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For a few sovereigns more

Sovereign wealth funds and the changing balance of power in financial markets and the world economy

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By Richard Cookson

Summary

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Anatomy of a row

How art the fallen mighty. Nowhere has the new-found power of the emerging world attracted more attention than the recent huge injections of capital in big developed-market banks by sovereign wealth funds. As symbolism goes, these are indeed dramatic. The emerging world, after all, had itself long been a byword for instability. From the Latin debt crisis of the 1980s, though the Tequila crisis of 1994-95, the Asian crisis of 1997 and Russia's default to Argentina's even larger one in 2001, the emerging world, always with its finances in a parlous state, rocked from one crisis to another. Now, huge quantities of money from the emerging world - some USD60bn at last count - are injecting a measure of stability into the arteries of the developed world's economies: some of its biggest, boldest and brashest banks, brought low, in their turn, by investments and finances that were themselves, it now transpires, an awful lot less stable than they or most others had assumed.

True, the money is not coming from countries torn by crisis in recent years; but to those of a dispassionate disposition; all this, nonetheless, has a certain poetic symmetry. In this debate, however, few are dispassionate. As well as the dramatic size of the investments, fears about the rapid growth, motives and measure of control potentially exercised by the so-called sovereign wealth funds (SWFs) that have invested the cash, have led to growing and heated debate. Should SWFs become more transparent? Will they use their investments for strategic or political purposes? Should there be limits on the sorts of firms or areas in which they invest? Or the amounts they are allowed to invest? Underlying all these questions is another: do their activities provide the most profound illustration yet of a sea-change in the world economic order and of the relative decline of the West? To this question is linked another, much chewed-over, but as important for the investment strategist: what will be the likely effects on different markets of the rise of sovereign wealth funds?

To answer these questions you need to know how big such funds are now and how large they are likely to become. Market wisdom puts their total size at USD2-3trn and growing like Topsey. Some estimate that, on present trends, they will grow to USD12-15trn within five years. We argue that the true size of SWFs, narrowly defined, is probably smaller, but that we should add to this excess foreign exchange reserves. That brings the current number to roughly USD5trn.

Extrapolating the recent growth of this number into the future is easy, but risky, if not wrong. The sharp rise in the amounts managed by SWFs rests on a number of factors that are, by historical standards, very unusual indeed: viz, the dramatic growth in foreign-exchange reserves, the result of a huge rise in emerging-world current-account surpluses. The huge transfer of capital from the emerging to developed world is, by historical standards, entirely without precedent, even during the oil shocks of the 1970s. Although we think that commodity prices will remain high for now, driven by the emerging world's high income elasticity of demand, we could be wrong. And even if commodities prices do stay strong, inflationary pressures, which are anyway rising, are likely to pick up further, driving up real exchange rates and, at some point, leading to a fall in nominal rates and foreign exchange reserves.

Of course, even if the gush of current-account surpluses turns to a dribble, that still leaves a huge stock of money. With government bond yields so low, the dollar so weak and risky assets so cheap, you would expect SWFs to reduce their exposures to government IOUs and increase their exposure to corporate equity and corporate debt. How fast they do that will depend in part on how long the fund has been in business: longer-established funds tend to have more appetite for risk than newer ones. But as the recent banking deals illustrate, price also plays its part. Given the sums that SWFs now hold, their activities should provide support for equity and corporate bond markets that have, in recent months, become very cheap indeed compared with government bonds.

These purchases, at least those of corporate equity, are very likely to increase tensions. It seems probable that SWFs will want to buy controlling stakes in companies, so as to have more say in how their money is used and because returns are likely to be higher than any future returns on government bonds now that yields are so low. Policy-makers in developed economies are crying foul, since these funds are government-owned, may not be investing for purely economic purposes and because emerging economies, they claim, aren't opening up their markets as fast as they have been.

How they can say any of this with a straight face is unclear to us. Most developed markets are far from being paragons of transparency and openness in which shareholder interests rein supreme. Just look at the US housing market, or France. FDI flows in emerging markets, not least into their banks, have been huge, and far and away higher than emerging-market flows into big western banks or to any other sectors, come to that. The owners of emerging SWFs look unlikely just to roll over. They are enjoying the boot being on the other foot after an awfully long time. The train-wreck that was the 1990s, when they had to go cap-in-hand to the developed world was bad enough. Going back further, western jibes about state capitalism would, perhaps, have more power had they themselves not ruled many of these countries for years via state-licensed companies. The British East India Company, the biggest of the lot, ruled India for almost 100 years and held sway over much of the rest of Asia, too. Memories in the emerging world run deep.

For a few sovereigns more

- The rise and debate about SWFs reflects a changing world order

Capital questions

Outside the rarified world of finance, few, even six months ago, had heard of sovereign wealth funds (SWFs), cared about them or had opinions about them. They have now. Rarely a day goes by without commentators fretting about their new-found power or pointing out that they have been important sources of capital for western banks in need of the stuff. SWFs had top billing at this year's Davos shindig. And much angst and fretting there was, too.

Merely because it received so much attention at Davos does not of itself mean that the subject is doomed to disappear from the headlines. This debate is likely to run and run. On one level, the row is between those who see the capital such funds are throwing around as stabilising to financial institutions and those who think, in contrast, that it reflects and portends a worrying switch in ownership to governments rather than private companies and to countries whose democratic credentials bear little scrutiny. Such countries could, so the argument goes, use their muscle for strategic ends, taking advantage of developed countries' freer markets in corporate control.

That might strike anyone with the slightest sense of history as a little surreal. Here's a challenge for some future professor of sovereign studies: find a period when western investors and governments *haven't* been prepared to take advantage of their greater economic muscle, deeper pockets and others' distress to buy something on the cheap. In reality, we think, the debate reflects deep fears that the activities of SWFs reflect a rapid shift of power from the developed to the emerging world.

But all of these concerns, taken together, make it entirely understandable that discussions have been forceful, heated even. Politicians from every corner of the globe have put in their two-penny worth. Hillary Clinton, she who would be president, has pronounced herself "very concerned" about SWFs' transparency. At Davos, Larry Summers, in normal blunt vein, professed he was baffled why SWFs were reluctant to sign a piece of paper saying "we're under no circumstance going to speculate in currencies; we're always going to be a long-term investor; we're never going to use our SWF to pursue any political objective." German politicians are drafting new laws that would enable the country to block SWF takeovers of German companies, the OECD has been asked by the G8 to do some research on the subject and the IMF is to come out with a code of best practice.

Quite whether a code of best practice from the IMF or anyone else will amount to much is, however, a moot point. The owners of the funds are irked by this treatment. Wei Benhua, the deputy head of China's State Administration of Foreign Exchange, argued that the developed world shouldn't indulge in "financial protectionism". Fears about SWFs were unjustified, says Alexei Kudrin, Russia's finance minister. And "any concern about the political underlining of these funds is exaggerated," he added, for good measure. Muhammad Al Jasser, the vice governor of the Saudi Arabian Monetary Authority opined: "You're talking about how to pre-emptively regulate something that may not happen. We've had a lot of resistance to regulating the hedge funds, and the rating agencies, even though there were failures galore. So, let's be a little bit more balanced."

Balance would be easier to achieve were we to have a good grasp of, *inter alia*, what counts as an SWF, how much money they manage, how much this is likely to grow and what they do with it now and what they are likely to do with it in the future. For all the dramatic headlines, these fears might, after all, be a storm in a teacup were the amounts that such funds managed small, unlikely to grow quickly, and invested, and continue to be invested, mostly in Treasury bills.

Unfortunately, this is complicated by the fact that there is no decent working definition of what constitutes an SWF and many, though not all of them are very secretive. The debate, in short, is notable for its definitional woolliness, startlingly large (but also startlingly speculative) numbers, extravagant extrapolation, ignorance, secrecy, hypocrisy, history and fear. There follows an attempt to untangle some of those strands and shed some light in the darkness.

What are sovereign wealth funds?

