John Gieve: Sovereign wealth funds and global imbalances

Speech by Sir John Gieve, Deputy Governor of the Bank of England, to the Sovereign Wealth Management Conference, London, 14 March 2008.

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Introduction

Much of the debate on sovereign wealth funds (SWFs) has focused on political questions: do they reintroduce the failings of public ownership into market economies by the back door, will SWFs use their ownership rights to pursue political ends, and will resistance to foreign ownership lead to a new wave of protectionism. I want to concentrate today on some economic issues: why have they become so prominent recently, how does that relate to imbalances in the world economy, how are they affecting financial markets and what are the policy implications of their growth.

Background

But first let me set out some of the background.

There is no off the shelf definition of an SWF. What I have in mind is a government investment vehicle that manages foreign assets with a higher risk tolerance and higher expected returns than for central bank foreign currency reserves.[1] The size of such funds is hard to measure, but may be in the $2-3 trillion range.

Origins of SWFs

Investments by SWFs are one type of capital flow between countries so they have always been closely related to global imbalances in trade. When countries run surpluses on their current account, they generate equal and opposite net capital outflows of one sort or another and those capital flows produce an investment income.

That has been the story of the UK economy over the last 150 years. We ran continuous surpluses in the 50 years before the first world war (Chart 1) and built up a large stock of foreign assets. Partly as a result of that, we benefited from a surplus on our investment account for most of the period since the 1870s.

There are two key differences between that period of the UK's investment abroad and the situation today. 100 years ago the developed countries were investing in emerging markets (at the time in the Americas and Australia) which had abundant land and natural resources but scarce capital and so the returns were high. Currently, capital is flowing "uphill" from emerging to mature economies. Secondly, the investors before were mainly in the private sector and were seeking out the best returns on capital. Today the investors are mainly EME central banks and governments and the build up of foreign assets reflects their policy choices.

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[1] There is some fuzziness at the edges of this definition. Central bank reserves in some countries, which traditionally have been invested mainly in liquid and safe instruments, are increasingly being switched into riskier assets. Also, in some countries, state-owned banks and companies invest in foreign assets where some of the policy issues are the same as for sovereign wealth funds.

Modern sovereign wealth funds are not new, in fact the first – the Kuwait Investment Office – was set up here in London in February 1953 – just as Edmund Hillary and Tenzing Norgay were setting out to climb Everest.[2] And the number of funds has been increasing since then like the traffic on the slopes of Everest.

The next wave were set up by other oil producers after the price increases in the 70s and 80s for persuasive reasons (Chart 2). First oil is a non-renewable resource so it can make sense for governments to spread the benefits of this endowment across generations by investing part of today's income in assets that will provide an income tomorrow. That would be so even if the path of oil prices was predictable but in fact it is not. That uncertainty about future income provides a second case for saving today. In the late 1970s, some oil exporters increased spending to match higher incomes and faced a painful adjustment when prices fell back again. Third, even if the rise in income was permanent there would be a case for phasing the growth of domestic spending and investment to prevent supply bottlenecks leading to inflation.

Recent growth of SWFs

Since the millennium at least 10 new SWFs have been set up and there are reports of plans for more for example in Brazil, Japan and India.

This reflects the remarkable shift of emerging-market economies from debtors to creditors. Ten years ago – at the time of the Asian crisis – emerging markets as a whole were running a current account deficit. Since then they have been running progressively bigger current account surpluses reaching an estimated $685 billion last year (1.3 % of world GDP).[3] The counterpart to this is that developed countries as a group have been running progressively bigger current account deficits not just in the United States but also in a number of other developed countries including the UK.[4] Of course there are some notable exceptions in each group: Canada, Japan and Germany for example are still creditors while many countries in central and eastern Europe and Africa are running large deficits. But maps 1 and 2 show how much the pattern has changed in the last 10 years. Most of South America and South East Asia have swung from deficit to surplus. Perhaps as important, the scale of the differences has grown with more countries running surpluses or deficits of over 5% of GDP.

Oil and other commodity inflation is part of the story, of course, but that does not account for the large current surpluses in most of East Asia. Here strong manufacturing growth resulting from higher labour productivity has not been matched by higher domestic spending so savings have grown ahead of even dramatic investment growth. A deliberate policy of fostering export industrial growth has slowed the rise of exchange rates that would reduce these imbalances.

