Developing Asia's Sovereign Wealth Funds,

Santiago Principles and the Case for Self-Regulation

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Abstract

Concerns in host countries about the investment activities of sovereign wealth funds (SWFs) arise from the potentially non-commercial motives and non-transparent nature of those institutions. Those concerns have abated in the wake of the on-going global financial crisis which has left Western financial systems in dire need of foreign capital. The general attitude of host countries toward SWFs has changed drastically since the third quarter of 2008 from outright hostility to enthusiastic welcome. Nevertheless, home and investor countries have begun to work together to set up the norms and laws which will help to define the governance and regulation of SWFs in the future. In particular, the Santiago Principles drafted by the International Working Group of Sovereign Wealth Funds (IWG-SWF) has brought into existence a set of voluntary principles and guidelines designed to guide the investment behaviour of SWFs. In this paper, we examine the emergence of SWFs in developing Asia to examine the rationale for their creation and the consistency of their interests with the national interest of host countries. The examination suggests that the Santiago Principles are redundant in the sense that they are largely consistent with the economic self-interest of the SWFs. The fact that the world's major SWFs voluntarily signed up to those principles is compelling evidence of such consistency. Most fundamentally, (1) SWFs are essentially commercial institutions driven by profit maximization and (2) it is in the commercial self-interest of SWFs to not engage in activities which invite financial protectionism in the home countries. Nevertheless, the Santiago Principles serve a valuable role as a mechanism which signals and crystallizes the commitment of SWFs to comply with the basic rules and regulations of the countries in which they invest.

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1 Introduction

The Santiago Principles, or Generally Accepted Principles and Practices (GAPP) for sovereign wealth funds (SWFs), were agreed upon by the International Working Group of Sovereign Wealth Funds (IWG) in Santiago, Chile, in October 2008. The IWG consists of 26 IMF member countries with SWFs, including China, Korea and Singapore, and was set up in April-May 2008 to identify and draft a set of generally accepted principles and practices that suitably reflect their investment practices and objectives. The GAPP is based on a recognition that it is important to demonstrate – to home and host countries, and the international financial markets, that the SWF institutional framework is properly set up and investments are made on the basis of economic and financial criteria. The GAPP is underpinned by the following guiding objectives for SWFs: (1) To contribute toward global financial stability and free cross-border flow of capital and investment, (2) To comply with the regulations and disclosure requirements of the host countries, (3) To invest purely on the bask of financial and economic risk and return, and (4) To set up a transparent and sound governance structure which ensures adequate operational controls, risk management and accountability.

The establishment of the Santiago Principles was a direct response to the fears and concerns about the alleged risks and dangers posed by the investment activities of SWFs. Those activities were viewed as potentially threatening and compromising the national security, economic interests and, more broadly, the national welfare of the home countries. The fact that the SWFs were primarily from developing countries with different political systems while the host countries were often industrialized countries further intensified hostility toward SWFs. The general lack of transparency and disclosure about their governance structure and investment strategy raised suspicions in the host countries that SWFs were motivated by ominous non-

commercial political or strategic objectives. Those suspicions were heightened due to the state-owned nature of the SWFs. The overall stereotype of SWFs in the host countries was one of opaque, well-endowed state-owned organizations from countries with different political systems seeking to take over firms and industries vital to the national interest. Host-country politicians stirred up the pot and called for strict regulations against investments by SWFs. While such hostility contained elements of legitimate concern, it also had more than a hint of financial protectionism. An additional underlying factor behind host-country fears about SWFs and their investment activities was their sheer size – the collective size of the assets under the management of SWFs had reached around US$3 trillion by 2007 and could reach US$12 trillion by 2015 – and explosive growth, especially evident in the emergence of new SWFs in developing Asia.

One of the most significant development in the global economic landscape since the Asian crisis of 1997-1998 is the transformation of developing Asia from a net capital importer to a net capital exporter. This development was to a large extent driven by the large and persistent current account surpluses developing Asia has run since the Asian crisis. It is important to note that before the Asian crisis, the region as a whole ran current account deficits. Therefore, contrary to popular perception, current account surpluses are a relatively new phenomenon in the region. A significant consequence of those surpluses has been an unprecedented accumulation of FX reserves by the central banks of the region. The reserves have grown so fast that there is now a growing consensus that they now exceed all plausible estimates of what are required for traditional liquidity purposes. The emergence of surplus reserves, in turn, has prompted widespread calls for more active management of FX reserves with a view toward maximizing risk-adjusted returns rather than preparing for shortages of international liquidity.

Sovereign wealth funds (SWFs) provide a natural blueprint for the proposed shift of surplus

FX reserves from passive liquidity management to active profit-seeking investment. Unlike central banks, which traditionally manage reserves for liquidity purposes, SWFs are state-owned institutions which use reserves to pursue commercial profits. The predictable response of regional policymakers to the emergence of large and growing surplus reserves has been to set up SWFs as a means of using those resources more productively. Although SWFs have been largely under the radar until quite recently, they have been around for a long time. In fact, the commercial success of some well-established SWFs has been a major motivation behind the establishment of SWFs in developing Asia. In particular, due to their strong investment track records, Temasek and GIC – the two Singaporean SWFs – have attracted the attention of regional policymakers as a potential benchmark model. In short, Asian countries are setting up SWFs as a policy tool for coping with the relatively new phenomenon of surplus reserves.

The central objective of the paper is to examine the consistency between the Santiago Principles or GAPP and the commercial self-interest of the SWFs. To the extent that the two are consistent, the GAPP are redundant in the sense that SWFs would have adopted them on their own purely out of self-interest even in the absence of GAPP. Put differently, even though the GAPP is a voluntary code of conduct without any binding force, its provisions are likely to be complied with by SWFs if it is in their self-interest to do so. Answering our central question – whether the Santiago Principles and SWF commercial self-interest are mutually consistent – requires delving into the origins of the SWFs – i.e. why they were created in the first place. The underlying rationale behind their creation will go a long way toward informing us about whether or not SWFs are likely to conduct themselves along the lines outlined by GAPP. More specifically, we delve into the origins of SWFs in developing Asia to identify the primary drivers of their creation. Crucially, as explained in full detail in Park (2007), developing Asia's SWFs

are fundamentally commercial entities which have been created to make more productive use of the region's large and growing surplus FX reserves. The essentially commercial character of the SWFs implies an intrinsic alignment between the interests of the SWFs and host countries, as discussed in more detail in this paper.

The rest of this paper is organized as follows. In Section 2, we provide a background for the emergence of the SWFs in developing Asia. In Section 3, we evaluate the consistency between the commercial self-interest of the SWFs and the Santiago Principles. Section 4 concludes the paper with some final thoughts and observations.

