

Sovereign Wealth Funds (SWFs)

Many capital exporting developing countries have begun to look for more systematic ways of raising returns on their international reserves on a longer-term basis by creating Sovereign Wealth Funds (SWFs). SWFs broadly refer to designated pools of assets owned and managed by governments and predominantly deployed worldwide to attain higher returns.

Countries usually have their international reserves managed by their central banks and held in liquid assets in reserve currencies (see International reserves). Since the primary functions of international reserves are to finance payment imbalances and limit exchange rate volatility, the reserves must have a high degree of liquidity. Since assets typically have lower rates of return the more liquid they are, however, for level of reserves greater than needed for these purposes, it can make sense for governments to invest in longer term, less liquid assets such as bonds and equities. Similarly there may be gains from diversification by investing in a broader range of countries than just those with major reserve currencies.

Perhaps the clearest rationale for the establishment of a SWF is to accumulate reserves in countries that are major exporters of nonrenewable resources such as oil and gas. Concern for future generations dictates that all current revenues from the sale of such commodities not be spent on current consumption. Nor, typically, could all of the remainder be spent productively on domestic investment. Usually a substantial proportion of these revenues accrue to governments from tax receipts or direct ownership. Thus governments accumulate reserves.

Oil producing countries make up more than half of all SWF funds (i.e., commodity-based funds) in terms of assets under management. Kuwait's International Authority funded from the oil fields was established in 1953 and is the oldest SWF. Another prime example is Norway's Global Pension Fund (GPF), funded by a portion of North Sea oil and gas. The UAE's Abu Dhabi Investment Authority Fund (ADIA), which was established in 1976, is the world's largest SWF currently, with US\$ 625 billion under management. Other oil exporters, Oman and Brunei, also created investment agencies to recycle their reserves holdings in the 1970s and 1980s, and Russia followed suit more recently by creating a Stabilisation Fund in 2003 (Lyons, 2007).

Among the better known non-commodity-based SWFs in Asia are Singapore's Government of Investment Corporation (GIC) and Temasek Holdings. In fact, Singapore is the only country that has two separate agencies among the top ten SWFs. Since some of the funding sources for the agencies also include pension contributions from Singapore residents, however, these entities are strictly speaking a combination of SWFs and Sovereign Provident Funds (SPFs). GIC was established in 1981. It has around US\$215 billion under management and tends predominantly to make financial and real estate investments. Temasek was established in 1974. It has around US\$100 billion under management and is a more active investor in international companies regionally and globally, including in India.

While SWFs have been around since the 1950s, they have only recently attracted much public attention. SWFs have taken on increased prominence with their phenomenal growth in recent times, especially with the creation of the China Investment Corporation (CIC) in 2007. The CIC, which is said to be modeled on Singapore's GIC in both concept

and design, began operations when the Chinese government transferred US\$ 200 billion of its US\$ 1,300 billion reserves to the agency, making it the world's fifth largest SWF. The new fund's first major investment was a US\$ 3 billion investment in the US-based private equity group, the Blackstone Group. SWFs took center stage at the October 2007 World Bank and IMF annual meetings, and the G-7 industrial countries have begun to pay greater attention to these entities.

Since many of the SWFs practice considerable secrecy, the total value of their assets is not known, but estimates put the figure at between two and three trillion dollars, substantially larger than the global aggregate of all hedge funds. Estimates also project a rapid rate of growth, with figures of ten trillion and above expected to be reached by early in the 2010s. ..

Another rationale for SWFs is to minimize the destabilizing effects of fluctuations in exports due to periods of more and less rapid growth in the world economy. Medium term fluctuations are common for a wide range of agricultural as well as both renewable and nonrenewable raw materials, so economists have long recommended that governments should accumulate international reserves in good times and draw them down in bad. This has proven difficult to do in many developing countries because of political pressures to spend all increases in reserves. These tendencies can be partially countered in part through the establishment of Sovereign Wealth Funds. An example is Chile's Economic and Social Fund established in 2006.