It sometimes seems that SWFs are defined as any government or semi-government fund that invests for the long term. But since this includes some funds that commentators don't want to include, SWFs come to be defined as including anything that people seem to think should be dubbed an SWF. So some national pension funds (Norway's, for example), are generally included, but others (eg, Japan's, the world's largest pension fund with some USD500bn under management) aren't. The omission is generally explained by calling attention to the fact that Norway's pension fund is financed with oil revenues and Japan's is not. Which is fine, except that this doesn't explain why many Asian funds, whose money doesn't come from commodities, are counted as SWFs.

The problems of definition partly arise because SWFs have been established for different reasons and with different aims. Called the Reserve Fund for Future Generations, the first SWF generally recognised as such was founded in 1953 in Kuwait. A smattering of further funds was set up in the 1970s and 1980s, in the UAE, Canada, Singapore and the US, among other places. Latterly, though, this trickle has turned into a torrent. From tiny East Timor to rather less tiny China, some 16 countries (from a total of 40), have set up some sort of SWF since 2001. The process has been accelerating recently; more are due to be set up in the near future. Japanese politicians are even muttering about the need for one there. However, since: (a) the country arguably already has one; and (b) their aim is mostly to support the local stock market, it's not entirely clear what one should make of this.

Most of the original SWFs were set up by commodity-producing countries. In the knowledge that the good times would not last forever, they wanted to invest for future generations their profits from energy and other commodity prices. You don't need to drill too deeply to ascertain why Kuwait, the UAE, Brunei and the like set up SWFs. But Singapore set up Temasek in 1974 and GIC in 1981, and the island state isn't a notable exporter of energy or mineral resources. Quite the opposite, actually. Nor, for that matter, are China or South Korea, both of which have, over the past couple of years, set up what most (themselves included) regard as SWFs. These countries have current-account surpluses, but they come from saving lots and making things that people want to buy.

Even those that set up funds with money from selling commodities often had different aims in mind. One of the aims of many Middle Eastern SWFs is to iron out the effects of the cyclicality of commodity prices. In the early 1970s, high oil prices led to a surge in government spending. When that spending collapsed when oil prices did in the early 1980s some countries set up SWFs to offset that cyclicality. But that desire for saving some of the gains within an SWF in fat years and spending them in lean ones—a fiscal stabiliser if you will—is quite different from using the proceeds from oil to earn a decent return for future generations, as Kuwait's, Norway's and Alaska's, to name but three, are meant to do.

As the last of those examples suggests, there are other important wrinkles. Although it is true for most, not all sovereign wealth funds are, in fact, sovereign. Alaska is an American state; Alberta, which also has what most consider an SWF, is a Canadian one. In the Middle East, it's often unclear where the state ends and ruling families begin. Or, to put it another way, the distinction between public and private is more than a little hazy, a comment that could be made about Russia, too. Is Gazprom, say, an arm of the Kremlin or a private company? And should one be any less concerned about its activities merely because it isn't thought of as an SWF?

In short, the definition of sovereign wealth funds is too woolly and too broad to be of much use. Financial commentators generally take the if-it-walks-like-a-duck attitude towards inclusion: if it feels right then put it in. As an exercise in terminological exactitude, though, this leaves something to be desired.

Table 1. Largest generally agreed sovereign wealth funds

Country	SWF	AUM USDbn
UAE	ADIA	400-450
Norway	Government Pension Fund – Global	370
Singapore	GIC	100+
Saudi Arabia	Saudi Arabian funds –various types	300
Kuwait	Reserve Fund for Future Generation	213
China	China Investment Corporation	200
Singapore	Temasek Holdings	100
Libya	Oil Reserve Fund	40
Algeria	Fond de regulation des recettes	40
Qatar	Qatar Investment Authority	50
US (Alaska)	Permanent Reserve Fund	37
Brunei	Brunei Investment Authority	45
Malaysia	Khazanah Nasional BHD	17.6
Russia	Stabilisation Fund	148
Korea	Korea Investment Corporation	20
Kazakhstan	National Fund	21
ROC (Taiwan)	National Stabilisation Fund	15
Canada	Alberta HeritageTF	16.1
Iran	Oil Stabilisation Fund	15
Chile	Copper Funds	11
TOTAL		c. 1660

Source: HSBC estimates

Conventional wisdom and the IMF (there isn't generally much difference between the two) has it that SWFs now manage USD2-3trn. On our estimates, the true number is anyway probably lower. That is partly because, as Table 1 shows, we don't think some of the biggest funds are as big as is widely assumed. We estimate that SWFs probably manage about USD1.7trn. Perhaps our estimates are no better than anyone else's, though HSBC's size and spread of business, especially in the emerging world, means that they are likely to be at least as good. As importantly, however, if you exclude some of the SWFs that aren't, by any reasonable definition, SWFs, the actual figure is lower still. Although, for example, most people count Saudi Arabia's funds as SWFs and we have them in the table, they (and we) probably shouldn't, if only because Saudi Arabia itself doesn't really think of them as such, which is why it says that it is about to set one up.

To the extent that the numbers are lower, so too should be fears about them, of course. Except that we think that, far from being too broad, a better working definition of SWFs –and of their likely influence—should include central banks' excess reserves. That would, by our calculations, give you a current total of about USD5trn.

Broad band?

If there is a commonality between these funds it is that they have generally been set up in countries with huge current-account surpluses. Although these often come from commodities, that doesn't have to be the source of their savings. In the case of many Asian countries - China is a case in point - they come from the accumulation of huge foreign-exchange reserves, the result partly of active intervention in the foreign-exchange markets to keep their currencies from rising too rapidly and partly of too few domestic investment opportunities.

This, it seems to us, points to a good reason for arguing for a much broader definition of SWFs. When you stop to think about it, there isn't, in fact, much difference between SWFs and central banks' foreign exchange reserves. True, there is a clear theoretical difference between the two: foreign exchange reserves are used to manage the vagaries of demand and volatility in foreign-exchange markets and are thus invested, for the main part, in short-term, very liquid, high-quality debt. With returns in mind rather than liquidity, SWF funds, in contrast, invest in theory for the longer term and more of their money can and should be invested in riskier assets.

There is, however, less to this neat difference than meets the eye. For a start, it's sometimes quite hard to tell where the central bank ends and the SWF begins. Norway's NBIM, after all, is an arm of the central bank. Saudi Arabia's existing funds are currently managed by SAMA, the country's central bank. Most of the money is apparently invested in fixed-interest securities. Russia's Stabilisation Fund was managed by the central bank and its asset-allocation strategy was broadly the same, though it has split this fund into a reserve fund and an SWF called the national welfare fund. This will be managed by the finance ministry, though some of the asset management will still be done by the central bank.

Not only are central banks often closely involved in the management of the funds, there's also much overlap in the sorts of assets in which they invest. In recent years central banks have increasingly taken more risk in their asset-allocation strategy. Many now buy longer-dated government bonds and corporate securities, and the Hong Kong Monetary Authority and the Swiss National Bank, to name but two, invest sizeable chunks of their portfolios in equities.

The incentive to be more risk-taking has become still greater now that reserves at many central banks have become so huge compared with any possible need to stabilise foreign exchange markets. Indeed, it has been the significant growth in foreign-exchange reserves that has prompted many countries to hive off a proportion of these reserves into a separate wealth fund.

But although it is true that SWFs generally invest in riskier assets - Norway's NBIM is aiming to increase its equity allocation from 40% to 60% and, according to press reports, the KIA already has that proportion of its portfolio in equities - there is a great deal of difference in SWFs' investment strategies. The most conservative are far more conservative than the most sophisticated central banks. Some have most or in a few cases all of their money invested in bonds. Chile's Copper Funds and Algeria's Revenue Stabilisation Fund invest only in fixed-income. For the time being, Russia's welfare fund will also be invested exclusively in foreign bank deposits and high-quality bonds.

