Priority must now be given to expanding free trade and cross-border capital flows in the face of greater regulation.

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About this time last year, government-owned investment pools in Asia and the Persian Gulf started to make headlines. Dubbed “sovereign wealth funds,” they were put under an international spotlight for at least three reasons. China had announced its intention to create one, using $200 billion to $300 billion from its $1.5 trillion in foreign-currency reserves. Morgan Stanley, among other investment banks, indicated that SWFs had about $2.5 trillion to invest, and they would be growing to well beyond $15 trillion in the next several years, as the trade surpluses of Asian and oil-producing nations continued to soar. And, third, sovereign funds were adding more opacity to a global financial system that was already too complex to understand.

As the debate intensified, I sided with those calling for tougher regulation. Aside from the lack of transparency in their operations, the danger that state owners could manipulate their investments to serve foreign-policy purposes seemed very real. Remember that, at the time, Gazprom had become a political instrument used by the Kremlin to pressure Eastern Europe. My recommendations: First, SWFs should be required to reveal—as a condition of any investment in Europe or the United States—their financial picture, their organizational structures, their strategies and their corporate-governance arrangements. Second, Washington and Brussels should ban SWFs from investing in sectors critical to national defense or in industries from which the government banned U.S. investors, and from buying more than 20 percent of any Western company without government approval. Third, the United States and Europe should coordinate their policies toward SWFs.

Looking back on the past year, I don’t regret the positions I took, but I now believe I misjudged the context of global capital flows in the last half of this decade. Of course, Washington should encourage more transparency and be vigilant about national security. But to a considerable degree, the Bush administration has made efforts in that direction by tightening provisions of existing legislation designed to vet foreign investment. Of course, more-effective global rules for cross-border investment would be desirable. But since last August, the rise of sovereign wealth funds has prompted the IMF and the OECD to work on codes of conduct for foreign direct investors and for the countries they invest in.

In the end, however, I believe we should be careful not to discriminate against SWFs, especially as compared with other investors such as private equity, hedge funds and corporations.

The fact is that priority must now be given to expanding free trade and capital flows across borders in the face of growing attempts around the world to apply more regulations to international transactions. A recent study by the Council on Foreign Relations called "Global FDI Policies: Correcting a Protectionist Drift" amplifies documents worrisome obstacles to global commerce—such as more complex screening mechanisms for evaluating investments on national security grounds, and looser definitions of national security itself—that are being erected in the United States, Canada, Germany, Japan, Russia, China and several other major nations. Besides, the United States is suffering from a credit implosion and needs at least $2 billion to $3 billion in foreign money per day to pay for such things as recapitalizing banks and refurbishing infrastructure, and is in no position to impede any kind of significant legal foreign inflow.

The concern remains that a future government in Beijing, Moscow or Riyadh could use its investments in America for other than purely commercial purposes. Maybe that seems farfetched today, but who can predict the nature of these regimes a decade from now? Ultimately, however, Washington needs to play the percentages and compare the relatively small number of funds that might act nefariously with the many others from places like Norway or Singapore that surely would not.
We also need to recognize the reality that the biggest reservoirs of capital in the future will be in Asia and in Saudi Arabia, Kuwait and the United Arab Emirates, and we should concede the limited ability of the United States or the EU to influence the shape and character of SWFs, given their size, their growing importance to capital markets and the options they have to invest in their own regions or in other regions, and bypass the United States and Europe if necessary.

Creating international economic policy involves constant trade-off between economics and politics, and, in this case, the SWFs have a good deal of the leverage. Moreover, it is very difficult to control capital flows of any kind without the law of unintended consequences kicking in and creating even bigger problems than the original ones. All things considered, Washington and America would be generally better off working as closely as possible with SWFs rather than making them feel unwelcome. It's not a perfect policy, but it's the least damaging one.