

# Sovereign Wealth Funds and the (in)Security of Global Finance<sup>1</sup>

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## Introduction

Sovereign wealth funds (SWFs) sit at the intersection of high finance and high politics. Their net worth is currently estimated to exceed \$3 trillion – more than the value of all private equity or hedge funds.<sup>2</sup> Their explosive growth of these funds raises regulatory and geopolitical concerns. The Deputy Treasury of the Secretary wrote in *Foreign Affairs* earlier this year that, “SWFs are already large enough to be systematically significant.... they are likely to grow larger over time, in both absolute and relative terms.”<sup>3</sup> Many policy analysts argue that SWFs are symptomatic of shifts in the global distribution of power away from the advanced industrialized states and towards authoritarian capitalist governments in the developing world.

Are these fears of sovereign wealth funds justified? In most respects, the growth of sovereign wealth funds has marginal effects on American national security and foreign policy. SWFs are a symptom of other national ailments – persistent macroeconomic imbalances and a failure to diversify America’s energy supply. As symptoms go, however, sovereign wealth funds are relatively benign in their foreign policy effects. If anything, these investments demonstrate the complex interdependence of the Pacific Rim and Middle East with the American economy. Some negative policy externalities come with these funds, however; their growth will significantly impair democracy promotion efforts in the developing world.

## Concerns about sovereign wealth funds

I will define sovereign wealth funds as *government investment vehicles that acquire international financial assets to earn a higher-than-risk-free rate of return*. They are not

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<sup>2</sup> These categories are far from mutually exclusive; sovereign wealth funds account for 10% of private equity investments globally.

<sup>3</sup> Robert Kimmitt, “Public Footprints in Private Markets,” *Foreign Affairs* 87 (January/February), p. 121

a recent invention – Kuwait created the first modern fund in 1953. What is new about SWFs is their recent investment trends and countries of origin.

To seek higher rates of return, sovereign wealth funds have shifted from bond and index funds to assets that carry greater risk. SWF cross-border mergers and acquisitions more than doubled between 2006 and 2007.<sup>4</sup> They have also been attracted to “alternatives” such as hedge funds, derivatives, leveraged buyout firms, and real estate. There are reports that sovereign wealth funds are increasingly big speculators in commodity futures markets.<sup>5</sup> Sovereign funds based in Bahrain and Dubai have begun to leverage themselves in order to make bigger overseas acquisitions.<sup>6</sup>

Although the concept of a sovereign wealth fund is not new, close to half of the top forty SWFs have been created since 2000. In the past two years, Saudi Arabia, Russia and China created large sovereign wealth funds. Press reports indicate that Brazil, India and Nigeria will create new funds in the near future. Two kinds of governments are pumping money into sovereign wealth funds: commodity exporters and countries running fiscal and trade surpluses. Commodity-exporting countries hold approximately two-thirds of total SWF assets. For the oil exporters, the incentive to create a sovereign wealth fund is three-fold. First, these economies want to create assets that ensure a long-term stream of revenue to cushion themselves against the roller coaster of commodity booms and busts. As many economists have observed, these countries are simply converting assets extracted from the earth into a more liquid form. Second, many of these governments are trying to build up reserve funds for the day when all of the oil is extracted from below ground. Third, by focusing on foreign investments, these governments are attempting to forestall the Dutch disease of rapidly appreciating currencies. Overseas investment via sovereign wealth funds can accomplish all of these tasks.

Export engines are also using sovereign wealth funds to keep their currencies fixed at a low par value. As of 2007, China had accumulated more than \$1.8 trillion in foreign assets in order to prevent the renminbi from appreciating too rapidly. This keeps Chinese exports competitive in the United States. More than 80% of these assets exist in the form of foreign exchange reserves – i.e., safe investments with very low rates of return. As these reserves have accumulated, so have the opportunity costs of amassing dollars in such low-yield investments. According to some estimates, the cost is close to \$100 billion a year.<sup>7</sup> This explains the 2007 creation of the China Investment Corporation. Sovereign wealth funds more of an effect than a cause of the macroeconomic imbalances that have led to the massive, decade-long increase in all government controlled assets.

