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The EU response to the rise of Sovereign Wealth Funds

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Ladies and Gentlemen,

Let me start by thanking Jean-Paul Carteron and the Crans Montana Forum for inviting me to speak this afternoon.

Today's forum is certainly timely. Sovereign Wealth Funds have become the latest topic *du jour* in international finance; their rapid expansion is sparking political debate and, it is fair to say, fuelling a certain amount of anxiety. So in my comments I would like to clear away some of the misperceptions surrounding Sovereign Wealth Funds and set out the European Union's position with respect to sovereign wealth.

But before I discuss the main issues at stake surrounding their growth, the implications and the EU response, let me give some brief background.

The rise of sovereign wealth funds

Sovereign Wealth Funds have been with us for more than half a century since the very first fund was established by the Kuwait Investment Office in 1953. And during the oil price increases of the 70s and 80s, a major wave of funds was set up by oil producers. But it is only in the last 10 to 15 years that we've seen a dramatic increase in the number of sovereign wealth funds worldwide.

This rise has been driven partly by high oil prices and financial globalisation. But another important factor behind the growth of Sovereign Wealth Funds – and this is an issue that I will return to later – are the continued imbalances in the global economy that have allowed some emerging market economies to rapidly accumulate foreign assets.

As a result, since the turn of the millennium about 20 new Sovereign Wealth Funds have been set up including Russia's Reserve Fund and National Welfare Fund and Korea's Investment Corporation. The China Investment Corporation, established only last year, manages $200 billion worth of assets and just last week announced its latest investment in the credit card company Visa.

And more Sovereign Wealth Funds are expected to be created, for example in Brazil, Japan and India. The IMF now estimates that sovereign fund assets could grow from today's figure of $2-3 trillion to about $6-10 trillion within five years.

These are huge numbers and there is no question that Sovereign Wealth Funds have become prominent and important players in many financial markets, alongside pension funds, mutual and insurance funds and other private investors. Of course, we should be careful not to overstate their impact on the global financial system. The total assets of Sovereign Wealth Funds still only account for about one twentieth of those held by private sector participants.

Nevertheless, they can have an important influence on the world's capital markets.

Benefits and concerns surrounding Sovereign Wealth Funds

Because Sovereign Wealth Funds have long term investment horizons and generally have no commercial liabilities, they are better placed than most private investors to withstand market pressures in times of crisis. For this reason, Sovereign Wealth Funds have been a stabilising force during the current financial turmoil.

In the last months, we have seen firms on both sides of the Atlantic receiving investment from sovereign funds. Overall, since last November, Sovereign Wealth Funds have injected nearly $60 billion of capital into European and US banks hit by subprime losses – a welcome move that has provided vital liquidity to markets.

And investments are not limited to the banking sector. Indeed, the nature of sovereign investments has changed markedly, with newcomers diversifying their portfolios into equity and non-banking sectors.

Therefore, it is only natural that the increased activities of Sovereign Wealth Funds are beginning to draw attention and scrutiny. And indeed, the rise of these state owned investments bring benefits but also raise some legitimate questions.

These questions are fuelled by the way that many of these funds are run. We often know little about their management and very few publish information about their assets, liabilities or investment strategies.

And because Sovereign Wealth Funds are owned by states and not private companies, some fear that certain funds are not being run on a purely commercial basis, but are rather fulfilling broader national goals. Their lack of transparency is feeding these doubts.

The real danger here is that these concerns could fuel sentiments of economic nationalism, drawing us into a downward spiral of protectionism. Needless to say, such a scenario would have disastrous consequences for the EU and the global economy.

I should stress that there are measures firmly in place in the EU to block any investments which threaten to compromise national security. Member States already possess adequate instruments which allow them to monitor foreign investment and react if concerns over public policy or public security are raised.

A number of them already use such measures to restrict investments in the defence sector and the Commission has recently proposed specific controls on investment in the energy sector.

But it would be a huge mistake to encourage the perception that foreign investment is in some way a threat even when the shareholders are government-linked. And the debate over Sovereign Wealth Funds should not be turned into an argument against allowing emerging market investors' access to our corporate sector.

The European economy is built on the principles of open markets and foreign investment. Indeed, the EU is the largest exporter of FDI as well as a beneficiary of FDI inflows. We are well aware that investment and openness are the elements that drive our economy forward and without them we cannot advance. This is why we are committed to remaining an open environment for investment.

All the same, we can and should demand proper arrangements for the governance of government-linked investment vehicles. Legitimate concerns over transparency need to be addressed. And the funds themselves need to recognise that new responsibilities come with their growing role in the global economy.

A coordinated EU response to Sovereign Wealth Funds

This is why, at the end of February, the European Commission adopted a communication proposing an EU stance on Sovereign Wealth Funds. This position was endorsed by EU heads of state and government during the European Council meeting last month.

The adoption of this communication marks an important step forward for two notable reasons.

First, it emphasises the significance of a coordinated European approach to Sovereign Wealth Funds. This is crucial because an incoherent, fragmented reaction to Sovereign Wealth Funds carries risks. A series of uncoordinated national actions by European countries with respect to sovereign fund investors would hamper the functioning of our Single Market and ultimately damage the EU economy as a whole.

