

## The economic significance of Sovereign Wealth Funds

### Key points

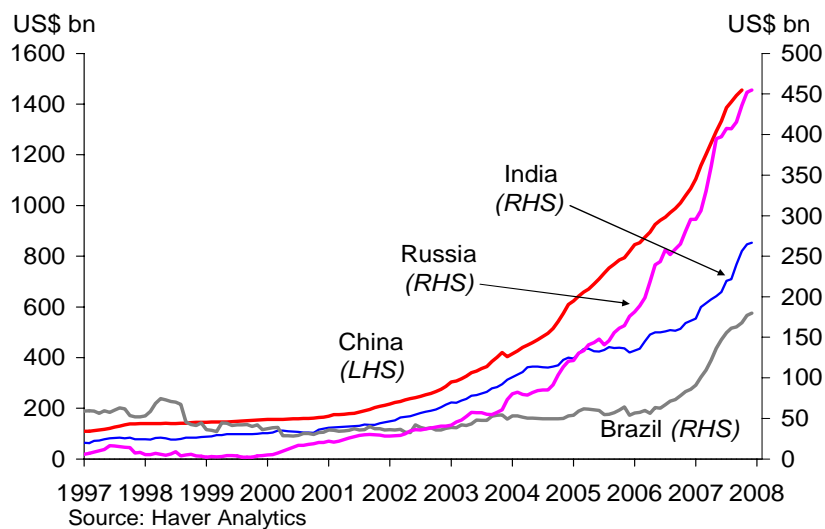
- Although Sovereign Wealth Funds (SWFs) currently account for less than 2% of the US\$165 trillion global total of traded securities, their importance may climb sharply in the next few years. Some 70% of total funds in SWFs derive from oil and gas, and continued high world oil and commodity prices will result in further large current account surpluses and climbing reserves in leading emerging markets such as China, Russia and some Middle East and Asian countries.
- The funds that are now being accumulated rapidly are being invested more actively, buying stakes in western companies with the aim of reducing the impact of volatile oil and other commodity prices on government revenues and the balance of payments, and to accumulate savings for future generations.
- But there is a lack of transparency about the operations of SWFs in some countries, and exact figures on the scale of these Funds and their activities are hard to come by.
- With emerging markets continuing to outgrow the developed economies and investing increasing amounts of their surpluses in the west, concerns about the power and investment strategies of these SWFs are mounting. These worries are most apparent in the US, although some EU countries are also expressing unease.
- Coupled with the on-going shift of manufacturing and financial sector jobs away from the west, this could trigger rising trade tensions and protectionism. But any move to restrict these investment flows, which represent a partial return to state capitalism after decades of privatisation in the west, would appear to defy economic logic, especially as the capital injections into western banks seen recently could help to stave off the impact of the credit crunch.
- However, the continued rise in reserve assets in Asia and the Middle East could spell even more US dollar weakness, further undermining its role as the world's main reserve currency. Some emerging markets are increasingly concerned about the impact of the falling US dollar on inflation and their trade balances.
- And if currency pegs to the US dollar are shifted, these countries may adjust reserve portfolios as well. With leading emerging markets accounting for some two-thirds of global official reserves, such an adjustment could result in an even more prolonged spell of US dollar weakness.

