Towards a Better Understanding of Sovereign Wealth Funds

Discussant Comments on Peterson Institute Senior Fellow Ted Truman’s Paper, “The Management of China’s International Reserves”

Presented at the Conference on China’s Exchange Rate Policy
Peterson Institute, October 19, 2007

Mohamed A. El-Erian

It is a pleasure to participate in this panel at the Peterson Institute for International Economics. I would like to thank Fred Bergsten, Morris Goldstein, Nick Lardy, and Ted Truman for inviting me. My objective is to provide some comments on Ted Truman’s paper that deals with the management of China’s reserves and, more generally, the growing systemic role of sovereign wealth funds (SWFs).

At the outset, I would like to thank Ted for his thoughtful work on SWFs—not only this paper but also the August 2007 Policy Brief. While I do have some questions about the methodology that Ted uses in the paper, his work is helping to bring some rationality to a topic that, until now, has been overly dominated by incomplete analysis, ill-defined concepts of national security and reciprocity, and monster-like characterizations of motives pertaining to political, military, and/or mercantilist aspects.

The importance of more thoughtful and well-researched analyses of the SWF phenomenon cannot be overemphasized. After all, the phenomenon is part of a broader realignment of the global economy that, if well managed, can be part of an orderly solution to current national and international imbalances—a solution that can alleviate the

---

1 President and CEO of the Harvard Management Company, and member of the faculty of the Harvard Business School.
2 Truman (2007).
growing risk of global financial dislocations while preserving the prospects for continued robust global growth.

My remarks will reflect the perspective of a market participant that (i) is involved on a daily basis in market segments where SWFs also have a presence and (ii) has spent time thinking and writing about the SWF phenomenon, including in the context of the secular and quarterly themes that anchor various investment strategies. They are organized as follows: I will start by offering a summary of what I see as the paper’s key points. I will then discuss the methodology taken by the paper to “score” SWFs, raising the question of why some of the scores conflict so strongly with the likely perceptions of a large number of market participants which have been interacting for long periods of time with some of the SWFs.

My remarks will then shift from what is covered in the paper, to some elements that could be considered in designing the future research agenda on SWFs. The main focus will be on how best to formulate and implement a strategy that can succeed in enhancing the governance and institutional robustness of the SWF complex in general while also recognizing its important systemic role.

A Summary of the Main Points

In summarizing the paper’s main points, let me start with the three main areas where there is likely to be complete agreement. First, the paper points to the tremendous increase in the level and rate of accumulation of China’s international reserves—a phenomenon that is also well documented in Morris Goldstein and Nick Lardy’s

---

3 See, for example, El-Erian (2007a) and (2007b).
overview paper for this conference. Second, it rightly argues that the reserve accumulation has not been an end in itself. Rather, it has been a by-product of other economic and financial policies; and I would add not only in China but also elsewhere. Finally, the paper suggests that, while the literature is far from precise on the topic, it is fair to say that China’s reserves now exceed what would be deemed reasonable for balance of payments purposes (and particularly in light of the country’s current economic parameters, including the set of capital controls).

These considerations lead the paper to argue, correctly, that the policy issue for China and other emerging economies relates not just to flows; it also pertains to the stock of international reserve holdings. As noted in the paper, “once they are there, what does a country’s government do with them?” It then argues that “China is being held, and should be held to the highest standard of accountability and transparency in this area.”

In this context, the paper seeks to demonstrate that China falls short of expectations when judged by an SWF scorecard that captures (i) structure, (ii) governance, (iii) transparency and accountability, and (iv) behavior. Indeed, several of the other SWFs are shown to score poorly, thereby generalizing the paper’s argument to the SWF complex as a whole.

Some Methodological Considerations

*Why are SWFs special?*

Let me now turn to the methodology used by the paper. The main focus will be on why the paper’s scorecard results in poor assessments of several SWFs that, for many funds, conflicts with the perceptions of market participants that interact with them.

---

4 Goldstein and Lardy (2007).
It is highly likely that if the paper’s methodology is applied to the most rapidly growing investment vehicles in the private sector—namely hedge funds and private equity—the scores would be as low, if not lower, than for the SWF complex. It is also true that, due to both their higher leverage and shorter investment horizons than SWFs, the potential systemic effects emanating from these “alternative” private sector vehicles are larger. Yet the serious regulatory debate is still quite a distance away from the set of best practices and standards that are being suggested by the paper, and in Ted Truman’s earlier Policy Brief.

