware of excessive transparency*. Regulators have singled out SWFs for their lack of transparency. Yet, many other investment vehicles, such as hedge funds, are just as opaque. While transparency is, in general terms, desirable, transparency imposed on select market participants can put those at a serious disadvantage and lead to unprofitable trading; in fact, evidence indicates that SWF profitability is inversely related to their transparency.[4] Any measure aimed at increasing transparency should not be targeted at any specific class of investors. SWFs need to provide information to regulators, but should not be subject to any further transparency requirements in respect to other market participants.
- *Act multilaterally - involve the World Trade Organization along with the IMF*. Past experience with FDI regulation suggests that multilateral action is more effective than bilateral agreements. Accordingly, we urge regulators to act in concert. The International Monetary Fund (IMF) brokered the Santiago Principles last year, and should remain involved in negotiations between SWFs and investee nations. Another international body that naturally emerges as a candidate for assuming a true regulatory role is the World Trade Organization (WTO), as it already enforces the General Agreement on Trades in Services which covers most SWF investments.
- *Remember that SWFs are not all equal*. Governments must realize that SWFs are a heterogeneous group. They vary dramatically in respect to size, funding, objectives, investment style and sophistication. Accordingly, regulators should resist the temptation to restrict SWFs unduly in the event of a fund "misbehaving." Regulation should, a priori, treat all SWFs equally, but any ad-hoc response should affect the offending fund, rather than the entire category.

Formulating the proper regulatory response requires striking a fine balance between the need for foreign capital and the danger of foreign governments interfering in sensitive sectors of the economy. Yet, while the benefits are clear, the risks are not yet understood. Unfortunately, a global financial crisis and recession is not the best time for the development of a cool-headed, rational,

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[3] For example, Organisation for Economic Co-operation and Development, "Sovereign wealth funds and recipient country policies," OECD Investment Committee Report (2008) and Warren Buffet, "Letter to the shareholders of Berkshire Hathaway Inc." (2008).

[4] Bernardo Bortolotti, Veljko Fotak, William Megginson, and William Miracky, "Sovereign wealth fund investment patterns and performance," Fondazione Eni Enrico Mattei Working Paper, mimeo (2009).

regulatory response, but the actions of western governments during this period are likely to shape the landscape of FDI for years to come. In the short term, we urge regulators to rely on existing FDI restrictions, already ensuring the avoidance of the most pernicious scenarios, and on SWF self-regulation, while encouraging the study of SWF investments.

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Vale Columbia Center on Sustainable International Investment (VCC), led by Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

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