Given that overlap, the lack of difference in the way in which many central banks and SWFs manage their money, that the build-up in both reflects the same forces and, crucially, that the money managed by both is government money, one should probably think of them in the same breath. Willem Buiter, a former member of the UK's MPC, put it in a recent article in the Financial Times: "The distinction between official foreign exchange reserves, which are historically invested in highly liquid and safe instruments…and state investment assets managed by SWFs, which can be invested in anything…is hazy and not terribly important. Unless a country is committed to a fixed or crawling peg for the indefinite future, true reserves will be very small. Most of the USD1.1trn still held as 'reserves' by the People's Bank of China represents in reality excessively cautiously invested SWF assets, even though the PRC appears committed to a de facto crawling peg for the Yuan for the foreseeable future."

How much is enough? The traditional rule of thumb is that a country needs enough foreign exchange reserves to cover three months' imports and the equivalent of its short-term foreign debt (one tells you about the size of reserves, the other about vulnerability to a run). In 1997, South Korea had reserves equivalent to only a third of its short-term debt, according to the EIU. Indonesia had reserves of half of its short-term debt. Thailand had reserves equivalent to 70% of its short-term debt. South Korea had one month of import cover, Russia two-and-a-bit months, Indonesia three months and Thailand five. These reserves proved woefully inadequate.

Clearly, one of the motives behind the huge subsequent build-up in foreign-exchange reserves was a desire to avoid the subsequent crunching devaluations and financial crises. Equally clearly, though, they now have more than enough reserves (not to mention far less highly valued currencies) for that purpose. Both Thailand and Indonesia now have six months import cover and these are the lowest coverage ratios in Asia. Russia now has reserves equivalent to 16.5 months import cover and China 18 months. Their ratio of reserves to short-term debt is in general also dramatically higher. India now has reserves of 19 times its short-term debt, Russia 15 times, Mexico ten times, and China six times. The lowest, among big emerging economies, is Indonesia, which has reserves of twice its short-dated debt.

Taking the two metrics for the ten largest emerging economies (which gives you 80% of the emerging universe) allows you to calculate, in very rough terms, the excess reserves held by emerging central banks. Put another way, it allows you to calculate the reserves that are, in essence, SWFs invested conservatively by the central bank.

Table 2. Excess reserves over short-term debt, for emerging economies with largest reserves

	1997		2007	
	USDbn	Ratio	USDbn	Ratio
China	112	5	1331	6
Korea	-42	0	166	3
Brazil	17	1	147	5
Russia	12	3	411	15
Indonesia	-15	1	26	2
Thailand	-11	1	61	4
India	23	5	264	19
Malaysia	6	1	85	8
Mexico	1	1	78	10
Algeria	8	51	104	115
Total	USD110bn		USD2.7trn	

Source: EIU

Table 3. Excess reserves over 3m import cover, for emerging economies with largest reserves

Reserves: 3 months' cover (USDbn)	**1997**		**2007**	
	USDbn	Ratio	USDbn	Ratio
China	89	4	1238	7
Korea	-19	1	136	3
Brazil	26	3	109	6
Russia	-4	1	249	8
Indonesia	1	2	17	3
Thailand	8	2	36	2
India	9	3	155	5
Malaysia	-2	1	50	3
Mexico	-2	1	7	1
Algeria	5	4	86	14
Total	**USD111bn**		**USD2.1tn**	

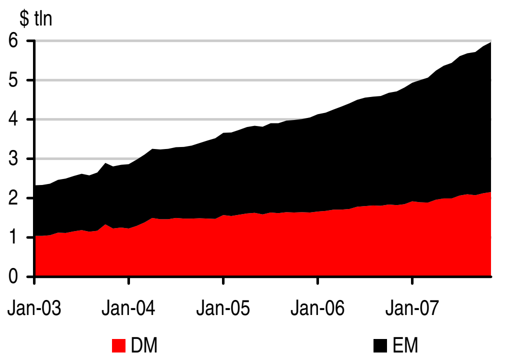
Source: EIU

Looking at reserves over short-term debt, these ten emerging central banks had excess reserves of over USD2.7trn, on EIU numbers. The more conservative assessment comes from looking at import cover, because it gives a lower figure – some USD2.1trn – for excess reserves. Extrapolating to emerging markets as a whole, a not unreasonable calculation given that most are in a similar position, gives you numbers of about USD3trn (using short-term debt) and USD2.3trn (using months of import cover). These numbers don't even include Japan, which, after China, has the world's second-biggest reserves. Putting that country in the picture – and if any country needed to invest for the future that country is surely ageing Japan – adds excess reserves of another USD600bn or so, bringing you to a conservative total of some USD2.9trn and a less conservative one of USD3.6trn.

Adding the two together – excess reserves at central banks and money managed by SWFs – gives you between USD4.7trn and USD5.4trn. So very roughly USD5trn – and that doesn't include the money which flows in semi-public hands in the oil exporting countries. Which means that there is, potentially at least, a huge amount of footloose government-owned money looking for a home, whatever name it travels under.

And, as the above numbers suggest, growing at a very fast lick indeed. World foreign exchange reserves have more than doubled since the end of 2003. Most of this rise has been driven by emerging economies, whose foreign exchange reserves have tripled over the past five years and by 560% or thereabouts over the past ten. At the beginning of 1998, emerging central banks held USD500bn of reserves. At the start of this year, they had USD3.2trn worth.

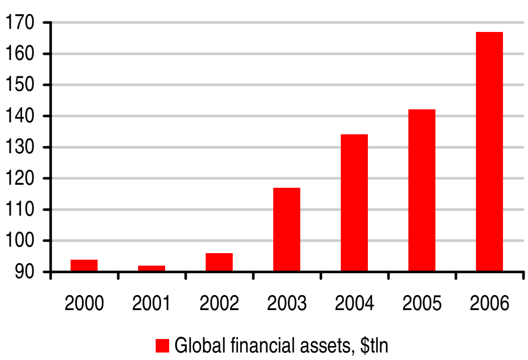
Chart 1. Growth in world foreign exchange reserves



Source: Bloomberg

How big are those numbers? Hedge funds and private equity funds, the whipping boys of yesteryear, each manage some USD2trn. So bigger than both added together and since some of the money in both comes from SWFs, there's also some double counting. According to the latest McKinsey survey, the total value of the world's financial assets amounted to just shy of USD170trn by the end of 2006, the latest year for which numbers are available. Assuming, thanks to sharp falls in credit and equity securities but rises in the value of government bonds, that this number is pretty much the same, USD5trn of SWF money amounts to about 3% of world financial assets.

Chart 2. Size of world markets



Source: McKinsey

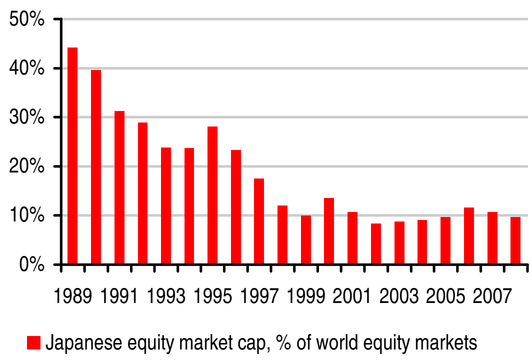
Growing pains

The tendency to extrapolate from present trends is very strong and often hopelessly wrong. Commentators have suggested that SWFs, even defined in the more usual way, will be managing eye-popping amounts in the none-too-distant future. Simon Johnson, the head of the IMF's research department, has estimated that, using the common classifications, SWFs could manage USD10trn by 2012. Some private commentators say the number could be higher still. Simple extrapolation gets you there. If you look at the excess reserves on our two measures and assumed that these excesses rose over the next five years at their rate of the past five years, then you'd get to excess reserves over short-term debt of USD13.5trn and excess reserves over import cover of about USD12trn.

Such estimates could be right, of course; but there are huge uncertainties in predicting how much they will manage because there are huge uncertainties in predicting commodity prices, current-account surpluses and movements in exchange rates. History is replete with consensus predictions that proved woefully wrong.

