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SOVEREIGN FUNDS: PARTNERS FOR GROWTH AND STABILITY?

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(The spoken-word-prevails)

Introduction

Ladies and Gentlemen**,**

I am particularly pleased to have been invited to provide a central banker's view in contributing to the debate on sovereign funds.

So far the Eurosystem has not adopted an official position[1] but it is fully supporting the European common approach as proposed by the European Commission and endorsed by the European Council on the 14th of March.

In particular, among the five principles put forward by the Commission, we underline the importance of the commitment to an open investment environment and the respect of European and international law.

The European Monetary Union was based on the free movement of capital, both internally and externally. We know that this principle does not constitute an obstacle to new measures aiming at a smooth functioning of the markets; on the contrary, the present financial turmoils demonstrate the need for better regulation and probably more active involvement of Central Banks in view of financial stability.

[1] The views expressed are purely personal and do not reflect necessarily the vision of the Banque centrale du Luxembourg or of the Eurosystem. I wish to thank in particular Mrs Onenne Partsch for her precious assistance.

In my capacity as central banker, I wish especially to analyse the phenomenon of sovereign funds in the light of the objectives and tasks traditionally conferred on central banks (namely, the pursuit of price and financial stability, the conduct of monetary policy, the holding and management of official foreign reserves and the conduct of foreign exchange transactions) and ask how sovereign funds fit into this picture.

In this perspective, the question of the interaction between sovereign funds and central banks arises, not only at a functional but also at an institutional level. At a functional level, the question arises of how to ensure an optimal intervention of central banks and sovereign funds in order to efficiently contribute to price and financial stability: should there be mechanisms of cooperation or consultation between sovereign funds and central banks? At the institutional level, the question arises whether some of the institutional guarantees (such as independence, accountability, transparency, immunity, prohibition of monetary financing) should be made applicable to sovereign funds.
The international role of the euro is expanding rapidly; it belongs to money to monitor carefully the development. The SWFs are diversifying the investment, are contributing to the development of the international use of the euro.
The development of sovereign funds is often presented as a shift from central bank foreign reserve assets into sovereign funds. This is not the situation in Europe.
In the euro area, one of the basic tasks of the central bank is to hold and manage the foreign exchange reserves of the Member States. The governments are only allowed to keep working balances. Management of reserves by central banks has proved to be beneficial. These reserves are essential for the performance of central banks functions; they also provide the State, in its capacity of shareholder of the central bank, with regular incomes.

Sovereign funds appear to be intimately linked to central banks, not only because of the origin of some of their funds, but also because their investment strategy should contribute to the price and financial stability of the all economies and be compatible with central banks' policies.

1. Economic and fiscal context of the creation and development of sovereign funds

The creation and rapid development of sovereign funds does not come *ex nihilo*[2]
Sovereign funds have been established in a very specific economic environment namely:

1/In resources-rich economies which have been benefiting for the last few years from high oil and commodity prices. These funds have as objective to stabilise government and export revenues and, frequently also to build up financial savings for future generations;

2/In countries, notably in Asia, which have experienced substantial build-ups in international reserves.

Moreover, countries with SWFs, usually have a great exposure to dollar, be it the currency of denomination of the revenues (e.g. in the oil industry), the currency to which the domestic currency is pegged or because of the dollarisation of official and/or private cross-border assets. They may be tempted by a diversification, notably in euro denominated assets.

Finally, the wealth generated in these countries is so huge that it cannot be absorbed by the domestic financial markets, which are comparatively underdeveloped and immature.

It is usually difficult, in these circumstances, to keep the monetary conditions balanced; these parameters create a great exposure to the turbulence of currency market, increase inflationary pressure and give rise to potential shocks to the balance of payment.

Specific measures, such as the conduct of foreign exchange transactions, combined with the possible sterilisation of foreign exchange interventions may be taken in order to keep the monetary conditions balanced. The conduct of such transactions, which are not always available and/or efficient in all countries, may, however, not be sufficient to keep the monetary conditions balanced.
The foreign reserves are usually invested in AAA-rated, highly liquid and relatively low yielding assets, such as Treasury bills and bonds[3].
It should be stressed, however, that the pace of official reserve accumulation clearly outpaces the net issuance of the most traditional reserve assets (such as US Treasury, US Agency debt, euro area government securities, UK Treasury), so that

[2] IMF definition includes both Government-owned and Government-controlled funds while the OECD seems to limit the definition to Government-owned investment vehicles only, see October 2007 edition of the Investment Newsletter, OCDE
[3] See ECB Occasional Paper No. 43, February 2006, ‘The Accumulation of Foreign Reserves’, p. 8.

the increased diversification of these foreign reserves may, to some extent, be inescapable[4].

Some countries are tempted to move the “excess” of foreign reserves to sovereign funds thereby escaping strict reserves investment policy and moving towards more flexible but more risky investment strategies.

