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Selling Out

Sovereign Wealth Funds and Economic Security

Gal Luft

In the past half-century, sharp increases in oil prices have been harbingers of most of America's economic recessions. Today is no exception: The quadrupling of oil prices in just six years is a leading cause of America's current economic predicament. But in addition to the traditional dislocations associated with high oil prices, the current spike is also driving a structural shift in the world economic balance of power. Trillions of dollars are migrating from industrialized and developing nations to the coffers of a small group of oil-producing nations, most of them authoritarian and many of them unfriendly to the West. And unlike previous price spikes, this one is likely to last a long time, so it is high time that we think about the longer-term implications, and what to do about them.

High Stakes

For developing countries, many of which still carry debts from the oil shocks of the 1970s, $100-plus oil is in effect a regressive tax that slows economic growth and exacerbates existing social tensions. It also makes them economically and politically dependent on some of the world's nastiest petro-regimes. For the United States, with its net foreign debt in excess of $3 trillion and with oil spending at $1 billion per day, the current wealth transfer heralds geopolitical decline and eventual erosion of sovereignty in the form of lost control over major economic assets.

With annual oil revenues in excess of $1 trillion, the 13 members of the Organization of Petroleum Exporting Countries (OPEC) already wield tremendous economic power. As recent multibillion-dollar bailouts of major financial institutions like Citigroup and Merrill Lynch show, these countries are not just laughing all the way to the bank; they now *own* the bank (or at least part of it, anyway). The bailout of America's prime symbols of economic prowess signals not only the vulnerability of the U.S. economy but also the ascent of sovereign wealth funds as new power brokers in international relations. These government-owned investment funds, whose combined assets currently surpass $3.5 trillion, are pouring billions into hedge funds, private equity funds, real estate, natural resources, media conglomerates and other nodes of the West's economy. Distressed financial institutions facing liquidity problems often find cash injections offered by sovereign wealth funds the only way to stay afloat.

Some experts dismiss the concern about foreign acquisitions of Western assets as a new form of jingoism. They deride the "fear mongers" as disciples of those who stoked the anti-Japanese hysteria of the 1980s. Sovereign wealth funds, they believe, are a boon to our economy, providing the capital and support for the tumbling dollar that hold back a financial meltdown of historic proportions. Furthermore, such rescue packages create an incentive for even the least friendly foreign governments to protect their investment by ensuring America's prosperity.

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These claims may prove true if tensions between the United States and some of the investing countries eventually subside. If they do not, as is most likely, then soaking up Arab wealth (or Chinese, for that matter) could mean trouble, because there is a fundamental difference between state and private ownership. Lack of transparency allows many investor governments to blur the fine but clear line between government and private economic activity. Unlike ordinary shareholders and wealthy private investors who seek only profit, governments sometimes choose to maximize their geopolitical influence or promote anti-Western ideologies.

Of course, it depends on the state. Mitsubishi Estate, the Japanese company that caused an uproar when it bought Rockefeller Center in 1989, was not the Japanese government's handmaiden, and Japan was, and still is, an American ally. And Singapore, which recently promised the U.S. Treasury Secretary that it would not use its sovereign funds nest egg for political purposes, is also a friendly state that does not arouse much concern. The same can hardly be said about Russia, China or most OPEC members, some of which use their revenues to fund the proliferation of radical Islam, develop nuclear capabilities and serially violate human rights.

We dismiss this problem at our peril particularly because oil prices will not go down anytime soon. While OPEC governments enjoy wide and growing access to investment opportunities in the West, they have not reciprocated by opening their economies to foreign investment. On the contrary, they practice resource nationalism, stick to quotas and obstruct international companies from investing in their territories, limiting them to a minority share at best. This is one reason that Big Oil's access to equity oil and gas reserves has been in constant decline for decades, resulting in insufficient production of new oil. In the past decade, global oil demand grew by 11 million barrels per day, yet OPEC, which owns 77 percent of the world's reserves, contributed only half that amount.

Perpetually high oil prices will undoubtedly transform the existing world economic order, shifting the economic balance in OPEC's direction. Imagine, for instance that OPEC members are corporations and a barrel of oil is a share. At $100 per barrel of oil, OPEC's market capitalization, based on its proven reserves, stands at the time of this writing at roughly $92 trillion. This is about the total value of the world's stock and bond markets. Saudi Arabia's oil alone is worth $27 trillion, seven times the total value of all the companies traded in the London Stock Exchange. If one adds the worth of OPEC's huge gas reserves, as well as additional undiscovered oil reserves, OPEC's wealth more than doubles. If oil prices climb to $200 per barrel, as Venezuelan President Hugo Chávez recently warned they would, OPEC wealth will double again.

Such monumental potential wealth enables a level of buying power that far eclipses that of the West. For instance, at $100 per barrel of oil OPEC could potentially buy the Bank of America with two months' worth of production, Apple Computers with two weeks' worth and General Motors with just six days' worth. It would take less than three years' worth of production for OPEC to own a 20 percent share of every S&P 500 company (enough to ensure a voting block in most corporations). Takeovers of such magnitude are unlikely in the foreseeable future, but what is clear about the new economic reality is that the economic power of America and its allies is constantly eroding as OPEC's "share" price is steadily rising.

With soaring oil prices, Middle Eastern governments will have the ability to use their increased buying power as a means of extortion and overt intimidation whenever political differences emerge. This is all the more striking in light of the growing prospect of future bailouts in American sectors beyond banking—such as America's underfunded healthcare and retirement systems. The derivatives market, which has quintupled in the past five years, is another massive bubble waiting to explode—and potentially to be "saved" by OPEC state capital.

