http://dx.doi.org/10.18778/8088-331-4.03

Tomasz Kamiński
(University of Łódź)

Chapter 2

Political Significance of Sovereign Wealth Funds

Reflecting on sovereign wealth funds (SWFs) from the perspective of political science, one can perceive them as state-controlled entities that are instruments of state-sponsored foreign policy. As Gilpin (2001) noted, even in the context of "a highly integrated global economy, states continue to use their power […] to channel economic forces in ways favorable to their own national interests." SWFs, as investment arms of countries, can be obviously perceived as instruments of a statecraft.

The main aim of this chapter is to conceptualize the political significance of SWFs. The analysis starts from the concept of statecraft and its instruments. For the purpose of this work, the analysis is concentrated on foreign policy as an international dimension of the statecraft and explanation of the role of SWFs in this context. In the next part, the review of the academic discussion concerning motives behind the SWFs' activities with a central question about the importance of political ones is presented. Concluding that states through SWF investments can pursue their policy objectives both domestically and internationally, a review of concerns regarding SWF investments follows. Finally, the list of risks is presented that should be taken into account as long as SWF investments in the Central and Eastern Europe (CEE) are concerned.

2.1. Statecraft and the economic instruments of foreign policy

Statecraft has traditionally been defined as the art of conducting state affairs or all the activities by which statesman strive to protect cherished values and to attain desired objectives vis-à-vis other nations and/or international organizations (Sprout 1971). Generally, all agree that statecraft includes the domestic and international actions of a state and development as well as implementation of policy (Ping 2005, p. 13–17). However, the theoretical discussion about statecraft was vivid and different researchers employed different perspectives to describe "statecraft."

Baldwin (1985) in his classical "Economic statecraft" claims that in international relations statecraft could be understood as governmental influence attempts directed at other actors (both state and non-state) in the international system. In other words, it refers to "the selection of means for the pursuit of foreign policy goals." The techniques of statecraft are usually labelled as "tools," "means" or "instruments" and all of these terms could be used interchangeably. In his approach, there is not much difference between instruments of economic foreign policy and economic statecraft.

The instruments of statecraft have been subjected to the taxonomies of numerous scholars. Hans Morgenthau (1964) reduced the tools of statecraft to two categories: diplomacy and war. However, it is hard not to agree with Ping (2005) who said that this dichotomy is too simplified to explain the breadth of possible alternatives within peace and war, nor does it acknowledge the fundamental difference between domestic and foreign statecraft.

Much more useful, a four-way taxonomy of the statecraft was presented by Baldwin (1985). He distinguishes propaganda ("influence attempts relying primarily on the deliberate manipulation of verbal symbols"), diplomacy ("influence attempts relying primarily on negotiations"), military statecraft ("influence attempts relying primarily on violence, weapons and force") and economic statecraft that refers to "influence attempts relying on resources which have a reasonable semblance of market price in terms of money."

The Baldwin classification, like any other, has its deficiencies. For instance, it is not clear how to classify the sale of military equipment. Should it be considered as economic or military statecraft? Depending on the particular case, circumstances or analytical approach one might decide to classify them either way. Due to the fact that each taxonomy has its "borderline cases" we should agree with Baldwin, who claims that their existence does not do serious harm to the value of the whole concept.

Following Baldwin's approach we could define instruments of economic statecraft as all of the economic means by which foreign policy makers might try to influence other international actors. In this definition the focus is put on the implementation of state's foreign policy, so consequently, the international dimension of economic statecraft could also be called "economic instruments of foreign policy."

Analyzing instruments of economic instruments of foreign policy we can divide them into positive and negative or, in other words, persuasive and coercive. The former (collected in Table 2.1) are associated with attempts to promise or provide rewards, the latter (Table 2.2) with an attempt to threaten or punish.

Table 2.1. Examples of positive instruments of Economic Statecraft

Trade related	Capital related
Tariff discrimination (favorable)	Providing aid
Granting "most-favorable-nation" treatment	Investment guarantees
Tariff reduction	Encouragement of private capital exports or imports
Direct purchase	Taxation (favorable)
Subsidies to exports or imports	Promises of the above
Granting licenses (import or export)	
Promises of the above	

Source: (Baldwin 1985, p. 42).

