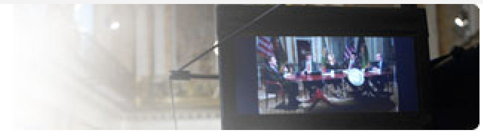
2-25-2008

Remarks by Treasury Assistant Secretary for International Affairs Clay Lowery at Barclays Capital's 12th Annual Global Inflation-Linked Conference

Clay Lowery



Remarks by Treasury Assistant Secretary for International Affairs Clay Lowery at Barclays Capital's 12th Annual Global Inflation-Linked Conference

2/25/2008

hp-836

Key Biscayne, Fla. – Thank you very much for that kind introduction. I am pleased to be here with you today to discuss an increasingly important topic: the role of sovereign wealth funds in the global economy. We have been working on this topic at the Treasury Department for well over a year now. This morning, I would like to take you through the key elements of our approach, and share with you some our latest thinking.

Let me start by saying that sovereign wealth funds are here to stay. If we can accept this statement, the first question we have to face as policy makers is what, if anything, to do about them. And here I think there is really only one answer: the international community must work toward the smooth integration of sovereign wealth funds into the international financial system. In helping to craft an international response to the issues raised by sovereign wealth funds, our primary objective at the Treasury Department has been and will continue to be to ensure an open and stable international financial system.

Context

At Treasury, we have defined sovereign wealth funds as government investment vehicles funded by foreign exchange assets and managed separately from official reserves. Although the term "sovereign wealth fund" was coined just a few years ago, the funds it describes are not new. Sovereign wealth funds have existed in various forms for decades in places as diverse as the central Pacific, Southeast Asia, Europe and the Persian Gulf.

Today, what is new is the rapid growth in both the number and size of sovereign wealth funds. Twenty years ago, there were a few funds managing total assets of several hundred billion dollars. Now there are as many as 40 sovereign wealth funds worldwide, collectively managing assets of roughly $2-3 trillion. While any projection of the future growth of sovereign wealth funds is of course dependent on assumptions about commodity prices and exchange-rate policies, some private sector analysts have projected that aggregate sovereign wealth fund assets will reach $10-15 trillion by 2015, implying an average annual growth rate of at least $1 trillion.

To get a better sense of the relative importance of sovereign wealth funds, it is useful to consider how they measure up to private asset markets and investment vehicles. Total sovereign wealth fund assets of $2-3 trillion may be small relative to the $190 trillion in global financial assets as of end-2006, or the roughly $62 trillion managed by private institutional investors. But sovereign wealth fund assets are currently larger than the total assets under management by either hedge funds or private equity funds (estimated at $1.5 trillion and $700 billion, respectively). While it is possible to make SWFs appear large or small depending on the metric, it is clear that they have already attained systemic significance.(1)

Conceptually, it is helpful to classify sovereign wealth funds into commodity and non-commodity funds, depending on the source of foreign exchange assets.(2) One key difference between the two types of funds is their asset-liability structure. Commodity SWF assets often derive from foreign currency accruing directly to the government, whereas non-commodity fund assets often derive from at least partially sterilized exchange rate intervention.

Another way to see how these two types of funds differ is to consider whether they may perpetuate undesirable economic policies. This is not a significant concern in commodity exporting countries, which are essentially replacing a physical asset in the ground with a financial asset to cover future expenditures. Whereas in non-commodity exporting country, it is important that they do not use a sovereign wealth fund as a means of further accumulating foreign assets in an effort to avoid appreciation of the local currency. Most observers are of the view that official reserves in this group of countries are sufficient by standard metrics of reserve adequacy, and greater exchange rate flexibility is often necessary.

Issues

The growth of sovereign wealth funds clearly has implications for the international financial system. These generally fall into two categories: financial market issues and investment issues.

As many observers have recognized, sovereign wealth funds have the potential to promote financial stability. They generally have a good track record as stable, long-term investors that provide significant capital to the system. Their long-term investment horizon should enable them to maintain their strategic asset allocations amid periods of short-term volatility. Sovereign wealth funds typically do not use leverage or have capital requirements that could force them to liquidate positions rapidly. Sovereign wealth funds often invest through well-regarded private fund managers and custodians

That does not mean, however, that there is nothing to think about. Sovereign wealth funds represent large, concentrated, and often non-transparent positions in financial markets, with the potential to move markets. Actual shifts in their asset allocations can cause price volatility. Even rumors of shifts may cause market participants to react to what they perceive sovereign wealth funds to be doing.

Of course, it is in the area of investment policy, that most of the attention to SWFs has been directed. There are two sets of issues to consider.