*By Christopher Portman, Oxford Economics*

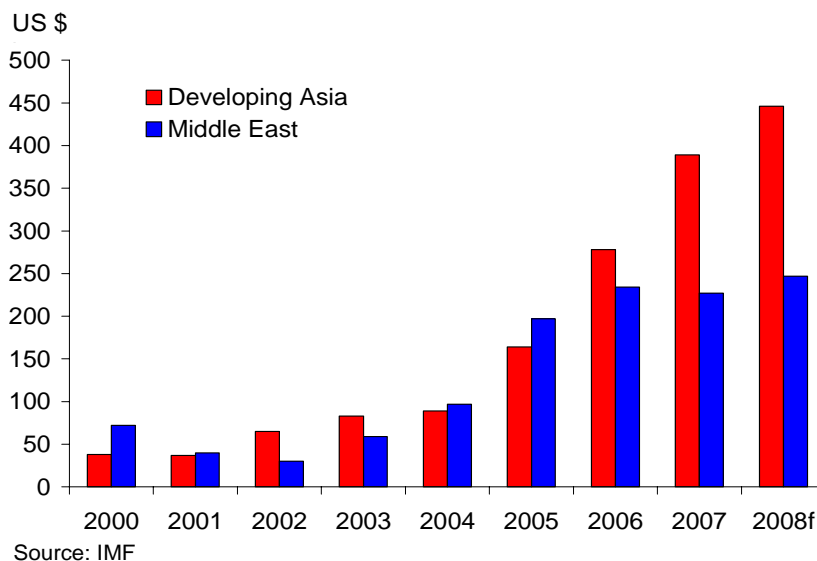
## SWFs climbing on the global agenda

The steep rise in oil and gas prices since 2002 has seen some emerging economies, including Russia and many in the Middle East, accumulate massive reserves, far greater than required for day-to-day needs such as protecting their exchange rates or meeting import requirements. In addition, some Asian countries, such as China and Singapore, have also been running substantial trade and current account surpluses. The desire to invest these reserves more actively, rather than holding them in hard currency or in safe but low-return assets such as US treasury bonds, has led to the upsurge of Sovereign Wealth Funds (SWFs) – that is, vehicles for investing these surplus state funds strategically and more profitably. And whereas private equity and hedge fund activity has been hit badly by the global credit crunch since mid-2007, the emerging markets and hence the SWFs in these countries have been little affected thus far.

### Emerging Markets: Foreign exchange reserves



### Reserves in Developing Asia and Middle East



SWFs have typically been set up with one or more of the following aims in mind:

- **Macroeconomic stabilisation** – economies that are dependent on oil and other commodities are exposed to sharp moves in world commodity prices. The main aim of SWFs in these countries is to smooth the short- and medium-term fluctuations, and thereby promote domestic economic stability.
- **Seeking higher returns** – non-commodity-based economies that currently hold reserves far higher than needed for normal usage are increasingly trying to maximise returns rather than holding them in low-return, risk-free assets.
- **Future generations** – some SWFs have been created with the long-term goal of creating a pool of wealth for future generations, to be used after natural resources have been depleted.
- **Domestic industries** - some SWFs have been used to restructure and encourage domestic industries.

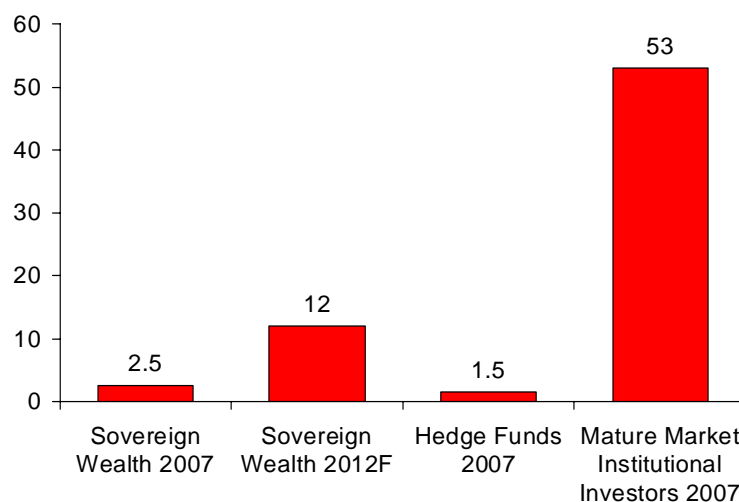
SWFs have been in existence since the early-1950s, ever since the Kuwait Investment Authority (KIA) was set up to invest surplus oil revenues in preparation for the time when the oil ran out. And Norway has been piling up funds for 17 years and is now estimated to be managing US\$322 billion, greater than the country's GDP and currently thought to be the third largest Sovereign Fund in the world.