Table 2.2. Examples of negative instruments of Economic Statecraft

Trade related	Capital related
Embargo	Freezing assets
Boycott	Controls on import and export
Tariff increase	Aid suspension
Tariff discrimination (unfavourable)	Deprivation of ownership (expropriation)
Withdrawal of "most-favored-nation" treatment	Taxation (unfavorable)
Blacklists	Withholding due to international organization
Quotas (import or export)	Threats of the above
License denial (import or export)	
Dumping	
Preclusive buying	
Threats of the above	

Source: (Baldwin 1985, p. 41).

The classification presented above is obviously not comprehensive. One of the elements that have to be added are foreign investments, both greenfield and capital. Nowadays, states, usually through state-owned entities such as SWFs or state-owned enterprises, invest abroad heavily. Consequently, acquisitions of foreign assets, or even promises of acquisition, are important positive economic instruments of foreign policy and the withdrawal of money or promises of withdrawal are negative instruments. SWFs, employed to use these tools, can be classified as "providers" of some instruments of economic statecraft.

2.2. Sovereign wealth funds and the foreign policy of the state

Sovereign wealth funds have attracted a lot of attention of economists but relatively little of political scientist. Even new and widely acclaimed books on foreign policy do not mention SWF (Alden, Aran 2011) or discuss it one sentence (Hill 2016). Among the very few works that presented SWFs as instruments of foreign policy, the book of William Norris (2016) seems to be the most comprehensive, however it is focused on China only. Therefore, one can say that SWFs have not been yet conceptualized as instrument of foreign policy or economic statecraft.

We should have in mind, that "sovereign wealth fund" is an umbrella term – the breadth and depth of differences in fund organization, management and strategic asset allocation make it probably impossible to establish a standard for the relationships across the whole industry. A fund's objectives could be as diverse as SWFs are, and varied from strategic and highly-politicized to purely financial ones. Murphy (2012) called it a "double bottom line" that manifests in two ways. In addition to earning excess financial return, funds benefit from increased political influence or furthering strategic interests of the sponsor's citizens.

Some SWFs own statements support this view, admitting that non-financial motivations influence their investment decisions (Hatton, Pistor 2012). Norway's Government Pension Fund – Global, the largest SWF to operate globally (SWFI Rankings, 2014) is the best example. The fund is permitted to invest in targets as long as they will satisfy predefined environmental, labor or transparency standards (Chesterman 2008; Clark, Dixon, Monk 2013). So a form of "ethical screening" is needed prior to the investment, which obviously can be classified as politically-biased and not market-driven behavior.

However, as convincing as the above presented way of thinking is, answering the question if SWFs pursue strategic goals along with financial ones has become one of the fundamental issues that has been examined by various researchers. Many scholars have endeavored to assess to what extent SWFs follow investment strategies driven primarily by financial efficiencies and to what degree they respond to political agendas. Interestingly, depending on methodologies and time periods applied, varying conclusions come to the fore.

In Balding's (2008) analysis of foreign and private equity transactions undertaken by flagship SWFs, pointed to an absence of non-economic investment motives. Balding thus construed SWFs' policies to follow the path of expected investment efficiency. However, he admitted that "while the evidence that sovereign wealth funds have acted historically as instruments of state power or in collaboration remains thin, the logic behind the fear is not irrational." Lixia Loh (2010) strongly argued that anti-SWF concerns arise mainly from the lack of understanding the role of SWFs and Loh's research showed no clear evidence of funds acting out of purely political motives. Epstein and Rose (2009) even advised to make a prudent default assumption that SWFs are market-driven, due to the lack of contradictory evidence. Such voices are, however, in the minority.

Most of the other researchers argue that SWF investment policies are not entirely driven by profit maximizing objectives but they give different explanations. Chhaochharia and Laeven (2008), analyzing SWF investment strategies, found that funds largely invest to diversify away from industries at home and predominantly in countries that share the same culture. That suggested that their investment rules are not entirely driven by profit maximizing objectives but have some political motivations behind them.

Knill, Lee and Mauck (2012) agreed that political relations play a role in SWF decision making. In their empirical study they claim that contrary to predictions based on the foreign direct investment (FDI) and political relations literature, SWFs prefer to invest in nations with which they have weaker political relations and behave differently than rational investors who maximize return while minimizing risk.

