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SPECIAL SECTION: THE GEOPOLITICS OF SOVEREIGN WEALTH FUNDS

The Geopolitics of Sovereign Wealth Funds: An Introduction

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At the centre of the globalisation trend of the past few decades has been the creation of a global financial marketplace in which enormous sums of money came to be traded across the world unencumbered by capital controls. The future of this free wheeling, liberal international financial order is now in doubt. The most obvious challenge comes from the global financial crisis that began in 2007, a crisis that is prompting governments everywhere to reconsider their commitment to deregulated finance. But even before the crisis broke out, another phenomenon – the rapid growth of sovereign wealth funds (SWFs) – signalled a different kind of reassertion of state authority in the markets.

Precise definitions of SWFs vary from author to author, but the term generally describes state-owned or state-controlled pools of capital that are actively invested, at least partially, outside the country. These investment vehicles have a long history, but they have grown particularly rapidly over the last five years both in size and in number. At least forty countries now have SWFs and the total value of their assets is estimated to be between $2 and 3 billion. The largest funds can be found in oil-exporting countries (especially Abu Dhabi, Norway, and Kuwait) and East Asian countries that have been accumulating large trade surpluses (especially Singapore and China).[1]

Through their creation of SWFs, states have reasserted their authority in global finance not as regulators but as major investors in the market.[2] From an economic liberal perspective, this phenomenon has raised concerns. If the decisions of these new investors are guided by government priorities

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rather than profit-maximisation, the markets will be "politicised". Particularly worrying has been the prospect of SWFs – many of which lack transparency and clear lines of accountability – being used by governments to pursue geopolitical goals. Not only could investments of this kind undermine the efficient international allocation of capital, but they might also trigger protectionist reactions against capital inflows on national security grounds.

These reactions have in fact already begun, particularly in the US and other Western countries. In an effort to head them off, the IMF led an international initiative in 2008 to encourage SWFs to embrace greater transparency, accountability and a commitment to base investment decisions primarily on economic and financial goals. This initiative resulted in the creation of the "Santiago Principles" in September 2008, to which many SWFs have now signed on. But because the content of the Principles is rather general and non-binding, the challenge of reconciling liberal international finance with geopolitical concerns remains very much alive.

To what extent does the rise of SWFs in fact pose geopolitical challenges to Western states? There has been very little academic literature that might help us address this question. To date, most writing about SWFs has come either from economists, who are less inclined to explore this issue, or from the policymaking and journalist communities. We have been missing both a systematic scholarly analysis of the relationship between SWFs and geopolitics as well as detailed political studies of individual SWFs from country specialists and comparative political economists. The articles in this special section of *Geopolitics* are designed to begin to fill these gaps in the literature. The special section begins with an overview article by one of the leading scholars of the geopolitics of global finance, Jonathan Kirshner, who dissects the issues raised by debates about SWFs and national security. His article is followed by a number of case studies that analyse politically some of the largest SWFs – those of Abu Dhabi, China, Norway, and Singapore – as well as one further country, Saudi Arabia, which has the clear potential to create a SWF that joins this select group.

Taken together, these articles suggest the challenges posed by SWFs to the existing geopolitical order are often overstated. To begin with, Kirshner highlights that many of these alleged challenges really reflect concerns stemming simply from broader shifts in sovereign wealth; that is, the growing official wealth of East Asian exporters or oil producers poses geopolitical challenges whether it is invested via SWFs or through other means. Kirshner suggests, in fact, that the kinds of investments made by SWFs may pose less of a security threat than shifts in official foreign exchange reserves which can cause more targeted monetary disruption abroad.

Indeed, when the SWF debate is placed in the broader context of literature on the geopolitics of finance, it does seem rather unremarkable. Global financial markets are already "politicised" by the existence of other larger pools of sovereign wealth. Japan's foreign exchange reserves dwarf the size of almost every sovereign wealth fund. The institution managing China's reserve holdings (the State Administration of Foreign Exchange or SAFE) also controls a much larger sum of international assets than does the country's sovereign wealth fund (the China Investment Corporation). Because the former is subject to much less scrutiny than the latter, SAFE is in fact much more likely to be used as a conduit for diplomatic influence (as highlighted by the Chinese government's recent decision to use that institution – and not the CIC – to invest discreetly in Costa Rican government bonds as part of a 2007 China-Costa Rican agreement which saw the latter cut ties with Taiwan and recognise China[3]).

Institutions managing foreign exchange reserves are not the only other kind of government-controlled investment vehicles active in global markets. In China's case, state banks represent another set of institutions that can be mobilised to serve Beijing's foreign policy goals, especially as their international investments expand rapidly.[4] In the case of Abu Dhabi, Rawi Abdelal's article shows that the country's main sovereign wealth fund (the Abu Dhabi Investment Authority) has been used much less strategically than another government institution that invests internationally (the Mabudala Investment Company). It is also worth remembering those public pension funds that are becoming major players in world financial markets; the California pension fund, CalPERs, manages assets of a size that would make it the fifth largest sovereign wealth fund in the world.[5] Finally, Kirshner notes that even private funds investing internationally can be "politicised" and used as tools of foreign policy if they are subject to their home governments' regulations. Given all this, the case that SWFs represent some significantly new tool of foreign policy seems rather exaggerated.