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<sup>4</sup> Marko Maslakovic, “Sovereign Wealth Funds 2008.” International Financial Services, London, April 2008.

<sup>5</sup> David Cho, “Sovereign Funds Become Big Speculators,” *Washington Post*, August 12, 2008.

<sup>6</sup> Duncan Kerr, “Arab Sovereign-Wealth Funds Dip a Toe in the Debt Pool,” <http://blogs.wsj.com/deals/2008/08/13/arab-sovereign-wealth-funds-dip-a-toe-in-the-debt-pool/>, accessed August 15, 2008.

<sup>7</sup> Dani Rodrik, “The Social Cost of Foreign Exchange Reserves,” *International Economic Journal* 20 (Summer 2006): 253-266.

The growth of sovereign wealth funds have provoked a variety of policy concerns, ranging from their effects on corporate governance to fears of a protectionist backlash. Underlying these myriad issues are the twin problems of transparency and sovereignty. Compared to mutual funds or pension funds, the transparency of most sovereign wealth funds ranges from bad to worse.<sup>8</sup> The largest sovereign wealth fund, for example, is the Abu Dhabi Investment Authority (ADIA). An institution that has in existence for more than thirty years has yet to reveal its fund size, portfolio structure, performance, or investment objectives. Until earlier this year, ADIA's official website was confined to a single page containing no financial information; it now consists of several web pages containing no financial information.

The lack of transparency is problematic when combined with the size and sovereignty of these investment vehicles. SWFs are, by definition, extensions of the state. They are therefore viewed as maximizing their country's long-term strategic interests rather than as profit-maximizing actors. Even defenders of sovereign wealth funds as responsible financial actors acknowledge that some SWFs might have strategic objectives in their pattern of acquisitions. The funds themselves have repeatedly insisted that they merely seek to maximize their rate of return. Nevertheless, the perception among financial actors diverges from the self-perception of SWFs. A recent survey of global financial institutions revealed that private actors viewed sovereign funds as more likely to seek strategic interests than maximizing their financial returns – even though SWF respondents stressed the latter over the former.<sup>9</sup>

Without a clear read on the intentions of sovereign wealth funds, their actions have the potential to roil financial markets. As Alan Greenspan pointed out, the strongest check against financial misbehavior is “counterparty surveillance” – the incentive of investors to make sure that their investment funds are acting prudently and profitably.<sup>10</sup> The trouble with sovereign wealth funds is that, in most cases, there is no counterparty surveillance. In the best-case scenario, like Norway, democratically-elected parliaments must approve changes in investment strategies. This kind of oversight is consistent with the spirit of counterparty surveillance. In places like the Russia and China, however, the lack of transparency, oversight and accountability is much more problematic.

There are several means through which sovereign wealth funds could, theoretically, influence the policies and capabilities of recipient countries. The most direct means could take place through direct ownership and control of strategic sectors or critical infrastructure.<sup>11</sup> SWFs could sabotage the firms they purchase, crippling the recipient country's capabilities. Leverage could also be exercised through the threat of investment withdrawal. Indeed, the president of the Chinese Investment Corporation warned the *Financial Times* this year that, “there are more than 200 countries in the world. And,

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<sup>8</sup> Edwin Truman, “A Blueprint for Sovereign Wealth Fund Best Practices,” Peterson Institute for International Economics Policy Brief PB08-3, April 2008.

<sup>9</sup> “Sovereign Wealth Funds and the Global Private Equity Landscape,” Norton Rose, June 2008. Accessed at <http://www.nortonrose.com/knowledge/publications/2008/pub15287.aspx?page=all&lang=en-gb>.

<sup>10</sup> Alan Greenspan, *The Age of Turbulence* (New York: Penguin, 2007).

