Beware the dangers of sovereign self-rule

It's an encouraging sign that accounting statements of SWFs must undergo audit but national standards vary, hence leaving room for manipulation

by KAI-ALEXANDER SCOLEVIG

OW do you tame a buck? Ignoring a momentary attack, an experienced animal trainer is quick to hold up a chair and expects the beast to eagerly grab one of its legs. When sovereign wealth funds (SWFs) were ambushed by Western opponents, the leaders of these state-owned investment arms exploited the wisdom of savvy timers and exited the initiative.

Under the aegis of the International Monetary Fund (IMF), their representatives drafted the Generally Accepted Principles and Practices (GAPP) for sovereign funds in less than six months. Then, they held onto it to the furiously criticism as an attention-grabber and lightning rod. Also, these “Santiago Principles” suffer from the very illness they want to cure.

It is a sad irony that the guidelines that are to promote good governance fail to divide power and do not put in place effective checks and balances. Experience shows that self-legislation, self-regulation and self-policing do not always work. Follow the logic: political engineers dividend legislative, executive and judicial power in order to prevent officials from abusing their authority. Someone affected by guidelines can be asked for input, but given conflicts of interest, should not draft them.

For example, a responsible education minister does not allow students to set their own examinations rules. Unfortunately, the GAPP were developed by the International Working Group of SWFs.

According to Principle 24, it is up to the funds, their owners or governing body to decide whether they want to rewrite the implementation of the guidelines. There are no sanctions for non-compliance. Funds are free to choose whether they publish the findings of such an assessment, retaining the right to hold shortcomings. Irrespective of its instrumental value, self-regulation decreases the funds’ credibility. In future, a standing group at the IMF might review implementation, but it would be better if a truly independent agency were entrusted with this fundamental duty.

It is an encouraging sign that the accounting statements of sovereigns are supposed to be audited, but national standards vary. Besides, research has shown that auditors’ judgment can be biased due to conflicts of interest, even if they strive to be objective. The problems are compounded when they have to examine the investment arms of a country. No auditing firm wishes to be excluded from lucrative contracts in countries like China.

Furthermore, there is still much room for manipulation. The sub-prime crisis has shown how investments can be packaged in a way that conceals their riskiness.

Non-commercial pursuits

The state capitalists might lose interest in the guidelines and try to put them on the backburner, but the governments of host countries, media and other groups will ensure that sound sovereign investment practices remain a hot issue. In the course of time, the importance of credibility to some savers will deter sovereign funds from acting opportunistically and encourage a more long-term view.

Finally, the market will sanction irresponsible behaviour by sifting out state-owned investment arms with bad reputations. But all of these outcomes would have occurred without guidelines, which can prevent many unnecessary abstractions and much damage.

The central problem of allowing sovereign funds to expand globally is that they might pursue controversial aims. Among other things, they have the power to reward and sanction, to swing regimes in their favour.

Also, the IMF guidelines do not address this issue in a satisfactory manner. They do not preclude SWFs from pursuing non-commercial objectives. The investment pools are just encouraged to disclose such aims: they can oblige by stating them in very general terms. What’s more, publicity is the best way of concealing matters of great importance, since everybody assumes that the important will not be publicised.

A country that wants to achieve non-commercial goals but prefers secrecy can even practice the art of dismantling. Besides, it can use other means to gain undue control in recipient countries, such as intergovernmental transfers, guarantees and the financial investments of its state-owned enterprises.

Even though procrastination appears to be only a minor wrong, it is in reality one of the greatest evils. One highly efficient antibiotic is a credible deadline. Using this simple motivational and disciplining device, management consultants are able to focus a project team on completing the main pivotal tasks that their clients had postulated indefatigably.

In view of the value of deadlines, it is surprising that there is no mandatory implementation schedule for the Santiago Principles. In the best case scenario, it would have spurred the state capitalist to action. In the worst, it would have at least stung global sovereign funds into reconsider their strategies and embarrassed them in front of the global market.

Adverse selection is likely. This phenomenon manifests itself in the tendency for lemons to be sold in the used-car market while owners hold on to the good vehicles. Some of the established sovereign, examples, such as Temasek Holdings or the Government Investment Corporation (GIC) of Singapore, are quick to formally endorse and implement the guidelines. After all, it is in the self-interest of these state-owned investment arms that did not deserve criticism to increase their global respectability and acceptability.

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Safety in numbers

In this respect, safety lies in numbers. The guidelines will become meaningless if the majority of sovereign funds either overtly disregard them or through deception violate their spirit.

Succumbing to self-serving bias, these sovereign wealth funds have missed the chance of using pre-emptive action to stir the debate about them in the direction they desire.

A set of stringent principles duly enforced would have made it unnecessary for prospective host countries to draft national legislation enforcing unsustainable practices of state capitalists from abroad.

The prices for the failure will be high, since a boomerang effect is possible.

Those whose views have been ignored may conclude that the “Santiago Principles” as a red herring thrown out to distract them from the sensitive issues; eager to regain the initiative, they will raise the curtain for the next act of the sovereign drama.

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