As a result the build-up in EME foreign assets have been held mainly as central bank reserves especially in Asian countries (Chart 3). In total the foreign assets now held by EME central banks and governments is about $7 trillion dollars, which compares with only $60 billion gross foreign assets held by the UK government. Many emerging economies concluded after the Asian crisis a decade ago that they needed bigger liquid reserves in traditional government debt to defend themselves against volatility in financial markets even when that carried the likelihood of a negative return (taking account of expected exchange

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2 The Kuwait Investment Office is the in-house investment arm of the Kuwait Investment Authority (formerly known as the Kuwait Investment Board) and was established by Sheikh Abdullah Al-Salem Al-Sabah on 23 February 1953. Edmund Hillary and Tenzing Norgay reached the summit on 29 May 1953.

3 These figures include the NICs. Excluding NICs the estimated surplus is $596 billion (1.1%).

4 Latest data show that current account deficits were 5% of GDP or above not only in the United States but also in Spain, Greece, Portugal, Australia, New Zealand, UK and Iceland.

rate movements). But when the reserves outstripped the levels needed for that purpose, it was natural to look to increase the returns on investment by widening the range of investments.[5]

And in the next few years, these current account surpluses are likely to remain high and the build up of foreign assets by governments in oil exporting and Asian countries is likely to continue. According to the IMF's forecasts, the combined current account surplus of China and oil-exporting countries will be around $800 billion over the next 3 years. And the IMF estimates that sovereign wealth fund assets could grow to $6-10 trillion within the next 5 years.

The impact of SWFs on financial markets

These are huge numbers and SWFs have become prominent and important players in many financial markets. But we should not exaggerate their impact on the global financial system. In aggregate, their assets under management are currently only less than one-twentieth of those held by private sector participants such as pension, insurance and mutual funds as well as hedge funds and private equity (Chart 4). And they account for about 2% of the total size of equity and bond markets globally. Even in five years time – and on some of the fastest growth projections – assets under management by sovereign wealth funds are projected to reach only about 6% of global financial assets.[6] Moreover, though they have more assets under management than hedge funds they have smaller investments since they are not leveraged.[7]

It is not difficult to identify positive effects on the world's capital markets. Sovereign wealth funds have long investment horizons and generally have no commercial liabilities. Therefore, in periods of market stress they are likely to face less pressure than most private investors to reduce the size or increase the liquidity of their investments. They are well placed to play a contrarian role and help to stabilise markets by investing in times of stress. For example, when the global equity market fell sharply between 2000 and 2002, the Norwegian Government Pension Fund was a large buyer of global equities. And a number of sovereign wealth funds have played an important and welcome stabilising role during the current turmoil by providing around $40 billion of new capital since November to some of the world's biggest commercial and investment banks (Table 1).[8]

Taking a broader view, the switch of some reserves from government debt into SWFs which invest in a wider range of instruments should help to improve the allocation of resources if these investments are based on commercial criteria. Investing in equities may also help to reinforce and bring to the surface the common interest that EMEs and the advanced economies have in the good performance of the companies involved and the markets they operate in. It may thus help to integrate EMEs into the global financial system and encourage them to participate more in global policy making.

From a parochial point of view, the prospective increase in demand for equities relative to bonds could have a positive impact on London and sterling. Whereas the value of the UK

5 Foreign reserves held by EME central banks as a whole are about 60% (close to $3 trillion) higher than needed for conventional precautionary reasons to cover short-term external debt.

6 Morgan Stanley, "Sovereign Wealth Funds and Bond and Equity Prices", 31 May 2007.

7 That said, the assets held by sovereign wealth funds are highly concentrated, with around 70% of total assets held by the five largest funds. So the largest sovereign wealth funds could have an impact on some markets especially smaller ones such as other EMEs.

8 Also, a number of central banks from countries with large current account deficits have been willing throughout the current liquidity crisis to lend to international banks, including UK ones, at longer, three-to-twelve month, maturities.

market for public debt securities is only 3.3% of the global market, UK equities account for 7½% of the value of global equities. The rapid growth in sovereign wealth funds is also a fillip for London as a leading international financial centre.

SWFs and transparency

The main doubts concern their objectives and how far their investments will be driven only by financial returns.

