

**What we know about sovereign wealth funds
Comments on Krishna Srinivasan**

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Thank you

It is good to be here today and I look forward to the stimulating range of papers on the conference agenda. Can I add the standard disclaimer: view are mine and not those of the NZ Treasury or government.

Krishna covered a huge amount of ground, leaving the way open for me, as discussant, to follow my fancies.

Srinivasan reminds us that from small beginnings, SWFs have in the last decade or so have assumed a size and significance that has begun to raise questions – reflected in a proliferation of papers and in conferences such as this one.

He reminds us that the SWF grouping is not a homogeneous one - in several respects: origins; investment approach; goals; governance. These differences are important - especially “origins” – and I don’t think he develops the point enough. Some are intrinsically at risk of destabilising; others are not. But perhaps he doesn’t touch on the most important set of differences: there are big funds and small funds, and funds owned by friendly or inoffensive countries, and those that are not. In this case, names on bundles of money are not indifferently interchangeable. I will return to this point.

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Discussion of SWFs proceeds at two levels: first,(and this is the focus of Srinivasan's presentation) is largely technocratic (and hence technocratic solutions) and, secondly, at the interface between nationalism, foreign policy and the like. The latter may have economic implications.

At the technocratic level, there probably isn't much to be concerned about at present. Most of these funds now have good structures and good people - and if they need more investment management expertise there is probably going to be a glut of investment professionals looking for jobs. Moreover, for now most seem to have relatively conservative investment strategies

I'm reluctant to join the ranks of those – including Srinivasan - welcoming SWF investments in struggling financial institutions. It is not that they were probably any worse than anyone else's investment decisions, but it is hardly stabilising to buy over-valued assets (which many of these purchases manifestly were). And it is telling that none of the investments were made after 16 April, and most were done before January. But in a world coping with the aftermath of an unprecedented leveraging-up, at least the large pools of money held by SWFs haven't been leveraged, and hence won't be part - in aggregate - of the great deleveraging that is likely to underway for some time to come.

But that, of course, is to take the SWFs as given. If, for example, some of the leveraging around the Western world was actually the result of Chinese (in particular) highly distortionary exchange rate policies, which in turn led both to the huge increase in total Chinese fx assets (and its SWF), and markedly boosted oil prices, helping to supercharge the stock of assets in the funds of oil producing countries (Middle East and Russia), then perhaps we might be less relaxed. We can all still be glad to have avoided second round effects from those funds being leveraged, or moved around in capricious/disruptive matters, and we still want the funds that do exist to be well-managed, but.....perhaps better to have avoided them altogether - many are, almost by construction, disequilibrium phenomena. It might have been better, for example, if US (and other Western countries) tradables sector to have been stronger, and not have needed such low interest rates supercharging

housing booms around the West, and drawing financing from all and sundry (SWFs and reserves managers among them) directly or indirectly into assets supporting the boom.

Nonetheless, I think we can be reasonably comfortable that in normal times and normal circumstances that the activities of SWFs (and similar funds) as they are constructed and managed today, shouldn't, as a technocratic matter, be too much of a concern, even if the choices that give rise to the funds are, in some cases. This is especially so if, as I suspect, the big funds don't end up getting hugely bigger. The guidelines that the consultative process is bringing forth are likely to be helpful confidence building measures. And yet I don't think they will make as much difference as Krishna suggests - transparency can be helpful, and one doesn't argue against it, but just how much difference it is likely to make is open to question.

And yet I suspect that technocratic issues are not really where the main debate, and public unease, is at.

Money is power, actual or potential (and debt is vulnerability). We all know this in our personal lives. Brad Setser in his recent CFR report is particularly good on this - beginning his report noting that in the Suez crisis, Britain's foreign policy initiative was aborted as the US exercised its financial power (and US clout in the IMF was simply another financial asset - supposedly held for "economic and financial purposes" not for use in exerting leverage in foreign policy disputes). If money is power - purchasing power or power to induce behavioural change - concentrated money is the potential for concentrated power.

And, in life, we are more willing to make ourselves vulnerable to those we trust - or at very least to those whose actions/intentions we can verify.

In reality, thus, no one much cares about most of the funds. At present, we can be blunt: were it not for the fact that large assets were held by China, and oil producing countries (especially Islamic ones), none of this debate/discussion would be going on. The activities of the NZSF, as an example, could conceivably matter to almost

no one (both because of the absolute size and because we are mostly a non-threatening sort of country); let alone the Botswanan or Kiribati funds, or the old Nauru fund. Public and politicians care about funds controlled by governments with whom there is **potential** for seriously antagonistic relationships, especially if those funds/countries are large enough (however defined) or concentrated enough to matter.