2 Surplus FX Reserves and the Rise of Sovereign Wealth Funds (SWFs) in Developing Asia

Prior to the 1997-1998 Asian financial crisis, developing Asia as a whole has run a current account deficit vis-à-vis the rest of the world but since the crisis, the region has run a large and persistent current account surplus. This reversal of the current account position explains much of the region's unprecedented accumulation of FX reserves in the post-crisis period. In some countries such as China and Korea, substantial amounts of net capital inflows have further added to the reserve build-up. There are two main explanations for the build-up – the precautionary motive and the mercantilist motive.[1] According to the precautionary explanation, in response to the economic and social devastation wrought by the 1997-1998 Asian financial crisis, Asian countries sought to protect their economies against sudden shortages of international liquidity by accumulating a large war chest of reserves. It is difficult to exaggerate the deep impact of the crisis on the collective psyche of the region. According to the mercantilist explanation, developing Asia's soaring reserves are definitive proof of the region's over-dependence on exports as an engine of growth. Asian central banks purchase foreign exchange to keep their

[1] In their empirical analysis, Aizenman and Lee (2005) find that the precautionary motive was more important than the mercantilist motive in explaining the reserve build-up.

currencies weak and thus promote exports.

Whatever the motive behind the accumulation of reserves, and both precautionary and mercantilist motives probably played some role, what is beyond doubt is that the accumulation has been truly phenomenal in its scope and speed. Figure 1 below shows the growth in developing Asia's total FX reserves between 1990 and 2008 in both nominal and real terms. During this period, developing Asia's reserves surged from US$202 billion to US$3,370 billion in nominal terms and from US$267 billion to US$2,695 billion in inflation-adjusted terms. During the sub-period of 1990-2000, the region's reserves rose from US$202 billion to US$709 billion in nominal terms and from US$267 to US$709 billion in real terms. During the more recent sub-period of 2000-2008, the growth of regional reserves has further picked up, rising from US$709 billion to US$3,370 billion in nominal terms and from US$709 billion to US$ 2,695 billion. In nominal terms, the average annual growth rate of the reserves was 16.9%, 13.4% and 21.5% for 1990-2008, 1990-2000 and 2000-2008, respectively. In real terms, the average annual growth rate was 13.7%, 10.3% and 18.2% during the same periods. The overall picture is one of secular growth in developing Asia's reserves since 1990, punctuated by a noticeable acceleration of growth since 2000.

[Figure 1]

The growth of FX reserves in absolute terms over time partly mirrors developing Asia's economic growth over time. Therefore, to put the region's reserve build-up in better perspective, we scale its absolute reserves by its GDP. Figure 2 below shows the amount of reserves relative to GDP. The reserves-GDP ratio shows a similar pattern as the amount of reserves – an uninterrupted increase. Developing Asia's reserves-GDP ratio rose from 13.1% in 1990 to 21.9% in 2000 and further to 40.2% in 2008.

[Insert Figure 2]

Yet another measure worth looking at to bring the region's FX reserve accumulation into sharper focus is the share of the region's reserves in total world reserves. A tangible rise in the region's share would give further credibility to the global significance of developing Asia's reserve growth. Figure 3 below shows that the region's share of global reserves rose from 24.4% in 1990 to 36.6% in 2000 and 50.2% in 2008. This suggests that developing Asia has indeed been accumulating reserves at a faster pace than the rest of the world, in fact more than twice as fast. However, the region's reserve accumulation is an integral part of a broader trend of accelerated reserve accumulation by developing countries, whose share of global reserves has risen from 30.2% to 67.6% in 2008. China accounts for more than 50% of developing Asia's total reserve growth between 1990 and 2008. Therefore, while the contribution of China to the reserve build-up is notable the build-up is a region-wide rather than a China-specific phenomenon. Table 1 below lists the region's top 10 reserve holders as of the end of 2008.

[Figure 3]

[Table 1]

Foreign exchange reserves held by the central bank provide a range of possible benefits. Most immediately, liquid foreign currency assets are believed to provide an important source of self-insurance against the consequences of future financial crisis. Indeed, it has been argued that a sufficiently large stock of foreign exchange reserves might actually lower the probability of such a crisis occurring [see, for example, Hviding, Nowak and Ricci (2004) or Frankel and Wei (2004)]. This motive for developing Asia accumulating reserves has possibly been accentuated by their experience in the Asian crisis. Having been hurt once, they are wary of being short of liquidity again. It is possible, too, that an ample supply of foreign exchange reserves can improve

a country's sovereign credit rating and, in this way, lower its overseas borrowing costs through the sovereign ceiling. Aizenman and Lee (2006, 2005) provide extended discussions of the reasons for holding reserves and find strong empirical support for self-insurance motives.

The second main reason for a central bank to purchase foreign exchange reserves is to lower the price of the domestic currency, or at least slow its rate of appreciation. Indeed, some of the region's central banks seem to have been purchasing foreign currency to slow rates of domestic appreciation, even though nominal exchange rates of East and Southeast Asian countries have become more flexible in the postcrisis period. Such currency market intervention is frequently justified by a variety of reasons, but government concerns about the impact of a rapidly appreciating currency on macroeconomic stability and on the export sector often loom large. It is empirically difficult to assess the relative importance of the two main benefits of holding reserves, and it is likely that both have played a role in developing Asia's FX reserve build-up.

Yet reserve accumulation also entails costs—some combination of higher inflation, expanded fiscal liabilities, and a higher interest rate. The central bank's issuance of domestic currency to purchase foreign exchange lifts reserve money, which may percolate up to inflation. So, in order to "sterilize" the potential inflationary impact of reserve accumulation, central banks typically attempt to withdraw domestic liquidity by selling debt (in the form of bonds) to the nonbank public. But such sterilization operations entail fiscal costs when, as is often the case, the interest rate the central bank pays on its outstanding domestic bonds exceeds the yield on its foreign reserve assets. Higher interest rates may also follow—since they may be required to persuade the nonbank public to hold a larger stock of (sterilization) bonds. It is only an unusually favorable constellation of factors, such as the benign global inflationary environment and ample global liquidity, that has so far limited the costs of the recent run-up of reserves in Asia, according to

Mohanty and Turner (2006).

So what is the central bank's optimal reserve level? Clearly, this is neither infinite (since reserves entail costs) nor zero (since they yield benefits). Reserves are at their optimal level when the marginal benefit of a dollar of extra reserves equals its marginal cost, provided that the reserves are in the range where benefits exceed costs. At least beyond a certain level, the marginal benefit of reserves is likely to diminish as they increase. Beyond a point, the level of reserves may do little to reduce the likelihood of crisis or the capacity to cope with one. Likewise, beyond a certain level, the marginal cost of reserves is likely to rise as they increase, as sterilization operations become more expensive, complicating monetary policy.