First, transactions involving investment by sovereign wealth funds, as with other types of foreign investment, may raise legitimate national security concerns. Countries that receive sovereign wealth fund investment need to ensure that national security concerns are addressed, without unnecessarily limiting the benefits of an open economy. Our experience with the Committee on Foreign Investment in the United States, known as CFIUS, shows that it is possible to safeguard national security while continuing to welcome foreign investment. CFIUS, which Treasury chairs, reviews foreign direct investments that result in foreign control of U.S. businesses and which may raise national security considerations. Since CFIUS began reviews in 1988, its caseload has included numerous foreign government-controlled investments, including by sovereign wealth funds. At the same time, national security should not be used as an excuse for pursuit of protectionist policies, industrial policy, or the creation of national champions.

Second, sovereign wealth funds raise a number of non-national security investment issues related to potential distortions from a larger role of foreign governments in markets. For example, through inefficient allocation of capital, perceived unfair competition with private firms, or the pursuit of broader strategic rather than strictly economic return-oriented investments, sovereign wealth funds could potentially distort markets. Sovereign wealth funds may also indirectly invest abroad through domestic state-owned enterprises. However, such action by a SWF is more likely to be viewed as a direct extension of government policy.

There are those who say that sovereign wealth funds should not be allowed to vote their shares when they take a non-controlling stake in a U.S. company. I think this goes too far. Most – but not all – classes of equity securities allow their owner to vote on major matters of corporate policy and the board of directors. That is one of the most fundamental rights of ownership in U.S. corporations. It is integral to the vitality and attractiveness of our capital markets.

It is perfectly legitimate, though, to consider how this applies in the sovereign wealth fund context. I think there are two perfectly defensible paths for sovereign wealth funds. First, some sovereign wealth funds have an explicit policy not to vote their shares. This may also be the case for some central banks that hold a portion of official foreign exchange reserves in the form of equities. The Swiss National Bank, for example, explicitly states that it usually does not exercise its voting rights at annual shareholder meetings. Sovereign wealth funds that choose not to vote their shares may be motivated by a desire to keep a certain distance from matters of business operation and potential political concerns – but that is for them to say. Whatever the motivation, their choice not to vote their shares should be respected.

Second, other sovereign wealth funds choose instead to vote their shares, viewing the exercise of shareholder voting rights as instrumental to creating value in the corporation over the medium term. This choice should also be respected. However, in looking at both a large sovereign wealth fund (Norway's Government Pension Fund-Global) and a large U.S. state pension fund (CalPERS) which exercise their voting rights, two things stand out. One is the utility of laying out in advance the broad policies that guide how the fund votes, in order to avoid undue, unwelcome surprises. Another is the utility of disclosing the actual votes themselves, so that outside observers can assess whether the fund is following its stated broad policies.

It is also worth noting that the U.S. Securities and Exchange Commission passed a rule in 2003 requiring mutual funds to disclose proxy voting policies and records. Just as the 2003 rule seeks to address investors' concerns about real or perceived economic conflicts of interests through transparency, I think SWFs' voluntary disclosure of voting policies and voting records, in the context of best practices, may help mitigate concerns about real or perceived conflicts between economic and political interests that can arise with large cross-border government investment vehicles like SWFs. Experience with mutual funds in the United States suggests the overall costs of disclosure are minimal.(3)

The investment policy issues I have just described – both the national security and non-national security issues – have the potential to provoke protectionist responses from recipient country governments. It is my view that protectionist sentiment stems partly from a lack of information and understanding of sovereign wealth funds, which in turn is partly due to a lack of transparency and clear communication on the part of many of the funds themselves. Further, concerns about cross-border investment by state-owned enterprises are often misdirected at sovereign wealth funds as a group. Better information and understanding on both sides of the investment relationship is therefore needed.

As for the Bush Administration approach to investment – I can be unequivocal – we stand for open investment. As President Bush said in his May 2007 Open Economies Policy Statement, "a free and open international investment regime is vital for a stable and growing economy, both here at home and throughout the world." International investment in the United States fuels our prosperity by creating well-paying jobs, bringing new technology and business methods, helping finance U.S. priorities, and providing healthy competition that fosters innovation, productivity gains, lower prices, and greater variety for consumers. In 2006, foreign owned firms contributed almost six percent of U.S. output and 14 percent of U.S. R&D spending. Nearly one in ten U.S. private sector jobs is created or supported by these firms. U.S. affiliates of foreign-owned firms employ over five million Americans, paying on average 25 percent higher wages than the U.S. private sector average, and support approximately the same number of jobs indirectly.

Policy Approach

The Department of the Treasury is leading an effort with other U.S. government agencies to shape an appropriate international policy response to the financial market and investment issues raised by sovereign wealth funds. Our approach is based on the belief that both sovereign wealth funds and the countries in which they invest have a strong stake in ensuring a stable international financial system that remains open to investment.

