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Sovereign Wealth Funds, Oil and the New World Economic Order

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Mr. Chairman, members of the Committee, less than a decade ago Washington was consumed by a debate on what would be the best policy to absorb the then multi-billion dollar federal surplus. Reductions in outstanding debt, tax cuts and spending increases were the most touted solutions. The least popular policy was for the government to invest the accumulated excess balances in private-sector financial markets. Former Office of Management and Budget (OMB) Director Alice Rivlin wrote in 1992, "No good would come of making the government a big shareholder in private companies or the principal owner of state and local bonds." Fed Chairman Alan Greenspan said in a 1999 testimony that federal investment in the private sector "would arguably put at risk the efficiency of our capital markets and thus our economy." Two years later, on January 25, 2001, he underscored this point at a Senate Budget Committee hearing: "The federal government should eschew private asset accumulation because it would be exceptionally difficult to insulate the government's investment decisions from political pressures. Thus, over time, having the federal government hold significant amounts of private assets would risk sub-optimal performance by our capital markets, diminished economic efficiency, and lower overall standards of living than would be achieved otherwise." These words are worth remembering today as we are again facing a similar dilemma about what to do with government surpluses just that this time it is not our own government's surplus that knocks on the door of our financial system but that of some of the world's least democratic, least transparent and least friendly governments.

The rise of sovereign wealth funds (SWF) as new power brokers in the world economy should not be looked at as a singular phenomenon but rather as part of what can be defined a new economic world order. This new order has been enabled by several mega-trends which operate in a self-reinforcing manner, among them the meteoric rise of developing Asia, accelerated globalization, the rapid flow of information and the sharp increase in the price of oil by a delta of over $100 per barrel in just six years which has enabled Russia and OPEC members to accumulate unprecedented wealth and elevate themselves to the position of supreme economic powers. Oil-rich countries of OPEC and Russia have more than quadrupled their revenues, raking some $1.2 trillion in revenues last year alone. At $125 a barrel oil they are expected to earn close to $2 trillion dollars in 2008.

The resulting transfer of wealth from consumers to exporters has already caused the following macroeconomic trends:

1. Regressive tax on the world economy. As a result in the rise in oil prices consuming countries face economic dislocations such as swollen trade deficits, loss of jobs, sluggish economic growth, inflation and, if prices continue to soar, inevitable recessions. The impact on developing countries, many which still carry debts from the previous oil shocks of the 1970s, is the most severe. Three-digit-oil will undoubtedly slow down their economic growth and exacerbate existing social illnesses; it would also make them economically and politically dependent on some of the world's most nasty petro-regimes.
2. Change in the direction of the flow of capital. Historically the flow of capital has always been from industrialized countries to the developing ones. The rise in oil prices coupled with growing dependence on oil and other commodities by the industrialized world have reversed this course and today it is the developing world which feeds the industrialized world with capital.
3. Change in ownership patterns. During the post-Cold War era, there has been a decline in direct state ownership of business and a significant strengthening of the private sector. Throughout the world private businesses took ownership over what were once state-owned companies. In some cases, like Russia, such privatization happened too fast, leading to various socio-economic problems. The tide is now turning against the private sector as governments accumulate unprecedented wealth which allows them to buy stakes in what were once purely private companies.

In this context, we should view SWF as *enablers* of the new economic order. SWF are pouring billions into hedge funds, private equity funds, real estate, natural resources and other nodes of the West's economy. No one knows precisely how much money is held by SWF but it is estimated that they currently own $3.5 trillion in assets and within one decade they could balloon to $10-15 trillion, equivalent to America's gross domestic product. While much of the economic activity is generated by the Asian funds, particularly China's and Singapore's, I will focus my testimony on the activities of the SWF from oil producing countries primarily the five Persian Gulf states that account for nearly half of the world SWF assets --Abu Dhabi, Dubai, Qatar, Kuwait and Saudi Arabia—as well as SWF owned by oil producing countries like Nigeria, Oman, Kazakhstan, Angola and Russia which have been among the fastest-growing over the last five years.