Figure 4 presents a stylized illustration of the optimal reserve level R*, where the marginal benefit of reserves—the benefit of an additional dollar of reserves—equals their marginal cost—the cost of an additional dollar of reserves. Beyond R*, which is where many of the region's central banks are thought to be, accumulating reserves reduces social welfare since the cost of a dollar exceeds the benefit. If, for example, the actual reserve level was R_1, the amount of "excess reserves" is ($R^* - R_1$) and the total cost due to the excess is the triangle C. Reducing excess reserves would thus theoretically increase social welfare.

[Figure 4]

Evidently, if a central bank has accumulated more reserves than is theoretically optimal, one must ask why, and what policy adjustments are needed to improve welfare? The most obvious solution to the problem of welfare-reducing excess reserves is to avoid accumulating them to begin with. But such a response will necessarily entail structural adjustments and rebalancing of the economy and as such has greater relevance over the longer run. More flexible exchange rate policies may also help, but they offer no guarantees of reversing reserve accumulation. For

example, Korea's currency has appreciated sharply since early 2002, yet its reserves have continued to grow.

There is now a growing consensus that developing Asia's reserves now exceed the optimal level. That is, the region now has "too much" reserves and hence surplus reserves. To estimate the magnitude of developing Asia's surplus reserves, we now turn to some well-known measures of reserve adequacy.[2] While these measures are informal rules of thumb based on intuition rather than rigorously derived theoretical concepts, they perform quite well in empirical studies of reserve adequacy and thus provide useful guidance for policymakers. Many such studies find one such rule of thumb – the ratio of reserves to short-term external debt – in particular to be a significant determinant of an economy's vulnerability to financial crisis. According to the so-called Greenspan-Guidotti rule, the critical value of this ratio is one, with a value below one signaling danger. The underlying idea here is that country which has reserves equal to or more than all external debt falling due within one year should be able to service its immediate external obligations even during a financial crisis. Figure 5 below clearly reveals that developing Asia comfortably passes the Greenspan-Guidotti test of reserve adequacy. The implication is that the region has substantial amounts of surplus reserves.

[Figure 5]

Another widely used indicator of reserve adequacy is the ratio of reserves to M2 or broad money. This ratio is especially relevant for countries which are subject to a significant risk of capital flight. The underlying intuition is that the higher the ratio, the greater the confidence of the general public in the value of the local currency and hence the lower the likelihood of crisis-provoking flights into other currencies. While there is no general consensus on the critical value

[2] Edison (2003), ECB (2006) and Green and Torgerson (2007) discuss the various reserve adequacy measures in detail.

of the reserves-M2 ratio, which is understandable given the inherent difficulty of measuring capital flight, the suggested values range from 5% to 20%. Figure 6 below shows that the reserves-M2 ratio falls comfortably within 5%-20% for the major reserve holders of developing Asia. In fact, the ratio is above 20%, in some cases well above 20%, for most of the countries in many years. A look at the reserves-M2 ratio confirms that developing Asia's reserve build-up may have resulted in substantial amounts of surplus reserves.[3]

[Figure 6]

The presence of large and growing surplus reserves suggests that the region would be better off by investing those reserves more actively to maximize risk-adjusted returns. The alternative of continuing to use excess reserves to purchase safe and liquid but low-yielding traditional reserve assets is indeed a costly waste of valuable resources. Therefore, the notion that developing Asia should manage at least some of its growing stockpile of reserves more actively is not only politically popular but economically sound. A group of state-owned financial institutions known as the sovereign wealth funds (SWF) have a long history of using publicly owned foreign exchange to pursue commercial profits. In contrast to central banks, which managed foreign exchange assets largely to protect the country from sudden shortages of international liquidity, SWFs used foreign exchange assets to maximize risk-adjusted returns. As such, the shift from passive to more active, profit-oriented management of excess reserves is analytically equivalent to a shift from central banks to SWFs. As such, SWFs provide a natural institutional model for more active, profit-oriented management of developing Asia's excess reserves. This is especially true when a number of existing SWFs have established solid track records for consistently successful investment performance. Within the region, Singapore is widely seen as a role model

[3] Park and Estrada (2008) provide a comprehensive empirical analysis of developing Asia's reserve adequacy, and confirm the presence of substantial amounts of surplus reserves in the region.

in light of the extraordinary success of its two SWFs – Temasek and GIC. New SWFs are already emerging in Asia and many more are in the planning stages.[4] Korea set up the Korea Investment Corporation (KIC) in 2005 and China has followed suit with the China Investment Corporation (CIC) in 2007. Table 2 below lists the major SWFs of developing Asia.

[Table 2]

4 The Santiago Principles and Their Consistency with SWF Commercial Self-Interest

In Section 2, we saw that the emergence of new SWFs in developing Asia was motivated by the rapid accumulation of FX reserves which resulted in substantial amounts of surplus reserves. The widespread belief that the surplus reserves should be used more productively led to the creation of SWFs tasked with profit-oriented investment of the surplus reserves. In Section 3, we outlined the design principles for good practice which would enable SWFs to achieve their central objective of maximizing the risk-adjusted return for its owner, the government. One key principle was that the SWFs must be commercially oriented and free from political interference. In this section, we review the Santiago Principles against the background of (1) the rationale for the creation of Asian SWFs outlined in Section 2 as well as the (2) design principles for good practice outlined in Section 3. We do so to gauge the extent to which they are consistent with the commercial self-interest of the SWFs. If the principles and practices laid out in GAPP are fundamentally consistent with the self-interest of SWFs, they are redundant in the sense that the SWFs would have pursued them on their own even in the absence of GAPP. On the other hand, if the two are fundamentally inconsistent, GAPP does provide a concrete road map for SWFs to follow if their investment activities are to gain greater acceptance in the host countries.

Before we discuss the consistency between the Santiago Principles and the commercial self-interest of the SWFs, it is useful to briefly outline the principles themselves. The principles were

[4] Park (2007) provides a comprehensive review of the emergence of SWFs in developing Asia.

set up in October 2008 by International Working Group of Sovereign Wealth Funds (IWG) whose 24 members are primarily developing countries which have SWFs, including China, Korea and Singapore.[5] The code includes 24 principles that cover the legal framework, objectives, coordination with macroeconomic policies, institutional framework, governance structure, and investment and risk management framework of SWFs. The principles were prepared by IWG members with the assistance and coordination of the International Monetary Fund (IMF), and are the result of several months of work by the IWG. The principles are strictly voluntary and do not have any binding force but are nevertheless expected to be implemented by SWFs in all of the IWG member countries. The principles are largely a response of SWF home countries to the concerns of Western governments about the activities of SWFs and the growing specter of financial protectionism in host countries. They are intended to improve outsiders' understanding of as fundamentally commercial institutions so as to prevent protectionist measures targeting SWFs.