<sup>11</sup> Gal Luft, “Selling Out: Sovereign Wealth Funds and Economic Security.” *The American Interest* 3 (July/August): 53-56.

fortunately, there are many countries who are happy with us.”<sup>12</sup> Alan Tonelson articulated a similar concern earlier this year: “If, for example, the Chinese government held significant stakes in a large number of big American financial institutions, especially market-makers, and if our nation’s current period of financial weakness persists, how willing would Washington be to stand up to Beijing in a Taiwan Straits crisis?”<sup>13</sup>

Leverage can also be exercised more subtly, through the cooptation of domestic interests within recipient countries. As previously observed, SWFs have acquired ownership stakes in many Western financial institutions. Private equity and hedge funds rely on SWF investments for a significant fraction of their capital. Even if these sovereign wealth funds adopt a passive investment posture, it is hard not to believe that some implicit degree of cooptation would not take place. For example, after receiving a \$3 billion investment from China’s sovereign wealth fund, the CEO of Blackstone wrote an op-ed in the *Financial Times* warning against any measures to block SWF investment, comparing such steps to the Smoot-Hawley tariff.<sup>14</sup>

Even without direct ownership, financial institutions can profit from harmonious relations with SWFs, through consulting and asset management contracts.<sup>15</sup> For example, State Street Global Advisors – who coined the term “sovereign wealth fund” – has an Official Institutions Group that manages approximately \$270 billion in assets from more than 70 government clients. With sovereign wealth funds sitting on so much capital, the financial sector will tend to lobby politicians in their home countries on behalf of these entities. Since these firms represent a powerful interest group within the OECD economies, they could act as a conduit to blunt policy responses to SWFs.

From an American perspective, the authoritarian cast of the fastest-growing sovereign wealth funds is an additional source of concern. Sovereign wealth funds based in authoritarian countries theoretically possess two advantages over SWFs based in democratic countries. First, consistent with their regime type, authoritarian SWFs would be expected to be less transparent, allowing them to act with greater agility. Second, because authoritarian societies are better able to suppress dissent, they should be able to make investments that might be unpopular in the short-term but yield much greater long-term rewards. Some analysts are concerned that the “patient capital” of capitalist authoritarian states could cause their SWFs to act in a more strategic and a more profitable manner.

This leads to the final, more existential policy concern. As a long-term development model, sovereign wealth funds are viewed as one component of a possible rival to liberal

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<sup>12</sup> Quoted in Jamil Anderlini, “China fund shuns guns and gambling,” *Financial Times*, June 13, 2008.

<sup>13</sup> Alan Tonelson, testimony before the U.S. China Economic and Security Review Commission hearing on the Implications of Sovereign Wealth Fund Investments for National Security, February 9, 2008. Accessed at [http://www.uscc.gov/hearings/2008hearings/written\\_testimonies/08\\_02\\_07\\_tonelson\\_statement.php](http://www.uscc.gov/hearings/2008hearings/written_testimonies/08_02_07_tonelson_statement.php), February 2008.

<sup>14</sup> Stephen Schwarzman, “Reject sovereign wealth funds at your peril.” *Financial Times*, June 19, 2008.

<sup>15</sup> Andy Mukherjee, “Sovereign Wealth Funds a Boon for Asset Managers,” Bloomberg News, October 23, 2007; Chris Larson, “Managers Eye Asian SWF Billions,” *Financial Times*, August 3, 2008; Miracky et al, “Assessing the Risks,” p. 28-29.

free-market democracy. State-led development societies – in which governments use SWFs to buy off dissent and promote development and technology transfer – could emerge as a viable challenger to the accepted political economy of the advanced industrialized states. This would have corrosive effects on the West’s soft power. It would be an open question whether the rest of the world would look at the Western development model as one to emulate. Crudely put, far fewer countries would want what the United States and European Union wants.

