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We need rules for sovereign funds

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The growth of government-owned investment companies, often called sovereign wealth funds, has caused a lot of hand-wringing in the US and Europe – and rightly so.

Washington has asked the International Monetary Fund and World Bank to establish a code of good practice for SWFs. Berlin is eyeing new legislation to deal with these funds, modelled on US procedures for screening incoming foreign direct investment. Brussels is considering a European-wide set of guidelines. But so far no western government has had the courage to admit that dealing with SWFs may require departures from the conventional liberal orthodoxy concerning global trade and investment flows. Yet this is precisely what is needed.

When relatively few SWFs existed, such as Singapore's Temasek Holdings or the Kuwait Investment Authority, the challenge they posed to the global financial system and to market-based cross-border investment was small. But now sovereign funds in countries such as Saudi Arabia and Russia are becoming active, Beijing is establishing the government-owned China Investment Corporation, and Japan and South Korea are contemplating similar SWFs. Moreover, the amounts under sovereign management could soar from about \$2,500bn today to \$12,000bn in 2015, according to Morgan Stanley.

These funds are going to have the

ability to buy any global company, to create panic in markets if they move too precipitously, even to dwarf the political clout of international financial institutions. They can no longer be ignored.

The agenda for dealing with SWFs must take account of disturbing trends in the global marketplace. For all the backslapping among finance officials and private bankers about the benefits of increasing globalisation and the diversification of risk via securitisation and high-technology derivatives, the fact is that the capital markets have become increasingly opaque.

Between the growth of impossible-to-value derivatives, the phenomenal increase in secretive hedge funds and the multiplying layers of connections among different markets, a critical assumption underlying a liberal economic order – that market participants have the information they need to make rational decisions – is being jeopardised.

This is where sovereign wealth funds come into the picture. Yes, they are only part of the global financial black box, but because they are driven by governments, they nevertheless compel immediate attention. As they expand their presence, they could undercut another key premise of a global market – that it is dominated by private participants seeking to maximise their welfare and that of their shareholders.

Of course, in 2007, sovereign funds may seek to invest excess foreign exchange reserves or extraordinary profits from oil for nothing more than higher returns than would be earned

from US Treasuries. But who knows what the governments of countries such as China, Russia and Saudi Arabia may look like a decade from now, and what their political motivations might be?

In the first instance, the US and European Union should harmonise their policies rather than pursue their usual go-it-alone response to important global issues. Among the principles that Washington and Brussels ought to consider are these:

Transparency is the key. In order to be treated as normal investors, SWFs

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should be obliged to publish internationally audited reports on their entire portfolios at least twice a year. They should disclose the precise mechanisms by which they themselves are regulated in their home countries – including the specific individuals charged with that oversight. From the SWF disclosures we should know the fund's investment philosophy, its corporate governance process and its risk management techniques.

Reciprocity should be required. If western host countries are going to treat SWFs like any other market participant, the economy of the SWF's home country must be as open as the country in which the SWF aspires to

invest. In addition, if a sovereign fund was established because of currency manipulation in the host country that led to excess reserve creation (China), or if it is the result of strident resource nationalism (Russia), or if it is due to monopolistic pricing practices (Saudi Arabia), then consultations should be initiated between the two governments to reduce these policy distortions.

Ownership guidelines are essential. SWFs should not own more than 20 per cent of any company in the US or Europe, without a decision of the host government to go higher. The underlying premise must be that SWFs are political entities and should be treated as such.

Many in global financial markets will see these proposals as having a protectionist thrust. However, it would be equally dangerous to pretend that governments will always invest like normal market participants, or that without effective rules, the growing activity of SWFs will not set off an even larger protectionist backlash than the rules themselves would create.

Others will worry that the US will jeopardise much-needed funding for its large current account deficits. It is equally possible, though, that predictable rules could facilitate capital flows. One thing is for sure: it will become more difficult to deal with SWFs once they become an entrenched feature of the world economy. Now is the time to act.

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