Consider a couple of them. The wonder that was technology stocks briefly shined in the late 1990s, when anything with a dotcom suffix was valued as though it was the rarest of caviar. In the late 1980s the Japanese, you might remember, were set to take over the world. Lots of alarmist books, a few trophy assets and the rapid rise of Japanese banks to the top of the list of the world's most valuable companies (yes, really) epitomised the paranoia that gripped the US in particular of this apparent change in the pecking order. Suffice to say that this didn't quite happen either. What once looked inevitable, given the prevailing trends, turned out to be anything but.

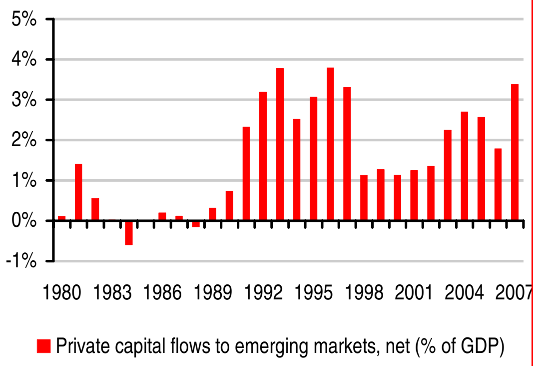
Chart 3. The price was wrong



Source: MSCI

Notably, of course, the two examples above were bubbles. But the same might, of course, be true for the vast current-account surplus that the emerging world is currently running and the consequent rocketing of foreign-exchange reserves. The words "bubble" and "emerging market" have often been closely entwined over the years. From the late 1980s to the mid-1990s, investors poured their money into emerging markets as though they were going out of fashion. As it happens, they did. The strength in the emerging world rested on very flimsy foundations. Where once they could do no wrong, from the mid-1990s on they could do no right. Net private capital flows shrivelled.

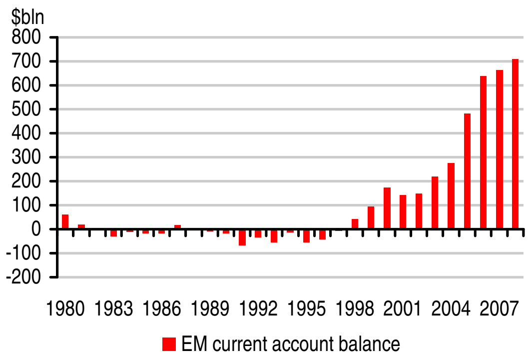
Chart 4. The ebb and flow of popularity



Source: IMF

But then the crises stopped – Argentina's default in 2001 and Brazil's currency crisis the following year were the last two – and capital flows surged. Emerging markets again now seem able to do no wrong; most wobbles in recent years have come from the very strength of emerging markets rather than their weakness. While we think that there have, in fact, been important structural changes, it is of course possible that this euphoria will prove as ephemeral as previous episodes.

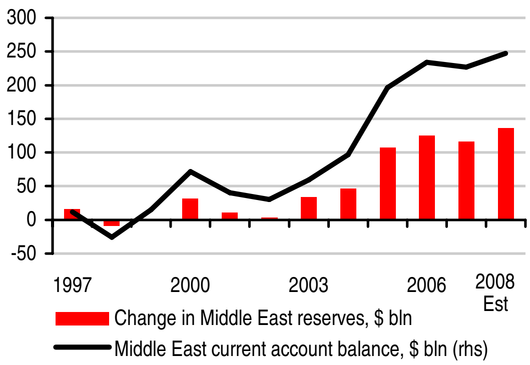
Chart 5. The flow from poor to rich



Source: IMF

One thing worth certainly bearing in mind is that the current huge transfer of capital from the emerging to the developed world is, by historical standards, utterly unprecedented. It simply hasn't happened before. The normal condition of poor, fast-growing economies is to attract capital from rich, slower-growing economies, rather than the reverse. True, the rise has been going on for nine years and this year will bring the total to ten, but even ten years is but a small drop in the ocean of economic history.

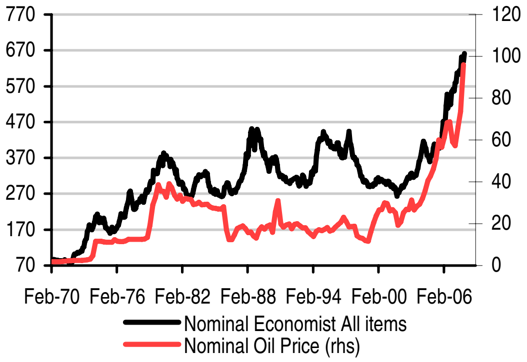
Chart 6. Most money flowing into the Middle East doesn't go into central bank coffers



Source: IMF

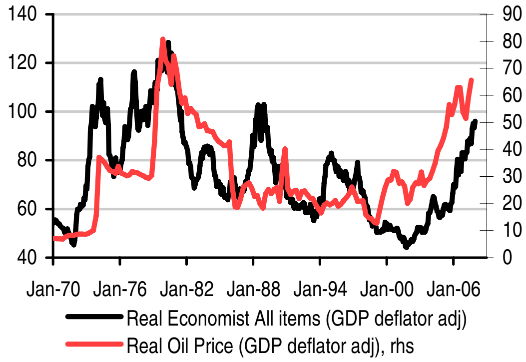
These current-account surpluses have rested on two things: the surge in commodity prices, which has boosted the terms of trade for any country that exports stuff that is dug out of the ground, and, for other countries, mostly in Asia, high savings rates, lack of domestic capital markets and the suppression of rises in their currencies so as to keep exports competitive. Current-account surpluses have, in turn, led to a huge rise in foreign exchange reserves, though in many countries, especially those in the Middle East, the money has often flowed into the semi-public hands of the ruling families; witness the fact that foreign-exchange reserves have grown at a much slower rate than current-account surpluses.

Chart 7. Commodity prices have surged in nominal terms



Source: The Economist, HSBC, Thomson Financial Datastream

Chart 8. But in real terms the previous fall was as striking as the recent rise



Source: The Economist, HSBC, Thomson Financial Datastream

That first trend is perhaps less dramatic than it looks, despite the sharp rise in the price of commodities of every description over the past few years. Chart 7 shows nominal movements in the rise in *The Economist*'s commodity-price index and the price of a barrel oil since 1970. This looks dramatic and the latter is now a long way from the sadly infamous cover of *The Economist* in 1999 predicting a fall in the price of a barrel of oil to USD5 (another warning, were any needed, of the perils of extrapolation).

In real terms, however, what looks as dramatic as the recent rises in commodity prices were their previous falls (commodities were the thing that investors least wanted to own in the second half of the 1990s, for the apparently reasonable but utterly mistaken belief that they would continue to fall). For all the headlines, real commodity and energy prices are actually still lower than they were in the early 1980s. By the late 1990s, commodity prices had fallen in real terms to their level at the beginning of the 1970s. The recent rise in the real price of commodities is actually less dramatic than their rise in the mid-1970s.

Now, commodity prices are, we think, unlikely to collapse, because global growth is increasingly being driven by emerging markets which, at their current stage of development, have a very high income elasticity of demand (see *Goodbye to all that*, Global Economics, Q1 2008). But while this does mean that a dramatic fall, thanks to a sharp slowdown in the developed world, is unlikely, it doesn't mean that they won't fall. It simply means that they would fall less than they would have done previously. And a moderate fall would still mean that commodity exporters would be running large current-account surpluses.

We could, of course, be wrong and commodity prices might drop like a stone as the developed world slows. Were commodity prices to fall sharply, large current-account surpluses for commodity-exporting countries would fall or perhaps even be reversed. In that last case, instead of a build-up of foreign currency reserves, such countries would be faced with the opposite, as their currencies came under pressure.