### **Evaluating the policy concerns**

Looking at the empirical record, many of the concerns articulated in the previous section appear to be either overblown or cross-cutting. For example, the argument that sovereign wealth funds co-opt domestic interests in recipient countries also cuts in the opposite direction; private actors benefit from their association with a sovereign wealth fund when acting in the SWF’s home market. It is possible, for example, that Blackstone has had preferred access to the Chinese market following CIC’s investment in that private equity firm. In the time since CIC’s investment, Blackstone announced its purchase of a 20% stake in a state-owned Chinese chemical manufacturer, as well as a high-end commercial building in downtown Shanghai. They have announced plans to set up a Beijing office to facilitate even more transactions, relying on CIC for assistance within China. Blackstone’s successes have occurred while other private equity firms encountered fierce resistance to similar kinds of investment.<sup>16</sup>

The argument that SWFs exacerbate market uncertainty also appears to lack empirical foundation. It contradicts the supposed comparative advantage of sovereign wealth funds – which is that they can hold large positions for long stretches of time, weathering short-term panics and downturns. Sovereign wealth funds would therefore be expected to function in a countercyclical, stabilizing manner – as their investments in the financial sector earlier this year suggest. Furthermore, in contrast to their private sector counterparts, SWFs traditionally have not been highly leveraged. Their equity investments to date have been focused in regions and sectors where they have local knowledge. The general consensus among financial analysts is that sovereign wealth funds have taken a long-term, passive approach to their overseas investments.<sup>17</sup> The bulk of recent SWF equity investments in OECD countries has been for either non-voting shares or stakes too small to warrant corporate control.

While sovereign wealth funds have been increasing their risk profiles, it is not clear that they are acting in a riskier fashion than peer financial institutions. Given the current state of financial markets, large private institutions are also interested in investing in higher-yield assets, particularly in the developing world. After analyzing recent acquisition patterns of several large SWFs, Rachel Ziemba concluded, “Increasingly a vast array of

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<sup>16</sup> Tony Munroe and George Chen, “Blackstone Group opening Beijing rep office,” Reuters, August 4, 2008.

<sup>17</sup> For a dissent, see Brad Setser, “Just How Stabilizing?” July 30<sup>th</sup>, 2008. Accessed at <http://blogs.cfr.org/setser/2008/07/30/just-how-stabilizing/>.

pension funds, endowment funds, sovereign funds all seem to be coalescing to a similar asset allocation – high equity, more exposure to alternatives, real assets like commodities and less exposure to bonds. And everyone wants more emerging market exposure.”<sup>18</sup>

The strategic concerns about sovereign wealth funds also rest on uncertain grounds. Financial analysts identify the primary “strategic” goal of SWFs as acquiring expertise or technology that can facilitate economic development in the home country. Many of these investments complement the home country’s preexisting comparative advantage. Arab SWFs, for example, are more likely to acquire equity stakes in the energy sector; Singapore’s Temasek has been more likely to acquire port facilities. A recent Monitor Group study examined 785 SWF equity purchases from 2000 to the present.<sup>19</sup> They found that investments in strategic sectors – transportation, defense, aerospace, and high technology – comprised less than one percent of the value of all purchases. Even expanding the definition to include energy and utilities, less than five percent of all sovereign wealth fund acquisitions were for controlling interests in strategic sectors in OECD markets.<sup>20</sup>

Nevertheless, some sovereign wealth funds have made investments decisions based on criteria other than profit maximization. In the United States, CalPERS decided to divest its holding in firms doing business in Sudan. The recent Divest Terror campaign has been designed to use U.S. state pension funds to pressure European firms into divestiture from Iran. Norway’s GPFG has articulated a set of ethical guidelines to regulate its equity investments – but one country’s ethics is another country’s politics. In early 2008, Muammar Khaddafi threatened to withdraw Libyan SWF investment from African nations resistant to his idea of strengthening the African Union.<sup>21</sup> There is no evidence, however, that any of these attempts to exercise leverage had any policy effects. A recent European Central Bank paper examined stock prices after Norway’s SWF strengthened its ethical guidelines for investment and divested from firms like Wal-Mart and United Technologies. They found no significant effect on firm performance or rate of return.<sup>22</sup>

These results are consistent with the general consensus in international relations – threats of economic exit only work under a limited set of circumstances.<sup>23</sup> The literature on economic coercion and economic interdependence also suggests that sovereign wealth funds lack the capability to coerce the OECD economies. Even relative optimists about

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<sup>18</sup> Rachel Ziemba, “Growing Sovereign Wealth,” August 27, 2008. Accessed at <http://blogs.cfr.org/setser/2008/08/27/growing-sovereign-wealth/>, August 2008.

