6-21-2007

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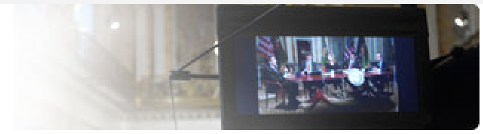
U.S. DEPARTMENT OF THE TREASURY

Press Center



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hp-471

San Francisco--The financial crisis that struck East Asia ten years ago had many causes – fixed but adjustable exchange rate regimes, balance sheet mismatches in the financial and corporate sectors, and inadequate financial sector regulation and supervision, among others. Ultimately these causes manifested themselves in large-scale capital outflows and insufficient official foreign exchange reserves.

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At the time, a number of working groups were established to address issues coming out of that crisis. One group recommended that the international community – largely led by the IMF – improve the coverage, frequency, and timeliness of data on foreign exchange reserves. The idea was to improve financial stability by providing clarity on what had been shown to be misleading data regarding gross reserves. Though much has been accomplished, further progress, particularly on coverage, is needed.

East Asia today looks considerably different in many respects, but perhaps none more so than foreign exchange reserve holdings. In East Asia, and around the world, reserve accumulation has sharply accelerated. From 1997 to 2001, global foreign exchange reserves including gold increased at 6 percent per year on average. Since 2002, the annual average increase has been a phenomenal 20 percent. Global reserves currently stand at roughly $5.6 trillion. Many countries with large reserves surpass, by several multiples, benchmarks of reserve adequacy developed after the Asian Financial Crisis.

But reserves do not tell the whole story as they generally do not include Sovereign Wealth Funds. Sovereign Wealth Funds are not new – they have existed for over three decades, even if the term as such was only coined to my knowledge in 2005. What *is* new is the number of Sovereign Wealth Funds and their sheer current and projected sizes. Private analysts put current Sovereign Wealth Fund assets in a range of $1.5 – 2.5 trillion, which would bring total foreign assets held by sovereigns to roughly $7.6 trillion, or 15 percent of global GDP.

These trends raise broad, strategic issues for the international financial system. What are the underlying policies driving the accumulation, and should they be adjusted? What financial market and, over the medium-term, financial protectionism challenges could arise from this tremendous increase in sovereign cross-border asset holdings? How can countries in which these funds are invested best promote openness and welcome foreign capital? The common objective should be an international financial system where countries do not accumulate more foreign assets than they want or need, and where cross-border investment remains healthy and open.

At Treasury we are actively considering these issues, and potential steps that could be taken multilaterally, bilaterally, and by national authorities. While we clearly do not have all the answers, I would like to walk you through some of our initial thinking. I believe that the IMF and World Bank could take a very constructive step through the drafting of best practices for Sovereign Wealth Funds. Complementing the work of the International Financial Institutions, I would expect that the issue of sovereign foreign asset accumulation will increasingly arise in informal multilateral discussions. National authorities will also have an important role to play. Moreover, the U.S. government itself has responsibilities.

Definitions and Differences

First let us be clear on what we are talking about. There is no universal, agreed definition of a Sovereign Wealth Fund. I will use the term to mean a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from official reserves. Sovereign Wealth Funds generally fall into two categories based on the source of the foreign exchange assets.

- *Commodity funds* are established through commodity exports, either owned or taxed by the government. They serve different purposes, including stabilization of fiscal revenues, inter-generational savings, and balance of payments sterilization. Given the recent extended sharp rise in commodity prices, many funds initially established for fiscal stabilization or balance of payments sterilization purposes have evolved into savings funds.

- *Non-commodity funds* are typically established through transfers of assets from official foreign exchange reserves. Large balance of payments surpluses have enabled non-commodity exporters to transfer "excess" foreign exchange reserves to stand-alone investment funds to be managed for higher returns.

There are three key differences between these two types of funds:

- First is their asset-liability structure. Commodity funds often derive from foreign currency accruing directly to the government, so the foreign currency is not converted to domestic currency, does not enter the domestic economy, and does not need to be sterilized through the issuance of domestic debt to avoid unwanted inflationary pressures. In contrast, non-commodity Sovereign Wealth Fund assets often derive from exchange rate intervention, much of which is usually sterilized. These funds' net return will depend on the difference between the yield they earn on their investments and the yield they pay on their sterilization debt. So they may be thought of more as "borrowed funds" than traditional "wealth."

- A second difference involves how countries have allocated their foreign assets to Sovereign Wealth Funds and reserves. Commodity exporters have typically chosen Sovereign Wealth Funds, while Asian countries have chosen reserves. There are exceptions – Singapore created its Government Investment Corporation back in 1981 and Russia established its oil stabilization fund only in 2003 – but the general trend has stood. Now, though, Asian countries are increasingly establishing non-commodity Sovereign Wealth Funds.