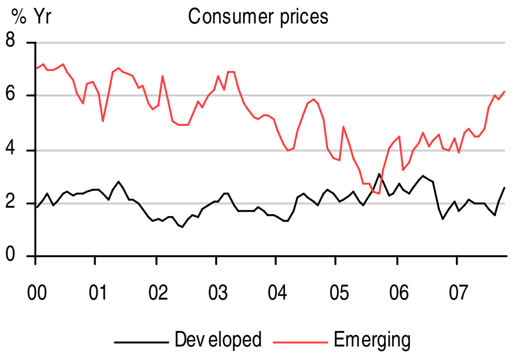
Booming current-account surpluses are not just a story about strong commodity prices, though. Another reason for these huge and growing current-account surpluses, as Stephen King argued in *Global Imbalances: Economic Myth and Political Reality* (May 2006), is that emerging markets don't have sufficiently developed capital markets and investment opportunities. That means that they can't allocate capital efficiently and have left it largely to the US to do this (though recent sub-prime problems have presumably made them think twice about the wisdom of this policy). Regardless of any change in savings behaviour in China or the rest of the emerging world, their current-account surpluses will tend to grow simply because emerging economies are growing more quickly than their developed counterparts.

Stephen puts it this way: "So long as China grows quickly and there is no change in the balance between savings and investment, slower-growing countries elsewhere in the world…will inevitably experience widening current account deficits both absolutely and as a share of their own GDPs (although, interestingly, not as a share of China's GDP). Should China slow down, the absolute amount of its current account surplus would also slow, implying lower growth to the rest of the world. Similarly, should Chinese savings fall relative to Chinese investment…the Chinese current account surplus would come down, thereby reducing the US current account deficit." Put another way, the growth in SWFs reflects stronger growth in the emerging world compared with the developed world and emerging economies that, moreover, don't know what to do with their savings domestically.

Ultimately, as Stephen points out, the perils in this are political rather than economic. Globalisation creates a gap between the sovereignty of nations and the sovereignty of the market. While markets might be content with large external imbalances, nations are less happy. Nor were they at the start of the 20th century, one factor behind the descent into global conflict. The political resistance to this process, Stephen argues, is the biggest single risk to financial markets.

The short-term risks , though, are inflationary and this in itself has implications for exchange rates and foreign-exchange reserves. Inflationary pressures in emerging economies have been rising sharply in recent months. That's partly because commodity prices have been so strong; but burgeoning current account surpluses add to these problems. Emerging economies' insufficiently developed capital markets means that their central banks don't have the tools to mop up or "sterilise" all the yuan or rupees or rubles that they print to buy, say, dollars, by issuing local-currency bonds. That's inflationary because all that extra local currency then leaks out into the economy.

Chart 10. Emerging inflation picking up relative to the developed world



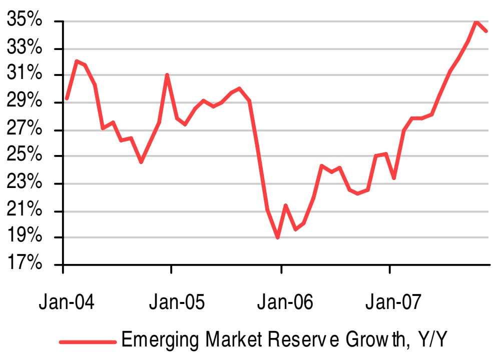
Source: HSBC

And probably more so than the official statistics show. In many countries, the underlying inflationary pressures aren't being reflected in headline measures, such as CPI, because many emerging economies are simply choosing to freeze prices (though a few, such as Argentina, simply choose to be a little economical with the true level of their inflation). China, for example, has frozen, as it were, transport and energy prices. This is unlikely to work, of course. If goods are in short supply, few take any notice of the official price. The unofficial (read: actual) price still goes up.

Whether they admit to them or not, one way in which emerging economies can dampen those inflationary pressures is to let their nominal exchange rates strengthen. They are, however, loath to do this for fear of choking their export competitiveness. The result is that they have intervened still more heavily in currency markets. You can see this in the growth in foreign exchange reserves. This growth rate has actually risen in recent months (see Chart 12), thus storing up still more inflationary problems down the road.

Strong inflation in the emerging world relative to inflation in the developed world will still drive up emerging economies' real exchange rates. Again, calculating the real rate is complicated by the fact that official inflation numbers may be under-reporting actual inflation. But whatever the short-comings of the reported inflation, actual inflation and actual real exchange rates have been rising strongly relative to the developed world. All things equal that will, at some point, lead to depreciating nominal exchange rates and thus, presumably, to a reduction in foreign exchange reserves and of flows into SWFs.

Chart 11. Growth in emerging central bank reserves has picked up



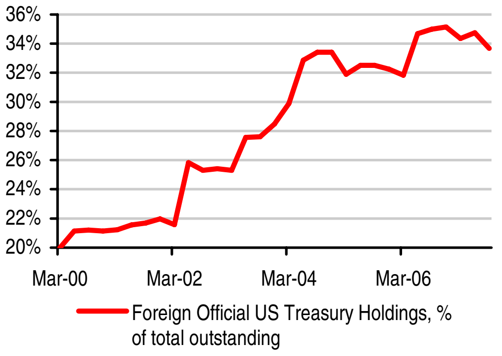
Source: HSBC

Our arguments suggest that you need to be careful about simply extrapolating current large current-account surpluses and booming foreign-exchange reserves. But even if they only shrink, rather than reverse, that still leaves an awful lot of existing and new money to be invested. In a recent McKinsey quarterly, for example, Diana Farrell and Susan Lund estimated that even at USD50 a barrel, net capital outflows from oil exporting countries, for example, would amount to USD387bn a year – a bit more than USD1bn a day. At USD70 a barrel, the figure would rise to USD628bn by 2012. On their estimates, investors from oil-exporting countries already owned USD3.4-3.8trn of foreign financial assets by the end of 2006. At USD70 a barrel, that would rise to USD6.9trn by 2012. But although these amounts are large, the actual sums they might or might not pour into SWFs, broadly defined, are crucially dependent on oil prices.

Where is the money invested?

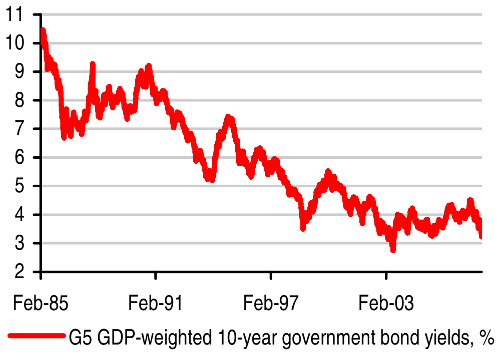
Until now, most of that government money has been lent, in effect, to other governments. That is one reason why government-bond yields have remained so low for the past few years. Of the USD2.3trn US Treasuries outstanding, just over USD1.4trn – a third of the total – are now held by foreign central banks. Inertia and an innate conservatism mean that much of this central bank and SWF money will continue to be invested in government bonds for the time being. For all that some SWFs act swiftly, most don't. As Stephen argued in *Global Imbalances*, although there is a large opportunity cost in investing mostly in low-yielding government bonds rather than in their domestic economies, and an actual cost because the bonds they issue to sterilise the build-up of foreign-exchange reserves often carry a higher rate of interest, there are also benefits to be weighed against this, such as the investments that subsequently return to those countries and the higher growth that would be the result.

Chart 12. Foreign central banks' holdings of US Treasuries



Source: US Treasury

Chart 13. Global government yields have tumbled



Source: Thomson Financial Datastream, HSBC

That said, there seems little reason why, on the asset side of the ledger, emerging economies would feel the need to accept those lower returns from government securities, given how large their assets have become and how low the available yields. There are also adverse currency movements to consider. Low-yielding government bonds are bad enough; low-yielding bonds in currencies against which your own has been consistently appreciating is doubly bad. Singapore established GIC in 1981 specifically to protect the purchasing power of the country's substantial foreign-exchange reserves. Even if other countries don't say this explicitly, we believe it would be entirely rational for them to think about it; indeed, it would irresponsible for them not to.