Underlying the Santiago Principles are four guiding objectives for the conduct of SWFs: (1) help support a stable global financial system and free flow of capital and investment, (2) comply with regulatory and disclosure requirements in the countries in which they invest, (3) invest on the basis of economic and financial risk and return-related considerations, and (4) erect and maintain a transparent and sound governance structure that provides for adequate operational control, risk management, and accountability. The Santiago Principles cover three general areas: (1) principles 1-5 cover the legal framework, objectives and coordination with macroeconomic policies; (2) principles 6-17 cover the institutional framework and governance structure; and (3) principles 18-23 cover the investment and risk management framework. The last principle calls for a process of regular review of the implementation of the principles.

[5] IWG (2008) is the official report which formally lays out the Santiago Principles.

Let us now look at the principles in more detail. As Kelly and O' Keefe (2009) point out, Principles 1-5 address (1) the adequacy of the SWF's legal framework, and public disclosure of its key features, (2) the clear definition and public disclosure of the SWF's policy purpose, (3) the clear provision for, and public disclosure of, policies and procedures relating to funding, withdrawal and spending operations, and (4) other principles relating to coordination of activities with domestic fiscal and monetary authorities where they have significant direct domestic macroeconomic implications, and provision of relevant statistical data to the SWF owner for inclusion in macroeconomic data sets.

According to Kelly and O'Keefe (2009), Principles 6-17 pertain to (1) the adequacy of the governance framework for purposes of facilitating accountability and operational independence of the SWF; the allocation of responsibilities among the SWF owner, any governing body of the SWF and management of the SWF; and the need to publicly disclose the governance framework and objectives, and the manner in which the SWF's management is operationally independent from the owner, (2) the need for the SWF to have a clearly defined accountability framework, (3) the obligation of the SWF to prepare an annual report and accompanying financial statements in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner; the need for the financial statements to be audited in accordance with recognized international or national auditing standards in a consistent manner; and the need for the SWF to publicly disclose relevant financial information in order to demonstrate its economic and financial orientation, (4) the need for the SWF to adopt clearly defined professional and ethical standards for the members of the SWF's governing body(ies), management and staff, as applicable; and the need to follow clear rules and procedures in dealing with third parties, with dealings to be based on economic and financial grounds; and (5) the

obligation of the SWF to comply with the regulatory and disclosure laws of host countries.

Kelly and O'Keefe (2009) point out that Principles 18-23 touch upon (1) the need for the SWF's investment policy to be clear and consistent with its defined objectives, risk tolerance and investment strategy, and a description of the investment policy to be publicly disclosed, (2) the need for investment decisions to be based on maximizing risk-adjusted financial return in a manner consistent with the investment policy, based on economic and financial grounds, (3) the inability of the SWF to take advantage of privileged information or inappropriate influence by the broader government in competing with private entities, (4) the need to exercise shareholder ownership rights in accordance with the SWF's investment policy and to publicly disclose the SWF's voting policy, (5) the need for the SWF to have a framework that identifies, assesses and manages the risks of its operations and to publicly disclose the general approach to risk management, and (6) the need to measure and report to the owner the asset and investment performance of the SWF according to clearly defined principles or standards.

Quite clearly, there is a great deal of overlap between Santiago Principles and the commercial self-interest of SWFs. The broad basic thrust of the Santiago Principles is that SWFs should: (1) have well-defined strategic objectives or goals which are widely known among the general public, (2) have operational autonomy and invest purely on the basis of commercial criteria subject to the broad parameters set by the government, (3) become transparent about governance structure, investment policy/practice and investment performance, (4) establish a sound governance structure which ensures adequate operational control, risk management and accountability, and (5) abide by the rules and regulations of host countries. While the Santiago Principles were established primarily to reassure host countries about the impact of SWF investment activities on their economies and welfare, in fact they also provide a concrete road

map for SWFs to achieve their central objective of maximizing risk-adjusted returns. That is, profit-maximization by SWFs and their compliance with host-country rules and regulations are mutually consistent. Governance structure and investment conduct which are conducive for profits are also conducive for allaying the fears and concerns of host countries about SWFs and their investment activities.

Upon closer thought, the consistency between the commercial self-interest of the SWFs and the Santiago Principles is hardly surprising. The analysis of Section 2 should make it abundantly clear that the creation of developing Asia's SWFs was driven by popular pressures for more active, profit-oriented management of the region's large surplus reserves. The continued investment of surplus reserves safe and liquid but low-yielding traditional reserve assets such as US government securities was widely viewed as a waste of valuable national resources. The fundamental insight here is that the search for yield is what motivated the emergence of new SWFs in developing Asia. In other words, developing Asia's SWFs are essentially commercial entities which were created with the explicit purpose of making as much as money as possible for their owners – the government. In view of this, while there are certainly some legitimate grounds for anxiety about the ulterior motives of developing-country SWFs in host countries – e.g. national security, in retrospect such fears and concerns were probably exaggerated. It is difficult to see how non-commercial geopolitical or strategic objectives can dominate the inherently commercial objective of maximizing risk-adjusting returns when the very rationale for the creation of SWFs lies in investing surplus reserves more profitably.

In any case, the distinction between commercial and geopolitical/strategic objectives is not always clear-cut. For example, when, say, CIC or some other Chinese government fund acquires oil fields or other commodity-producing assets in, say, Africa, such an acquisition may serve

strategic purposes – enhancing China's energy security and its long-term strategic need for natural resources – as well as commercial purposes – the acquisition may very well turn out be profitable even in the absence of any non-commercial benefits. Furthermore, whether an acquisition of an asset has strategic or geopolitical implications may differ from the viewpoints of home and host countries. For example, CIC may acquire a US firm which has sophisticated telecommunications technology purely out of profit-seeking motives, but if such technology can potentially be used for military purposes, the acquisition will run into serious opposition from the US. There is inevitably a lot of ambiguity in separating out commercial from non-commercial motives but the broader point is that the underlying impetus for the creation of SWFs is predominantly commercial. As such, while host countries have every right to consider the possible adverse effects of SWFs on their markets and economies, they would do well to keep in mind the commercial origins of SWFs.

The general lack of transparency among SWFs, with the notable exception of Norway's Government Pension Fund, has contributed a great deal to the negative perception of SWFs in host countries. Not only are SWFs well-endowed outfits from distant, politically different developing countries with large pools of capital at their disposal, but they are notoriously secretive and opaque entities which fail to disclose information about their governance structure or investment practice. However, just as with non-commercial objectives, concerns about lack of transparency and accountability may also be overblown. It is certainly true that SWFs as a group provide far less information about their investment practice than most of their private sector financial-industry counterparts, with the exception of hedge funds, private equity firms and others. However, this should not obscure the fact that there is a great deal of domestic political pressures for transparency and accountability and, more generally, good governance. Precisely

because they are government-owned institutions entrusted with managing national wealth, they are answerable to the whole population rather than just shareholders as is the case for private sector institutions. For example, when CIC suffered heavy losses on its investment in Blackstone, a US private equity firm, there was a major public outrage in China. It would be a serious mistake to presume that SWFs in countries with less pluralistic systems do not face questions about their investment strategy or performance at home. To the contrary, even in the absence of external pressures from host countries, powerful domestic pressures for better governance will encourage SWFs to become more transparent and accountable. The fact that SWFs are perceived as custodians of national wealth will further intensify such pressures. As noted earlier, however, transparency may come at a cost in terms of investment performance, especially if it leads to a myopic short-term investment outlook at the expense of long-term investment horizon.