Public sector owners might have other objectives including national political interests, such as, accessing military technology, controlling strategic resources or markets, and influencing public opinion.[9] There are often complaints that sovereign wealth funds lack transparency. Decoded, this is a request for reassurance about their investment policies.

I am certainly not going to argue against more transparency (except in the very special case of the market operations of central banks). More openness from SWFs may help to alleviate concerns in recipient countries – and thus reduce protectionist pressures. And it may improve the dissemination of information to market participants and to their own citizens. I know many SWFs are working with the IMF to produce a voluntary code of conduct that is based on best practices for the governance and transparency of sovereign wealth funds. For example, it would be helpful if all sovereign wealth funds were transparent about their overall strategies, objectives and broad investment guidelines. Norway's Government Pension Fund is a good example in this respect.

But there should be a level playing field applied to all investors. The case for greater transparency applies to other investors too. SWFs may take some comfort that they are not being singled out and that there are equally powerful pressures for transparency on hedge funds and private equity investors. In this respect, two recent initiatives are particularly welcome. First, a report under the chairmanship of Sir Andrew Large – my predecessor as Deputy Governor for Financial Stability at the Bank – on voluntary standards, including on disclosure, for hedge funds. And, second, a report by Sir David Walker – a former Executive Director of the Bank – on guidelines for disclosure and transparency by private equity funds.[10]

And transparency should not be one sided among countries. I know SWFs themselves are often keen for more transparency from recipient countries on whether and how far they are welcome and the rules of engagement.

The UK in recent years has been unusually open to foreign investors and foreign ownership both in comparison to our past and in comparison to most other developed (and emerging) countries today. We have relied on regulation of infrastructure industries and on competition law to prevent the abuse of market power and most of our utilities, much of the financial sector, as well as an increasing number of our leading football clubs have come into foreign ownership. In its latest survey of international direct investment trends, the OECD ranked the UK as having one of the least restrictive regulatory environment for foreign direct investment across all OECD member countries (Chart 5). And the UK has welcomed a number of SWFs to London as a base for international operations.

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9 Note though that this distinction between foreign public and private sector owners is not cut and dried. Foreign private sector purchases of football teams or newspapers do not always seem to be driven by the profit motive.

10 Hedge Fund Working Group (2008), "Hedge Fund Standards: Final Report" and Walker Working Group (2007), "Guidelines for Disclosure and Transparency in Private Equity". The Large Report recommends a set of best practice standards for hedge funds in terms of disclosure, valuation, risk, governance and shareholder conduct. The Walker Report recommends a set of guidelines for disclosure and transparency by private equity funds, including the publication of regular information on their financing, ownership and prospects.

Sovereign wealth funds and global imbalances

However, the emphasis on transparency and the politics of SWFs risks missing a bigger policy issue: the recent rapid growth in SWFs reflects large and persistent global imbalances which are a continuing threat to the stability of the world financial system and the global economy.

Global imbalances and financial crises

While there are many examples of countries which have run deficits for many years such as Australia and New Zealand, history also shows how painful the eventual adjustment can be. There are many examples in which capital flight has resulted in a huge fall in GDP growth and broader financial crises – for example in Latin America in the early 1980s, in the Nordic countries in the early 1990s and the east Asian economies a decade ago – which, in turn, weakened global GDP growth or global financial institutions.

Countries with large deficits are vulnerable to a rapid reversal of capital flows. If investors are no longer willing to finance the deficit, domestic spending will need to be cut relative to output through a combination of reducing spending and switching production to the tradable sector. A recent IMF study reviewed 42 episodes of large reductions in current account deficits in developed countries over the past 40 years. In a quarter of the cases, which were mainly countries with limited real exchange rate depreciation, annual GDP growth fell by 3½ percentage points on average.[11]

There are dangers too for surplus countries. Large foreign exchange inflows are not easy to sterilise. They tend to contribute to asset price bubbles and higher inflation which itself can undermine economic and financial stability. The effect of such inflows into China and oil-exporting countries have been compounded recently by their exchange rates being pegged or managed against the falling dollar. This has contributed not just to the build up of reserves and SWFs but also to the build up of inflationary pressures within these countries.

No one would blame EMEs for the current turmoil in Western financial markets. It has been generated at home by the widespread mispricing of financial assets; this has been most obvious among the assets based on the US housing market but it is not confined to that sector. However the way that the boom developed did owe a great deal to global imbalances.