Clark and Monk (2012) defined SWFs as "long-term investors, whose holdings are selected on the basis of their strategic interests (fund and nation) rather than the principles of modern portfolio theory." In this definition they made an important distinction between the owner and the fund itself suggesting that sometimes the ruling elites of a country and its fund managers might have conflicting interests.

Hatton and Pistor (2012) in their very interesting paper also put attention on the role of ruling elites. In their work they observed that in political entities without electoral democracy, such as China, Singapore, Kuwait and Abu Dhabi, the overriding objective of SWFs is to maximize the gains of the politicians. They claim that SWF behavior can be explained by the "autonomy-maximization theory." In accordance with this theory the true stakeholders in SWFs are the ruling elites in the sovereign sponsor, and that as such, it is the interests of these elites that SWFs advance. To these elites, SWFs "serve as a valuable tool for protecting their interests." The first and foremost among these interests is maintaining their privileged position. Obviously this position is often very much dependent on domestic stability or the security of the state, so the activities of SWFs may serve a state's interests as well.

None of the existing characterizations can adequately explain the full range of observed SWF behaviors and there is no clear consensus in academic literature as far as the explanation of SWF investment strategies is concerned. Presumably any pan-industrial conclusions would be highly precarious to draw and the level of politicization is highly fund specific. The most convincing argument is presented by Manda Shemirani (2011), who claims that we should simply apply three different perspectives to the study of SWFs and that help us to explain the differences with respect to a funds' behavior. Firstly, SWFs can act as a tool in a state's foreign policy. Secondly, funds are a "metamorphosis of state-run business" and together with other state-owned or state-controlled entities they are instruments of states acting as a entrepreneur e.g. increase earnings and manage political risks. Lastly, SWFs serve for various types of "domestic compensation." A political leader might need, for instance, to provide compensation for their voters or supporters of the political regime in order to ensure continuity of their government. Another example is the need to manage macroeconomic deficiencies or bail-out some troubled institutions.

Following Shemirani's way of thinking we can assume that a behavior of a particular SWF is always a mix of those three motives. They are mixed in different proportions depending on the fund and may change over time. As she noted: "The SWF's goals can be multiple, changing, or even overlapping, in which case the critical question to ask is how the owner balances their various goals against each other." For example, states are faced with extreme external pressures, for example global recession may result in the abandonment of the main goal of a SWF and divert the fund's resources for coping with economic problems at home. This was the case with Russia. The economic troubles resulting from falling oil prices and the sanctions imposed on this country after its aggression on Ukraine, forced the Kremlin to fall back on the SWF's assets to shore up the cash-strapped national budget and wobbly Russian Ruble (Flood 2015).

Keynes said years ago that "international cash-flows are always political" (Keynes 1933) which today can support the view that when analyzing SWFs activities one has to presume there are political motives behind them. As Truman (2010) rightly observed "SWFs are political by virtue of how they are established, and by their nature are influenced to some degree by political considerations." This conclusion has resulted in distrust by Western policymakers about SWF intentions and implementing new, protectionist policies designed to minimize perceived SWF threats (Monk 2008). The types of concerns Western countries have are analyzed in the following subchapter.

2.3. Concerns regarding SWF activities

Concerns over SWF activities have been publicly voiced since 2007. In May 2007 information about the acquisition of stakes in Blackstone, an American investment fund, by Chinese SWF China Investment Corporation hit the headlines of all major newspapers (Arnold et al. 2007). The size of the transaction (USD 3 billion), provenance of the capital and rumors that the new Chinese fund is going to invest abroad USD 300 billion, made Westerners nervous and started a vigorous debate about the potential consequences of capital expansion by SWFs.

The most interesting observation, as far as consequences of SWFs rise in prominence are concerned, was made by Lawrence Summers who wrote in the Financial Times that funds "shake logic of capitalism" that used to be based on ongoing privatization (Summers 2007):

> The question is profound and goes to the nature of global capitalism. A signal event of the past quarter-century has been the sharp decline in the extent of direct state ownership of business as the private sector has taken ownership of what were once government-owned companies. Yet governments are now accumulating various kinds of stakes in what were once purely private companies through their cross-border investment activities.