More generally, it is fundamentally in the self-interest of developing-country SWFs to refrain from activities which invite financial protectionism in the host countries. Financial protectionism restricts the investment universe of a SWF and, as such, amounts to a substantial cost of business from the viewpoint of SWFs. It is therefore profitable for SWFs to comply with the rules and regulations of the countries in which they invest. SWFs which fail to do so risk being singled out for protectionist measures in the future and in other countries. Assuming that SWFs can behave arbitrarily in any way they want without due regard for the national interest and welfare of the host countries amounts to implicitly attributing an inordinate amount of market power to the SWFs. In fact, SWFs not only compete with each other but also with a multitude of private sector financial institutions. Host countries will be more welcoming toward SWFs which make every effort to comply with their rules and regulations than those that flout them. Pure self-interest and competitive pressures are thus two powerful forces which help align the actual

behavior of SWFs in line with the behavior prescribed by the Santiago Principles. The fact that the world's major SWFs have voluntarily signed up to those principles, which, on the surface, imposes a wide range of restrictions on SWFs and their activities, is compelling evidence that the conflict between the interests of the SWFs and host countries is more apparent than real.

5 Concluding Observations

The climate of fear and hostility toward developing-country SWFs in developed countries reached a crescendo in the second half of 2007 and first half of 2008. This unfavorable climate was driven by the fact that the SWFs were state-owned institutions from distant countries with different political systems and values, had access to large and growing pools of capital, and tend to have low levels of transparency and disclosure. They were viewed as serious threats to the markets, economy, interests and welfare of the countries in which they invested. Given their sheer size and lack of transparency, they were also viewed as a major threat to global financial stability.[6] Although antagonism toward SWFs was most pronounced in developed countries, some of which threatened to impose restrictive legislation on SWFs, it was also evident to a lesser extent in developing countries. One example was the heated controversy surrounding Temasek's purchase of Shin Corp, which contributed to the change of government in Thailand. Since the bankruptcy of Lehman Brothers intensified the global financial crisis, many Western financial institutions have come under a lot of stress. In particular, they found themselves facing severe balance sheet problems and an acute shortage of capital. Since Lehman, there has been a sea change in the attitude of host countries toward SWFs and their investment activities, from outright hostility to enthusiastic welcome. Somewhat unrealistically, they were viewed as potential saviors of global financial stability. More realistically, they were viewed as sources of much-needed capital for distressed Western financial institutions. In truth, SWFs are a large and

[6] See, for example, IMF (2007).

growing part of the global financial system, but their potential for harm and good tend to be exaggerated. Nevertheless, some rules of the game which would reassure host countries that SWFs are not inimical to their interests would benefit not only the host countries but also the SWFs themselves.

The Santiago Principles are essentially a collective response of developing-country SWFs to the increasingly vocal opposition and even hysteria which characterized the attitude of host countries, especially developed countries, to the emergence and growth of SWFs from developing Asia and Middle East in 2007-2008.[7] In particular, they commit the SWFs to invest on the basis of purely commercial considerations, set up a sound governance structure, and become more transparent about their governance structure and investment policies. Even though Santiago Principles basically spell out the type of investment behavior that developing-country SWFs would have engaged in anyway, that does not make them useless or unnecessary. Far from it! In fact, the Santiago Principles serve a highly valuable role as a mechanism which signals and crystallizes the commitment of SWFs to comply with the basic rules and regulations of the countries in which they invest. Just as WTO membership signals a commitment to free trade and non-discriminatory trade policies, signing up to the Santiago Principles signals a commitment to refrain from behavior which harms the interests and welfare of the host countries. Conversely, a SWF's failure to sign up may signal to the host countries that the SWF does not intend to comply with the rules and regulations of the host countries, and thus invite protectionist measures. Therefore, the primary value of the Santiago Principles may be more informational than prescriptive. Compliance to the principles is fundamentally in the own commercial self-interest of the SWFs for the reasons outlined in the previous section. This implies that even though the

[7] See, for example, Behrendt (2008),

Santiago Principles are a voluntary code of conduct, there is a good chance that they will be implemented by the SWFs, at least in spirit if not to the exact letter.

A more legitimate source of concern about the SWFs and their investment activities, a concern which is not addressed sufficiently by the Santiago Principles, is the unfair competitive advantage which SWFs may derive from their government ownership. Real-economy state-owned enterprises such as airlines or telecoms may have a competitive advantage over their private sector counterparts due to the implicit guarantee of a government bail-out in case of bankruptcy. Such implicit guarantees have often induced state-owned enterprises to become less efficient than their private sector counterparts who are more exposed to the discipline of the market. By the same token, in the financial sector, state-owned financial institutions such as SWFs may enjoy a competitive advantage over their private sector counterparts. For example, they may be spared from having to pay the full costs of excessive risk-taking due to the implicit guarantee of government bail-out should investments go wrong. This, in turn, may encourage them to take excessive risks in the first place, and thus expose them to the types of risk and level of risk which they are ill prepared to handle. The consequent increase in risk appetite may put private sector financial institutions at a competitive disadvantage in some situations. For example, the implicit guarantee amounts to a reduction in purchase cost and can thus enable SWFs to make a higher bid than their private sector counterparts when bidding for the same asset. Some rules of the game which would restrict governments from supporting SWFs in the case of failed investments would encourage SWFs to better manage their risks and, more generally, to become better at investing.

Upon closer reflection, while Santiago Principles play a highly valuable role in creating a more conducive and friendly environment for SWF investments by allaying the fears and suspicions of

host countries toward SWFs, they can at best be only one half of the solution toward a free and open system for cross-border capital flows. In order for SWFs to fulfill their underlying potential as major contributors to global financial stability and efficiency, host countries must also do their part to ensure a free and open system for capital flows. In particular, they must commit themselves not to abuse the state-owned nature of SWFs as an excuse to adopt protectionist policies which seek to keep out foreign capital for political and nationalistic reasons. The OECD has already begun some work in spelling out an appropriate and desirable policy framework of host countries toward SWF investments.[8] Such a policy framework must safeguard the legitimate national interests of the host country – e.g. national security – while at the same time do not discriminate or unfairly treat foreign investors. In principle, SWF investments can bring a great deal of benefits to both home and host countries. For home countries, SWFs provide a vehicle for more productive use of surplus reserves which would add to the fiscal resources of their owner – the government. The consequence of fiscal space will enable developing-country governments to better tackle the vast array of developmental challenges which they typically face. For host countries, the benefits of SWF investments are those usually associated with all forms of foreign investment – i.e. stimulation of economic activity and creation of jobs. Just as the Santiago Principles formalizes and crystallizes the commitment of SWFs to refrain from conduct detrimental to the interests of host countries, a similar set of principles which commit the host countries to treat SWFs in a fair and non-discriminatory will go a long way toward maximizing the benefits of SWF investments for both home and host countries.