The "savings glut", to quote Ben Bernanke[12], that developed in the oil exporting countries and China contributed to the fall in real long-term interest rates.[13] In the UK, for example, real long-term interest rates, measured by the difference between the nominal 10-year government bond yield and the annual rate of inflation, fell from around 3.9% in 1997 to 1.6% in 2005. A similar pattern was also evident in the US (Chart 6). In particular, interest rates on safe assets fell since the build up in foreign assets were invested mainly in government bonds.[14] That both discouraged saving and boosted asset prices. In order to maintain their traditional returns, the private sector sought higher yielding strategies and were too ready to

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[11] IMF (2007) 'Exchange rates and the adjustment of external imbalances' IMF WEO April, Chapter 3.

[12] Bernanke, B (2007) "Global Imbalances: Recent Developments and Prospects", speech delivered for the Bundesbank Lecture, Berlin, and Bernanke, B (2005) "The Global Savings Glut and the U.S. Current Account Deficit", speech delivered for the Sandridge Lecture at the Virginia Association of Economists.

[13] A fall in desired investment (investment 'strike') in some countries also contributed to the decline in global real interest rates. For example, investment-GDP ratios fell sharply in the Newly Industrialised Countries in the wake of the east Asian crisis a decade ago.

[14] For example FE Warnock and VC Warnock (2006) ('International Capital Flows and US interest rates', NBER Working Paper, 12560) estimate that foreign official flows reduced US 10-year Treasury nominal yields by about 100 basis points lower than otherwise in the year to June 2005.

believe that these could be attained through new products without running bigger risks. We are now dealing with the consequences of that mistake.

Global imbalances – where to from here

Looking forward, the unwinding of global imbalances requires some combination of a slowdown in the growth of domestic demand in deficit countries and an increase in domestic demand in surplus countries. If the slowdown is not to dominate, we need to see a shift in relative prices to rebalance demand – that is a gradual real exchange rate depreciation of deficit countries against surplus ones.

The rise of SWFs may play a part in this dynamic. Their emergence is a sign that surplus countries may be less willing in future to accept such low yielding assets. That should put pressure on exchange rates to adjust and contribute to a reduction in global imbalances. So while SWFs may be a product of global imbalances, they may also play a part in the adjustment.

There are signs that in the United States, at least, imbalances are beginning to adjust. The US current account deficit now looks past its peak and the marked fall in the dollar – about 25% in real traded-weighted terms – since its peak in early 2002 should help in the adjustment. However, the decline in US relative demand is coming about mainly through slower domestic demand growth at home rather than faster demand growth abroad while the dollar has fallen less against currencies with the largest current account surpluses (Chart 7). There is a risk, therefore, that the fall in the US current deficit will not be matched by a fall of surpluses in high surplus countries but a rise in deficits in other deficit countries. The imbalances could be transferred not reduced.

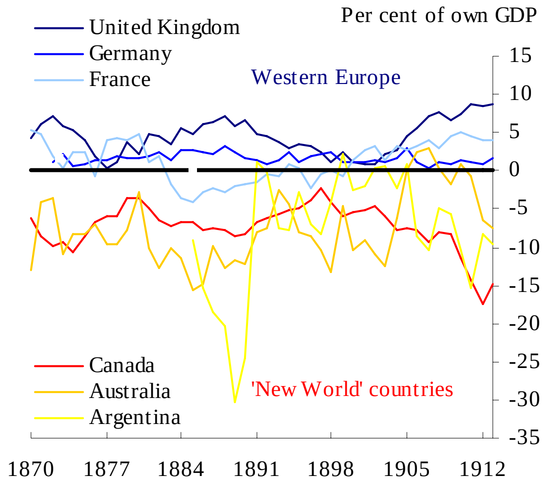
So it is important that the current large gap between savings and investment in the Far East and oil exporting countries narrows. In the near term, the ability to increase spending will be constrained by the recent increase in inflationary pressures in these countries. But more exchange rate flexibility should be helpful on both fronts. And over the medium-term, in oil exporting countries, government spending is likely to increase further in response to past increases in incomes since part of the rise in the oil price looks to be permanent. This gives oil exporters the opportunity to spend more on diversifying production in their economies. It is encouraging also that in China the government has plans to increase its own expenditure on the infrastructure, encourage higher spending by households through speeding up financial sector reform and improving the safety net as well as allowing more flexibility than in the past in the exchange rate.