It is worth noting that none of the existing SWFs or large funds is owned by traditional major economies - the G7. Thus perhaps some of the angst is about the emergence of new financial “powers” But one wonders how the world would have coped with a US pre-funding SWF. If, say, the US had a fund on the scale of NZSF (stil in its early years) it would already be far larger than any of the others. And we might wonder how democratic systems, with strong external interests, would cope with such balances.

If actual or potential influence or power is a concern, one might think that small countries should have more to worry about than large ones. But it may be telling that a recent poll in the US apparently suggests that overwhelming majorities of Americans believe that SWF investments harm both the US economy and US national security (with a partic emphasis on investments from East Asia and Middle East).

One of the problems in reading the tea leaves is that we have never been this way before. There have never been funds on such scale controlled by a government of the second or third largest economy in the world, investing across “ideological” boundaries. The closest parallel might have been Britain’s ability to marshall capital – though not typically state resources even then - in a way that led to informal empire in a variety of countries (eg Argentina_). That is hardly likely to be seen by recipients of capital as a promising precedent.

We can fully accept that SWFs/reserves managers haven’t acted very politically so far. But they could: who knows how political processes in owner countries will play

out over the next 10- 20 years – and note the recent FT story about SAFE buying Costa Rican bonds as part of a deal to shift recognition from Taipei to Beijing.

Thought experiments can be useful here.

I noted that none of the SWFs had been owned by G7 countries. Suppose that Western countries had, in fact, had large SWFs in recent decades. What if those state funds had been invested in apartheid South African firms or government bonds - pressure for divestment would have come more powerfully/quickly, than through private institutions. Of course that looks like a good outcome - more pressure on a policy we deplore.

But what if it was exercised against a policy we supported? Liberation of the Falklands , the invasion of Iraq, or refusal to allow nuclear ship visits. Ethical investment pressures - whether whaling, tobacco, cluster bombs etc are real, especially on state entities – and can be seen by those on the receiving end as coercive use of state power. In the frenzied environment that renamed French fries, freedom fries, how might the US body politic have coped with owning large sovereign assets in France and Germany when those countries opposed the Iraq war. It is not that divestment would necessarily have occurred, but the possibility would further have upped the heat in the debates of the time.

Govts have policy objectives - not just making money. Interests and policy objectives can conflict. Financial assets can be an instrument of power - if the stakes are high enough or public demand intense enough, no ex ante rule can stop them being so.

Perhaps too it is worth thinking about trade parallels. Governments typically aren't large traders in goods and services. We have a WTO process that tries to draw countries into a mutually beneficial trade regime. Individuals can refuse to deal with companies and countries, they disapprove of, but we try to eschew the use of trade policy itself for political policy purposes - no matter how much citizens might disapprove of the policies etc of other countries. Would that be as credible if governments themselves were large traders? Many have aimed to build a similar

relatively liberal framework for private capital flows and investment. But SWFs and state assets involve direct state ownership/divestment choices – and hard to make that not responsive to political ends. Some of those will be benign or widely shared, but sometimes they won't. SWFs may even make the cause of capital/investment liberalisation - in the West and in emerging markets – harder. Concern about the activities of foreign govts, and their agencies, will often be greater than that about offshore private investors.

There can be good reasons for states to hold substantial financial assets. Large cross-border accumulation of funds, or concentrations of investments, by governments of small friendly countries are not likely to represent any material problem – and even if they are mismanaged, as Nauru, simply too small to matter. But for anyone else, the pressure to watch, monitor, verify and, in extremis, restrict is likely to be both understandable and unavoidable. All the more so if the funds have accumulated as a result of highly distortionary policy choices, in which reserves accumulation moves from being an insurance policy (on which a premium is paid), to becoming a profit centre. And it is hard to imagine that the US could really establish a pre-funding scheme, akin to NZSF, without creating significant market, liberalisation, and political challenges.

Guidelines likely to emerge from the current consultative process are a “good thing” but are hardly likely to change the nature of the realpolitik issues. As just one example, the US would not allow an Iranian fund to own Citicorp, nor would Iran be likely to tolerate a US sovereign fund owning major firms in key sectors of its economy. Fortunately for the NZSF and NZ taxpayers, only the scruples of our own citizens are likely to act as much of a constraint on our fund's investment universe.