His observation was later supported by Professors Gilson and Milhaupt (2008) who have characterized SWFs as "neo-mercantilist" institutions that use "company-level behavior" to maximize "country-level [...] economic, social, and political benefits."

That narration has been particularly widespread in the United States, where almost all agree that, as state sponsored actors, SWFs can be used by their mandators for politically driven purposes, potentially harmful for the US. Even Barack Obama, during his initial presidential campaign in 2008 commented: "I am obviously concerned if these... sovereign wealth funds are motivated by more than just market consideration and that's obviously a possibility" (Loh 2010).

However, just what are the main threats related to SWF activities? Truman (2010) enumerates five types of concerns, though some of them are shared by all government-sponsored institutions and do not exclusively relate to sovereign funds.

1. Mismanagement of investments by SWFs to the economic and financial detriment of the country with the fund.
2. Pursuit of political and economic power objectives via SWFs.
3. Exacerbation of financial protectionism inspired by SWFs.
4. The potential for financial turmoil and uncertainty associated with SWF activities.
5. Conflicts of interests between countries with SWFs and countries in which they invest.

The first concern primarily involves countries that are home to SWFs, so it is beyond the scope of our interests, but the other four deserve closer investigation.

Pursuit of political and economic power objectives via SWFs

Governments may use their SWFs to implement various political goals. Firstly, thanks to SWF investments states can increase their political influence in foreign countries. For example, the People's Republic of China using promises of SWF investment convinced the government of Costa Rica to sever diplomatic ties with Taiwan and establishing them with Beijing. According to La Nación, Costa Rica's largest newspaper, China's SAFE Investment Company bought USD 300 million in Costa Rican government bonds in two lots in January 2008 and January 2009 in return for this diplomatic move. That was kept in secret, however, the newspaper revealed this case and even won the lawsuit, defending their right to publish this information (Anderlini 2008; Norris 2016).

Another example of rising political influence comes from Europe. SWFs money started to be extremely attractive to European countries seeking investment in times of Eurozone crisis. Italy's finance minister, Giulio Tremonti, who was at first skeptical to what he called the "reverse colonization of Europe," in 2011 turned to cash-rich Beijing in the hope that Chinese SWFs would help rescue his country from financial crisis by making "significant" purchases of Italian bonds and investments in strategic companies (Dinmore 2011). Such behavior obviously put Italy in an unfavorable position vis-à-vis China.

The more SWFs invest in a particular country, the bigger the "threat of disinvestment" as a political tool. An announcement about the possible withdrawal of money from a particular market could be very useful to pressure foreign partners. In early 2008, Muammar Gaddafi threatened to withdraw Libyan SWF investment from African nations resistant to his idea of strengthening the African Union (Drezner 2008). In 2010, during the G20 meeting in the Korean city of Busan, Eurozone officials met powerful Asian investment groups and government officials who expressed concerns about Europe's financial woes and according to the "Financial Times" said "they would reduce or halt future purchases of Eurozone bonds unless something was done to allay the fears about Europe's banks." This declaration had an impact on European officials as in that very difficult moment the last thing that any debt-laden European government wanted were problems with selling bonds (Tett 2010).

Secondly, there is a threat that through SWFs foreign governments could take control over strategic industries or critical infrastructure. Alan Tonelson articulated this concern in his testimony in American Congress in 2008: "If, for example, the Chinese government held significant stakes in a large number of big American financial institutions, especially market-makers, and if our nation's current period of financial weakness persists, how willing would Washington be to stand up to Beijing in a Taiwan Straits crisis?" (Drezner 2008).

Not only the Chinese threaten Western analysts. For example, in 2007 an investment company owned by the Abu Dhabi government picked up an 8.1% stake in the American-based and second-largest maker of computer microprocessors. This investment has raised worries among politicians in Washington over increasing Arab-nation involvement in potentially crucial intellectual property in sensitive areas such as defense and technology (Wray 2007).

Another particularly vulnerable sector is energy. For such SWFs owners like China, foreign acquisition of energy companies is perceived as a strategic national interest and key issue for the energy security of a country. Host countries are naturally cautious about such investments (Sun et al. 2014).