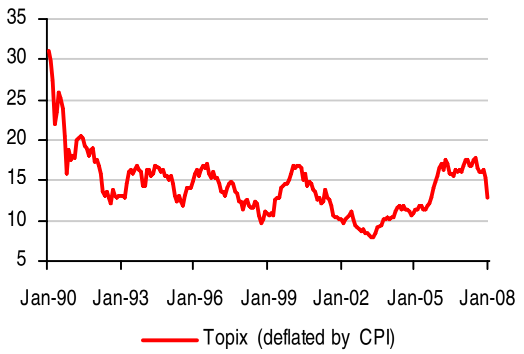
Although US Treasuries and other developed world government bonds now offer slim pickings, the present turmoil in risky-asset markets could make them think twice before increasing their exposure to these markets – once bitten twice shy. Or it could mean quite the opposite, given that many risky asset markets are cheaper than they have been for an awfully long time. So far, the behaviour of such funds suggests the latter interpretation. At the margin, they seem likely, we think, to step up purchases of riskier markets. Following are our reasons for thinking that.

Opportunity knocks

The costs of investing in government debt is not only measured by the somewhat anaemic yields they offer, currency movements and yields of the domestic debt they issue. Over the long term, there is also, of course, the opportunity cost of investing in something that yields a little versus something that potentially yields a lot.

That is why many SWFs have already switched more money into riskier assets. Understandably, SWFs that have been around for a long time, such as the KIA, ADIA and the Alaskan Reserve Fund and are noticeably less risk averse than those that have been set up more recently, such as the Algeria Revenue Stabilisation Fund or the Chile Copper Funds. Over time, then, and regardless of the amounts that they manage, SWFs will tend to increase the riskiness of their portfolios. Among others, ADIA and the KIA have strongly increased their exposures to emerging markets in recent years.

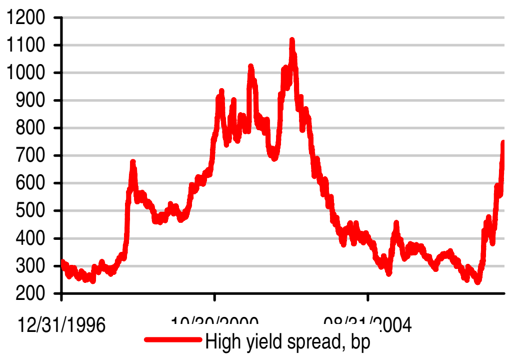
Chart 14. Getting your fingers burnt from hot markets (1)



Source: Bloomberg

The longevity of the fund and experience of its managers are one determinant of their behaviour. The big question now is how much price matters, too. The extra returns you get over time compared with government bonds depends on the riskiness of the asset, the time frame and the cheapness of those markets compared with government bonds. Equity markets will generally, over time, provide greater rewards than corporate debt which will, in turn, earn greater rewards than government bonds. The weasel words in that sentence are "generally" and "over time".

Chart 14. Getting your fingers burnt from hot markets (2)

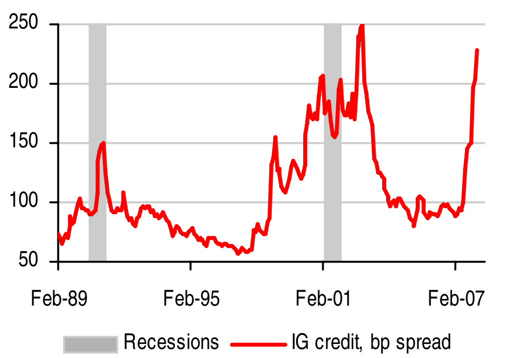


Source: Bloomberg

Anyone that bought Japanese stocks in January 1990 will be nursing real losses of 50%. Investors that bought junk bonds in June of this year, when they yielded a spread of 250bps over Treasuries (half the spread they have averaged historically), must now wonder what they were thinking about, since spreads have almost tripled. Price and valuation matter. Broadly, as those examples suggest, buying markets that are out of favour is likely to earn you far greater returns over time than buying those that are red hot. Although short-term market risks are higher, long-term investment risks are lower. Ask Warren Buffett.

Although government bonds are hugely popular for now, the lower that yields fall, the lower, presumably, their potential future returns. Such is the flight to government paper and away from corporate risk that nominal US Treasury yields are almost at the lows that they reached in June 2003. So are real yields. Inflation expectations are about a percentage point higher than they were back then, but inflation is also a lot higher, especially in the US. It could fall, giving room for nominal yields to drop further, but with US inflation at over 4% and breakeven rates at 2.25%, investors are already taking an awful lot on trust. Not, on the face of it, a wonderful risk/reward trade-off.

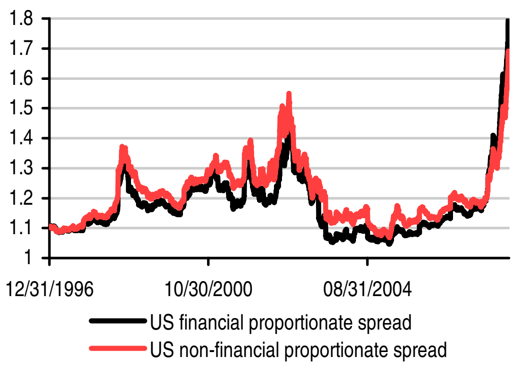
Chart 15. Investment-grade bp spreads higher than coming out of last two recessions



Source: Bloomberg

By the opposite token, the more that riskier markets, such as corporate debt and corporate equity, fall, the cheaper they become and the greater the opportunity cost of *not* investing in them. When you are an investor that is anyway choc full with government debt, there comes a point at which other markets become sufficiently cheap compared with government bonds (or government bonds sufficiently expensive compared with the alternatives) that it is worth putting more money into those alternatives.

Chart 16. Proportionate investment-grade spreads even higher than in 2002

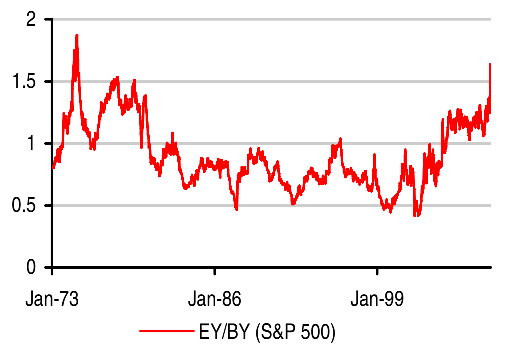


Source: Bloomberg, HSBC

Corporate equity and, especially, corporate debt now look far cheaper than government bonds, especially the latter of these two markets. Credit spreads are very high in both basis point and proportionate terms. In proportionate terms – the extra percentage of yield you get over government bonds – they are higher, on our calculations, than at any time since the Great Depression. Defaults will pick up from their present record low, but there are very good reasons (huge and long contingent credit lines to the banks and far looser covenants) that they won't rise anything like as much as many investors fear.

For their part, equities are their cheapest compared with government bonds in almost 25 years. Reasonable people can dispute whether earnings are about to drop, and by how much, thanks to a global slowdown. But that still doesn't alter the fact that equities are cheap compared with government bonds (though of course they might get cheaper in the short term). The implied equity risk premium in the US is now 5.0% compared with a long-term risk premium of 3.5%. Earnings yield/bond yield ratios show the picture still more dramatically. Equities are cheaper than government bonds than at any time since 1975.

Chart 17. Earnings yield/bond yield ratio higher than at any time for thirty years



Source: Thomson Financial Datastream

The rewards of patience

For patient investors, who don't have to worry overly about marking their positions to market, falling markets are markets which, by definition, have become cheaper. For the most part, central banks and sovereign wealth funds are the archetypal patient investor. Even though markets could become cheaper still in the short term, such investors can afford to play the long game because the tyranny of mark to market is rather lessened when the money they manage isn't likely to be whisked away by disgruntled investors.