Conclusion

Given the growth of the foreign currency reserves in many EMEs, the emergence of SWFs making long term investments on financial criteria in a wider range of instruments is a positive development. Some increase in the *transparency* both of *the* strategy and objectives of the funds *and of recipient countries'* approach to *inward investment* should help dispel concerns and ensure they are a force for greater global financial integration rather than a prompt for a new wave of financial protectionism. SWF's recent investments in global financial institutions have been helpful in easing the current financial market turmoil. And the fact that they, and their central banks, are looking for higher returns and greater asset diversification should be beneficial both to the EMEs and to the recipient countries since it should improve the efficiency of global asset allocation.

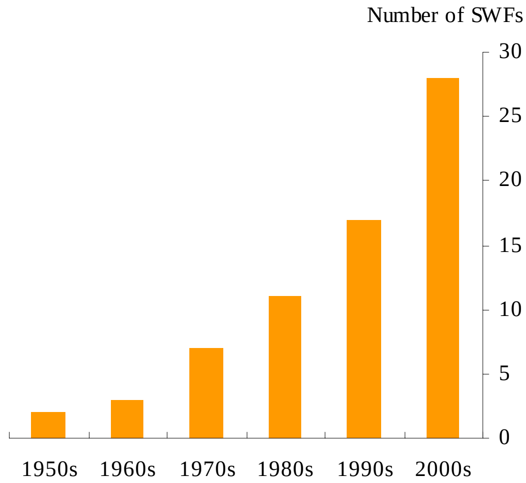
But that positive story should not conceal that the growth of SWFs is also a result of persistent global imbalances in trade. These imbalances have helped create vulnerabilities in financial markets and in the wider economy. Our current experience is one more illustration of how painful the unwinding of such imbalances can be.

Chart 1: Current account balances in the first wave of financial globalisation



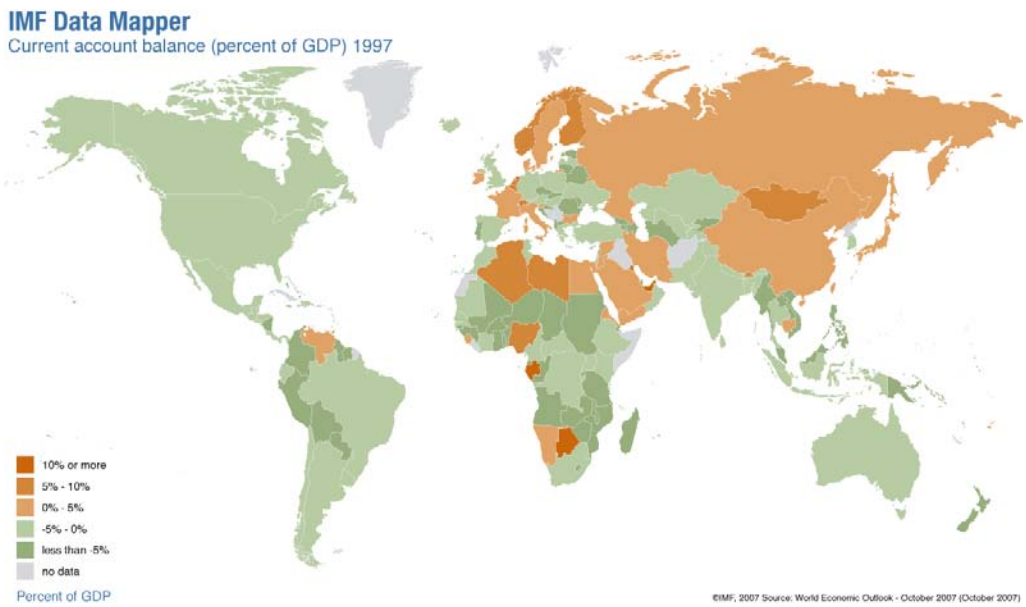
Source: Taylor, A (2002), "A century of current account dynamics", Journal of International Money and Finance, pp 725-748.