Much of the fear and hostility aroused by the emergence of developing-country SWFs as major players in the global financial system has subsided as a result of the global financial crisis. The worst of the crisis seems to be now over and a semblance of normalcy has returned to global

[8] See, for example, OECD (2009).

financial markets. Many of the Western financial institutions which were severely distressed during the peak of the crisis have regained much of their health. Furthermore, the global real economy is also slowly but surely picking itself up from the worst global recession in the postwar period, even though some parts of the world are recovering faster than others. The big risk for SWFs is that as both financial markets and real economy regain their momentum, pressures for financial protectionism may reassert themselves. Such an outcome benefits neither the SWFs nor the host countries, nor indeed the global financial system. In this sense, the Santiago Principles are a welcome development that institutionalizes the promise of good corporate citizenry by SWFs to host countries. Such an institutionalized commitment is permanent and will withstand the ups and downs of the global business cycle. A Santiago Principles for host countries which similarly institutionalizes their commitment to avoid financial protectionism will further consolidate a conducive investment environment for SWFs on a permanent structural basis.

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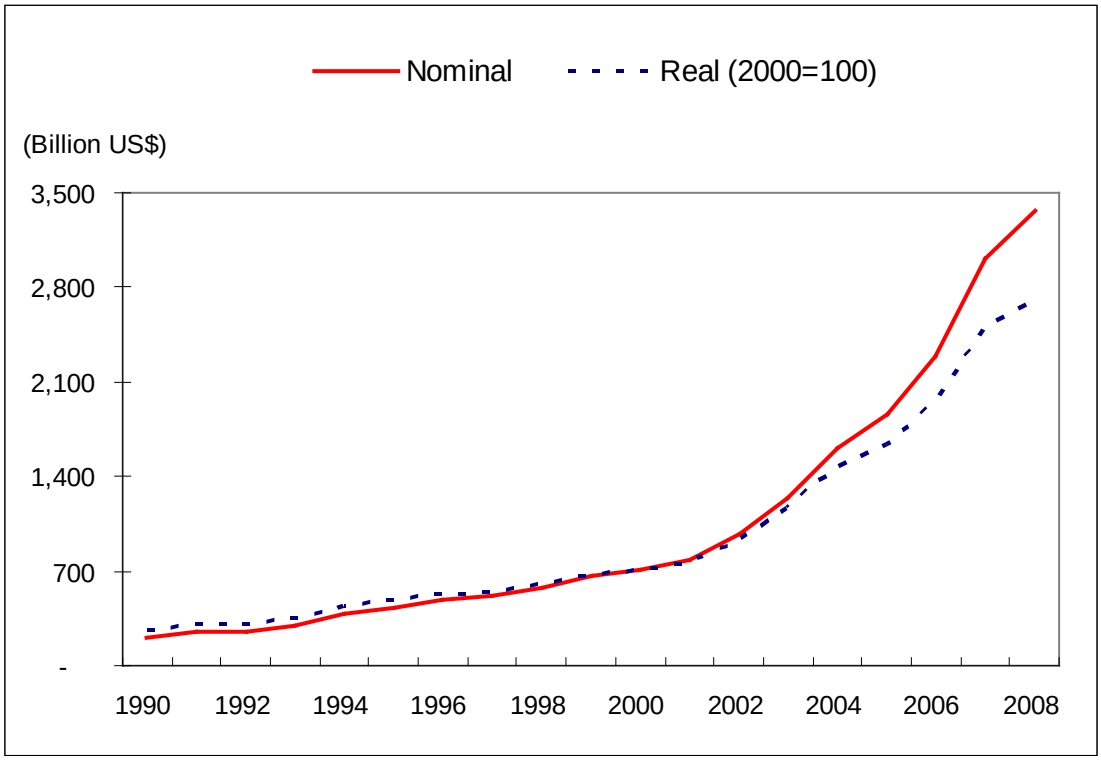
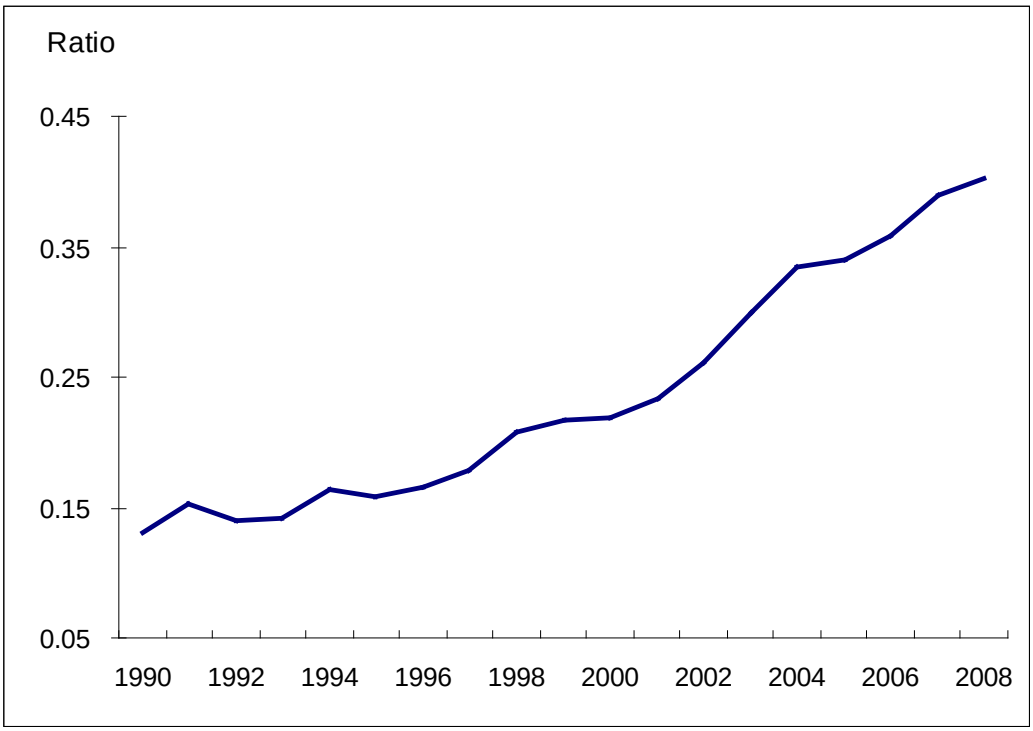
Figure 1
Nominal and Real Foreign Exchange Reserves
of Developing Asia, 1990-2008