But even if we accept that SWFs are an important new instrument for power politics, the question of whether they pose a threat to the existing geopolitical order does not have a clear answer. Many of the largest SWFs come from countries – such as Singapore, Kuwait, and Abu Dhabi – that are close US allies. If these states use their SWFs to promote geostrategic objectives, it is likely to be in support of US goals. In times of crisis, their support could be particularly helpful since their investments are likely to be more stable and patient than fickle international private investors. As Abdelal points out, it is ironically the lack of transparency and accountability – the very features now criticised by many US policymakers – that allows these funds to take a longer term view that is not so focused on maximising profits for quarterly reports.

A case can also be made that the growth of SWFs from countries that are *not* allies may even be a force for stability. Kirshner highlights that the policy makers in these countries suddenly acquire a new stake in economic prospects of the countries in which their SWFs invest. More generally, as the assets of their SWFs become ever more far flung, these governments may increasingly associate their interests with those of global financial stability and openness. In these ways, the growth of SWFs may actually bolster those favouring international cooperation within the governments concerned.

This thesis is reminiscent of Karl Polanyi's case that "haute finance" was a force for peace in the pre-1914 era.[6] It also builds on Kirshner's own detailed historical analysis elsewhere about how private financial interests generally oppose war.[7] The new twist in the argument, however, is that these insights are applied to the behaviour of governments themselves, an application derived from the fact that states have become active players in the global markets via their SWFs. From this perspective, SWFs foster a kind of "financialisation" of the state over time wherein policy makers' "passions" to maximise power are increasingly tempered by their new "interests" in maximising profit.[8]

The articles in this special section present one final reason not to overstate the challenges that SWFs pose to the existing geopolitical order. Those convinced of the seriousness of the geopolitical threat assume the investment choices of SWFs are driven by an international power-maximising political logic. The country case studies presented here do certainly highlight the importance of seeing SWFs as political actors. But the political logic that drives their behaviour is much more often *domestically* than internationally focussed. To understand their behaviour, it is generally more useful to employ a domestic or comparative political analysis than one informed by the assumptions of realpolitik.

Victor Shih demonstrates the utility of the former approach with his comparison of the Chinese and Singaporean SWFs. The different behaviour of the SWFs of these two countries is best explained, he argues, not by their power position in an anarchic state system but rather by the degree of domestic unity of the state. Singapore's unified autocratic state enables its SWFs to focus on stable long-run goals. By contrast, the behaviour of China's CIC is more unpredictable because the fragmented nature of the Chinese state ensures that its SWF is subject to competing intra-bureaucratic and intra-elite struggles.

Kristin Diwan's study of the creation of the Saudi Arabia's SWF in 2008 reinforces the importance of domestic political analysis. Realists might interpret this initiative to invest Saudi's reserves more actively as an effort to reduce the country's dependence on the US, in whose dollars and Treasury bills most of the reserves have been passively invested. But Diwan shows that the creation of the SWF was driven instead by the domestic reformist goal of rationalising and bringing greater discipline to the decentralised investment activities of various bureaucratic actors within the state. Constraining intra-state rivalries, rather than flexing international power, was the central objective.

Bent Sofus Tranoy shows how the Norwegian SWF is also influenced heavily by the domestic politics of that country. Norway's Fund is often held up by economic liberals as a model of an "apolitical" fund because of its transparency, accountability and professional investing standards. But the country's social democratic traditions have prompted even this Fund to "politicise" global financial markets by applying various ethical standards to its investments (thereby reminding us just how difficult it will be for economic liberals to ever establish their dream of truly "depoliticised" international investing standards for SWFs). As Tranoy notes, the Fund's ethical decisions – such as its divestment from Wal-Mart because of alleged use of child labour in its supply chain – have even provoked complaints from the US government. Drawing on the work of Peter Katzenstein, Tranoy's analysis goes still further to highlight how even the Fund's "economic" investment strategies need to be seen as nested in the domestic commitment of the Norwegian political economy to flexible adjustment and domestic compensation.

Summing up, then, the articles in this special section suggest that SWFs are much less likely to serve foreign policy goals than domestic political ones. Moreover, even when they serve the former, they may not necessarily challenge the existing geopolitical order. Not only do many of the largest SWFs come from countries likely to back the US and Western goals, but a case can be made that SWFs from non-allies may bolster support within their governments for international cooperation and an open and stable global financial system. Finally, even when SWFs might be used to challenge the existing geopolitical order, they represent only one – and not even the most significant – category of investors among many that can be employed as a tool of the foreign policy. For all these reasons, it appears the geopolitical challenge posed by SWFs, while not non-existent, is often overblown.

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NOTES

1. Joshua Aizenman and Reuven Glick, 'Sovereign Wealth Funds: Stylized Facts about Their Determinants and Governance', Federal Reserve Bank of San Francisco, Working Paper 2008-33 (Dec. 2008).

2. For a broader discussion, see Eric Helleiner and Troy Lundblad, 'States, Markets and Sovereign Wealth Funds', *German Policy Studies* (forthcoming 2009).

3. Jamil Aderlini, 'Secretive Chinese Agency Uses Funds to Lure Costa Rica from Taiwan', *Financial Times*, 12 Sep. 2008.

4. Gregory Chin and Eric Helleiner, 'China as a Creditor: A Rising Financial Power?', *Journal of International Affairs* 61/2 (Fall 2008).

5. Benn Steil, 'California's Sovereign Wealth Fund', *Wall Street Journal*, 7 March 2008.

6. Karl Polanyi, *The Great Transformation* (Boston: Beacon Press 1944).

7. Jonathan Kirshner, *Appeasing Bankers* (Princeton: Princeton University Press 2007).

8. For the distinction between 'passions' and 'interests' in the politics of capitalism, see Albert Hirschman, *The Passions and the Interests* (Princeton: Princeton University Press 1997).