<sup>19</sup> William Miracky, Davis Dyer, Drosten Fisher, Tony Goldner, Loic Lagarde, and Vicente Piedrahita, “Assessing the Risks: The Behaviors of Sovereign Wealth Funds in the Global Economy,” Monitor Group, June 2008.

<sup>20</sup> Furthermore, this five percent is all the result of Singapore’s Temasek purchased four energy and utility firms in OECD countries – one in Australia, one in the United Kingdom, and two in South Korea.

<sup>21</sup> Reuters, “Libya’s Gaddafi says may pull Africa investments,” January 30, 2008.

<sup>22</sup> Roland Beck and Michael Fidora, “The Impact of Sovereign Wealth Funds on Global Financial Markets,” European Central Bank Occasional Paper Series no. 91, July 2008.

<sup>23</sup> See, for example, Jonathan Kirshner, *Currencies and Coercion* (Princeton: Princeton University Press, 1995); Daniel W. Drezner, *The Sanctions Paradox* (Cambridge: Cambridge University Press, 1999); Mark Crescenzi, “Economic Exit, Interdependence, and Conflict.” *Journal of Politics* 65 (August 2003): 809-832; Benn Steil and Robert Litan, *Financial Statecraft* (New Haven: Yale University Press, 2006).

the utility of financial statecraft place strict preconditions on the ability of states to use it. The sender must be significantly more powerful than the target. The sender must be able to assemble an institutionalized multilateral coalition to enforce the sanctions. The expectations of future conflict between the target and the sender coalition must be low. In the absence of these conditions, financial statecraft will almost always fail.

The home countries of sovereign wealth funds possess none of these advantages in trying to leverage their investments into political gain. Small countries closely allied with the United States – Norway, Singapore, the United Arab Emirates, Qatar, Kuwait – own and operate the largest SWFs. These economies have the potential to inflict economic harm on the advanced industrialized states – but they would damage their own economies even more in the process. Even when expectations of future conflict are very high, no country has even tried to deploy economic coercion when their own costs exceed those of the target costs. In theory, there is the possibility that states with sovereign wealth funds could create a balancing coalition against the United States and/or the European Union. On many issues – particularly energy prices – the Pacific Rim economies and oil-exporting states have divergent foreign policy interests. The likelihood of coordinated coercion against the established markets is quite low.

Over time, as SWFs acquire even more assets in recipient countries, their bargaining leverage could increase. The complex interdependence created by sovereign wealth funds cuts both ways, however. To be sure, the United States needs SWF investment to finance its large current account deficit. However, most other asset markets are neither big enough nor open enough to cater to large-scale sovereign wealth investments. Large market jurisdictions – the United States and European Union – should be able to dictate most of the rules and regulations regarding these funds.<sup>24</sup> While some OECD economies might need SWF investment, it is equally true that capital exporters need America and Europe to keep their jurisdictions open to inflows. These markets remain the only ones deep and liquid enough to absorb inflows in the trillions of dollars. Indeed, the very countries that are bulking up their sovereign wealth funds at the moment are the most protectionist when it comes to inward investment.<sup>25</sup>

The IMF process to create a code of conduct for sovereign wealth funds bears this point out. In 2007 the G-7 Finance Ministers requested the IMF to develop a code of conduct for sovereign wealth funds. This initial reaction of sovereign wealth funds to this step ranged from tepid to very hostile. For example, Gao Xiqing, the president of the Chinese Investment Corporation, told *60 Minutes* that an IMF code would “only hurt feelings”

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<sup>24</sup> Daniel W. Drezner, *All Politics Is Global: Explaining International Regulatory Regimes* (Princeton: Princeton University Press, 2007).