Depending on the founding principles governing these sovereign funds, they may seek better returns, more diversified allocations with higher stakes in equities, currency diversification and a wider geographical dispersion. Most sovereign funds seem, for instance, to diversify their exposures globally instead of allocating their assets in specific countries or economic zones. Besides, sovereign funds may seek to diversify their portfolios among the different asset classes **(**including non-tradable or non-public shares) with, potentially, a longer investment horizon (central banks being mostly guided by liquidity motives in their investment policies due to very short-term liabilities stemming from the nature of their mandate). Finally, sovereign funds may opt for investment strategies which are more risky than a typical central bank.

Thanks to the greater flexibility offered to sovereign funds, these may pursue purposes, as various as smoothing fiscal revenues (in stabilisation funds in oil producing countries), intervening as second line of defence in the context of currency crisis, recapitalising the state-owned banks in China, repaying the external debt in Russia, funding investment in Taiwan, elsewhere saving part of the oil revenues for future generations.

2. Interaction between sovereign funds and central banks: functional and institutional levels

Having identified that sovereign funds may be intimately linked to central banks, not only because of the origin of some of their funds, but also because of their investment strategy, they may contribute to the price and financial stability of the domestic economy, the question of the interaction between central banks and sovereign funds now arises.

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[4] For example, even if emerging market central banks had purchased the total net primary issuance of these traditional reserve assets in 2007, they would still have had roughly USD 742 billion left over to invest.

At a functional level, although sovereign funds may pursue very diverse objectives (including higher return, saving oil revenues for future generations), they may also be involved in operations traditionally entrusted to central banks, such as the management of foreign reserves (e.g., GIC in Singapore), the intervention as second line of defence in the context of currency crisis (e.g., GIC in Singapore and KIC in Korea) or the recapitalising of domestic or foreign banks, which may be seen as similar to 'lender of last resort' function.

In other cases, such as in Russia, the creation of the stabilisation fund has been perceived, in its effects, as a substitute for sterilisation. It has been considered, however, that such a measure can be no substitute for sound, medium-term-oriented fiscal policies and that the current monetary and fiscal policy frameworks and instruments need to be further adjusted if progress is to be achieved in keeping inflation under control in the period ahead.

These examples show that although they may be complementary with central banks tasks, interventions of sovereign funds may sometimes relieve the short-term pressure on a domestic government and deter the latter from taking the appropriate steps as far as monetary and exchange rate policy are concerned in the longer term.

This brings us to the sensitive relations between monetary policy and exchange reserves (entrusted to financially, institutionally and functionally independent central banks) and the fiscal and economic policy, entrusted to the government, the latter being nevertheless, encouraged to conduct sound national fiscal policies in order to avoid undue inflationary pressures and distortion in the definition and implementation of monetary policy by the central banks.

The due separation between monetary policy and exchange rate policy, on the one hand, and fiscal and economic policy, on the other hand, is usually based on the concept of independence of central banks, the latter exercising their powers and carrying out their duties without intervention of government or any other body. Such independence is, however, counterbalanced by the concept of accountability, the central bank being fully responsible for the proper discharge of its obligations, strict transparency and auditing requirements applying in this respect.

It should be stressed, however, that one of the most prominent features of the sovereign funds, established as Government controlled public agencies, is, precisely,

that they create unprecedented bridges from monetary and exchange rate policy to fiscal policy.

This is clearly not acceptable since this may not only endanger the independence of central banks (potentially moving away from the latter the financial means necessary for the due performance of its obligations) but also distort the efficiency of its monetary policy and exchange rate policy. In addition, this would also discourage the home government from adopting sound fiscal measures in order to achieve, in the long term, a truly stable economic environment, conducive to lasting growth.

In view of the above, and as far as the intervention of sovereign funds may overlap with traditional central banks' tasks, it would be appropriate to consider creating mechanisms of cooperation (be it in the form of exchange of information, consultation or cooperation) in order to coordinate the respective interventions of the former and the latter, in the due respect of the independence of the central banks[5].

In any case, sovereign funds should abide by strict transparency requirements, so as to allow all relevant stake holders to identify, analyse and appropriately assess the consequences of their intervention on monetary policy, exchange rate policy, and the economic and fiscal policies of a country. Nowadays the involvement of central banks in financial stability matters is increasingly a substantial part of their activities; the *slide 6 annexed to the presentation* shows, outside the transparency and corporate governance requirement, some specific concerns with regard as financial stability. As positive element is mentioned the broadening of long-term investments, the contribution to the global risk sharing is the fact that typically, SWFs are not leveraged.
The main concern is related to the interference of non economic motives and as a consequence, possible distorsion of price mecanisms, the inevitable risk of herding behaviour, for large amount as well as abrupt sales of assets or modification of currency distribution.

In order to fulfil their tasks and monitor financial activity, central banks require high-quality statistical information from the investment funds[6].