Simon Johnson, the IMF’s Economic Counselor and Director of the Research Department, touched on this issue in one of his recent writings. He notes that “The consensus so far is that while hedge funds deserve considerably greater scrutiny, there are advantages for the allocation of global capital flows if this sector continues to have a relatively light direct regulatory burden.” And those in the markets with significant capital exposure to these vehicles—i.e., institutional investors—are still happy to judge the vehicles by their output (i.e., risk-adjusted investment returns) rather than a strict adherence to the elements in the paper’s scorecard.

This initial “compare and contrast” does not, of course, take into account a notable difference in structure. Hedge funds and private equity firms are owned and controlled by the private sector whereas SWFs have governments behind them. As such, SWFs are inevitably subject to higher scrutiny lest their investment decisions be hijacked by “noncommercial” considerations pertaining to political, military, and mercantilist drivers.

5 Johnson (2007).
Interestingly, the issue that dominates the public debate is not whether SWFs will produce superior investment returns and, in the process, benefit current and future generations and contribute to enhanced efficiency in the flow of capital and the completion of markets. Indeed, there was little public concern among observers when the investment of China’s (and Russia’s) excess reserves was even more highly concentrated than it is now (i.e., in holdings of US government and agency bonds) which, virtually by definition, was inefficient from a return and risk perspective.

In the past, concerns about the impact of “noncommercial” investments by foreign governments have been handled through the imposition of appropriate mechanisms at the level of the recipient country. Such mechanisms are visible in the US (e.g., the role of CFIUS, or the Committee on Foreign Investment in the United States), and have been used successfully to block investments in what are deemed to be sensitive areas from a national security dimension. In the current debate, however, they seem to be viewed as necessary but not sufficient.

One argument that has been postulated in support of this is the risk that the absence of adequate safeguards at the level of the SWFs (as opposed to the recipient country) will end up feeding general protectionist pressures in the global economy. The specific risk is a proliferation of capital account protectionism and negative externalities in the form of further delays in completing the next stages of trade liberalization.

There could well be merit in this argument given what else is going on in industrial economies, particularly the US. The political calendar is approaching a cyclical peak with upcoming presidential and congressional elections; the debate about financial sector instability has been fueled by this summer’s liquidity sudden stops and market
turmoil; and the economy is facing headwinds on account of the weakening of the housing sector.

The multilateral framework is also under pressure and, accordingly, cannot be expected to act as a credible circuit breaker in the context of rising protectionist pressures. The legitimacy and effectiveness of the multilateral institutions are being questioned openly and widely.\textsuperscript{6} By excluding key emerging economies that have systemic importance, the G-7 process is viewed increasingly as outmoded and unproductive given the current configuration of influences on global growth, trade, price formation, and capital flows. And there is yet to emerge any credible substitute.

Accordingly, the argument for SWFs to commit to higher standards relates in large part to deficiencies in the international economy as a whole. To use a sports analogy, in order to play “defense” to limit their sensitivity to collateral damage, SWFs need to play offense. This offense speaks in particular to specific aspects of disclosure and transparency.

The agenda here is not open ended. Specifically, it need not encompass all and every elements of SWFs’ operations as some have suggested. Rather, the emphasis should be on three aspects: first, the governance structure and, in particular, the extent to which political ownership is appropriately separated from operational issues and subject to the required level of checks and balances; second, the investment process, including the robustness of the approaches that underpin asset allocation and the related choice of investment vehicles; and third, risk management, including the ability to set appropriate risk limits, monitor them, and implement the required reaction function.

\textsuperscript{6} See, for example, the discussion in Truman (2006).
Limitations of the Scorecard Approach

The paper’s scorecard exercise results in a highly counterintuitive outcome with respect to long-established SWFs whose behavior patterns have been repeatedly observed by market participants. Indeed, I would postulate that the vast majority of experienced market participants would be shocked to see the low scores that the paper assigns to some long-standing SWFs—including ADIA, GIC, and KIA—whose behavior, investment savvy and systemic impact have been observable for long periods of time. It also runs counter to the way that some of the newer SWFs, including the Dubai entities and QIA, have approached their recent investments.