Financial protectionism

Concerns associated with SWF activities stimulate many countries to impose new barriers to capital flows. New or improved regulations were introduced by such countries as the US (Lovery 2012), Canada (Safarian 2012) and Germany (Jost 2012). The European Union decided to avoid bringing legislative action at the EU level but proclaimed a special document (European Commission 2008) in which they recommend soft measures, such as non-binding guidelines, as a more appropriate response to the rising SWF activity in Europe. Consequently, the EU strongly supports the International Monetary Fund (IMF) initiative to prepare a set of rules that were voluntary agreed upon by owners of SWFs in 2008 and are known as "the Santiago Principles."

Protectionism is perceived by many observers as something principally negative because capital markets should remain open to foreign capital flows and direct investments. In the opinion of Robert Dohner, an American official from the Treasury, it is the most pressing concern that the proliferation of SWFs "could provoke a new wave of investment protectionism, which would be very harmful to the global economy" (USCC 2008). Kratsas and Truby (2015) presented academic proof that regulatory responses on SWFs are associated with the risk of becoming overtly protectionist and imposing unwanted costs on the global financial system.

Nevertheless, the author found no evidence that these newly erected barriers really cause harm to the financial system or stop the flow of SWF capital. We can presume that the relatively low number of SWF investments in Germany and comparatively large ones in the United Kingdom, is to some extent linked to the more open attitude of the British government and liberal law environment. Obviously the German law that allows the government to block SWF acquisition of large stakes in German companies that could "threaten

Germany's interests" may seems discouragingly arbitrary, but there is no proof that this is a reason behind the lower attractiveness of the German market for SWFs.

To conclude – the threat of protectionism is so far much more potential than real. For instance, Thatcher's (2013) comparison of German, Italian and French policy toward SWFs even proved that although all three countries have passed legislation regulating foreign equity investment, the provisions remain limited, and direct actions against have almost never been used.

Financial turmoil and uncertainty

The next concern related to SWFs is linked to their impact on financial market stability. There is a vivid academic discussion over the question whether SWFs contribute to capital market volatility or if they can act as market stabilizers. A few stylized facts can be derived from this ongoing debate (Wiśniewski, Kamiński, Obroniecki 2015).

Firstly, some SWF features make them natural market stabilizers. They are relatively large, highly liquid, long term orientated, not significantly leveraged, with a substantial appetite for risk, less sensitive to market conditions (than other institutional investors) and focused on global portfolio diversification in search for superior returns (Mezzcapo 2009). Due to such characteristics, SWFs can promote stability in the global financial market.

Secondly, companies tend to profit from SWF investments. Fernandes's (2009) research on SWF portfolio activities in 2002–2007 demonstrated that capital markets had placed a high premium on SWF co-investment (such a premium had reached 20%). Such favorable market reaction to SWF entry announcements confirm the findings of Kotter and Lel (2008), who found that SWF investments have a positive effect on a target firms' stock prices around the announcement date, although not in the long run.

Thirdly, SWFs generally follow investment practices of other established classes of institutional investors (such as public pension-, mutual- or hedge funds). Kotter and Lel (2011) suggested that SWF behavior mirrors that of other institutional investors in their preference for target characteristics and in their impact on target firm performance. Similarities to mutual funds were proved by Avendaño and Santiso (2012) who claimed that despite contrasts in portfolio allocation, the two types of collective investment schemes do not radically differ in their investment routines. These may suggest that SWFs behaviors are no riskier than other market players.

Fourthly, SWFs have the potential to play a stabilizing role on worldwide capital markets because they serve as the "buyers-of-last-resort" when markets are falling. Despite their heavy losses sustained during the global financial crisis (Kunzel et al. 2010), and the fact that during the liquidity crunch SWFs were used to provide liquidity for their home markets, the funds did not refrain from international lending. For certain cash-strapped companies in the West, they turned out to be veritable "white knights" – friendly investors that despite high risks moved to salvage distressed companies. Couturier et al. (2009) cite the example of Bank Barclay, which being on the verge of bankruptcy managed to attract funding from three Gulf SWFs (albeit on premium terms). In a broader context, the SWFs' readiness to invest counter-cyclically is per se a stabilizing factor.