<sup>25</sup> Takeshi Koyama and Stephen Golub, “OECD’s FDI Restrictiveness Index: Revision and Extension to More Economies,” OECD Working Paper on International Investment 2006/4, December 2006 ; Rachel Ziemba “Responses to Sovereign Wealth Funds: Are ‘Draconian’ Measures on the Way? RGE Monitor, November 2007; U.S. Government Accountability Office, *Laws and Policies Regulating Foreign Investment in 10 Countries*, GAO-08-320, February 2008.

and characterized the idea as “politically stupid.”<sup>26</sup> Nevertheless, the U.S. Treasury Department persuaded ADIA and GIC to jointly issue a set of policy principles regarding SWFs and recipient countries. These included commitments to governance and transparency standards, as well as a pledge to use commercial and not political criteria in determining investments.<sup>27</sup> As of this writing, an IMF appears on track to approve a set of Generally Accepted Principles and Practices (GAPP) at its fall meeting. Implicit pressure from recipient countries – as well as the larger and older SWFs – should cause the “Santiago Principles” to have an appreciable effect on SWF transparency.

Are SWFs based in authoritarian countries different from those based in democratic countries? Yes and no. On the one hand, there is indeed a strong relationship between SWF transparency and the political characteristics of the home country. The transparency of government investment vehicles is closely and positively correlated with the home country’s rule of law and democratic accountability. Multivariate tests also find a strong and positive correlation between a country’s political and civil liberties and the quality and transparency of its sovereign wealth funds.<sup>28</sup> Not surprisingly, sovereign wealth funds headquartered in the OECD economies are much more transparent than those headquartered in the developing world.

There is less evidence, however, that authoritarian regimes have exploited their opacity to outperform the market, or invest their capital more patiently. The recent experiences of Russia and China are revealing in this regard. The China Investment Corporation (CIC) has received considerable domestic flak for its investment in Blackstone, after that firm’s stock value has plummeted by 40%. The way CIC is financed – through domestic bond sales rather than an explicit transfer of foreign exchange from SAFE – actually forces the fund to try to maximize its short-term rate of return in an unforgiving exchange rate environment. CIC’s performance has exacerbated tensions between China’s finance ministry and its central bank over the management of foreign reserves. A few months after the Blackstone investment Lou Jiwei, the head of CIC, did worse than expected in Central Committee elections. In response to CIC missteps, the central bank’s State Administration of Foreign Exchange (SAFE) began to act like a sovereign wealth fund, adding more confusion to their foreign investment strategy. Similarly, Russia’s central bank received withering domestic criticism when it was revealed that it held over \$100 billion in Fannie Mae and Freddie Mac securities. In response, the bank cut its exposure by forty percent – but to do this it was forced to sell low.<sup>29</sup>

Authoritarian countries might not have elections, but they still must cope with bureaucratic rivalries, domestic discontent, and audience costs. Furthermore, while there

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<sup>26</sup> *60 Minutes* transcript accessed at

<http://www.cbsnews.com/stories/2008/04/04/60minutes/printable3993933.shtml>, August 2008; Jamil Anderlini, “China fund shuns guns and gambling,” *Financial Times*, June 13, 2008.

<sup>27</sup> Bob Davis, “U.S. Pushes Sovereign Funds to Open to Outside Scrutiny,” *Wall Street Journal*, March 3, 2008. Policy principles accessed at <http://treas.gov/press/releases/hp881.htm>, August 2008.

<sup>28</sup> Beck and Fidora, “The Impact of Sovereign Wealth Funds on Global Financial Markets.”; Olivia Mitchell, John Piggott, and Cagri Kumru. 2008. “Managing Public Investment Funds: Best Practices and New Challenges.” NBER Working Paper 14078, June 2008.