Before I delve into the specific issues related to SWF, I would like to remind the Committee that those funds are not the only way states can exert influence in global financial markets. High net worth individuals, government controlled companies and central banks are just as important in this context. Each one of the governments which are concentrating wealth has a different portfolio of investment instruments. Saudi Arabia, for example, accounts for roughly half of the GCC's private foreign wealth yet, unlike the UAE, where SWF control foreign assets, most Saudi foreign wealth is in the hands of private investors who are mostly members of the royal family. Only recently the Kingdom announced its intention to create a large SWF. While I applaud the Committee for holding this hearing on this important topic, we should realize that SWF are only part of a much bigger problem.

The second thing to bear in mind is that to date there has been little evidence that SWF attempt to assume control of firms they invest in or use their wealth to advance political ends. This is perhaps why so many experts dismiss the fear of foreign money acquiring portions of Western economies as a new form of jingoism, deriding the "fear mongers" as disciples of those who propelled the "Japanese-are-coming" hysteria of the 1980s. I do not share their dismissive view. The key issue to understand is that there is a fundamental difference between state vs. private ownership, and that because governments operate differently from other private sector players, their investments should be governed by rules designed accordingly. Unlike ordinary shareholders and high net wealth private investors who are motivated solely by the desire to maximize the value of their shares, governments have a broader agenda—to maximize their geopolitical influence and sometime to promote ideologies that are in essence anti-Western. Non-democratic and non-transparent governments can allow the use of their intelligence agencies and other covert as well as overt instruments of power to acquire valuable commercial information. Unlike pure commercial enterprises, state owned investment funds can leverage the political and financial power of their governments to promote their business interests. Governments may enter certain transactions in order to extract a certain technology or alternatively in order to 'kill' a competing one. The reason the Japan analogy is incorrect is that Mitsubishi Estate, the Japanese company that bought the Rockefeller Center in 1989 was not Tokyo's handmaid and Japan was—and still is—an American ally. This can hardly be said about Russia, Communist China or OPEC members some of whom use their revenues to fund the proliferation of an anti-Western agenda, develop nuclear capabilities, fan the flames of the Arab-Israeli conflict and serially violate human rights. As it is now known to all, for decades the de facto leader of OPEC, Saudi Arabia, has been actively involved in the promotion of Wahhabism, the most puritan form of Islam, and its charities and other governmental and non-governmental institutions have been bankrolling terrorist organizations and Islamic fundamentalism. To this day, the Kingdom's petrodollars pay for a hateful education system and fuel conflicts from the Balkans to Pakistan. With a little over one percent of the world's Muslim population, Saudi petrodollars support today 90 percent of the expenses of the entire faith. U.S. Undersecretary of the Treasury in charge of fighting terrorist financing Stuart Levey recently said in an interview: "If I could snap my fingers and cut off the funding from one country, it would be Saudi Arabia."