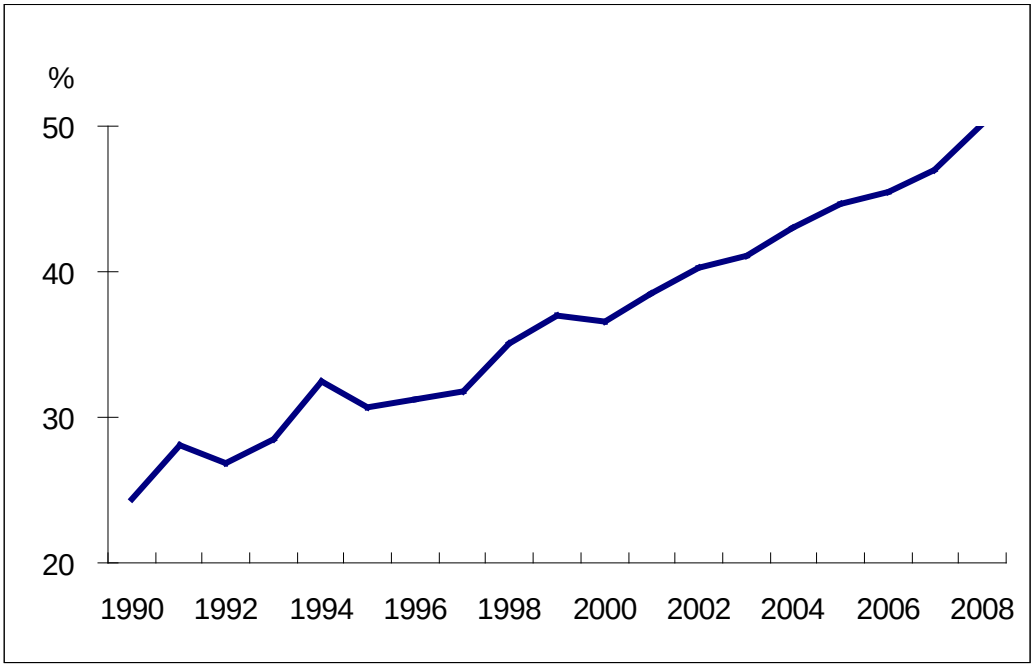
Sources: Author's estimates based on data from CEIC Data Company Ltd. and International Monetary Fund, *International Financial Statistics* online database, both downloaded 15 June 2009.

Figure 2
Ratio of Foreign Exchange Reserves to GDP,
Developing Asia, 1990-2008



Sources: Author's estimates based on data from CEIC Data Company Ltd. and International Monetary Fund, *International Financial Statistics* online database, both downloaded 15 June 2009.

Figure 3
Developing Asia's Share of World Reserves, 1990-2008



Source: Author's estimates based on data from CEIC Data Company Ltd., International Monetary Fund (IMF), *International Financial Statistics* online database, and IMF, Currency Composition of Official Foreign Exchange Reserves,available: http://www.imf.org/external/np/sta/cofer/eng/index.htm; all downloaded 15 June 2009.

Table 1
Developing Asia's Top 10 Reserve Holders, 31 December 2008

Rank	Country	Stock of Foreign Exchange Reserves (Billions of US$)
1	China, Peoples Rep. of	1,946
2	Taipei,China	292
3	India	247
4	Korea, Rep. of	200
5	Hong Kong, China	182
6	Singapore	174
7	Thailand	108
8	Malaysia	91
9	Indonesia	49
10	Philippines	33

Sources: CEIC Data Company Ltd.; International Monetary Fund, *International Financial Statistics* online database; both downloaded 15 June 2009.