Treasury Deputy Secretary Kimmitt has provided a guide to the way forward by outlining last month in Foreign Affairs magazine two sets of principles for discussion: one set for sovereign wealth funds and the other for countries in which they invest.(4) As a policy maker in a country that is a potential investment destination, we must keep in mind that we have responsibilities and they start with four guiding principles. First, avoid protectionism. Countries should not erect counterproductive barriers to investment, regardless of whether the investor holds a controlling interest in national firms. Second, uphold fair and transparent investment frameworks. Investment policies and processes, especially those involving national security considerations, should be public, clearly articulated, predictable, and nondiscriminatory. Third, within those frameworks, respect investor decisions. Having laid out the ground rules, recipient countries should not tell sovereign wealth funds how to invest their money. Decisions on how to allocate investments across countries and asset classes are for the funds' managers alone, particularly given the potential for losses as well as gains. Finally, treat investors equally. Tax and regulatory policies should not discriminate between foreign and domestic entities.

As for sovereign wealth funds, I would also suggest four guiding policy principles. First, invest commercially, not politically. Sovereign wealth fund investment decisions should be based solely on economic grounds, rather than political or foreign policy considerations. Sovereign wealth funds should make this statement a formal part of their basic investment management policies. Second, convey world-class institutional integrity. Sovereign wealth funds should be transparent about their investment policies and have strong risk-management systems, governance structures, and internal controls. Although not highly leveraged and, in principle, long-term investors, sovereign wealth funds can represent large, concentrated, and opaque positions and thus may cause worries of systemic risk. Third, compete fairly with the private sector. Sovereign wealth funds should be careful not to be seen as having an unfair advantage in competing with the private sector for transactions, including by financing acquisitions at below-market rates. Finally, respect host-country rules. Sovereign wealth funds should comply with and be subject to all applicable regulatory and disclosure requirements of the countries in which they invest.

These principles will help inform the international dialogue on the issues raised by sovereign wealth funds. The principles also provide a framework for thinking about what we believe is the most appropriate international response to these issues: multilaterally-agreed best practices for sovereign wealth funds and for the countries in which they invest.

Last year, the United States proposed, along with other nations, that the IMF identify a set of voluntary best practices for sovereign wealth funds. This work, I am pleased to say, is already underway in the Fund. Building on existing IMF guidelines for the management of foreign exchange reserves, best practices could cover the overall objectives and principles of sovereign wealth funds, their institutional arrangements, their risk-management frameworks, and their transparency and accountability. Best practices would provide guidance to new funds seeking to make sound decisions on how to structure themselves, mitigate any potential systemic risk, and help demonstrate to critics that sovereign wealth funds will continue to be constructive, responsible participants in the international financial system.

Some observers have questioned the logic of voluntary best practices. They argue sovereign wealth funds do not have adequate incentives to adopt best practices, and that a tough enforcement mechanism is needed. This misses the point that the intent behind identifying best practices for sovereign wealth funds is to create a dynamic rise to the top that makes such regulation, which could become draconian, unnecessary. A set of best practices will create a natural incentive among funds to hold themselves to high standards. Sovereign wealth funds themselves are increasingly aware that the increase in the number and size of these funds has, rightly or wrongly, raised reputational issues for them all.

Recognizing that investment is a two-way street, however, we are also encouraging the Organization for Economic Cooperation and Development (OECD) to identify investment policy best practices for countries that receive foreign government-controlled investment, including from sovereign wealth funds. Recipient countries have a responsibility to maintain openness, and the OECD has a long history of promoting open investment regimes. A dialogue is currently underway in the OECD on investment policy issues raised by sovereign wealth funds.

Returning to the question I raised at the outset: if sovereign wealth funds are not going away, then we must work to ensure their smooth integration into the international financial system. Given the legitimate policy issues they raise, this may not be an easy task. But most things worth doing are not easy. While it is imperative that the U.S. government remain vigilant, the United States will continue to benefit from keeping its doors open to foreign investment, including from sovereign wealth funds, so long as this investment is consistent with free and fair competition.

1)Robert M. Kimmitt, "Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy," Foreign Affairs, Volume 87, No. 1, Jan-Feb 2008.

2)"Sovereign Wealth Funds," Appendix II, Semi-Annual Report on International Economic and Exchange Rate Policies, U.S. Department of the Treasury, June 2007.

3)http://www.sec.gov/rules/final/33-8188.htm, See also: "Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting," Report to the Ranking Minority Member,

Committee on Health, Education, Labor, and Pensions, Government Accountability Office, August 2004.

4)Robert M. Kimmitt, "Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy," Foreign Affairs, Volume 87, No. 1, Jan-Feb 2008.

-30-