But the main focus in the last few years has been on the vast funds in the Middle East, Russia and China, with oil producers running a cumulative current account surplus of US\$500 billion and China's at US\$325 billion. As a result, reserves of oil producers have risen to US\$3.5 trillion, while China has US\$1.3 trillion and Russia has US\$425 billion. Fourteen of the largest 20 SWFs have oil or other commodities as their main source of income. As a result, some 70% of total funds in SWFs derive from oil and gas. And it is this wall of money flowing out of these countries into investments in developed economies that is an increasing focus for western governments.

Currently, Sovereign Wealth Fund assets are thought to total some US\$2.5-3 trillion, having risen by about US\$1.2 trillion in 2006 alone. But the total could be as high as US\$7 trillion if official foreign exchange reserves of some US\$4.5 trillion of these countries in Asia and the Middle East are included. Although this is still some way short of the power of pension funds, which managed funds totalling over US\$21 billion in 2006, it is already ahead of hedge funds, currently estimated to manage funds of a little under US\$2 trillion, while private equity is thought to amount to some US\$700 billion.

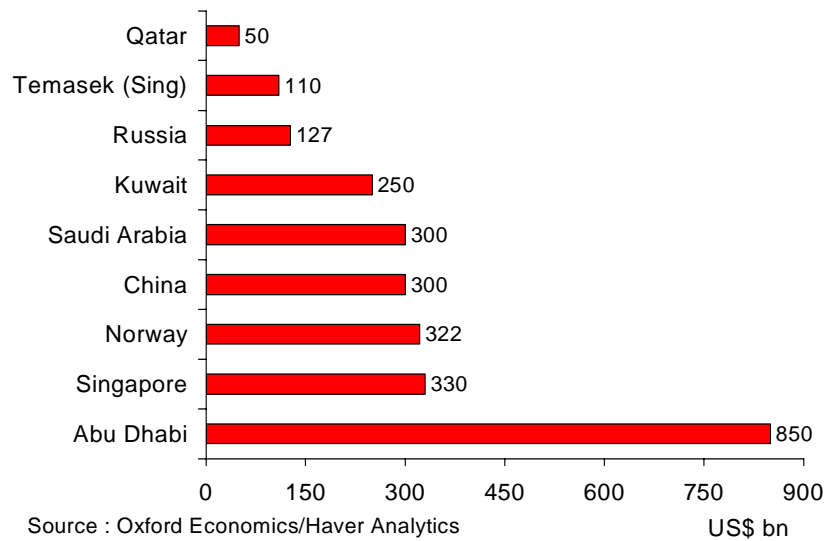
## Sovereign Wealth Funds in perspective

Assets, US\$ tn



Source : IMF

## Largest Sovereign Wealth Funds



### Lack of transparency sparks concern...

SWFs are entities that manage national savings for the purpose of maximising long-term investment returns, over-and-above the role of short-term foreign currency operations aimed at currency stabilisation and liquidity management traditionally operated by central banks. Some countries that are running either hefty budget and/or current account surpluses, and have little external debt, have accumulated reserves far in excess of the level needed for normal operations and have established organisations to manage these reserves, including official investment companies, state pension funds, sovereign oil funds and, sometimes still, the central bank. As noted above, the objective of these funds could be to reduce the impact of volatility of oil and other commodity prices on government revenues and the balance of payments or more explicitly to accumulate savings for future generations. And it is not only SWFs that are used as investment vehicles. State-owned enterprises have also been increasingly used by some countries – China in particular – to channel surplus current account earnings abroad. Chinese banks, for example, have been acquiring large stakes in some western banks, which in turn could have an influence on the lending operations of these financial institutions.