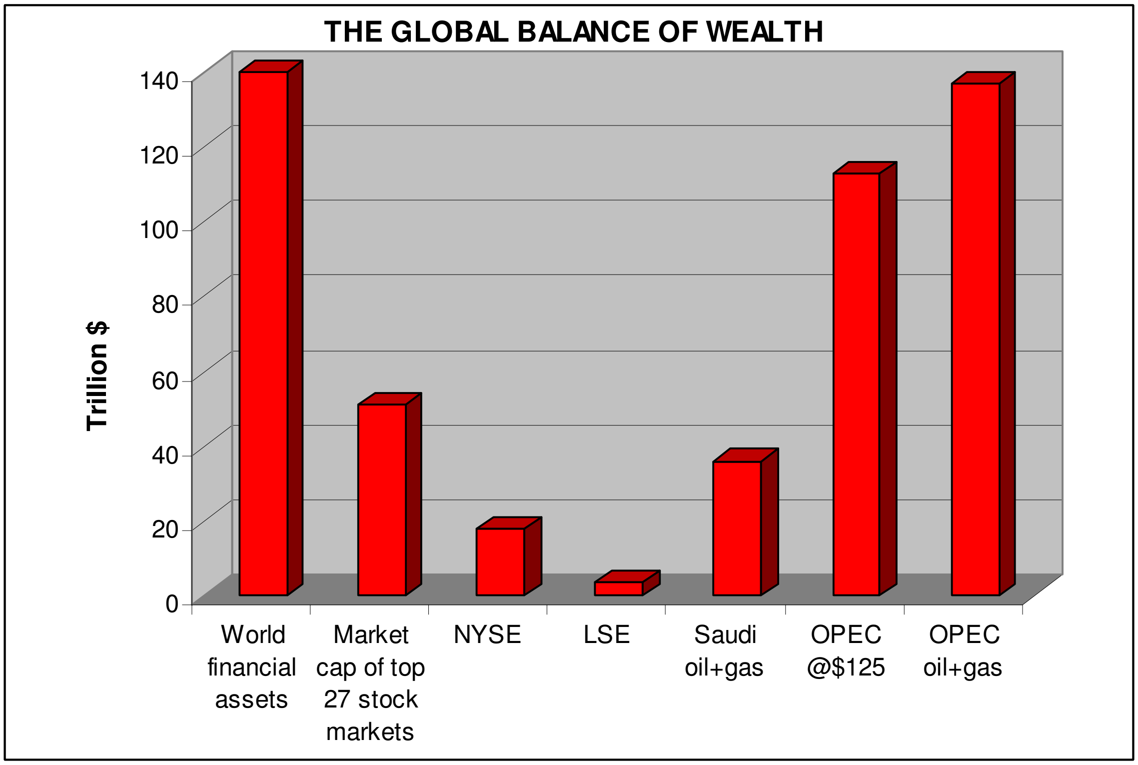
Mr. Chairman, from an international relations perspective most of the concerns raised about SWF only really matter if in the years to come the relations between the U.S. and the investing countries were to deteriorate. If tension between the U.S. and the Muslim world subsided and if China maintained its peaceful rise without undermining U.S. strategic interests there would hardly be a reason for concern; if the opposite occur, then indulging on Arab or Chinese wealth could be outright dangerous. The best example here is CITGO. PDVSa's successful acquisition of CITGO in the U.S. (50 percent in 1986, the remainder in 1990) triggered very few concerns at the time. But if such a takeover were attempted by Hugo Chavez today, when U.S.-Venezuela relations are acrimonious, the public outcry would be huge. Therefore, our discussion on foreign investment should not be dominated only by "what is happening today" but also in view of "where we are headed" considering the trajectories and patterns we can already begin to observe, the most important of which are the unabated rise in oil prices combined with questionable international behavior of some of the major oil producing countries.

Despite the attention given to SWF, they are still relatively small players in the global economic system. Their assets exceed the $1.4 trillion managed by hedge funds but they are far below the $15 trillion managed by pension funds, the $16 trillion managed by insurance companies or the $21 trillion managed by investment companies. Here again it is more important to look at the trend rather than the present situation. At their current growth rate of 24 percent a year SWF are beginning to present tough competition to other institutional investors over access to investment opportunities. To understand the anatomy of the competition between government entities and commercial firms one needs only to observe the process in which International Oil Companies (IOC) have gradually lost their competitive edge vis-à-vis National Oil companies (NOC). IOCs find themselves unable to compete against the deep-pocketed NOCs which do not face the same regulatory limitations, do not have to provide the same measures of transparency and do not have to abide by stringent environmental and humanitarian constraints. As SWF gain strength and volume they could sideline other players vying for investments. Unlike pension funds and other institutional investors who are slow in their decision making process, following strict timelines set by their investment committees, SWF are agile. They have the in-house structure and the resources to make investment decisions quickly.

