

# 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.

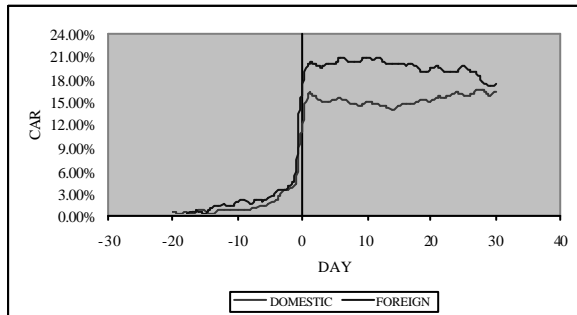
## Objections to SWF

- 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

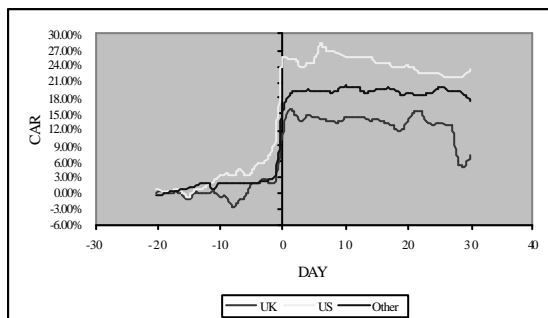
- Do foreigners take advantage of Australians?

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



## 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