Chart 2: Number of sovereign wealth funds since the 1950s



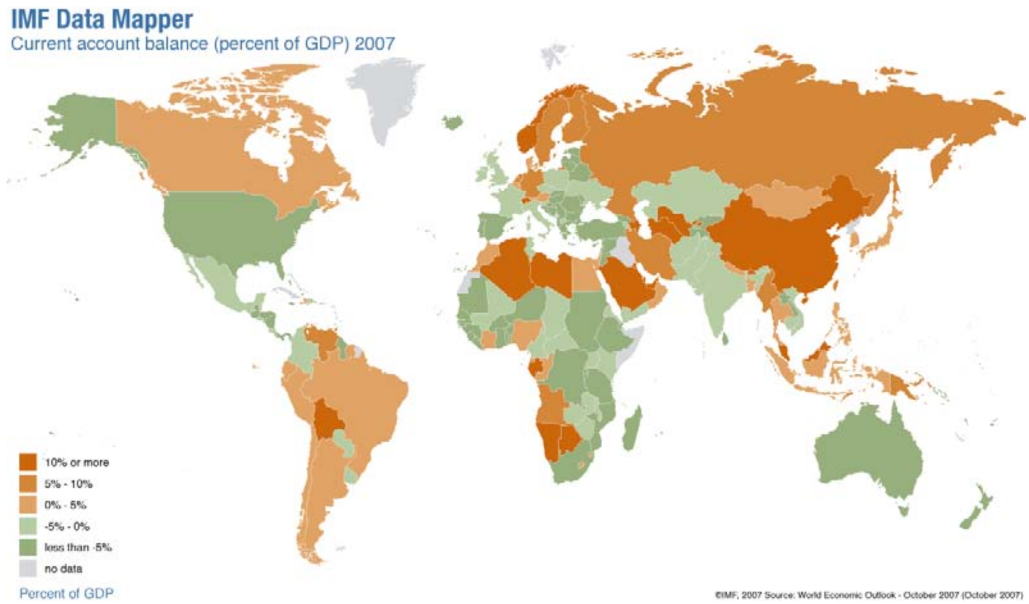
Source: Morgan Stanley, Deutsche Bank

Global map 1: Current account positions (% of own GDP) in 1997



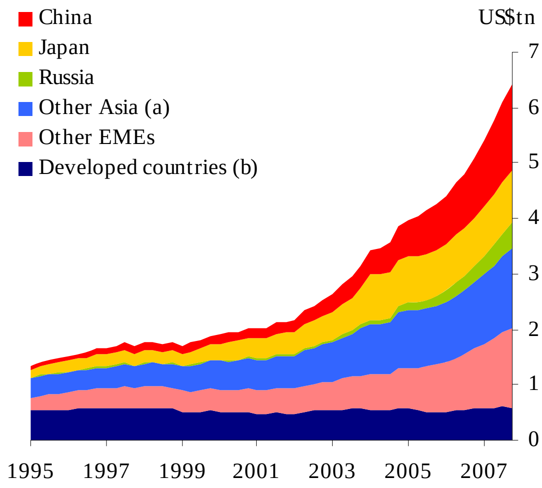
Source: IMF, *World Economic Outlook*, 2007

Global map 2: Current account positions (% of own GDP) in 2007



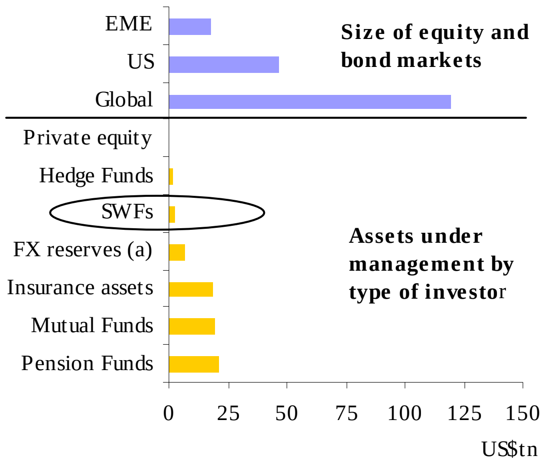
Source: IMF, *World Economic Outlook*, 2007

Chart 3: Global holdings of fx reserves (excluding gold), 1995-2007



Source: International Financial Statistics.
(a) Excluding China and Japan.
(b) Excluding Japan.

