Do sovereign wealth funds make economic or political decisions

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Should we worry about Sovereign Wealth Funds?

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Definition

• A SWF is any government-controlled fund that manages and invests government savings, regardless of the revenue source.
  – The Future Fund is a SWF.

• Sources normally include
  – Proceeds from natural resources (Oil)
  – Foreign exchange reserves
  – Budget Surpluses
  – Superannuation / Pension
  – Acquisition of distressed assets (?)

  – SWF tend to have ‘illegitimate’ origins.
Government Ownership

• State Owned Enterprise
  – Wholly owned and controlled entity

• Publicly Listed Firms.
  – Government ownership/control of listed firms is common.
  – Classic LLSV (1999) paper – ‘Corporate Ownership around the World’ – 18.33% of the world’s largest listed firms are controlled by government at 20% level.
    – For High Anti-director Rights economies – 13.75%
    – For Low Anti-director Rights economies – 22%
    – Australia – 5% (Telstra)
  – Other studies that replicate the LLSV paper for larger samples and different economies find even higher levels of government control of listed firms.

Government Ownership

• LLS (2002) look at government ownership of banks
  – Development Hypothesis
    – Alexander Gerschenkron – Bank finance is important in economies with under-developed financial systems
  – Political Hypothesis
    – Government controls banks to capture private benefits of control and to direct those benefits to supporters and friends
  – In a sample of 92 economies (including Australia) LLS find that the evidence tends to support the Political Hypothesis
    – Government ownership tends to be higher in economies with ‘under-developed financial systems, interventionist and inefficient governments, and poor protection of property rights’.
Government Ownership

- Simon Johnson and Todd Mitton looks at government and business relationships in Malaysia.

- Raymond Fisman looks at Suharto family business relationships in Indonesia.

- Both find that political interference is high (leading to value discounts) and evidence of crony capitalism.

Government Ownership

- Adam Smith was suspicious of joint-stock companies and government interaction.
  - “They have, accordingly, very seldom succeeded without an exclusive privilege; and frequently have not succeeded with one. Without an exclusive privilege they have commonly mismanaged the trade. With an exclusive privilege they have both mismanaged and confined it.”

- Similarly Ludwig von Mises is suspicious
  - “those who really are in power always manage business in their own interests, whether this coincides with the shareholders’ interests or not”

- Government involvement in business is not in the interests of either consumers or the firms themselves.

- Where do SWF come into that equation?
Rationales for SWF

- Diversification away from commodities (Oil)
  - Intergenerational equity
- Higher returns on forex reserves
- Distressed assets
- Superannuation / Pension
  - Puzzle – why not more SWF?
- But not any argument about ‘commanding heights’, market failure.

Objections to SWF

- Bryan Caplan's biases
  - Anti-market bias
  - Make Work bias
  - Anti-foreign bias
  - Pessimistic bias
  - Bias against SWF combines at least two if not three biases.
- Dislike of foreigners
  - Variation of the old ‘White Australia Policy’
    - Grades of Foreigner
  - Selling the Farm
    - Entrepreneurship is a non-renewable resource … and we have already used it all up.
    - Cultural Cringe – Foreigners take advantage of Australians
Objections to SWF

• Do foreigners take advantage of Australians?

Market model cumulative abnormal returns (CARs) for domestic and foreign offers for the 51 days surrounding the announcement day for target firms.

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Objections to SWF

Market model cumulative abnormal returns (CARs) for the 51 days surrounding the announcement day for target firms partitioned by country specific.
Objections to SWF

• Political Concerns
  – Lack of information about Objectives
  – Lack of Accountability
  – Political Risks*
    – Investments in large well-known iconic firms
    – National Security
    – Strategic Interests
    – Reversing two decades of privatisation

  *Suspicion of government is good.

Objections to SWF

• What are SWF Objectives?
  – Promote Economic Development
  – Industry Policy
  – Macro-economic Stabilisation

  – Social Objectives
  – Diversification
  – Savings

• That is a combination of activities that
  – Governments already undertake
  – Large investors already undertake
Objections to SWF

• Are SWF unaccountable?
  – In their home economy SWF are subject to their domestic legal/constitutional framework
  – In any foreign economy they are just as accountable as is any other large foreign investor
    – Foreign government have no/few sovereign powers outside their home jurisdiction
    – Any investor can be expected to act in their own best interests subject to the laws of the land

Objections to SWF

• Political Objections
  – National Security and Strategic Interests
    – We already have institutions whose job it is to manage national security issues
    – What precisely is the concern?
      – Tom Clancy’s Debt of Honor
  – Investment in Iconic firms
    – Well-known phenomenon in international investment
    – Foreign investors face asymmetric information problem
    – SWF probably face more political risk
  – Reversal of Privatisation
    – Except foreign government control rather than domestic government control
The Real Issue

• Good Corporate Governance lies at the core of concern about SWF
  – Mechanisms that prevent large shareholders from expropriating the wealth of small shareholders
  – SWF are simply large shareholders
  – Michael Jensen identifies four mechanisms for good corporate governance
    – Capital Markets
    – Legal/political/regulatory System
    – Product and Factor Markets
    – Internal Controls

• As long as SWF obey the law of the land, they are no different from anyone else
• The problem with government is the exercise of sovereign power – foreign governments have no sovereign power here.

Do SWF make Economic or Political Decisions?

• To the extent that they exist and are ultimately controlled by politicians, SWF make political decisions
• That does not matter
  – All investors should act in own best interest
  – Domestic legal/regulatory framework inhibits coercion and market manipulation

• Domestic government however can use force and can intervene in market processes