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New Bogeymen[1]

After the hedge funds it is now the sovereign funds that have become the fear of the western industrialized world; but protectionism is not the solution

Investment protectionism instead of open markets? Countries that long espoused the gospel of global market economics now preach protective shields for the enterprises of western industrialized countries. Angela Merkel and Franz Müntefering are keen promoters of investment protectionism. The Chancellor and Vice-Chancellor are not alone: the US government has encouraged IMF and the World Bank to draft a code of conduct for sovereign funds; the EU Commission will examine if corporate takeovers through foreign state-controlled investment funds threaten European capital markets. The head of IFO, Hans-Werner Sinn, chimes in: "Foreign state-owned enterprises have nothing to do in Germany".

However, protectionism would in consequence make it harder for German companies to invest abroad. We should also not forget that our own government-invested enterprises invest all over the world. The German government owns – partly via the state-owned KfW Bank – around 30% of the shares in Deutsche Telekom; and Deutsche Telekom is very active in overseas markets. Also Deutsche Post, which is also expanding abroad, largely belongs to the German government. To find a durable solution one needs to shield reflexive protective impulsive in favour of a search for root causes. Here it is:

China was earlier know as producer of "cheap" goods, but these days the country is even more so a source of "cheap" savings. Insofar as most of China's external reserves have been invested in low-interest US government bonds amid a weakening dollar, and at the same time the United States had a big current account deficit with China, the Chinese also provided the Americans with cheap supplier credits. The ascent of China and India has, supported by low interest rates in Japan, moreover created a super cycle. By this I mean a decades-long increase in real raw material prices in consequence of the industrialization of this heavily populated region. This has resulted in large saving surpluses in the oil producing countries.

For the oil exporters there are good reasons to save a part of the proceeds from this Bonanza, not only under the auspices of the central bank but in other parts of the public sector. This then leads to the foundation of the feared sovereign funds. How much should these countries be saving? If the earnings rely on finite resources then to so-called long-term consumption rule applies: annual price increase divided by annual extraction quote. Concretely, if prices increase by one per cent per year and reserves cover another 33 years of demand then the country should consume one third and save two thirds of the revenues. Exceptional price fluctuations should be fully reflected

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in savings. Forcing the resource producing countries to ignore such basic rules would condemn them to an unwarranted consumption-crunch in the longer run and the “resource curse” in the short run.

The surpluses in China are not conditioned on such rules. High profits, low social security provision and the extreme inequality that has emerged in “communist” China are the root causes of the enormous glut of Chinese savings. It is incomprehensible that no basic medical insurance is available in rural China when, at the same time, every citizen of China “owns” more than 1000 euros worth of official external reserves. The problem here is therefore different from the one faced by resource exporting countries: too little is consumed as the rapid economic growth goes hand in hand with increased precautionary savings. Some very different solutions offer themselves. Asking the oil producers to pump more oil will have even less effect than usual if at the same time they are denied the right to re-invest their export earnings. The Chinese we must convince to put in place a social network of the European kind, including sickness and retirement benefits.

What then makes the sovereign funds to frightening? First, their size, second, their owners! Estimates by Morgan Stanley of the assets of the sovereign funds currently stand at US$ 2.5 billion, which already exceeds the assets under management in hedge funds. It is projected that sovereign funds in ten years will control assets worth around US$ 17.5 billion. That amount is large enough to justify financial supervision. From foreign-based sovereign funds we should demand serious transparency: investments and placements of funds held on a fiduciary basis must be disclosed. The nature of the ownership – state-owned enterprises – is a problem if goals are pursued that are not compatible with market principles. An oft-cited example is Gazprom, which belongs to the Russian government and oil stabilization fund.

A solution might be golden shares giving our government a veto. In that case, however, it would have to be decided vis-à-vis what companies or industries such rights could be exerted. Until now the foreign trade law of German only gives the state the right to prevent takeovers and investments in the armaments industry. A better solution is the non-voting share. The engagement of the Chinese sovereign wealth fund in Blackstone took place via non-voting shares in this recently-listed US investment company. This option is generally preferable when dealing with sovereign funds, because it aligns their goals as investors with our commonly accepted principles for private enterprise.