New economic balance of power

No doubt perpetual high oil prices will shift the economic balance between OPEC and the West in the direction of those who own the precious commodity. As Robert Zubrin points out in his book *Energy Victory,* in 1972 the U.S. spent $4 billion on oil imports, an amount that equaled to 1.2% of our defense budget. In 2006, it paid $260 billion which equals to half of our defense budget. In 2008, it is likely to pay over $500 billion which is equivalent to our full defense budget. Over the same period, Saudi oil revenues grew from $2.7 billion to roughly $400 billion and with it their ability to fund radical Islam. In the years to come this economic imbalance will grow by leaps and bounds. To understand the degree of the forces in play it is instructive to visualize the scale of OPEC's wealth in comparison to the consuming countries. The value of OPEC's proven oil and gas resources using today's prices is $137 trillion. This is roughly equivalent to the world's total financial assets—stocks, bonds, other equities, government and corporate debt securities, and bank deposits—or almost three times the market capitalization of all the companies traded in the world's top 27 stock markets. Saudi Arabia's oil and gas alone is worth $36 trillion, 10 times the total value of all the companies traded in the London Stock Exchange. If one adds the additional oil and gas reserves that have not yet been discovered, OPEC's wealth more than doubles. If oil prices climb to $200, as OPEC's president Chakib Khelil recently warned, the wealth nearly doubles again. In an economic system of $200 barrel oil we can expect the value of financial institutions to shrink while the transfer of wealth to the oil producing countries increases in velocity. Such monumental wealth potential will enable buying power of the oil countries that far exceeds that of the West. For demonstration sake, at $200 oil OPEC could potentially buy Bank of America in one month worth of production, Apple Computers in a week and

General Motors in just 3 days. It would take less than two years of production for OPEC to own a 20 percent stake (which essentially ensures a voting block in most corporations) in every S&P 500 company. Of course, takeovers of such magnitude are unlikely, but $200 oil and additional trillions of dollars in search of a parking spot are very likely. What is clear about the new economic reality is that while the economic power of America and its allies is constantly eroding, OPEC's 'share' price is on a solid upward trajectory and with it an ever-growing foreign ownership over our economy.



Vulnerable sectors. SWF have lost $25 billion on their recent investments in struggling banks and securities firms worldwide. In the near future, they are not likely to be as enthusiastic to bail out additional financial institutions. But with high oil prices here to stay and with the International Energy Agency projecting that "we are ending up with 95 percent of the world relying for its economic well being on decisions made by five or six countries in the Middle East," it is hard to see how OPEC's massive buying power would not upset the West's economic and political sovereignty. This is particularly true in light of the prospects of potential future bailouts in sectors other than banking should the U.S. economy continue to decline. As populations in Western countries age and dwindle, it is only a matter of time before the under funded healthcare and retirement systems begin to face similar liquidity problems. Foreign governments have already put their sight on auto manufacturers, buying stakes in companies like Ferrari and Daimler. In 2004, Abu Dhabi attempted to buy 25 percent of Volkswagen's shares after the German automakers profits fell sharply. The danger here is that SWF might be the first to step in to save the ailing U.S. auto industry from its pension obligations if the industry continues to under perform.

What would this mean for the effort to make our cars less dependent on petroleum is a question policymakers should think about before such crisis occurs.
Media organizations are another sector worthy of attention. In September 2006, with mainstream news organizations in the U.S. reporting falling earnings and downbeat financial assessments, information ministers, tycoons and other officials of the 57-nation Organization of the Islamic Conference (OIC) gathered in Saudi Arabia where OIC Secretary General Ekmeleddin Ihsanoglu urged them to buy stakes in Western media outlets to help correct what he views as misconceptions on Islam around the world. To date, though private investors from the Middle East have made substantial acquisitions of global media, SWF have not bought holdings in this sector. A change in SWF behavior which leads to attempts to gain control over media organizations could lead to an erosion in freedom of speech and freedom of information. Pervasive influence of Saudi money in the publishing world coupled with growing number of litigations against scholars critical of Saudi Arabia is shielding from public scrutiny the one country that is most responsible for the proliferation of radical Islam.