If the underlying concern relates to the impact of SWFs on global stability, funds such as these have simply not behaved in a manner suggested by their low scores. If anything, the deployment of their “patient capital” has acted as a stabilizing influence on a global economy that has been increasingly sensitive to balance sheet excesses and extreme financial alchemy in industrial countries. The catalyst to, and the aftermath of this summer’s liquidity dislocations and market turmoil are yet another example of this duality.

Indeed, the paper’s attribution of low scores to several SWFs is not a reflection of their activities, behavior or temperament. Neither is it due to how they have interacted with the realities of the marketplace. Instead, it is a reflection of the paper’s limited access to information.

Understandably, the paper uses publicly-available information to compile the rankings. Indeed, it is explicit about this. And the rather puzzling outcome is a reflection of how little information is disseminated by SWFs as a group. A similar outcome would
materialize if the approach were applied to hedge funds, private equity firms, and the proprietary desk activities of major Wall Street banks.

Given the scope and recommendations of the paper, I would suggest that further work seek to expand the information set. Pending this, the paper’s findings speak more to data limitations than to a genuine assessment of SWFs.

The Strategy for Productively Engaging SWFs

Let me now turn to a strategy issue that would benefit from greater attention in the work plan on SWFs: how best to encourage SWFs to make progress, as appropriate, on issues pertaining to governance, investment process, and risk management.

History suggests that, in the vast majority of cases, the approach of debtors lecturing to creditors is not a very effective one. It does not help that such lecturing has materially intensified after some of the newer SWFs, including China, made the sensible decision to embark on a gradual diversification of hitherto excessively concentrated reserve holdings.

It is also inconvenient that such lecturing is coming on the heels of this summer’s disruptions. After all, the systemic shock originated in the most sophisticated financial system in the world, involved the migration of activities outside the purview of adequate oversight, and led to disruptions at the very heart of the market system in industrial countries—be it in terms of segments (i.e., inter-bank, commercial paper, and money markets) or in terms of markets parameters (e.g., valuations, price discovery, and visibility).
The risk is that, no matter how sensible the proposals may be, they will fall on deaf ears on account of the strategy being deployed to advocate them. This consideration assumes added importance since it is reinforced by another hypothesis: It is not just that ill-conceived pressure could be ineffective; it could also be harmful for the long-term welfare of the global economy.

One possibility is that ill-conceived pressure ends up inhibiting the asset diversification process that SWFs are, and should embark on. The result would be a set of market mispricings and distortions, including in US fixed income. We already know how this can contribute to interest rate conundrums, overly subdued market volatility, and excessively tight credit spreads. The result could well be another phase of overproduction and overconsumption of risk assets in the most sophisticated financial system that subsequently requires a costly clean up process.

Another possibility is that China and other SWFs adopt an approach that heavily outsources its reserves management to private sector institutions. While these private vehicles theoretically come under the domain of industrial country oversight, they involve a significant degree of limitations on information dissemination. Transparency would still be lacking. And a host of other considerations would arise, including whether these vehicles would efficiently deal with size.

**Bottom Line**

Where does this leave us? The debate on China and other SWFs should start from the hypothesis that it is in the interest of the global economy to have excess reserves managed in a diversified and commercially oriented manner. The resulting flow of
capital—across geographical, product, and risk boundaries—can help sustain economic growth in the context of a process of adjustment that is necessitated by the large global imbalances, overstretched US consumers, and a need for emerging economies to gradually shift to greater emphasis on the domestic components of aggregate demand.

Against this background, the analyses of how SWFs behave, including their systemic impact, should be based on a comprehensive set of data. It should include an assessment of how long-standing SWFs have operated in many different market environments. This would assist in refining what tends to be an overly broad set of recommendations to China and other SWFs. The outcome would be targeted improvements in governance, investment process and risk management as opposed to an excessively broad-based approach that has little chance of gaining traction and may even be counterproductive.

For this effort to have a greater probability of being effective, it is best pursued in the context of a holistic approach. Such an approach would be well advised to address the legitimate deficiencies in the international system that penalizes countries such as China, including questions of representation in multilateral forums.

Thank you.
References