Many of the SWFs lack transparency – indeed, it is against Kuwaiti law for the KIA to reveal its assets - so exact figures on the scale of these Funds and their activities are hard to come by. The largest SWF currently is thought to be the Abu Dhabi Investment Authority, managing as much as US\$850 billion, followed by the Government Pension Fund of Norway and the Government of Singapore Investment Corporation, both of which have over US\$300 billion at their disposal. At the other end of the spectrum are a host of smaller countries, including Botswana, whose Pula Fund of US\$5 billion invests the country's revenues from diamond mining. And even Libya, for so long a pariah in the west, has now set up a US\$40 billion SWF to spend its surplus oil wealth on portfolio and real estate investments in order to diversify its sources of foreign income. Some of these SWFs are trying to highlight their transparency by publishing full financial accounts, such as Singapore's Temasek, which manages funds totalling just over US\$100 billion. But the fact that Temasek's chief executive is the wife of the country's prime minister makes it difficult to believe that its SWF operates independently of government, casting doubt over whether its investment decisions are taken without political influence.

## **...but their profile will continue to rise...**

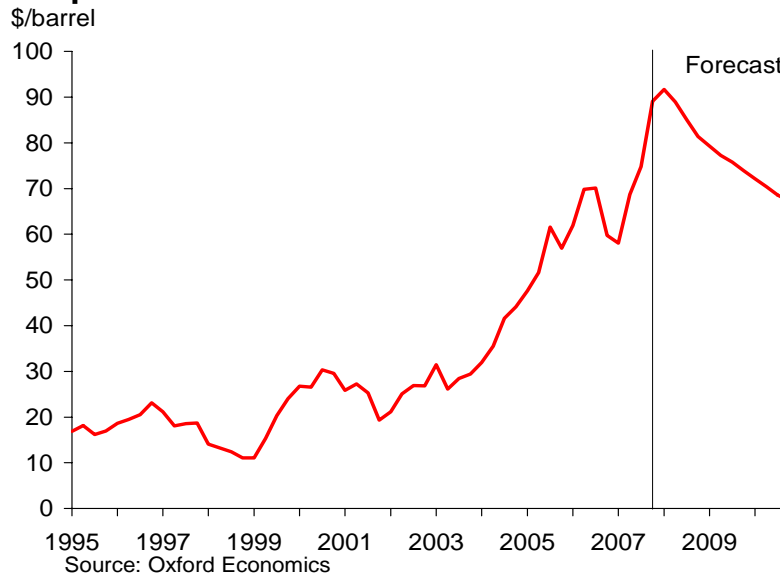
Overall, estimates suggest that SWFs in total carried out over 120 deals that altogether were worth US\$140 billion in the last two years, with 37 of these deals involving more than US\$1 billion. And the trend is probably set to continue rising strongly. Whereas the activity of hedge funds and private equity will have been hit, and possibly quite badly, by the global credit crunch, the continued strong economic growth in the emerging markets – expected to be around 6-7% over the next five years – and the likelihood that oil prices will stay at around current high levels for quite some time mean that the reserves available for the SWFs will increase further. And if the global economy does slow by as much as some commentators fear (a concern we do not share) and asset values decline, then the SWFs will have even greater buying power despite the likelihood that revenue flows to these countries will slow. This trend will be further enhanced if the US dollar remains weak, making the US a prime target for acquisitions by SWFs.

With China possibly adding up to US\$200 billion to its Fund each year and Russia's Fund climbing by US\$40 billion a year, the IMF estimates that the global total of SWFs including official reserves could top US\$12 trillion by 2012. This weight of cash will make these SWFs an increasingly important force in world capital markets in the coming years, although, as the IMF notes, this will still only be a small percentage of the global value of traded securities, currently put at US\$165 trillion. And its conclusion is that there is no apparent reason to see the continued existence of SWFs as destabilising or worrying. Indeed, the IMF has always encouraged exporters of non-renewable resources to build up such funds in preparation for the "rainy days" that will inevitably come along at some stage.