Opaque investment patterns and the risk of predatory behavior. When it comes to governance, transparency and accountability SWF are not cut from the same cloth. There is a profound difference between SWF of democratic countries like Norway and the U.S. and those of non-democratic regimes. In some of the latter countries, like Kuwait, SWF are barred by the country's laws from revealing their assets. The Linaburg-Maduell Transparency Index which was developed at the Sovereign Wealth Funds Institute shows significantly lower SWF transparency ranking among non-democratic countries as opposed to democratic ones. Not surprisingly, nine out of the ten worst ranked funds are those of oil producing nations. Lack of transparency and accountability among those SWF makes them a disruptive factor in our overall highly transparent market economy. To avoid scrutiny, SWFs have fostered new alliances with private equity funds which offer a culture of secrecy. SWF already account for approximately 10 percent of private equity investments globally and this number will grow further in the coming years. Last year, Chinese entities bought the largest external stake in Blackstone that, indirectly through its holdings, is one of the largest employers in the U.S. Carlyle Group sold 7.5 percent stake to a fund owned by Abu Dhabi which also bought 9 percent of Apollo Management. The situation is similar in hedge funds. One of the dangers here is that through their investments SWF can shape market conditions in sectors where their governments have economic and/or political interests or where they enjoy comparative advantage. In recent months, for example, commodity futures have increased dramatically largely due to astronomical growth in speculation and bidding up of prices while actual deliveries are far behind. Commodity markets are easily manipulated and the impact of such manipulations could often reverberate throughout the world as the current food crisis shows. While U.S. companies are not allowed to buy their own products and create shortage to increase revenues, foreign governments with economic interest in a particular commodity face no similar restrictions bidding on it, via their proxies, in the commodity market. Under the current system, oil countries can, via their SWF as well as other investment vehicles that receive investment from SWF, long future contracts and commodity derivatives and hence affect oil futures in a way that benefits them. This would be tantamount to the U.S. government using its position as the world's largest exporter of corn to bid up corn futures.

Country	Fund Name	Assets $Billion	Inception	Origin	Linaburg-Maduell Transparency Index
UAE - Abu Dhabi	Abu Dhabi Investment Council	$875	1976	Oil	3
Norway	Government Pension Fund – Global	$380	1990	Oil	10
Singapore	Government of Singapore Investment Corporation	$330	1981	Non-Commodity	6
China	SAFE Investment Company	$311		Non-Commodity	2
Saudi Arabia	SAMA Foreign Holdings	$300	n/a	Oil	4
Kuwait	Kuwait Investment Authority	$250	1953	Oil	6
China	China Investment Corporation	$200	2007	Non-Commodity	2
China - Hong Kong	Hong Kong Monetary Authority Investment Portfolio	$163	1998	Non-Commodity	7
Russia	National Welfare Fund	$162	2008	Oil	4
Singapore	Temasek Holdings	$159	1974	Non-Commodity	7
Australia	Australian Future Fund	$61	2004	Non-Commodity	9
Qatar	Qatar Investment Authority	$60	2000	Oil	1
Libya	Libyan Arab Foreign Investment Company	$50	1981	Oil	1
Algeria	Revenue Regulation Fund	$43	2000	Oil	1
UAE - Dubai	Investment Corporation of Dubai	X	2006	Oil	5
UAE - Federal	Emirates Investment Authority	X	2007	Oil	1

Source: Sovereign Wealth Funds Institute

Boardroom presence. To date, the influx of petrodollars has not translated into overbearing presence of government agents in corporate boardrooms. In fact, many of the SWF buy holdings under the 5 percent benchmark that triggers regulatory scrutiny and forego board seats. But at the current rate of investment and many more years of three-digit-oil combined with deepening geopolitical tensions, foreign governments might be more willing to translate their wealth into power, dictating business practices, vetoing deals, appointing officers sympathetic to their governments and dismissing those who are critical of them. Direct influence of foreign government could lead to inefficiencies, capital misallocations and political interference in business decisions. This is why it is my view that SWF acquisitions should be restricted to non-voting stakes.