Chart 4: Assets under management by SWFs relative to other investors and size of capital markets, 2006[a]



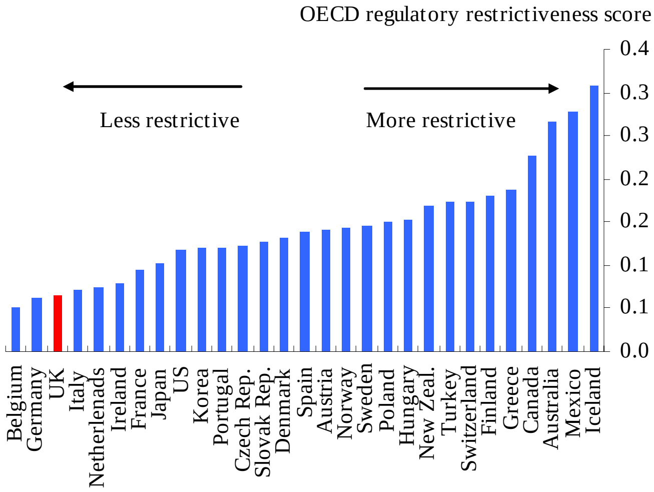
(a) FX reserve holdings and estimates of SWF assets under management are for 2007.
Source: IMF *GFSR* September 2007, McKinsey and Co., International Financial Statistics, various estimates of SWF assets under management.

Table 1: SWF capital injections in financial institutions since November 2007

Date of announcement	Sovereign Wealth Fund	Financial Institution	Amount (US$bn)
26/11/2007	Abu Dhabi Investment Authority	Citigroup	7.5
10/12/2007	GIC - Singapore	UBS	9.8
19/12/2007	China Investment Corporation	Morgan Stanley	5.0
24/12/2007	Temasek - Singapore	Merrill Lynch	4.4
15/01/2008	GIC - Singapore	Citigroup	6.9
	Kuwait Investment Authority		3.0
15/01/2008	Korea Investment Corporation	Merrill Lynch	2.0
	Kuwait Investment Authority		2.0
TOTAL			40.6

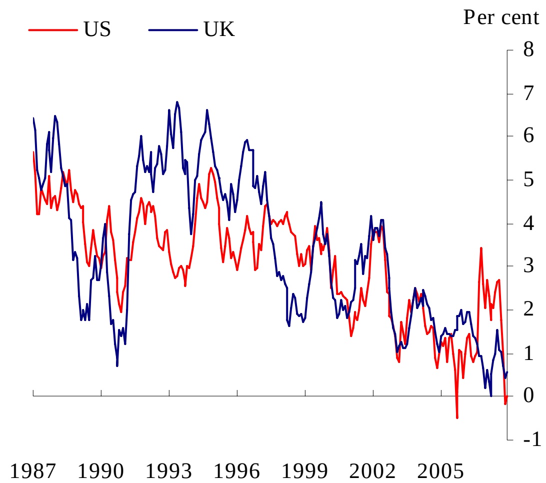
Source: Press releases, market reports.

Chart 5: OECD FDI regulatory restrictiveness index, 2006



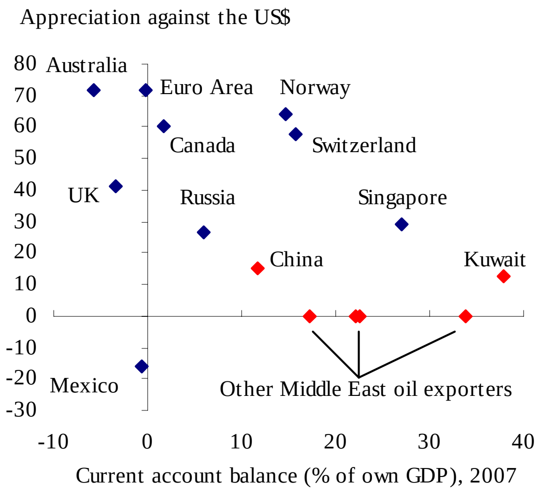
Source: OECD

Chart 6: Real long-term interest rates[a] in the UK and the US, 1987-2007



(a) Nominal yields on 10-year government bonds minus the 12-month rate of inflation.
Source: Bloomberg, International Financial Statistics, Bank calculations.

Chart 7: Nominal exchange rate adjustments since 2002[a] and current account balances[b]



Source: IMF, Bank calculations.
(a) February 2002 to January 2008.
(b) Estimated current account balance in 2007.