- A third difference concerns the future pace of asset accumulation. Oil exporters in particular are essentially replacing a real asset in the ground with a financial asset in an account. If oil prices remain high, these governments are likely to accumulate foreign assets going forward even after the implementation of sensible domestic fixed investment plans. In contrast, the extent of asset accumulation in non-commodity funds will depend heavily on how successful emerging markets are in shifting to increased exchange rate flexibility.

Benefits and Risks

The creation and expansion of Sovereign Wealth Funds is understandable given the significant increase in official reserves. To be considered reserves, foreign currency must be invested in liquid and marketable instruments that are readily available to the monetary authorities to meet a balance of payments need. The idea of a Sovereign Wealth Fund is to diversify foreign exchange assets and earn a higher return by investing in a broad range of asset classes, including longer-term government bonds, agency and asset-backed securities, corporate bonds, equities, commodities, real estate, derivatives, alternative investments, and foreign direct investment.

Some back-of-the envelope math demonstrates why this trend toward higher risk-return management of official assets is to some extent inescapable, or what has been perceptively called "forced diversification." In 2006, official foreign exchange reserves grew by 20% or $843 billion. If we assume for simplicity a similar percent increase in Sovereign Wealth Fund assets, we add $336 billion. Setting aside valuation changes, this brings total 2006 official flows to nearly $1.2 trillion.

In comparison, 2006 net issuance of the most traditional reserve assets – U.S. Treasuries, U.S. Agencies, euro area government securities, and UK Treasuries – totaled $461 billion. So even if reserve and Sovereign Wealth Fund managers had purchased *all* 2006 net issuance of these traditional reserve assets, they would still have had some $720 billion left over. Of course this remainder can be invested in the existing stock of these securities, but part is also likely to find its way to other assets and asset classes.

These trends can bring benefits to countries in which these funds are invested. From the U.S. perspective, we unequivocally support international investment in this country – both portfolio and direct investment – and are committed to ensuring that the United States continues to be the most attractive place in the world to invest. Most market estimates, though highly dependent upon underlying assumptions, expect future official flows to have a material though moderate impact in bidding up prices and lowering risk premia of riskier, less liquid assets, while at the same time resulting in continued strong demand for traditional reserve assets. This may contribute to continued benign financing conditions.

There are also risks, however. The first concerns these funds' potential impact on financial market stability. To be sure, there is much that is reassuring. Sovereign Wealth Funds are, in principle, long-term investors that can be expected to stick with a strategic asset allocation despite short-term losses. They are not highly leveraged. They cannot be forced by capital requirements or investor withdrawals to liquidate positions rapidly. They have access to, and frequently make use of, well-regarded private fund managers, consultants, administrators, and custodians.

Yet it is hard to dismiss entirely the possibility of unseen, imprudent risk management with broader consequences. Sovereign Wealth Funds are already large and projected to get much larger. Little is known about their investment policies, so that minor comments or rumors will increasingly cause volatility as market participants react to what they perceive Sovereign Wealth Funds to be doing. Sovereign Wealth Funds are typically not directly regulated by their domestic financial authorities, and the extent of indirect regulation may also be limited. Investor discipline will depend on what their citizens know and how active they are in monitoring fund activities, rather than the market discipline of savvy institutional investors. Further, the funds' counterparties and any creditors may simply assume a sovereign guarantee and fail to exercise market discipline.

The second risk is that, over the medium term, the size, investment policies, and/or operating methods of these funds fuel financial protectionism. It is no secret that globalization, despite its benefits, is raising sensitivities around the world. This is not just a U.S., European, or even industrialized country issue. Emerging markets have also at times expressed sensitivity to certain investments by other emerging markets. There will likely be much public attention to whether Sovereign Wealth Funds exercise the voting rights of their equity shares, and if so, how. If Sovereign Wealth Funds obtain operational control of the companies in which they invest, the fact that they are government entities may invite additional scrutiny. Finally, these sensitivities and pressures to block sovereign investment would worsen if Sovereign Wealth Fund investment decisions were made for non-economic reasons.

I think I can identify two other risks, which are largely domestic but could potentially be international. One is that with so much money invested across a wider range of asset classes, Sovereign Wealth Funds will need to have strong fiduciary controls and good checks and balances to prevent corruption. Another is that, while Sovereign Wealth Funds should be managed as professionally and independently as possible, my experience in government suggests that once a bureaucracy is created, shutting it down becomes difficult. Therefore, a fund created to handle what could be a temporary phenomenon should not impede thorough examination of underlying policies and avoid becoming self-perpetuating.