Finally, there is no evidence of their destabilizing activities on the markets. Sun and Hesse (2009) even tried to prove the opposite – in their study they tried to prove that there was a significant destabilizing effect of SWFs on equity markets, at least in short-term perspectives. Obviously, they stressed that the assessment of the longer-term impact of SWF investments and their potentially stabilizing role will require more research but thus far SWFs have behaved responsibly.

The above mentioned arguments seems to prove that SWFs are not destabilizing as such. Their potential contribution to market turmoil depends on sponsoring states. In one set of circumstances a given SWF can contribute to financial stability but in another the very same SWF can foment the hostile political strategy of its state.

Conflicts of interests

Investments by SWFs also create clear possibilities of conflicts of interests between the funds, owners or managers of targeted companies as well as governments of the host countries. It is easy to imagine that a politically motivated fund invests in a company to be able to influence the management or gain access to privileged technological or military know-how. Sensitive information could be stolen and transferred to, for example, a state-owned enterprise that is a direct competitor. From the investor state point-of-view, losses from the investment in a foreign company can be balanced by additional gains in the domestic company. Apart from industrial espionage a hostile fund can also facilitate sabotage of critical infrastructure such as aqueducts or electric plants.

The above mentioned concerns are usually refuted by SWFs and some researchers on the basis of observation that funds tend to concentrate on long-term profits, buy minority stakes and are not interested in having some impact on the management of a company. In other words, SWFs are usually passive and not active investors (Fotak et al. 2013). However, this is not always the case. China Investment Corporation (CIC), for instance, whose president publicly said in 2008 that the fund does not want board seats and has instructions to take passive roles in its investments, has gained influence on the boards of four prominent companies (Koch-Weser, Hacke 2013). Some of them are operating in sectors perceived as sensitive or strategic.

On the board of the AES Corporation, a global power company, CIC installed Zhang Guobao, who was a high-level Chinese government official, former vice-chairman of the National Development and Reform Commission, the main planning agency. Such an appointment has to raise doubts about potential political motivations behind his activities.

Other companies with CIC representatives on the board were: Canadian Teck Resources, Shanduka Group from South Africa and Heathrow Ltd., the operator of London's biggest airport. Nobody has been caught red-handed but potential conflicts of interests between a foreign country, to which a member of board is subordinate to, the interests of the company and host country are clear. The absence of negative experiences does not remove concerns that the occurrence of abuses will only be a matter of time.

Conclusions

Diplomacy can and should be viewed through lenses of political interests of actors. SWFs are not independent political actors but only investment arms that a state can instrumentally use to pursue political and economic power. Therefore, the political significance of SWFs, its stabilizing or destabilizing inclinations, are a function of their sponsoring states. In one set of circumstances a given SWF can contribute to financial stability but in another the very same SWF can implement the hostile political strategy of its state. Consequently, it is instructive to analyze the manifest or covert interests and political strategies of countries exerting control over specific SWFs – and not funds as such.

SWF activities in the region could be potentially harmful only when the donor state were to demonstrate explainable interests in destabilizing the CEE states and when the scale of involvement were to be big enough. Unless the SWF owner does not have vital national interests in the region. The risk of hostile maneuvering via SWFs is limited. Due to this fact, all analyses of fund activities have to include an assessment of the political interest of their owners in a particular state or region.

As far as types of risks regarding usage of SWFs by sponsoring states are concerned we could point out three that seem to be particularly important from the perspective of CEE countries. Firstly, SWFs are convenient to use leverage on a host country. In fact, all CEE states have to actively search for foreign capital and investment promises from foreign financial institutions are very much welcomed. It provides space for political pressure from states behind potential investors. Secondly, SWFs could be used to exercise control over strategic resources or critical infrastructure. Taking into consideration many security threats for the countries in the region that come from energy or economic dependency from foreign countries (most notably Russia), further losing control over sensitive assets may be risky. Thirdly, through SWFs foreign countries could search for access to privileged technological and military know-how, facilitate espionage or sabotage sensitive enterprises. Market valuation of "crown jewels enterprises" of CEE states are usually relatively low, in comparison with the enormous capital gathered in the SWFs. Many of them are already privatized, with only minority stakes in governmental hands. That is why, they are vulnerable for hostile take overs.

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