To date, the influx of petrodollars has not purchased too many seats for foreign agents in Western corporate boardrooms. That is because many of the sovereign wealth funds are

Associated Press

The fast-growing Dubai skyline: Guess who's paying for it?

prepared to forego board seats by buying holdings under the 5 percent benchmark that triggers regulatory scrutiny. But at the current rate of investment, and assuming several more years of high oil prices, some wealthy foreign governments might look to translate their wealth into power—by dictating business practices, vetoing deals, appointing officers sympathetic to their governments and dismissing those who are critical of them.

The gradual penetration of *sharia* into the West's corporate world is another sign of our time. *Sharia* countries like Saudi Arabia have strict guidelines of economic conduct, such as prohibiting the collection and payment of interest and investments in businesses that sell unlawful products like alcohol and pork. Banks and investment houses are beginning to employ a new breed of executive, the chief *sharia* officer (CSO), whose sole job is to ensure compliance with Islamic law. Over time, such compliance could put pressure on companies at variance with Islamic principles to become more "Islamic." Imams sitting on *sharia* boards could be pressured to withhold their approval of any business dealing connected with countries or institutions that are offensive to Islam. The first signs of this can be seen in China, where pork, a food forbidden in Islam, is central to the cuisine. *Sharia*-compliant funds investing in commercial real estate force their tenants to limit the sale of pork and alcohol. "I need to go through each tenant's balance sheet to ensure that the non-*sharia* elements are at an acceptable level", said one Chinese trust manager.

Balancing Risks

Protecting America's economic sovereignty does not mean pulling up the drawbridge and isolating ourselves. America's commitment to open markets and the free flow of capital around the world has been a source of respect and admiration. Investment protectionism would hurt U.S. prestige while undermining economic growth and job creation at home. Nevertheless, we must strike a new balance, for current macroeconomic conditions clearly call for heightened vigilance.

The United States already has a rigorous safeguard mechanism to protect national security assets in sectors such as

telecommunications, broadcasting, energy and minerals: the Committee on Foreign Investment in the United States (CFIUS). CFIUS has paid less attention to sectors with less obvious connections to national security, such as the auto industry. Yet sovereign funds have already put their sight on auto manufacturers, buying stakes in companies like Ferrari, Aston Martin and Daimler. In 2004 Abu Dhabi almost bought 25 percent of Volkswagen's shares after the German automaker's profits fell sharply. It is not unlikely that Arab sovereign wealth funds would be the first to step in to save the ailing U.S. auto industry from its massive pension obligations. What this might mean for U.S. efforts to make our cars less dependent on petroleum is a question policymakers should debate before such a crisis is upon them.

Adopting the principle of reciprocity is also an important step for policymakers to take. As mentioned, many of the countries investing in the West are notorious for their inhospitality to foreign investors and their egregious violations of free trade principles. The least we can do is demand that foreign nations treat us as we treat them. Despite being the leading violator of free trade by dint of its leadership of OPEC, Saudi Arabia was admitted to the World Trade Organization with U.S. support in 2005. This was a terrible blunder. Since their admission, the Saudis have responded to American generosity with nothing but continuous manipulation of oil prices. When President Bush went to Riyadh in January 2008 to beg the Saudis to increase oil production, the Saudis announced that oil prices would remain "tied to market forces" (read: the whims of the OPEC cartel). When he went again this past May, he got little more. The lesson here is that enjoying the benefits of free trade should be an earned privilege, not an entitlement, and foreign governments that wish to acquire assets in the West or seat their agents in Western boardrooms should be obliged to show similar hospitality to Western companies.

In the long run, the only way to roll back OPEC's influence, and with it Western vulnerability to potentially hostile use of sovereign wealth funds, is by reducing the strategic value of petroleum. The keys to this strategy are parked in our garages. Two thirds of the oil the West uses is consumed in the transportation sector. Since the average lifespan of a car is nearly two decades, continuing to make cars that can run on nothing but petroleum recklessly locks our transportation sector to oil for the foreseeable future.

A shift toward a global transportation system based on next-generation, non-petroleum fuels should be America's top strategic economic priority. The first step should be to ensure that every car put on the road is a flex fuel car, which looks and operates exactly like a gasoline car but has a $100 feature that enables it to run on any combination of gasoline and alcohol.

Millions of flex fuel cars on the road will ignite a boom of innovation and investment in alternative fuel technologies. The West is blessed with a wealth of affordable sources of alcohol fuels (ethanol and, better still, methanol). Among them are hundreds of years' worth of coal reserves, vast rich farmland and billions of tons per year of agricultural, industrial and municipal waste. (Remember that scene in one of the *Back to the Future* movies where the DeLorean retrofitted in the future is fueled from a neighbor's garbage? It was funny in the movie, but it may soon be no joke.) In an alcohol-fuel economy, scores of poor developing countries that now struggle with high oil prices would be able to excel as biomass-derived energy exporters, emerging as a powerful force in the global transportation sector.

It is in America's interest to help steer the wealth transfer inherent in high energy prices to countries that are friendlier and better behaved than those of the Middle East, Russia and Venezuela. Failure to do so will guarantee a metastasizing loss of sovereignty, economic and political decline, and a situation in which, in the words of the chief economist of the International Energy Agency, "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."