The Work Ahead of Us

We want of course to maximize the benefits of these funds while reducing the risks. A sound global financial system and the maintenance of open markets are in the common interests of all. Sovereign Wealth Funds raise issues of the appropriate institutional arrangements, governance, operational and risk management, accountability, and – critically – transparency of the funds' rules, operations, and asset management guidelines and performance.

So what to do?

First, I believe that the IMF and World Bank could take a very useful step by developing best practices for Sovereign Wealth Funds, perhaps through a joint task force. The IMF has the requisite expertise on wider systemic and macroeconomic subjects, such as the link to fiscal policy. The World Bank is knowledgeable about country governance and accounting and fiduciary issues, including the fiduciary duty these funds have to their citizens as investors. The IMF and World Bank also have the broad membership of 185 member countries, including countries that have these funds, countries in which they invest, and countries that simply have a stake in a healthy overall international financial system.

One caveat is that I do not think that the International Financial Institutions should be in the business of competing with the private sector to manage reserves or Sovereign Wealth Fund assets on behalf of countries. This is clearly beyond their mandates. Proposals along these lines have been justified by the concern that an individual reserve manager may be reluctant to invest excess reserves more aggressively for fear of disapproval (or worse) if returns are negative in a given year. This issue is best addressed by building support domestically, including through the establishment of a stand-alone domestic institution if appropriate. A country naturally also retains the right to fire asset managers that underperform their designated benchmarks. Finally, it is critical that the International Financial Institutions avoid feeding a misperception that more reserves are necessarily better, both for the countries themselves and the broader system.

Second, the subject of sovereign foreign asset accumulation will increasingly arise in informal multilateral discussions, which can complement and provide impetus to the work of the International Financial Institutions. At last April's meeting of G-7 Finance Ministers and Central Bank Governors, the Treasury Department hosted a special outreach dinner with Russia, Saudi Arabia, and the United Arab Emirates to discuss investment flows from oil exporters, including in the form of Sovereign Wealth Funds. In May, Treasury and the Federal Reserve co-hosted with the South African Treasury and Reserve Bank a meeting of G-20 Finance Ministry and Central Bank officials on Commodity Cycles and Financial Stability, where we discussed, among other topics, Sovereign Wealth Funds.

Third, national authorities will have an important role to play, and certainly at Treasury we will continue to explore ways to address the challenges and opportunities provided by Sovereign Wealth Funds. Finance Ministries and Central Banks are in increasing contact with these funds to promote common understanding. National securities regulators should treat these funds as they would any large institutional investor. National governments also maintain mechanisms to review foreign direct investment in a manner that preserves national security without creating unnecessary and counterproductive barriers.

Long-established and well-run Sovereign Wealth Funds may wonder why they should adjust their practices, particularly on transparency. I hope they will find that transparency is good for the funds as well as the international financial system. Lack of transparency puts heavy demands on the quality of fund administration. Even where fund administration is solid, greater transparency would enhance the likelihood that the fund serves its intended purposes and reduce the likelihood of future governance problems. The experience of large corporations in the industrialized world demonstrates that potential for error and abuse exists even in apparently highly-rated and well-managed organizations. From a systemic perspective, transparency will facilitate the maintenance of openness to investment. What may have been tenable in a world where Sovereign Wealth Funds manage only several hundred billion dollars may not be tenable in a world where Sovereign Wealth Funds manage several trillion dollars.

Finally, the U.S. government also has a direct responsibility – which is making our investment regime as open and consistent as possible for welcoming Sovereign Wealth Fund investment. We are doing that by working with Congress to get a sound CFIUS bill and we are doing that by reaching out around the world to explain the U.S. investment climate. Just this week for instance Deputy Secretary Kimmitt has been traveling in Beijing and Moscow meeting with government officials and business leaders to promote open investment policies and to gain clarity on their new investment laws and to better understand the nature and investment priorities of their soon to be established sovereign wealth funds. The message delivered clearly to the Deputy Secretary from officials in both countries is that the funds would focus primarily on portfolio investments such as corporate bonds and equities. When asked about the possibility of foreign direct investment acquisitions, officials in both countries indicated that is not in their current planning but if such an opportunity arose in the future, it would be in non-sensitive sectors.

Never Forget the Underlying Issues

In considering Sovereign Wealth Funds, we should not lose sight of the underlying issues – the need for increased exchange rate flexibility in many emerging markets and the need for oil exporters to formulate and implement fixed investment plans even if further foreign asset accumulation can reasonably be expected. Otherwise the official sector would be doing the equivalent of treating the symptoms rather than the condition.

However, Sovereign Wealth Funds are not going away, and it will be increasingly necessary to work to integrate these funds as smoothly as possible into the international financial system.

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