WebMemo

Published by The Heritage Foundation

No. 2175
December 18, 2008

Sovereign Wealth Funds: New Voluntary Principles a Step in the Right Direction

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In October 2008, the International Working Group of Sovereign Wealth Funds (IWG) released a set of generally accepted principles and practices (GAPP) for the conduct, governance, and accountability of sovereign wealth funds (SWF).

First conceived in the 1950s by foreign governments as a means to invest surplus foreign exchange earnings in the U.S. and markets abroad, SWFs have been the subject of intense media and government scrutiny after a flurry of investment deals in 2006 and 2007 caught the public's eye. Because many SWFs lack transparency, critics have been concerned that these government-owned investment vehicles could be used to advance political, as well as economic, agendas.

Some observers fear that rather than using SWFs as a means to hold a diversified asset portfolio and earn a solid return on investment, countries might use these funds to destabilize financial markets, protect industries and companies, or even expropriate technology. With little public information available on most sovereign investors' financial objectives, countries—including the U.S.—began to question the value of SWF benefits and whether action should be taken against what may instead represent a threat to their economic and national security.

In response to the rising threat of nations adopting barriers to sovereign wealth investment, 26 countries with sovereign wealth funds convened the IWG to collaborate with the International Monetary Fund, the World Bank, and the OECD in drafting the GAPP framework.[1] The GAPP recommends 24 voluntary principles that, if adopted, will enable countries to better manage their SWFs while promoting investor confidence. Although the current financial crisis has given SWFs a boost in popularity—these days nations are happy to get capital from any source—the implementation of GAPP practices should help prevent a return to the hostile investment environment of the recent past.

During development of the GAPP, IWG nations collaborated with policymakers from recipient countries. Consequently, these nations were afforded a greater understanding of the real issues surrounding sovereign wealth funds, which, in turn, allowed participating countries to balance their open markets with national security concerns. The GAPP should not only result in greater transparency and sounder investment decisions in SWFs but also mitigate the biggest threat to the world's economic and national security—protectionist investment policies.

Sovereign Wealth and the GAPP. The U.S. Department of the Treasury defines a sovereign wealth fund as a "government investment vehicle which is funded by foreign exchange assets, and

This paper, in its entirety, can be found at:
www.heritage.org/Research/TradeandEconomicFreedom/wm2175.cfm

Produced by the Center for International Trade and Economics (CITE)

Published by The Heritage Foundation
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Washington, DC 20002–4999
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which manages those assets separately from the official reserves of the monetary authorities."[2] SWFs are financed by surplus foreign exchange earnings from commodity exports, balance of payments or government budget surpluses, and foreign currency operations. These funds are generally established as long-term investment vehicles designed to cover future expenditures on pensions, smooth the effects of volatile commodity prices on government revenue flows, or invest reserves.[3]

Since 2000, the number of these state-owned funds has grown from 20 to almost 50 while managing an estimated \$2.7–\$3.2 trillion of global assets.[4] The size of these funds can be difficult to estimate because governments are not required to disclose information about the fund's assets, liabilities, or underlying investment strategy. While such lack of information makes it difficult to assess the impact such funds could have on the global economy, even the higher estimate of \$3.2 trillion is but a fraction of global investment—conservatively estimated at around \$229 trillion in 2007.[5]

GAPP Objectives. Although these funds represent only a relatively small share of the total global financial market, the rise of sovereign wealth funds carries implications for worldwide market stability, corporate governance, and national interests. The GAPP helps to address these concerns by establishing the following objectives for SWFs[6]:

- To invest in assets that deliver a rate of return on the basis of sound economic and financial variables that appropriately accounts for risk. Additionally, SWFs should implement transparent governance structures that clearly establish the roles and responsibilities—while enhancing the accountability—of management. These objectives establish the importance of using economic rather than political criteria as the foundation of an effective SWF investment strategy.
- To comply with laws, regulations, and disclosure requirements of the countries receiving SWF investment. This critical objective identifies the important role that disclosure of a fund's investment policy, asset allocation, approach to risk management, and other financial data play in mitigating governments' and markets' uncertainty about the purpose of that fund.
- To help maintain a stable global financial system and the free flow of capital. By clearly stating the need and criteria for SWFs to act as responsible players in the world's asset markets and to promote sound macroeconomic and investment policies, the GAPP addresses larger concerns regarding the distorting effect SWFs can have on markets.

While market pressures are already working to prompt improved transparency from some sovereign investors, GAPP guidance that clearly describes methods of implementing good governance prac-

1. International Working Group of Sovereign Wealth Funds, "Generally Accepted Principles and Practices: 'Santiago Principles,'" October 2008, at *http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf* (December 15, 2008). IWG members include Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Islamic Republic of Iran, Ireland, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad and Tobago, the United Arab Emirates, and the United States. Oman, Saudi Arabia, Vietnam, the OECD, and the World Bank are permanent observers to the IWG.
2. U.S. Department of the Treasury, *Semiannual Report on International Economic and Exchange Rate Policies*, June 2007.
3. Cornelia Hammer, Peter Kunzel, and Iva Petrova, "Sovereign Wealth Funds: Current Institutional and Operational Practices," IMF Working Paper WP/08/254, November 2008, pp. 5–6, at *http://64.233.169.132/search?q=cache:pxzUVS1fzNkJ:www.imf.org/external/pubs/ft/wp/2008/wp08254.pdf+Sovereign+Wealth+Funds:+Current+Institutional+and+Operational+Practices,&hl=en&ct=clnk&cd=1&gl=us* (December 17, 2008).
4. U.S. Government Accountability Office, *Sovereign Wealth Funds: Publicly Available Data on Sizes and Investments for Some Funds Are Limited*, GAO-08-946, September 2008, at *http://www.gao.gov/new.items/d08946.pdf* (December 15, 2008).
5. International Monetary Fund, "Global Financial Stability Report, October 2008," p. 185, at *http://www.imf.org/external/pubs/ft/gfsr/2008/02/pdf/text.pdf* (December 15, 2008).
6. *Ibid.*, pp. 7–9.

tices, greater measures of accountability, and sound financial investment strategies will help countries to structure and operate their funds more effectively and responsibly. Equally as important, these principles delineate a path for SWFs to ensure that their investments do not distort or destabilize markets in a way that reduces their return on investment or harms the economies in which they invest.

Moreover, the IWG/IMF process promoted meaningful debate and research about sovereign wealth funds. As a result, participating nations gained an increased understanding of SWFs' impact on U.S. and world markets in addition to sovereign investors themselves. This forum should remain active, providing a means to discuss the effectiveness and impact of the GAPP on SWF management and to address new concerns that may arise from global debate on international financial regulation or from countries receiving new sovereign wealth investment. Keeping channels open for cooperation will make it easier for nations to stand firm against implementing protectionist barriers against foreign investment.

The Ties That Bind. The rise of sovereign wealth funds carries implications for global financial market stability and the national interests of countries receiving these funds. Newly released principles should help to ensure that SWFs are managed effectively, make sound investment decisions, and are more transparent. As the collaborative process to establish the GAPP indicates, the growing trade and investment ties that bind the economies of the world together are more likely to promote responsible economic behavior than to entice mayhem. Investment is about creating wealth, not destroying it. Erecting barriers to foreign investment would stifle that creative process, leaving all countries poorer.

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