Figure 4
Optimal Level of Foreign Exchange Reserves

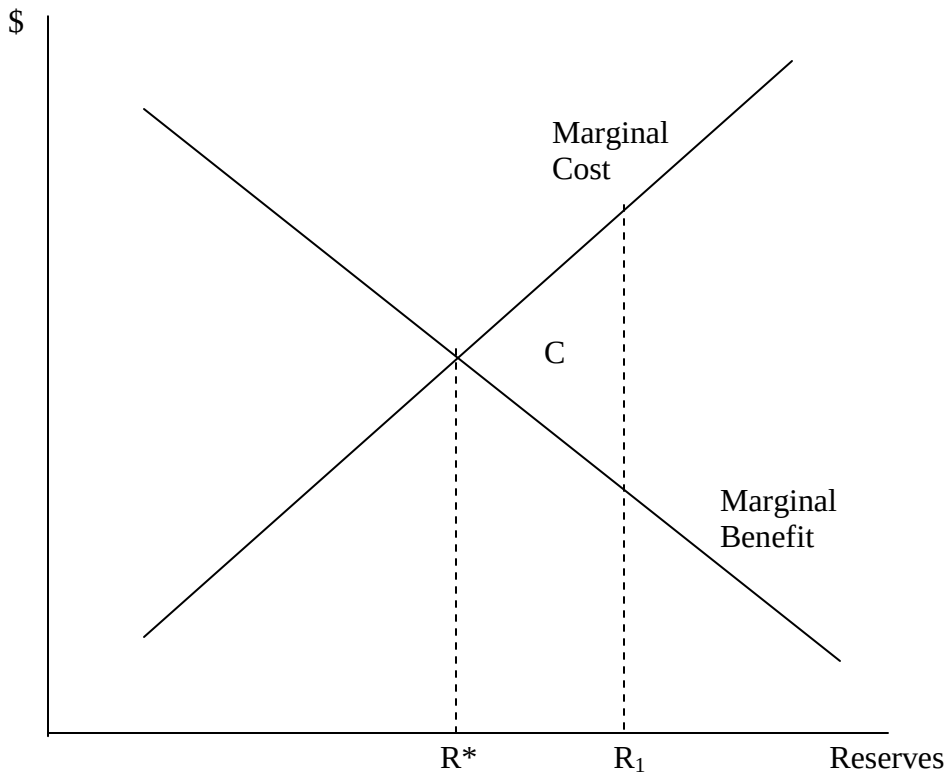
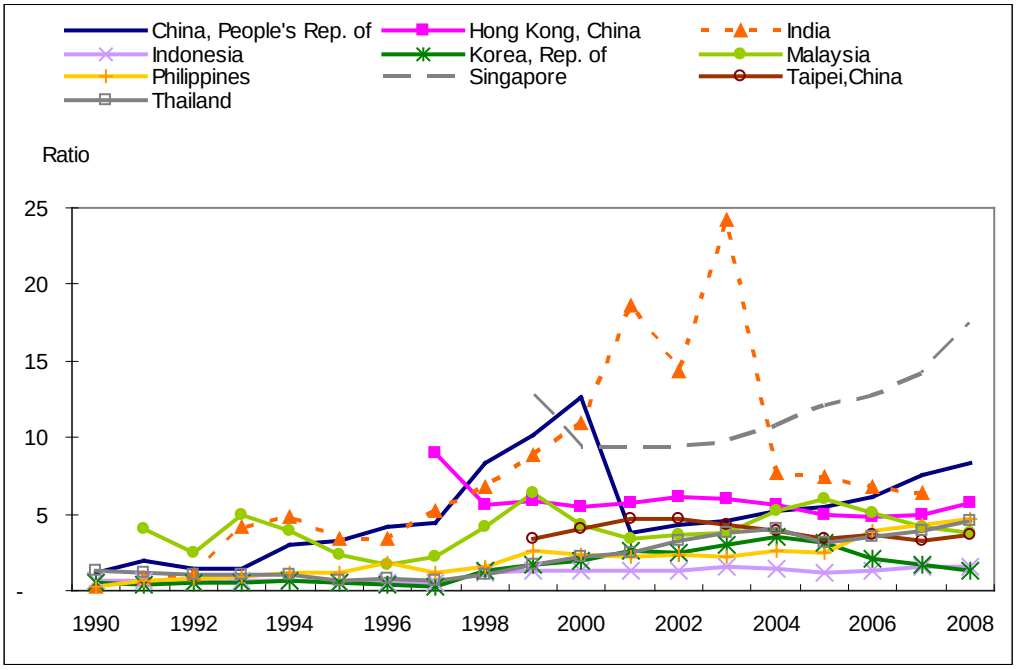
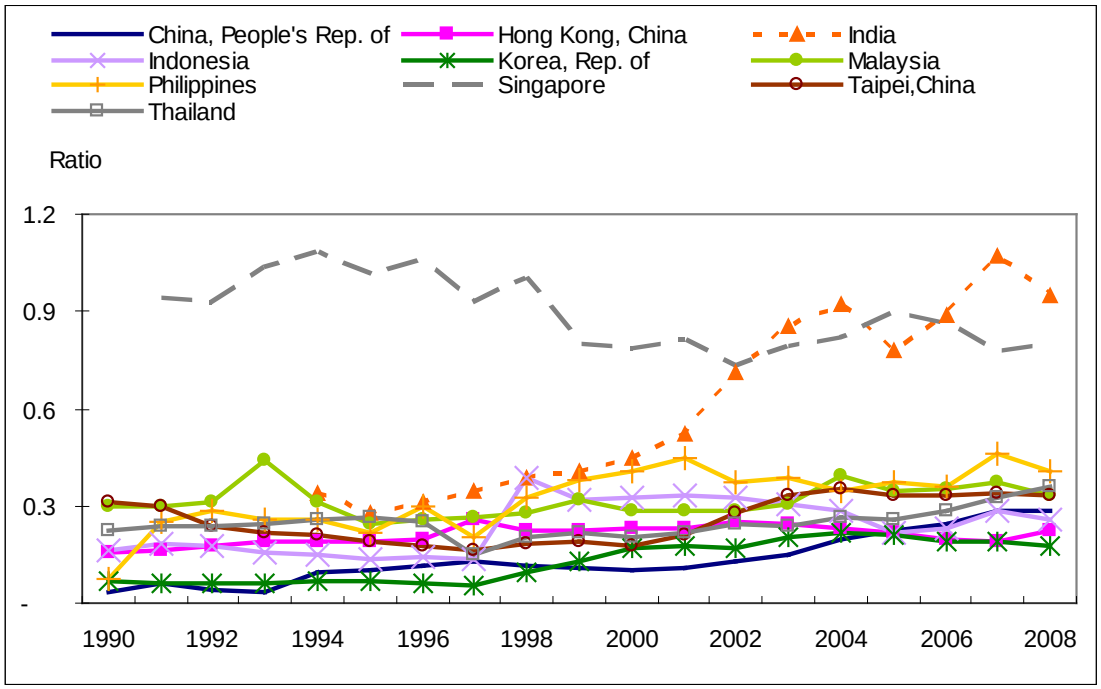


Figure 5
Ratio of Foreign Exchange Reserves to Short-Term External Debt in Developing Asia's Top 10 Reserve Holders, 1990-2008



Source: Authors' estimates based on data from CEIC Data Company Ltd., Deutsche Bank Research, available: http://www.dbresearch.de/servlet/reweb2.ReWEB?rwsite=DBR_INTERNET_EN-PROD, International Monetary Fund, *International Financial Statistics* online database, and World Bank, *Global Development Finance Online* database; all downloaded 15 June 2009.

Figure 6
Ratio of Foreign Exchange Reserves to M2 in
Developing Asia's Top 10 Reserve Holders, 1990-2008



Source: Authors' estimates based on data from CEIC Data Company Ltd., International Monetary Fund, *International Financial Statistics* online database, and World Bank, *Global Development Finance Online* database; all downloaded 15 June 2009.

Table 2
Sovereign Wealth Funds of Developing Asia

Country	Name of fund	Assets (US$ Bn)	Year of inception	Type
Singapore	Government of Singapore Investment Corporation	330	1981	Non-commodity
China, People's Rep. of	China Investment Corporation	200	2007	Non-commodity
Singapore	Temasek Holdings	100	1974	Non-commodity
Hong Kong, China	Investment Portfolio (HKMA)	100	1998	Non-commodity
Brunei Darussalam	Brunei Investment Agency	30	1983	Commodity: Oil
Korea, Rep. of	Korea Investment Corporation	20	2005	Non-commodity
Malaysia	Khazanah Nasional BHD	15	1993	Non-commodity
Kazakhstan	National Oil Fund	15	2000	Commodity: Oil, gas, metals
Taipei, China	National Stabilization Fund	15	2000	Non-commodity
Azerbaijan	State Oil Fund	1.6	1999	Commodity: Oil
Timor Leste	Petroleum Fund	1.22	2005	Commodity: Oil and gas
Uzbekistan	Fund for Reconstruction and Development	0.5	2006	Commodity and non-commodity
Kiribati	Revenue Equalization Reserve Fund	0.47	1956	Commodity: Phosphate mining
Nauru	Nauru Phosphate Royalties Trust	0.07	1968	Commodity: Phosphate mining
India	To be named	n.a.	n.a.	Non-commodity
Thailand	To be named	n.a.	n.a.	Non-commodity

Note: A number of trust funds in the Pacific Region, which have been financed by government and donor funds, are not included in the above list and have an aggregate size of about $500 million. Due to lack of official information from the funds themselves, asset sizes are largely estimates from unofficial sources such as Jen (2007).
Sources: Jen (2007), Rozanov (2005) and Setser and Ziemba (2007).