WebMemo
Published by The Heritage Foundation

No. 1713
November 30, 2007

Sovereign Wealth Funds No Cause for Panic

Daniella Markheim, Ambassador Terry Miller, and Anthony B. Kim

Sovereign wealth funds, which are established by governments as a means to invest their foreign exchange earnings abroad, are the latest bugaboo of economic nationalists. Abu Dhabi's purchase of 4.9 percent of Citicorp inspired the latest panic. Even *The Wall Street Journal* characterized the investment as something other than "a normal commercial transaction," noting that "[i]t comes from a sovereign wealth fund controlled by a foreign government, which has political as much as business interests; from an Arab government that has a troubling history with American banking laws; and it offers a middle eastern entrée into the U.S. financial system that since 9/11 plays a pivotal role in the war on terror."[1] But worries that government-owned investment funds could be used to advance a political agenda are often unfounded. America has the banking, investment, and security mechanisms in place to reduce the risk associated with foreign ownership of critical assets and so can reap the economic benefits that come from foreign investment. Policymakers should not consider stricter investment controls.

Sovereign Wealth Funds and the U.S. Market. Sovereign, state-owned wealth funds manage an estimated $2–3 trillion of global assets.[2] The size of these funds can be difficult to estimate, because governments are not required to disclose information about the fund's assets, liabilities, or underlying investment strategy. While this makes it difficult to assess the impact such funds could have on the global economy, even $3 trillion is but a fraction of global investment, conservatively estimated at around $165 trillion.[3]

Despite current jitters in U.S. financial markets, worries over America's trade and budget deficits, and concern over the falling value of the U.S. dollar, foreign investment in the U.S. remains strong. Just like any investor, a country may seek to hold a more globally diverse asset portfolio by selling some U.S. bonds or other assets, but fundamentally, foreign investors consider the U.S. a top destination for investment.

That's a good thing. Taxes on savings and government budget deficits combine to keep America's savings rate too low to satisfy U.S. demand for capital. Foreign investment fills the savings-investment gap, promoting long-term economic growth and job creation. In 2005, foreign investors held about 32 percent of U.S. financial assets, including publicly held federal debt and corporate stocks and bonds.[4]

In the normal course of everyday trade, billions of dollars flow into and out of the U.S. Most of this flow of funds in the U.S. is controlled by the private sector, based on the consumption and investment decisions of individuals and corporations. That is not so in much of the Middle East and in China, where the

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm1713.cfm

Produced by the Center for International Trade and Economics (CITE)

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

state continues to control most economic activity. The top five sovereign wealth funds are listed in Table 1, along with the respective country scores from The Heritage Foundation's *2007 Index of Economic Freedom*. It is clear that many of the sovereign wealth funds originate from countries that need greater financial and investment freedom, for the benefit of domestic and foreign investors alike.

Table 1 WM 1713

Top 5 Largest Sovereign Wealth Funds

As of March, 2007

Country	Global Assets	Economic Freedom	Financial Freedom	Investment Freedom
UAE	$875 billion	60.4	40	30
Singapore	$430 billion	85.7	50	80
Saudi Arabia	$300 billion	59.1	40	30
Norway	$300 billion	70.1	50	50
China	$300 billion	54.0	30	30

Sources: Morgan Stanley; the Economist Group; and Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007).

Issues with corporate governance, transparency, and financial market openness plague many of the countries most actively relying on sovereign wealth funds as a means to invest foreign exchange earnings. Uncertainty over the investment strategies underlying these funds, and the worry that these funds could be manipulated to disrupt the U.S. economy, increase with each new story about an American asset coming under foreign ownership.

Current Institutions Address the Risk of Disruption. Fortunately, opportunities for such manipulation are significantly constrained by market forces and existing U.S. policies designed to protect U.S. national security interests from foreign investment activities. When the U.S. economy stutters, much of the rest of the world feels some cost. The growing trade and investment ties that bind the economies of the world together are more likely to promote responsible economic behavior than provide enticement to cause mayhem; investment is more about creating wealth than destroying it.

However, not all countries are rational economic agents all of the time. Were a country to successfully exploit its piece of the American pie as a means to cause harm, the market would operate to help protect the U.S. economy. For example, a quick drawdown of foreign dollar-denominated reserves would be equivalent to a sudden increase in the U.S. money supply, causing a decrease in the value of the dollar, provided that enough dollars were dumped to influence currency markets. Of course, the Federal Reserve and other foreign governments could react quickly by removing dollars from circulation. There would be disruption, but hardly catastrophe. The increased demand for U.S. products and services as a result of the cheaper dollar could, in fact, lead to a short-term boom and eventual appreciation of the dollar to rates based on market dynamics, rather than speculative or intentional market manipulation.

It also seems worrisome to some that foreign governments are holding ever larger amounts of U.S. debt and assets, but the likelihood that governments are doing this as a means to disrupt the U.S. economy is slim. Few governments would intentionally allocate scarce resources to gain control of a U.S. asset for the sole purpose of destroying the value of that asset. Even if a country felt wealthy enough to destroy its wealth—and suffer the international retaliation that would likely follow—no

1. "Citi of Arabia," *The Wall Street Journal*, November 29, 2007, p. A18, at *http://online.wsj.com/article/SB119630344845307407.html?mod=googlenews_wsj*.
2. Simon Johnson, "The Rise of Sovereign Wealth Funds," International Monetary Fund, September 2007, Vol. 44, No. 3, at *www.imf.org/external/pubs/ft/fandd/2007/09/straight.htm*.
3. *Ibid.*
4. James K. Jackson, "The United States as a Net Debtor Nation: Overview of the International Investment Position," Congressional Research Service, Report for Congress No. RL32964, October 18, 2007.

single foreign country owns enough of America to cause long-term disruption.

Beyond open market dynamics and direct intervention to restore market stability, the U.S. Committee on Foreign Investments in the United States (CFIUS) provides an objective, non-partisan mechanism to review, and if necessary block, risky foreign investments that may have national security implications. In addition, the U.S. has a full range of commercial laws, banking regulations, and domestic investment regulations designed to ensure necessary transparency in the corporate world.

Conclusion. The rise of sovereign wealth funds carries implications for global financial market stability, corporate governance, and national interests. Several factors—including the relatively small share these funds represent in the total global financial market, financial and other market dynamics, the CFIUS process, and other U.S. regulations—work together to reduce the likelihood that foreign investment will bring more harm than good to the U.S. economy. Of course, it never hurts to think about policies to boost domestic savings and investment.

The fundamental reason foreign holdings are so high is that U.S. citizens save so little. The most direct and least costly way to boost domestic savings and reduce America's reliance on foreign capital is to reduce the federal deficit and taxes on savings.

There is no question that America must ensure that the laws and procedures governing foreign investment are robust, up-to-date, and functioning effectively to achieve the purposes for which they are designed. But the knee-jerk equation of "foreign" with "threatening"—particularly if the "foreign" happens to be Arab or Middle Eastern—is a different sort of reaction, one unworthy of a country like the U.S., whose immigrant heritage and commitment to freedom, equality, and openness know no equal.

—Danielle Markheim is Jay Van Andel Senior Analyst in Trade Policy in, Ambassador Terry Miller is Director of, and Anthony B. Kim is Policy Analyst in the Center for International Trade and Economics at The Heritage Foundation.