

***Comment for FT.com on Larry Summers' "Sovereign Funds Shake the Logic of Capitalism," FT, July 30, 2007.***

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Sovereign Wealth Funds, the latest "new new thing," do carry the possible dangers of which Larry and others have warned. The governance of SWFs should be made transparent and independent, on the order of good governance for central banks. Maximizing risk-adjusted expected returns should be their explicitly assigned task, as price stability is the task assigned to central banks. Otherwise, in many countries, cronyism and political shenanigans are sure to intrude, particularly worrying at the international level. Norway's Pension Fund is the way to go. So far as I know -- correct me if I am wrong -- Singapore, Chile, and the UAE have pretty good records too. It is not inevitable that SWFs will make poor capitalists.

There is an irony that should be noted here. Larry (and others) have over the last year (correctly, in my view) been telling developing countries, especially Asians and commodity-producers, that they should diversify their reserve holdings out of US Treasury bills, which have low returns. The move to Sovereign Wealth Funds among new players like China is an effort to do precisely that. The advantage of transferring the portfolio to a Sovereign Wealth Fund, is that when the foreign assets are removed from the central bank's balance sheet, the problem of sterilizing reserve inflows so as to prevent inflation is automatically solved. Of course an alternative is to allow the currency to appreciate, and probably China and more Persian Gulf states should be doing that. But if the producer of a booming commodity wants to avoid the Dutch Disease -- real appreciation, loss of manufacturing exports, reduced international investment position -- SWFs are one way of doing it. Admittedly, if domestic private sector investors went abroad, which is currently impeded in countries with capital controls, the same goals would be accomplished (saving, and staying price-competitive), while avoiding the tricky question of whether a Sovereign Wealth Fund can stay out of politics.