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[5] In Norway, the Sovereign wealth fund is a remakable example; by vertu of the law, the central bank of Norway is interested with the managment of the fund.
[6] This is the reason why the Governing Council of the European Central Bank has adopted last year the regulation No 958/2007 of the ECB of 27 july 2007 concerning statistics on the assets and liabilities of investment funds.

Although this may be difficult in practice, it should also be considered whether additional institutional guarantees usually applicable to central banks in the performance of their duties (including independence, accountability and potentially, immunity of jurisdiction and of execution) should not be applied to sovereign funds when intervening in support of central banks' activity.
The management of foreign reserve assets by Eurosystem central banks enjoys specific legal protection. The prohibition of monetary financing makes these reserves unavailable for financing government budgets. Their management is transparent[7]. The Central Bank Gold Agreement provides also good example of transparency.

We know that according to the US Foreign Sovereign Immunity Act 1976 (FSIA) the property of a foreign central bank or a monetary authority shall be immune from attachment and from execution, unless there is an explicit waiver by the central bank.
More and more European States have adopted legislation in view of protecting foreign reserve assets in Europe. This is especially the case in Luxemburg where a new law of 2007 has granted a very generous immunity regime to foreign assets held with the Luxembourg central bank by third countries or foreign central banks[8].
Moreover, my central bank is, together with five other Eurosystem central banks, developing new reserve management services, in accordance with a guideline of the Governing Council of the European Central Bank of 7 April 2006, to the benefit of third countries or their central bank.

3. Conclusion

Sovereign funds are a multidimensional phenomenon, which we have approached, in this talk, from the view point of the tasks traditionally entrusted to central banks.

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[7] Most Central Bank report their foreign reserves holdings to the IFM (International Monetary Fund) under SDDS (Special Data Dissemination Standard) and publish a annual report.
[8] A new article was introduced in the Organic law of BCL by the law of 13 july 2007: « Art. 27-1.(2) No account with the Central Bank intended to be used in the context of common monetary or exchange policies or in the context of the management of foreign reserve assets held for foreign central banks or foreign States may be subjected to any seizure, sequestration or blocking order». According to the European Central Bank: « as the euro is increasingly used as an international reserve currency and in line with recent changes made to the laws of other Member States, the ECB would recommend that this provision clarifies in an unambiguous manner the protection usually granted to foreign reserves held by the BCL by inserting the words as well as of the management of foreign reserves assets held for foreign central banks or foreign States». ECB Opinion of 11 December 2006 (CON/2006/56).
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Sovereign funds have been established in a very specific economic environment, characterised by high volatility of commodity and asset prices in markets with a strong exposure to the dollar; they have to provide certain countries with a meaningful vehicle for diversifying their investment. They have contributed to the maintenance of price and financial stability in the short term, thereby acting as a partner for both growth and stability in the short term.

In the longer term and in the interest of a true contribution by sovereign funds to both growth and stability, we would recommend that stake holders, based on a thorough analysis of the global economic context in which these sovereign funds have been established and are operating, recommend and implement the necessary reform in order to effectively remedy the structural deficiencies having led to the current situation. We especially think that countries, confronted with a large surplus, could adopt structural and macro-economic reforms designed to foster domestic demand and enhance financial systems both at domestic and regional level. There is a need to reflect on the possible consequences of a shift from reserve assets to Sovereign funds vis-à-vis exchange rate policies and the conduct of efficient monetary policy.

A matter of particular concern is the possible interference of non-economic motives with regard to the control by foreign government. Good governance of Sovereign funds may be inspired by central bank experience.

As SWFs are typically State-owned, or at least State-controlled, their transparency and accountability should be exemplary.

In any case, we would recommend the greatest caution as to the possible impact on the independence of central banks and the efficiency of both monetary policy and exchange rate policy or the intervention of sovereign funds in tasks traditionally entrusted to the latter. A possible way forward, in the absence of concrete regulatory action at international level, would be the creation of cooperation arrangements between central banks and sovereign funds so as to properly coordinate the respective intervention of the former and the latter in the due respect of the independence of central banks.

The efforts of IMF and OECD in view of best practices are of course welcome. Nevertheless within the European Union it may be assumed that the European Institutions should take a leadership position in shaping the regulatory landscape pertaining to globalisation and SWFs. We must ensure that the European Union is the level at which the most efficient regulatory action is taken; a regulatory initiative at UE level is the best guarantee to avoid the fragmentation of capital markets and the protection of purely national interests. Regulatory frameworks should include

adequate information disclosure, in particular full disclosure of asset allocation in term of currency composition and instruments of SWFs, with direct reporting to the Eurosystem. Corporate governance measures could include a regime for the "golden shares" as well as regulation of services of general interest. It is up to European legislator to provide adequate legislation aiming at protecting the legitimate interests both of the investors and of all our citizens.
In this context, further dialogue with the Eurosystem central banks is, in my view, welcome.

Thank you for your attention.