## **...if oil prices stay high**

The IMF estimates that SWFs plus official reserves could reach US\$12 trillion by 2012 is based on a fairly conservative oil price, with the assumption that prices drop back to more 'normal' levels in the next few years. But if oil prices stay at around current levels, then Middle East reserves and those in Russia and other oil producers will inevitably continue to grow very strongly, further boosting the role of SWFs. If oil prices stay in the US\$90-100 a barrel range for the next few years, or even rise above US\$100 a barrel, then we would expect the total wealth held in reserves and SWFs to be closer to US\$15 trillion in 2012. Conversely, a sharp drop in oil prices would see the rise in Middle East SWFs levelling out, in turn curbing their purchasing power in acquiring stakes in western companies as their domestic spending priorities continue to rise.

But the rise in the value of SWFs will probably continue to outpace the growth of official reserves, which are already at very high levels, and this trend could accelerate if governments opt to shift more of their traditional reserves into their SWFs. Asian reserves, for example, currently amount to some US\$3.7 trillion, two-thirds of the global total of US\$5.8 trillion. If the returns on SWFs prove to be more attractive than the return on the more normal form of reserve holdings – in safe but low return assets such as US treasuries – then Asian governments may well be tempted to move some of their official reserves into more productive forms of investment, in turn implying even faster growth of total assets held by the SWFs in these leading emerging markets.

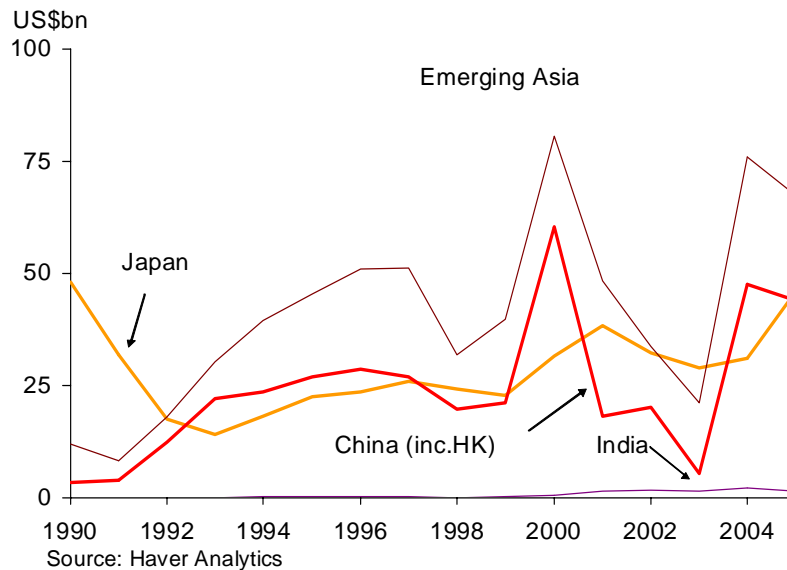
**Oil price forecast****...and emerging market FDI will climb further**

Many of the SWFs tend to invest cautiously and have spread their assets fairly widely over time, especially the “future generations” funds with high levels of transparency, such as those in Norway, the US and Canada. Indeed, the Norwegian Fund owns shares in about 3,500 companies, with stakes that are generally below 1%. And stabilisation funds are usually aimed at delivering stable and low-risk returns, and so are limited to investing in AAA-rated sovereign bonds. But a number of SWFs have been acquiring significant stakes in foreign companies in recent years - these Funds include the China Investment Corporation, Singapore’s GIC and Temasek, the Kuwait Investment Authority and the Qatar Investment Authority.