The rise of Sharia finance. The gradual penetration of Shariah (Islamic Law) into West's corporate world is another characteristic of the new geo-economic order. Islamic countries operating on the basis of compliance with Shariah have strict guidelines of economic conduct. Banks and investment houses gradually employ a new breed of executive--the Chief Shariah Officer (CSO)--whose sole job is to ensure compliance with Islamic law and hence attract more business from the Muslim investors. Over time, such compliance could put pressure on companies not consistent with Islamic principles to become more "Islamic." Imams sitting on Shariah boards could be pressured to withhold their approval of any business dealing directly or indirectly connected with countries or institutions that are offensive to Islam. One can only guess what this would mean for publishing houses, Hollywood movie studios, the alcohol and gambling industries. A sure casualty of the Islamization of the corporate world would be Israel, which has for years been subjected to the Arab boycott. According to the U.S. Department of Commerce, last year, American companies reported no fewer than 486 requests from UAE companies alone to boycott Israel.

Building a fireless firewall

None of the potential risks to which I alluded entails lifting the drawbridge and becoming economic hermits. America's commitment to open markets has been a source of respect and admiration around the world and reversing it through investment protectionism would only hurt U.S. prestige while undermining economic growth and job creation at home. To arrest the current economic trend and to hedge the risk of sovereignty loss the U.S. should apply a healthy dosage of vigilance and develop a system of indicators to determine and examine when SWF pursue different approaches from other institutional investors. Willingness to pay above market prices, use government assets to back up financial deals or manipulate prices to increase returns should all be red flags that trigger response. The U.S. already has a rigorous safeguard mechanisms against undesirable foreign investors. The Committee on Foreign Investment in the U.S. (CFIUS) protects national security assets in sectors such as telecommunications, broadcasting, transportation, energy and minerals in which there is a clear potential danger to national security. I am delighted that many of the concerns about foreign investments have already been addressed in the CFIUS reform legislation entitled the Foreign Investment and National Security Act of 2007. The range of regulatory and supervisory tools available to the Federal Reserve Board as described in the Federal Reserve Act are quite satisfactory for the case SWF make an investment in a U.S. banking organization that triggers one of the Fed's thresholds. But in order to protect ourselves against sovereignty loss more safeguards are needed.

Reciprocity. While enjoying almost unlimited access to investment opportunities in the West, oil rich governments do not feel the need to reciprocate by opening their economies to foreign investment. The opposite is true: they obstruct international companies from investing in their midst limiting them to, at best, minority share. This is the root cause of insufficient production of new oil. Oil countries, together owning 80 percent of the world's reserves, practice resource nationalism, stick to quotas, refuse to provide transparency of oil activities including reserve studies and terms of contract with their own national oil companies and they are riddled with corruption and cronyism. The least we can do is demand that foreigners treat us as we treat them. Despite being the lead violator of free trade by dint of its leadership of the OPEC cartel, three years ago, with U.S. support, the Saudis were admitted to the World Trade Organization (WTO). This was a terrible mistake. Since the admission, the world's generosity toward the Saudis was rewarded with nothing but continuous manipulation of oil prices and behavior that can only be described as antithetical to free trade. Enjoying the benefits of free trade is an earned privilege not an entitlement, and foreign governments wishing to acquire assets in the West should be obliged only if they show similar hospitality to Western companies. We should not be shy to use retaliatory measures against serial violators of free trade principles. There are currently four OPEC members in waiting to accede to the WTO --Algeria, Iran, Iraq, and Libya. Oil producing countries with growing SWF like Russia, Kazakhstan and Azerbaijan are also on the waiting list. These countries' admittance to the organization should be contingent on compliance with those principles and on an unequivocal commitment to refrain from non-competitive behavior and anti-market activities. You cannot seek a seat at the WTO and at the same time promote a natural gas cartel.