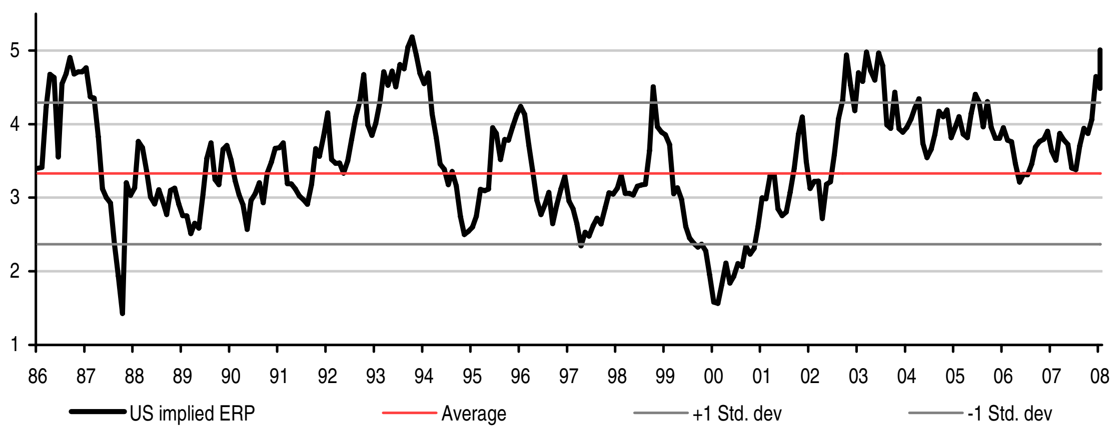
That gives them a huge advantage at times like these over most fund managers, especially those that are leveraged. Investors who have to judge their performance so regularly against the market are investors who, by definition, are skittish. Whatever their underlying views on the cheapness or otherwise of particular markets, they are unlikely to buy them if there might still be substantial downside. The opposite is true, too. Certain assets might be ridiculously expensive, but selling them is hard if their price is still going up strongly because an investor will at best underperform and at worst go bust. Just think of many investors' experience with technology stocks in the late 1990s.

These pressures are far less on government-controlled funds. So although there might be sharp comments in the press (think, for example, of the UK Treasury's decision to sell gold at what turned out to be the bottom of the market) taxpayers generally don't generally take to the streets when investment decisions seem to have gone awry. This applies in spades to many countries in the emerging world, where sharp comments can land you in trouble, though the likelihood of the general public finding out about investments in many of these is admittedly anyway small.

There is a catch here. Mark-to-market may not be too much of a problem for internally managed funds (though even if they can ride the volatility, the SWF that doesn't keep track of prices is hardly acting responsibly), but it is more likely to be a concern for the external managers to which many farm out funds.

Not all SWFs, especially newer ones, think they have the expertise to invest in riskier assets. Whatever their long-term short-comings, investing in government bonds, after all, is still pretty straightforward compared with, say corporate debt or equities. Even if they do have expertise, some SWFs prefer to buy in more by

Chart 19. Forward-looking US equity risk premium very high



Source: Thomson Financial Datastream, HSBC hiring external managers. Many SWRs have at least a portion of their funds managed by external managers. NBIM has just under a fifth of its funds managed by external managers; GIC a quarter.

Nor is this investment only in traditional fund managers. SWFs are big investors in private equity funds and hedge funds, though these allocations are typically a small part of their overall funds under management. But it makes sense, for farming out funds also provides SWFs with access to many of the best and brightest that the financial world has to offer. Being government or quasi government entities mean that they certainly get access to the best. But it also means that this money is unlikely to be as patient as money that is controlled directly and therefore less stabilising to markets.

Table 4. Which SWFs use external managers?

Country	SWF	External management
UAE	ADIA	Yes
Norway	Government Pension Fund – Global	Yes
Singapore	GIC	Yes
Saudi Arabia	Saudi Arabian funds –various types	Yes
Kuwait	Reserve Fund for Future Generation	Yes
China	China Investment Corporation	Yes
Singapore	Temasek Holdings	Yes
Libya	Oil Reserve Fund	Yes
Algeria	Fond de regulation des recettes	No
Qatar	Qatar Investment Authority	No
US (Alaska)	Permanent Reserve Fund	Yes
Brunei	Brunei Investment Authority	Yes
Malaysia	Khazanah Nasional BHD	No
Russia	Stabilisation Fund	No
Korea	Korea Investment Corporation	Yes
Kazakhstan	National Fund	Yes
ROC (Taiwan)	National Stabilisation Fund	Yes
Canada	Alberta HeritageTF	Yes
Iran	Oil Stabilisation Fund	No
Chile	Copper Funds	Yes

Source: HSBC

That said, although the money won't be as sticky, the amounts are likely to be similar over time, whether it comes through the front door or the side. External managers will be given mandates for certain markets and benchmarks that they must try and beat. But farming money out to external managers does have an important consequence because investments made directly rather than indirectly via an external manager touch more closely on the rawest of nerves for company managers and policy-makers in the developed world. They bring to the fore fears hat government SWFs will gain control of corporate assets. Whether acknowledged or not, that fear permeates he entire debate about SWFs.

Control issues

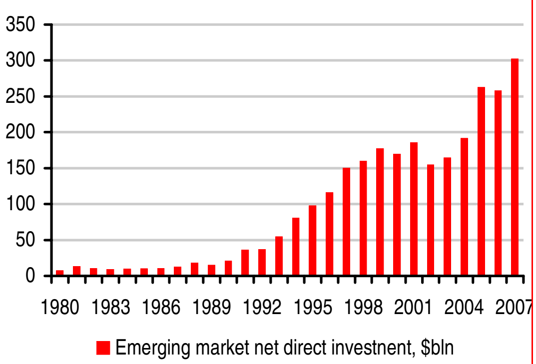
Consider the following. Would you, as a western policy-maker or company worry more about a large shareholding that had been bought by a Fidelity, a GSAM or, indeed, an HSBC, even if the money ultimately came from a sovereign wealth fund, than about a shareholding that was bought directly by the fund itself? Many commentators have portrayed both situations as very similar in the concerns they raise; in both cases, after all, it is government money being invested. But that interpretation seems wrong to us. As the example demonstrates, the former would probably elicit much less reaction than the latter.

Why might that be? In the first case policy-makers and companies alike can be pretty sure that a stake, and a generally a smallish stake at that, is being bought for economic reasons, whatever the ultimate source of the cash. Buying a stake in a firm is part and parcel of an investment decision by an investment firm that is being paid to perform.

It's the direct purchases (or proposed direct purchases) that have caused most fuss. This is because government-owned funds might not be buying a stake for entirely economic reasons. They may also be more interested in maximising sales or scale for its own sake or trophy assets or social welfare in some nebulous sense or national prestige or cocking a snook. These are genuine concerns: firms that are owned by non-profit-maximising owners are likely to distort pricing in the market as a whole. And control issues loom so large precisely because it is government rather than private money. There are too many historical examples of the dead hand of government leading to poor decisions on capital allocation. It was just that experience, lest we forget, that led to both Russia ditching what passed for Communism and China adopting a more market-based system.

Farming out money to third parties or indexing, as many SWFs recognise, is a way of mollifying such concerns. But if we're right about SWFs buying more risk assets, tensions will probably worsen. Buying Treasuries gets you ownership of government IOUs. Buying assets such as equities, on the other hand, gives ownership of real assets churning out real wealth, ones that will probably deliver much better returns over time and give investors more say in how their money is invested. The bigger the stake, the higher the potential influence they wield. Direct investment buys you, well, direct control. And if that direct investment is by governments, fears will rise.

Chart 20. FDI into emerging markets has boomed



Source: IMF

However, if indeed some of these funds might not be too troubled about shareholder value, there is little evidence for this as yet. Moreover, the double standards are breath-taking. Huge FDI flows into the emerging world have raised ownership and control fears in recipient countries, but western policy-makers have often dismissed these as protectionist. All these criticisms might, moreover, carry more weight if developed countries were themselves paragons of virtue. It would, however, be a travesty to describe many developed economies as paragons of transparent, free, open, shareholder-friendly markets.