<sup>29</sup> Reuters, “Media mudslinging scares Russian oil wealth managers,” August 1, 2008.

are sound policy reasons for these countries to set up SWFs, they must still cope with the political incongruity of investing billions of government dollars in the developed world while tolerating significant pockets of domestic poverty. In China, Russia and Singapore, governments have had to respond to domestic criticism of SWF investments; in the United Arab Emirates, they have had to address questions of corruption. In many ways, therefore, authoritarian politics can be just as limiting as democratic politics in hampering long-term strategic planning.

This is why the existential threat of sovereign funds as an alternative development strategy is likely overblown. As Kenneth Rogoff pointed out in testimony last year: “Governments have a long tradition of losing massive amounts of money in financial markets. This tradition is not likely to end anytime soon.”<sup>30</sup> Indeed, sovereign wealth funds based in Nigeria and Ecuador have gone bust in the past. One recent econometric study examined 53 SWF equity purchases from 1989 to 2008 and found that, on average, two year abnormal returns amounted to -41%.<sup>31</sup> The McKinsey Global Institute estimates that as of July 2008, SWFs had collectively lost \$14 billion from recent investments in the financial sector.<sup>32</sup>

### **Some warning notes**

Sovereign wealth funds are unlikely to disrupt the functioning of the American economy or compromise national security through their investment strategies. They are symptom of other problems, however. The rise of sovereign wealth funds highlights American macroeconomic weaknesses. In the future, they will impair American efforts at democracy promotion. They also threaten to reduce the degree of cooperation in global financial governance.

Sovereign wealth funds are simply the latest manifestation of the explosive growth in official assets ranging from currency reserves to state-owned enterprises. U.S. consumption is keeping energy prices high. A low U.S. savings rate, combined with the foreign manipulation of exchange rates, has allowed some Pacific Rim economies to inflate their current account surpluses. Those are the macroeconomic forces that are causing foreign governments to expand their sovereign wealth funds. Addressing those problems sooner, rather than later, will go a long way towards eliminating sovereign wealth funds as a political hot potato. Improving the savings rate of Americans, for example, would help to reduce the large current account deficit that is fueling the growth of sovereign wealth funds in the Pacific Rim. Reducing energy demand would also reduce the growth of sovereign wealth funds among energy exporters – though such a

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<sup>30</sup> Kenneth Rogoff, “Foreign Holdings of U.S. Debt: Is Our Economy Vulnerable?” Testimony prepared for U.S. House of Representatives Committee on the Budget, June 26, 2007. See also Anders Åslund, “The Truth about Sovereign Wealth Funds,” *Foreignpolicy.com*, December 2007. Accessed at [http://www.foreignpolicy.com/story/cms.php?story\\_id=4056](http://www.foreignpolicy.com/story/cms.php?story_id=4056), February 2008.

<sup>31</sup> Veljko Fotak, Bernardo Bortolotti, and William Megginson, “The Financial Impact of Sovereign Wealth Fund Investments in Listed Companies,” Working paper, University of Oklahoma, June 2008, accessed at SSRN: <http://ssrn.com/abstract=1108585>.

<sup>32</sup> Diana Farrell, Susan Lind and Koby Sadan, “The New Power Brokers: Gaining Clout in Turbulent Markets.” McKinsey Global Institute, July 2008, p. 9.

reduction would be partially offset by rising demand around the globe. Recent trends suggest that market forces are moving in the preferred direction. In recent years the Chinese renminbi has appreciated by 20% against the dollar. High fuel prices will likely contribute to greater conservation efforts and reduced energy demand.

The rise of sovereign wealth funds will also have some negative second order effects for American foreign policy. SWFs will impair democracy promotion efforts. These investment vehicles aid and abet in the persistence of “rentier states” – governments that do not need their citizens to raise revenue. Democratization is a much more difficult policy for the United States to pursue when the target government is sitting on trillions of dollars in assets to buy off discontented domestic groups. Authoritarian governments in the Middle East and East Asia will be more capable of riding out downturns that would otherwise have threatened their regimes. These funds are a means through which authoritarian regimes can guard against the vicissitudes of the free market. As the Asian financial crisis demonstrated a decade ago, market shocks can fell authoritarian governments. Sovereign funds, combined with ever increasing foreign reserves, can forestall economic crises before they topple authoritarian power structures.