Increase transparency. The scope and growth rate of SWF are so vast that their actions can have far-reaching influence on world financial markets whether intentionally or mistakenly. This begs for the introduction of intermediary asset managers and the creation of disclosure standards for SWF as well as other foreign institutional investors that are at least as stringent as those applied to other regulated investors. However, any go-it-alone effort to force SWF to adopt higher transparency standards would be unworkable and easy to circumvent. The guidelines of working with SWF should therefore be drawn in collaboration with the EU and other countries on the receiving end of sovereign money.

Break the oil cartel. In the long run, the only way to roll back the new economic order and restrain OPEC's control over the world economy is to reduce the inherent value of its commodity. This cannot be done as long as we continue to put on our roads cars that can run on nothing but petroleum. Every year 17 million new cars roll onto America's roads. Each of these cars will have a lifespan of nearly 17 years. In the next Congressional session 35 million new cars will be added. If the next president presides for two terms he or she will preside over the introduction of 150 million new cars. If we allow all those cars to be gasoline only we are locking our future to petroleum for decades to come. I cannot think of something more detrimental to America's security than Congress allowing this to happen. Congress can break OPEC's monopoly over the transportation sector by instituting fuel choice. The cheapest, easiest and most immediate step should be a federal Open Fuel Standard, requiring that every new car put on the road be a flex fuel car, which looks and operates exactly like a gasoline car but has a $100 feature which enables it to run on any combination of gasoline and alcohol. Millions of flex fuel cars will begin to roll back oil's influence by igniting a boom of innovation and investment in alternative fuel technologies. The West is not rich in oil, but it is blessed with a wealth of other energy sources from which alcohol fuels - such as ethanol and methanol – capable of powering flexible fuel vehicles, can be affordably and cleanly generated. Among them: vast rich farmland, hundreds of years' worth of coal reserves, and billions of tons a year of agricultural, industrial and municipal waste. Even better: in an alcohol economy, scores of poor developing countries which right now struggle under the heavy economic burden caused by high oil prices would be able to become net energy exporters. With hot climate and long rainy seasons countries in south Asia, Africa and Latin America enjoy the perfect conditions for the production of sugarcane ethanol, which costs roughly half the price and is five times more efficient than corn ethanol. Hence, a shift to alcohol enabled cars will enable developing countries to generate revenues and emerge as a powerful force that could break OPEC's dominance over the global transportation sector.

In addition to alcohols, coal, nuclear power, solar and wind energy can make electricity to power pure electric and plug-in hybrid cars. The latter have an internal combustion engine and fuel tank, and thus are not limited in size, power, or range, but also have a battery that can be charged from an electric socket and can power 20-40 miles of driving, giving the consumer the choice of driving on electricity or liquid fuel. Only 2% of U.S. electricity is generated from oil today. While plug-in hybrids have unlimited range and a cost premium of several thousand dollars, pure electric cars are planned to be sold at competitive prices in several countries, including the U.S. and Japan, as early as 2010. Because pure electric cars have a range limitation—at least two countries, Israel and Denmark, are now in the process of developing an infrastructure for battery replacement to address this problem— they may not satisfy the needs of many Americans. But electric cars can easily serve as a second or third family car. This "niche market" is roughly two thirds of America. Thirty one percent of America's households own two cars and an additional 35 percent own three or more vehicles. These are not the cars a family would use to visit grandma out of town but cars that drive routinely well below the full battery range. There are over 75 million households in the U.S. that own more than one vehicle and that can potential replace one or more gasoline only cars with cars with cars powered by made-in-America electricity.

Mr. Chairman, the new economic order is shaping up right before our eyes increasingly invalidating much of the economic paradigm to which we have been accustomed. For America, a continuation of the petroleum standard guarantees economic decline and perpetual economic and political enslavement to the OPEC cartel and its whims. If we want to address the challenge of SWF and increased foreign government control over our economy we must focus on policies that can empower countries that share our values rather than the petro-dictators of the world. We must bring down the price of oil before it hits a critical point beyond which sovereignty loss becomes inevitable.