Second, setting out a coherent EU position on Sovereign Wealth Funds will help provide originating countries with a clear, predictable and reliable legal environment for their investments. It also sends a clear signal that Europe is not about to step back from its commitment to provide an open environment for investment.

So, what is the substance of the EU's position?

In essence, the EU is calling on Sovereign Wealth Funds to commit to good governance practices, adequate accountability and a sufficient level of transparency. In particular, we ask for a clear division of rights and responsibilities between managers and their sponsor governments and an effective system of checks and balances in respect of investment decisions. It should be clear that funds are aware of their weight and of their ability to impact on markets with large shifts in their positions.

But Sovereign Wealth Funds are not just an issue for EU member States. The rise of sovereign funds is a global development and as such, we believe a global approach is the best way to address the fears they can raise.

This is why the EU is supportive of finding a multilateral solution. We fully endorse the work currently underway in the IMF on a code of conduct for Sovereign Wealth Funds that focuses on transparency, governance and accountability. I know that the IMF has started working with Members and Sovereign Wealth Funds on the development of best practices and will this month establish a Working Group of Sovereign Wealth Funds to begin technical discussions and drafting of a possible code of conduct.

The EU also supports the OECD's work in identifying best practice guidelines for recipient countries. After all, transparency should not be one sided. Sovereign Wealth Funds themselves are often keen to know from recipient countries as to whether and how far they are welcome and what the rules of engagement are. The OECD's efforts should provide greater predictability for sovereign fund investors and ensure that foreign investment continues to flow to our markets.

Our work at EU level aims to add content and momentum to this global process. With a consolidated European position, we can act as an important driving force in international fora and lead global debate on these issues.

But I want to underline that our approach relies heavily on constructive dialogue and a cooperative effort between recipient countries, the Sovereign Wealth Funds and their sponsor countries. Success depends on all actors taking ownership in the creation of a balanced and stable framework covering Sovereign Wealth Fund investments.

Our emphasis on the good practice of Sovereign Wealth Funds should not mean we overlook a very serious policy issue that is linked to their development – that of global imbalances. Therefore, before I conclude, allow me to say something on this subject.

Sovereign Wealth Funds and Global imbalances

The recent rapid growth in Sovereign Wealth Funds reflects large and persistent global imbalances which are a continuing threat to the stability of the world financial system and the global economy.

Over the past decade, emerging markets economies - in particular China and oil producing countries – have been running progressively larger current account surpluses that reached an estimated $685 billion dollars last year. According to the IMF, the combined current account surplus of China and oil-exporting countries will be around $800 billion over the next three years.

It is no surprise then that Sovereign Wealth Funds are on the rise as these economies look to invest their excessive foreign exchange reserves.

But the counterpart to these enormous surpluses are the current account deficits built up by developed countries, in particular the United States. And today, these imbalances have reached unsustainable levels.

Countries with large deficits can suffer a rapid reversal of capital flows if investors are no longer willing to finance the deficit. There are dangers too for surplus countries. Large foreign exchange inflows tend to contribute to asset price bubbles and higher inflation.

History shows how painful the eventual adjustment of these global imbalances can be. There are many examples where capital flight has resulted in a huge fall in GDP growth and broader financial crises, for example in Latin America in the early 80s and in the Asian economies a decade ago.

A disorderly correction of global imbalances would have dire consequences for the global economy as a whole, with the potential to disrupt international trade and fuel protectionist pressures that would restrict growth and prosperity worldwide.

All countries need to take policy actions to tackle the risks posed by global imbalances. It is important that the currently large gap between savings and investments in Asia and the oil exporting countries narrows.

China has agreed to increase domestic spending and investment and scale back its reliance on exports.

More flexible exchange rates in China and other emerging Asian economies would make also an important contribution to reduce global imbalances and would ease the pressure off the euro which is currently bearing the burden of adjustment alone.

In the US, although the current account deficit has declined recently, only a major effort to increase public and private saving will drive a substantial improvement in the long term.

Oil producing countries could channel more investment into developing and diversifying their economies and Japan, which has a current account surplus, should aim to boost growth through labour market reforms and measures to inject competition into its economy.

Meanwhile, in the euro area, we will continue to implement structural reforms of our economies to boost productivity and growth in order to better absorb imports from other parts of the world.

Conclusion

Ladies and gentlemen, let me conclude.

The European economy is built on the principles of openness to trade and investment. The EU will therefore not take a defensive approach to Sovereign Wealth Funds. They represent a major source of investment for the European economy and we recognise the benefits they bring and will continue to bring to global financial markets. Europe is not about to step back from its commitment to provide an open environment for investment.

If Sovereign Wealth Funds dispel mounting concerns with greater transparency and accountability, they will help further financial stability, rather than fuel financial protectionism. We expect sovereign funds will embrace this call.

But this positive angle should not conceal that the growth of Sovereign Wealth Funds is also the result of persistent imbalances in the global economy. We are already beginning to see how painful the disorderly unwinding of these imbalances can be. The key economic powers must recognise their responsibility and act now to prevent more severe repercussions in the future.