More perversely, the growth of sovereign wealth funds, combined with rising nationalism and anti-Americanism in capital exporting countries, would give the United States even less reason to *want* democratic transitions in these parts of the globe. Consider the effect of a populist or fundamentalist revolution taking over in Saudi Arabia or the Gulf emirates. Rampant anti-Americanism among the Arab populace could encourage a new government to purposefully sell off SWF investments in the United States in order to induce a financial panic. While such moves would be economically disastrous to these countries, such actions are not inconceivable in the early stages of a revolutionary government. Even if China or the Persian Gulf emirates were to democratize more gradually, one could easily envisage nationalist parliaments using their SWFs to constrain U.S. actions. Sovereign funds in democratic societies have been willing to inject political conditionality into their capital markets. As previously noted, interest groups have been eager to use America’s financial muscle to alter the behavior of foreign actors in Sudan, Iran and Russia. There would be no reason to expect other democratic, capital-rich countries to behave differently.

There is final, more sobering consideration. The emergence of sovereign wealth funds needs to be considered in the context of other changes in the global political economy. In the past, a key explanatory factor for high levels of cooperation in the global economy was the absence of tight coupling. Historically, the effect of a powerful actor defecting from the rules of the game did not usually have dramatic and immediate effects in international economics. The globalization of finance, combined with the re-emergence of powerful state actors in capital markets, changes this equation. As Larry Summers and others have pointed out, there are geopolitical concerns that come with the “financial balance of terror” created by current macroeconomic imbalances.

The shifting of government assets from central banks to sovereign wealth funds and state-owned enterprises exacerbates these concerns. Transparency measures cannot

completely erase concerns about the capabilities and intentions of powerful sovereign actors. These concerns, combined with the tight coupling of today's financial markets, will cause the incentive structures in global finance to more closely resemble those of nuclear deterrence – specifically, the logic of mutually assured destruction. This does not mean that the financial equivalent of World War III will take place. It does mean, however, that policymakers must be increasingly cognizant of that contingency.

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Beyond the academy, Drezner has served as an international economist at the Treasury Department's Office of International Banking and Securities Markets. He has also held a research position at the RAND Corporation. He has consulted for various for-profit, non-profit and public sector agencies, including the National Intelligence Council. He was a non-resident fellow with the German Marshall Fund of the United States, a Council on Foreign Relations International Affairs Fellow, and a post-doctoral fellow at Harvard University's Olin Institute for Strategic Studies. He received his B.A. in political economy from Williams College and an M.A. in economics and Ph.D. in political science from Stanford University.

Drezner is the author, most recently, of *All Politics is Global: Explaining International Regulatory Regimes* (Princeton University Press, 2007), which explores how and when regulatory standards are coordinated across borders in an era of globalization. His previous books include *U.S. Trade Strategy* (Council on Foreign Relations, 2006), *Locating the Proper Authorities* (University of Michigan Press, 2003), and *The Sanctions Paradox* (Cambridge University Press, 1999). His next book, *An Unclean Slate*, will examine the future of global governance.

He has published articles in numerous scholarly journals as well as in the *New York Times*, *Wall Street Journal*, *Washington Post*, *Foreign Policy*, and *Foreign Affairs*. He has provided expert commentary on U.S. foreign policy and the global political economy for C-SPAN, CNNfn, CNN International, and ABC's *World News Tonight*. He is currently a regular commentator for *Newsweek International* and NPR's *Marketplace*. He keeps a daily weblog at [www.danieldrezner.com](http://www.danieldrezner.com). He is a member of the American Political Science Association, International Studies Association, and the Council on Foreign Relations.