Comments at the Launch of

"Economics of Sovereign Wealth Funds—Issues for Policymakers"

Lawrence J. Lau*

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First of all, I would urge everyone to read this very valuable book produced by the International Monetary Fund. It takes a comprehensive look at the different aspects of Sovereign Wealth Funds, explains the Santiago Principles which have been embraced by most Sovereign Wealth Funds, and helps to de-mystify Sovereign Wealth Funds as cross-border investors. I wish to make four brief comments below.

1. The Origin of Sovereign Wealth Funds

Sovereign Wealth Funds (SWFs) typically find their origins in excess foreign exchange reserves held by their respective central banks, which in turn may have resulted from persistent domestic savings-investment imbalances, that is, when domestic savings far exceed domestic investment. However, excess foreign exchange reserves can also be caused by other than persistent savings-investment imbalances or current account surpluses. They can be caused by short-term capital inflows or "hot money" that can just as quickly turn into capital outflows.

Foreign exchange reserves can be regarded as the international working capital of a country. They are money balances that can be used to support normal international transactions and to provide a safety margin for emergencies. What is an adequate level of foreign exchange reserves for a country? Adequacy of foreign exchange reserves should be assessed as the expected level of possible total foreign exchange outflows in the event of a crisis: 12 months worth of imports that are not denominated in the domestic currency + total stock of foreign portfolio investment + stock of foreign-currency-denominated loans maturing within 12 months.

When foreign exchange reserves of a country become persistently more than "adequate" (for example, as defined above), the "excess" foreign reserves can be channeled into a SWF to be invested outside of the country to achieve higher rates of return for the long-term benefit of the citizens of the country.

*The author is Chairman, CIC International (Hong Kong) Co., Limited, Ralph and Claire Landau Professor of Economics, The Chinese University of Hong Kong, and Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University. All opinions expressed are the author's own and do not reflect the views of any of the organisations with which the author is affiliated. (Email: lawrence@lawrencejlau.com; WebPages: www.igef.cuhk.edu.hk/ljl)

2. Characteristics of Sovereign Wealth Funds

Typical Sovereign Wealth Funds have no need for liquidity, little or no need for cash flow and no debt. Typical Sovereign Wealth Funds invest mostly abroad, outside their respective countries. Their common goal is to achieve a good long-term risk-adjusted rate of return that is better than the rates of return on short-term foreign government securities.

Typical Sovereign Wealth Funds have the ability and flexibility to be contrarian, that is, to buy when the general market sells, and to sell when the general market buys, and they have the staying power to ride out cyclical downturns. Thus, SWFs make ideal cross-border long-term direct investors but they are not necessarily suited to be portfolio investors in public markets because they will then be bearing the costs of the liquidity which they do not really need. SWFs should capitalise on their unique advantages of not needing liquidity or cash payout and having no defined time horizon.

SWFs do need investment security or protection in the investee countries. They prefer stable exchange rates and stable and predictable political environments. As long-term direct investors, SWFs do not disrupt the capital or the foreign exchange markets of the investee countries. And in fact, as long-term direct investors, the interests of the Sovereign Wealth Funds and the interests of the investee countries are completely aligned. What is good for the investee country is good for the SWF investment and vice versa.

3. Global Re-Balancing

Sovereign Wealth Funds can assist in global re-balancing by “recycling” the excess savings of their respective countries to economies with savings deficits, especially given their long-term orientation. In developed economies, long-term equity investments are needed to enable the post-financial crisis de-leveraging of their financial institutions as well as other firms, and SWFs have the financial resources to do so. In developing economies, especially those with inadequate domestic savings, Sovereign Wealth Funds can be a welcomed source of long-term direct investment. Because of the long-term nature of SWF direct investments, they can have synergy with the work of multilateral development institutions such as the World Bank, the Asian Development Bank, and the International Monetary Fund.

4. Natural Long-Term Hedge of the Exchange Rate Risk of Cross-Border Direct Investment

Exchange rate risk is a major risk in long-term cross-border investment. An SWF seeks to avoid making money in the currency of an investee country only to find itself losing money in the home currency. In making a cross-border direct investment, a Sovereign Wealth Fund can hedge the long-term exchange rate risk by borrowing long-term directly in the investee-country in its domestic currency. Thus, no capital needs to be brought into the investee-country by the SWF, and the assets and liabilities of the SWF in the currency of the investee country will be approximately matched, greatly reducing the exchange rate risk for the SWF, and hence the need for hedging long-term in the foreign exchange markets, which is very costly if available at all and can in itself be disruptive and volatility-increasing. This arrangement works best when the investee-country does not have a savings deficit.

However, in order to discourage moral hazard, the SWF should also be required to provide simultaneously a direct loan guarantee for an equivalent amount of foreign (hard) currency to its lenders in the investee country, just in case the direct investment fails. The SWF is thus able to minimise the long-term exchange rate risk but must assume the business risk of the direct investment. The investee-country is able to secure a foreign direct investment without causing a large inflow of foreign capital that may possibly be disruptive to its foreign exchange markets. (Of course, the situation is different if the investee country itself has a savings deficit.)