Governments in the developed world routinely queer the pitch, not least in the market for banking. As Clive Crook, in splendidly lacerating style, wrote recently in the Financial Times: "Is there a housing-finance market on the planet that is more pervasively manipulated and distorted by government than that of the US, even before this latest intervention?" Germany's Landesbanks, if memory serves, are still owned by the German states, though the European Commission has tried to clamp down on the worth of their guarantee. The original Basle Accord on bank capital was enacted mainly because of the activities of Japanese banks, which were not then and aren't now profit-maximisers in any meaningful sense and which are tied intimately and unhealthily to the government. The French even have a government investment arm, CDC, which is specifically charged with defending national interests.

Western policy-makers say that they want a *quid pro quo* when it comes to investment. If SWFs from emerging countries want free access to their markets, they should also open up their own, goes the charge. How they manage to argue this with a straight face is anyone's guess. Many emerging economies have already opened up their domestic markets, and their banking markets not least, often after crisis. The value of financial sector FDI into emerging economies surged from USD2.5bn in 1991-95, to USD51bn in 1996-00, to USD67.5bn in 2001-05. To be sure, the opening up has been greater in some regions than in others: in Latin America, foreign ownership of banking assets rose from 7% in 1990 to 47% a decade later, whereas by 2000 foreigner firms owned only 12% of banking assets in Asia. However, both China and India, to name only the biggest economies in the region, are liberalising rules to allow more foreign ownership. China has sold large stakes in its big banks to foreign firms.

Apart from a few large, well-publicised stakes in big banks bought recently by investors from the Middle and Far East the proportion of banking assets owned by investors from emerging economies in big western banks is still negligible. Why are western policy-makers getting so excited about these stakes? Their present investments in big western financial firms provide a strong echo of the stakes that western financial firms bought in emerging-market banks in the late 1990s. Those stakes, often controlling ones, were also snapped up in the wake of myriad banking crises. Rest assured that this symmetry has not been lost on policy-makers from Mexico City to Seoul. Overall, you can't help but feel, there is an awful lot of cant and hypocrisy in the debate.

Perhaps that's understandable. You can argue the toss about how fast money will continue to flow into SWFs and about the speed with which this will or won't flow into risky assets. You can point to the thin veneer of rationality and rich vein of hypocrisy that permeates the debate. But what seems clear in all of this is that the activities of SWFs have raised deep-seated fears in the developed world. Even if these fears don't amount to Samuel Huntingdon's "clash of civilisations", they reflect, in a very obvious way, a changing order in the world. Concerns about SWFs crystallise worries that developed world power and influence is being eclipsed by that of emerging behemoths, such as China, Russia and India. In our view, they're probably right to worry.

Power struggles

In the debate about sovereign wealth funds, those of a sanguine disposition point to the experience of the first of them, the Kuwait Investment Authority, which, with a run-in or two (it was forced by the British government to sell half of its 20% stake in BP, after the latter had been privatised) has nevertheless proved a remarkably passive investor, with little or no interest in leaning aggressively on company managers to change direction. Such a view is neatly summed up in a recent article for the Washington Post by Gerald Hyman, from the Center for Strategic and International Studies. "The relatively benign experience of KIA…suggests that SWFs need not be a Machiavellian attempt by developing countries to take the global market economy hostage," he writes. Few have fretted either about the much larger Abu Dhabi Investment Authority, which has also proved a model corporate citizen.

The question is whether either the KIA or ADIA are suitable SWFs from which to extrapolate more generally. In our view, probably not. For all their oil wealth neither the UAE nor Kuwait are exactly economic colossi. Kuwait, moreover, is very obviously deeply beholden to the US in particular for protecting them against unpleasantness from neighbours, such as Iran. Nor do other countries in the region exactly stand alone: the US, after all, has a very large military presence in the Gulf.

Contrast these states with China or Russia. These really are economically large, politically far more important, and, increasingly, not afraid to throw their weight around in other ways. Why would they balk at using their muscle in financial markets for political and strategic ends? Neither has shown itself as a beacon of democracy in a troubled world. Neither seems afraid to tread on other countries' toes. Neither seems afraid to use its economic muscle. Russia has been using energy for political and strategic purposes and

China has been using its growing economic clout to get energy and other raw materials. But neither has bought many foreign assets – yet. China has a stock of FDI of only about USD60bn, most of it built up in the past three years. These emerging titans are, for now anyway, the ones with the cash and it is a general truth that whoever has the gold makes the rules.

Which brings with it troubling fears about the re-emergence of the state. Over the past three decades, the state has generally been removed, rightly in our view, from decisions on how firms allocate their resources. SWFs would seem to point in the other direction: governments are again becoming more involved with corporate decision making. And not only directly: in both Russia and China the lines between the state and the private sector are often very blurred. Many of the deals (proposed or actual) that have aroused controversy have not, in fact, come from SWFs. Think of CNOOC's failed bid for Unocal or Dubai Ports World's abandoned bid for P&O's US ports. Russia's Gazprom raises political hackles in the EU whenever its name comes up as a potential suitor. As Kerry Brown, of Chatham House, argues: "As foreign companies and governments look at these enterprises emerging from China, they see the shadow of the Chinese state."

It's a move towards state capitalism, in other words. Tensions seem bound to increase. Most policy-makers and politicians are calling for a code of conduct for SWFs and lots of transparency in their actions. There will leaders in *The Economist*, holding up Norway's NBIM, which is thoroughly transparent and decent, as a model citizen in this respect and contrasting NBIM with most other SWFs, which aren't. Doubtless, to avoid friction, the owners of the SWFs will pay lip service.

And do little. Who can blame them? Again, it's not as though policy-makers in the developed world are fearful about state ownership *per se*. Having privatised its utilities in the 1980s, Britain has allowed state-owned companies to buy these companies. EDF, one of Britain's biggest energy suppliers with 13% of the electricity market, is, after all, mostly owned by the French government. The issue seems to be which governments are allowed to own assets.

Transparency is not, moreover, a cure-all panacea. Developed banks are by and large pretty transparent. That didn't stop them getting into huge trouble with their sub-prime exposures. The important thing is to know what the numbers and positions mean. Nor, they might point out, are all fund managers in the developed world hugely forthcoming. Private equity firms and hedge funds are required to divulge very little about their holdings.

There are deeper reasons why SWFs are unlikely to play ball. For a start, many of the countries that are now in the driving seat were in the car-crash of the 1990s. It was only a decade ago that Russia defaulted. The Asia crisis is still remembered bitterly. Not so long ago many of these countries were supplicants. Now they are on top and if they are enjoying it hugely, who can blame them? But the wounds stretch back much further than that. Many countries that are now emerging were often taken over in the eighteenth and nineteenth centuries and run by companies from what are now the developed companies with the explicit backing of the state. They were on the receiving end of state capitalism then. Such memories do not lie far beneath the surface.

The biggest of them all by far was the British East India Company, which ran India for the best part of a century and even had its own army. It's impossible to overstate its importance in the history of the Far East for, *inter alia*, not only did it run India, it exported opium to China, too.

"By the time of its demise," writes Nick Robbins, a colleague and author of *The Corporation That Changed the World*, "the company had changed the course of economic history, reversing the centuries old flow of wealth from west to East". First in Bengal and then in China, through the opium trade, the Company broke this long-standing pattern of trade. When it first started out, Europe's economy was a small fraction the size of Asia's. By the time of its demise, Europe's economy was double the size of India and China.

Arguably the world economy is going full circle. One of the great mysteries of economic history is why China, having been so superior for so long, turned its back on the world and went backwards. Developed countries can moan, and doubtless will; but the balance of power in the world economy seems to be changing and not to their advantage. How fast this happens and how much friction it causes will determine how much protectionism will result. The present top dogs have been on top for such a long time that has been natural enough to think that they will continue to be. But extrapolation is a dangerous thing--even when measured in centuries.

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Disclosure appendix

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