The true value of state capitalism

ERE is a curious im- balance in global fi- nance. The majority of the most advanced and richest econo- mies in the world are suffering from huge national debt burdens. Meanwhile, several emerg- ing market countries with significant- ly lower gross domestic products are surplus savers and are being overtaken with vitality.

Their savings are partly chan- neled into the investment vehicles of state capitalism known as sovereign wealth funds (SWF). These institution- alized national cash pools, which are expanding abroad, have come under heavy attack. But in fact, they can en- dow a discerning recipient country with a national competitive advan- tage, increasing the prosperity and de- creasing vulnerability. This renders them particularly valuable in times of financial crisis.

Like the spectacle of communism in the past, state capitalism’s acquire- ment on the international stage can be dis- liked and feared for manifest rea- sons, making them ideal propaganda targets.

To start with, when a state inter- feres with the allocation of capital, the efficiency of markets may de- crease, leading to sub-optimal out- comes.

Sovereign funds can also serve as instruments for the remaking of one country by another glo- bally. Neo-mercantilists may resort to the strategies of a lunatic sheep’s clothing. An ambitious nation-state can use its status of an ostensibly benign, sovereign invest- ment vehicle to penetrate foreign mar- kets and pursue secondary economic projects that put it at odds with other players.

It may try to control foreign coun- tries, secure scarce tangible and intangi- ble resources, as well as undermine companies on their home turf to gain market-dominating positions. In the extreme, a foreign government may hold recipient countries hostage, threatening to withdraw funds and de- stroy their economy if they do not comply with its demands.

Sovereign funds are approaching a size that enables them to sway mar- kets. If they grow further, they can ex- ercise a significant impact on countries, re- gions, and ultimately the world. Espe- cially those Westerners who recall the “Yellow Peril” alarm will most likely fear being crushed by Asia. Sovereign assets are likely to rise to the tune of US$12.3 trillion by 2013, up from US$4.6 trillion at the end of 2007. Na- tional sentiment and xenophobia bias judgments. Many a Westerner might have already concluded that state capitalism is the investment vehicles if it were the coun- try that records the highest growth in reserves instead of better competitors.

In the case of China, sovereign funds may also be conditioned as a highly skilled player, whereas invest- ers’ policies aimed at keeping its cryp- to-currency, which aggravates global imbalances.

Fueled by emotions, people overlook the positive aspects of sove- reign funds.

First, in view of the grave prob- lems emerging from overleveraging in many advanced economies, it is a silver lining that some countries actu- ally have accumulated sizeable re- serve. The owners of the US national debt clock at New York’s Times Square have recently added new space for a quadrillion dollars after it ran out of digits when it exceeded the US$1 trillion mark, up from US$3.7 trillion in 1999.

Abolishing fiscal recklessness, thereby governments promote intergnera- tional fairness, an overloaded is- sue, since people tend to discount what lies ahead. Far-sighted leaders can invest reserves into education, health and other vital areas, securing a bright future for coming genera- tions. Covering fiscal liabilities from pension obligations by establishing funds with matching assets, instead of not mentioning the debt in the na- tional books at all, is a sign of prudent statesmanship.

Sovereign funds matter particularly in countries with aging populations. Under a pay-as-you-go pension sys- tem, they would suffer more from a worsening dependency ratio. Temasek Holdings (managing the direct investments of Singapore) and the Government of Singapore Invest- ment Corporation administering its foreign currency reserves, pensions and budget surpluses are the out- comes of prudent fiscal policies and serve as exemplars for countries like China.

Further, resource-rich countries are using state-owned investment ve- hicles as a means to diversify their economies and decrease dependency on volatile and finite commodities. Stabilization funds are also set up to decrease currency fluctuation. Sover- eignt investment across the globe might help to diversify a nation, creating positive spill- over effects around the globe. This holds well for the world given that many sovereign funds originate from countries in geopolitical hotspots.

It is also beneficial that govern- ments do not put their entire reserves into money markets, but increasingly use them for longer term invest- ments. Win-win situations are feasible: Foreign state capitalists funding a concrete undertaking outside their realm may benefit the recipient coun- try and in return reap higher yields than offered by treasury bonds. While with cash, sovereign funds might be even willing to export capi- tal for investments in grand infra- structure projects abroad that absorb significant amounts of money, even though the returns may not be very high.

By establishing economies at the grassroots, sovereign funds represent an alternative to the International Monetary Fund (IMF), which as lend- er of last resort backed out entire coun- ries. If a steadfast authoritarian sys- tem directs its investment vehicles with one national will, they might act faster and more consistently than a supranational body, albeit without democratic supervision. Especially when they rescue illiquid companies, they serve as direct means to absorb shocks in the system.

In contrast to speculators provid- ing hot money, many sovereign funds have long-term time horizons and thus can enhance macroeconomic re- business. They tend to operate at the microeconomic level and attempt to maximize profitability. In many cas- es, they are staffed with professionals who make the crucial investment deci- sions and can even improve their tar- get’s management through valuable know-how transfers. Granular sove- reign funding may thus generate bet- ter outcomes than politically motivated country rescue schemes, devised by public-choice politicians and bu- reaucrats without industry knowl- edge. For sure, many battered compa- nies will queue for the help of state-owned investment arms, but few requests for cash will be accom- plished by the cunning sovereigns.

In 1864, the British Prime Minis- ter John Russell declared: “The Great Powers had not the habit of consult- ing populations when questions affect- ing the balance of power had to be set- tled.” Admittedly, political leaders with such an attitude are likely to ignore the immediate wishes of their fol- lowers. But to poll-driven political leaders, who are predetermined by the will of the governed and the immediate needs of their constitu- encies, decisions that benefit only their people but promote global prosperity and intergenerational equity.

Like fire, sovereign investments from abroad can burn countries to the ground or provide ease warmth. To gain maximum benefits and min- imize risks, leaders should observe the following golden rule for dealing with foreign state capitalism: Trust, but verify!

The author is a professor of strategy and leadership at the National University of Singapore (NUS) Business School and author of ‘The Art of Cushion Management’ (NUS Press).