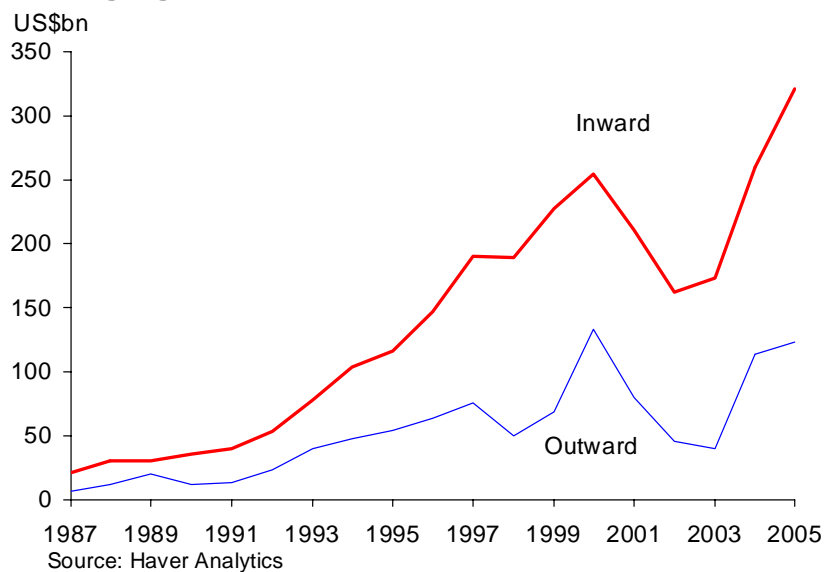
And it is two of the newer arrivals that have lit up warning lights in the west, namely Russia’s US\$140 billion Oil Stabilisation Fund, established in 2003, and the China Investment Corporation (CIC), launched in 2007 with US\$200 billion and which made its debut with a US\$3 billion investment in the June initial public offering of US private equity group Blackstone. The size of the Russian Fund will depend on the path of world oil prices, but is likely to increase significantly in the next few years. But the CIC Fund (which is to incorporate the US\$100 billion Central Hujjin Investment Corporation) may well continue to rise at anything up to US\$200 billion a year even if China does manage to rein in its huge current account surpluses. And if these Funds continue to grow in size, it is likely that the investment stance of these two countries will become increasingly aggressive, causing further concern in the west. As their economies and revenues will continue to outstrip growth in the rest of the world, they will be able to acquire even larger stakes in sensitive sectors such as energy, telecommunications and financial services. As a result, foreign direct investment from the leading emerging markets will continue to climb strongly, something that is already being seen in China’s involvement in countries in Africa in an attempt to ensure that its huge demand for commodities and energy, and hence its pace of economic growth, can be sustained.

And while China has specifically denied any ulterior political motives in its investments – indeed, it takes a strongly apolitical line in some of the more dubious countries in Africa, much to the annoyance of the west – there are reasonable concerns that countries such as the newly assertive Russia, which is undergoing a move away from proper democracy, may be basing some of its investment decisions on political considerations.

## FDI by region: outward FDI, Asia



## Emerging Markets: Inward and outward FDI



The continued rise in SWFs will give a substantial boost to investment from the main emerging markets into the west, which is already rising strongly. In 1997, for example, there were only four Indian projects and three Chinese investment projects going into Europe, but by 2006 those figures were 78 and 58 respectively. A similar pace of growth over the next ten years would result in both these countries being among the leading sources of FDI inflows into the EU by the middle of the next decade, adding to fears about loss of control over key sectors of the economy.

### **...lifting investment outflows from the west**

While it is difficult to give firm estimates, it is clear that this build-up of strategic assets overseas will in time result in significantly larger flows of investment income from the developed economies to the Sovereign Fund countries in the form of interest and dividends. This in turn will bolster the current account surpluses of oil producers in particular, but also the leading emerging markets, and weaken the current accounts of the target investment countries such as the US and the EU. Although the current account deficit in the US will narrow in due course from the current level of 6% of GDP as the lower dollar boosts exports, this will be offset to some extent by this likely shift in the balance on net factor income.