A third rationale for the creation of SWFs is to eliminate a continual surplus. When continuing disequilibrium in a country's balance of payments has led it to accumulate far more international reserves than it needs based on traditional criteria, and

the country expects to continue to accumulate reserves (or at least, not have huge reductions), then it makes no sense to hold all of its reserves in low yield liquid assets. The country could put its excess reserve into a new facility to earn higher returns, but if reserves are clearly excessive then it would most likely take actions to eliminate its continual balance of payments surplus. Only if the rate of return on domestic investment was quite low would it make sense for the government to continue to accumulate international financial assets, even if these were invested in less liquid, higher return securities. In a market-oriented economy without capital controls, private investment would tend to flow from lower to higher yield areas. Thus, if domestic investments were indeed lower yield, capital would flow out and eliminate the balance of payments surplus.

A prime example of such clearly excessive reserve accumulation is China since around 2000. China does have extensive capital controls that block this equilibrating flow of capital. The primary reason that the Chinese government has not taken sufficient adjustment actions to slow or reverse China's balance of payments surplus and accompanying reserves accumulation is that in the short-run the needed adjustments would hurt some sectors of the economy, and the government is greatly concerned about the short-run political and social instability that such disruptions might generate. Thus, while adjustment is in China's longer-run economic interest, in the government's calculation this is outweighed by the likely short-run political costs. Numerous policy announcements have made clear that the government would be happier if the surplus were reduced, but their limited actions reveals the priority given to avoiding short-run adjustment costs.

The limited adjustments taken by the Chinese government have also contributed to global economic imbalances and the risk they pose to global financial stability. Of course, China alone is not responsible for such global imbalances. From a global perspective, however, the creation of the SWF reduces the national economic cost of these continual reserve accumulations and hence reduces somewhat the pressures on China to do its part toward the needed mutual adjustments.

The greatest concerns about SWFs focus on a different type of issue, however: the fear of foreign government influence over the operation of key segments of domestic economies. As long as SWFs limit themselves to passive portfolio investments they do not pose major problems on this score. The problems come when they make direct investments of substantial stakes in sensitive industries. Such fears have been highlighted by the recent efforts of government-controlled enterprises in China and Dubai to purchase a US oil company and port operator, respectively. While in neither of these cases was a SWF involved (the bidders were state owned companies) these have led to considerable speculation about what could occur. Such concerns have generated calls for codes of conduct for SWFs. Some SWFs follow policies that are unlikely to generate conflicts. Norway, for example, provides considerable transparency and spreads its investments over a wide range of equities, taking only small stakes in any one. Many funds are currently quite opaque, however, and some have purchased substantial interests in what may be deemed by politicians as being “sensitive” industries. Concerns have also been raised that the large amounts of money controlled by some SWFs could generate disruptions in financial markets, especially in the smaller, less liquid markets in developing countries. While creating such disruptions would seldom, if ever, be in the

interest of SWFs, this may not be sufficient to calm all fears. The likely greater danger is that this range of fear would stimulate protectionist backlashes that could hurt both the SWFs and potential recipient countries.

Such considerations suggest that the development of an international code of conduct for SWFs could be in the mutual interests of both capital exporting and capital importing countries. The possibility of developing such codes has become a major topic of attention in many countries and international forums such as the G-7 and International Monetary Fund (for instance, see Truman, 2007).

See also: Capital controls, Fear of floating, Exchange rate intervention, Exchange rate volatility, Foreign exchange intervention, Global Imbalance, Hedge Funds, International capital flows to developing countries, International reserves, International Monetary Fund (IMF), Reserve currency.

Further Reading

Lyons, Gerard. 2007. "State Capitalism: The Rise of Sovereign Wealth Funds." Standard Chartered Bank, October 15. Offers a detailed analysis of SWFs worldwide.

Truman, Edwin, M. 2007. "Sovereign Wealth Funds: The Need for Greater Transparency and Accountability." *Policy Brief No. PB07-6, Peterson Institute, August*. Offers an overview of SWFs, focussing on their lack of transparency. It presents a framework to help evaluate the extent of transparency and accountability of the SWFs.

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