### **US is most vocally opposed as dollar weakens...**

With the IMF recently debating the need to set ground rules for the operations of SWFs, it is clear that many countries in the west are increasingly concerned about the investment intentions of these proliferating Funds. A number of leading countries, including the US, Germany, France and the UK, have all expressed worries about the increasing power being wielded by SWFs and have indicated that they are not going to be allowed free rein to take over key assets. In the US, for example, calls for greater protectionism against SWFs – mostly aimed at China – will become increasingly vocal as the November 2008 elections approach. This concern about national security became evident when congressional pressure forced Dubai Ports World to sell the six terminals that it had purchased when it took over P&O in February 2006. And this mood of suspicion will have been reinforced by the move by China's CIC to take a US\$1 billion stake in troubled investment bank Bear Stearns and Abu Dhabi's US\$7.5 billion capital injection into Citigroup.

Responding to what is perceived as a growing threat to its economic security, and one that will be exacerbated if the dollar continues to remain weak, the US Treasury Secretary has called on the IMF and the World Bank to try to draw up guidelines for this type of Sovereign Fund investment. The new managing director at the IMF has said that governments have been requesting deeper insight into SWFs and that in seeking to develop some guidelines, the Fund would look to distinguish among different types of SWFs – presumably based on measures of transparency and investment objectives. But, as noted above, the IMF is still fairly relaxed about the growing power of the SWFs, noting that these Funds are making long-term investments to diversify revenue streams in order to offset potential future commodity price weakness.

### **...but EU is also wary**

In Europe, the mood is almost as wary, with increasing talk of legislation to deter some unwanted strategic investment. In the UK, the London Stock Exchange has been at the centre of a struggle between the Funds of Qatar and Dubai – both vying for supremacy in the race to become the dominant regional financial hub in the Middle East – and Sainsbury's was until very recently a target for takeover by the Qatar Investment Authority. Against this background, the British government has been stating that foreign Funds are not going to have carte blanche to take over any company, with suggestions that this stance is aimed at preventing Russia's Gazprom from buying up Centrica, the parent company of British Gas (although there is, of course, an element of double standards here as Electricité de France has been buying up parts of the UK electricity industry without any opposition from government). Similarly, France has indicated that SWFs that do not meet

clear transparency criteria will not be allowed, while in Germany the government is expected to put forward legislation soon that would give it the power to vet such foreign investment.

Yet, at the same time, it is interesting that some Sovereign Fund investments that appear to be ultra-sensitive have been allowed to proceed, such as Dubai's acquisition of 3% of European Aeronautic Defence and Space (EADS), which makes the Eurofighter and other military planes and missiles. And Russian state-owned Vneshtorgbank holds 6% of EADS, having purchased a 5% stake when share prices fell sharply in mid-2006.

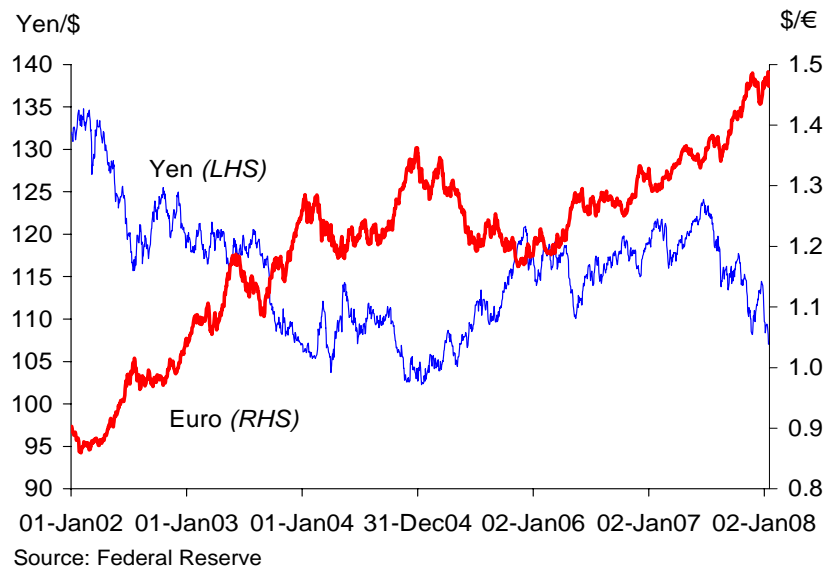
## **Policy responses may defy economic logic**

There seems little doubt that SWFs are set to become a major power in world capital markets in the next five years, with leading emerging markets such as China, Russia and some Asian and Middle East countries using them to gain increasing economic and political influence in the developed world. In one sense, the investment of substantial funds in the form of stakes in companies rather than in the form of government bonds or other liquid assets should reduce the risk of volatility. Taking sizeable stakes in large businesses displays a long-term commitment and cannot be easily liquidated, which in turn should be welcomed by western companies. And the move towards globalisation, liberalisation and the spread of the market economy have always implied that the role of the emerging markets would rise as their share of global GDP increased. The increased power of these SWFs means that foreign direct investment from the prominent emerging markets could rise very steeply in the coming years. And this growing financial clout of the leading emerging markets comes on top of their seemingly unlimited pool of labour that is threatening to take many more manufacturing and financial jobs away from industrialised countries in the current era of rapid technological advance.

But the argument in the US and some western countries – namely that some of these Funds are effectively state-owned and are therefore not operating within the principles of a market economy – appears to be self-serving. Most governments in the developed economies have not found any economic or philosophical ambiguity about ensuring that they retain golden shares in strategic companies while at the same time advocating that governments in emerging economies should open up their public sectors to foreign investment and privatisation. Moreover, in the wake of the credit crunch, the capital injections from SWFs into some western banks such as Bear Stearns, Citigroup and UBS could play an important role in stabilising financial markets. And there is a danger that, if the US and the EU attempt to put parts of their economies off-limits for foreign investment, then other countries might go down the same route, perhaps even encouraging some to impose much tougher conditions on western companies already operating in their own economies. This in turn could pave the way for a trade and investment war, reinforcing the move towards the new protectionism as developed economies feel under increasing threat from the leading emerging markets. And, ironically, after many years of free-market economic policies leading to greater private sector activity, it could also result in a partial reversal of this process and the rise of state capitalism once again.

As many have noted, the way to counteract these concerns is for the SWFs to become more transparent, which they will inevitably do if it becomes apparent that their investment strategies are suffering as a result of their secrecy. There is clearly nothing inherently wrong about SWFs, which is the basis for the IMF's fairly relaxed stance, but at a time of heightened geopolitical tensions this shift in economic power may add to the policy dilemmas facing governments in the west.

### Dollar exchange rates



### Continued rise of SWFs could weaken US\$ further

The likely continued rapid rise in SWFs and official reserves among Asian and Middle East countries may also have long-term implications for exchange rate management in the countries that are building these surpluses, especially those in the Middle East and China. The diversification of assets and revenue streams implied by the growth of SWFs and their overseas investments could mean that the move away from the dollar as the main reserve asset and a currency peg continues, especially if rising investment income outflows from the US help to keep the US current account in the red for longer, in turn keeping the currency weak. And in the short term, dollar weakness could well be exacerbated if US rates continue to fall, as seems quite possible given the current financial market instability and doubts about growth.

The dollar pegs in the Gulf Cooperation Council (GCC) countries, including Kuwait, Saudi Arabia and the UAE – all with major SWFs – are already under some strain because of the impact of imported inflation. And the increasing role of SWFs in these countries could well exacerbate these pressures even though their direct dependence upon oil revenues may be reduced in the years ahead. These countries will have to decide whether to stick with the weakening dollar and thereby continue to import inflation or whether to opt for harder currencies, such as the euro, the yen and the Swiss franc. This in turn could spell the beginning of the end for the dollar as the world's favoured reserve currency. As Middle East countries and China move from their current dollar pegs to fixing their rates against a mixed basket, or eventually floating freely, they are likely to readjust reserve portfolios as well. With these countries accounting for over two-thirds of global official reserves, such a shift could result in an even more prolonged spell of dollar weakness, in turn reinforcing the move into other currencies.