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Sovereign Wealth Funds: Stumbling Blocks or Stepping Stones to Financial Globalization?

Sovereign wealth funds (SWFs) are saving funds controlled by sovereign governments that hold and manage foreign assets. Private analysts put current sovereign wealth fund assets in the range of $1.5 to 2.5 trillion. This amount is projected to grow sevenfold to $15 trillion in the next ten years, an amount larger than the current global stock of foreign reserves of about $5 trillion (Jen 2007). While not a new phenomenon, the recent activities and projected growth of SWFs have stirred debate about the extent to which their size may allow them to destabilize financial markets and their policies may be driven by political, rather than economic and financial, considerations.

This *Letter* gives an overview of the debate about the expanding role of SWFs in international financial markets. We explain the forces leading to their growth and the challenges they pose for financial globalization. While there is no quick fix to these challenges, encouraging SWFs to invest in well-diversified equity indexes in individual countries, such as the S&P 500 in the United States, may transform the role of these funds from stumbling blocks to stepping stones towards financial globalization.

Reasons for the growth of SWFs

The growth of SWFs may be viewed as an unintended consequence of countries running persistent current account surpluses and accumulating net foreign assets. SWFs arise as a by-product of these current account surpluses in circumstances where sovereign governments retain control of the foreign assets.

There are several reasons for the accumulation of net foreign assets by sovereigns and the resulting growth of sovereign wealth funds. First, the recent commodity price boom has swelled the sovereign asset holdings of commodity-exporting countries where the public sector controls commodity exports or heavily taxes the revenues earned by private commodity exporters. Earlier commodity price booms vividly illustrate the adverse effect on competitiveness of domestic inflation and large real appreciations induced by using these windfall gains for domestic expenditures, particularly when the gains are transitory. For example, the windfall gains associated with the sharp rise in the price of oil in 1973–1974 induced oil-exporting countries to increase government spending; this spending fell sharply when oil prices collapsed in the early 1980s. Consequently, some sovereigns have sought to deal with these concerns by saving a share of the gains in SWFs. In some cases these savings are used as a financial stabilizer if commodity prices decline and depress tax revenue. In other cases, SWFs serve as mechanisms to transform concentrated exposure of public assets to volatile commodity prices into a more balanced and diversified global exposure, thereby protecting the income of future generations.

A second factor behind the growth of SWFs is the effort by many emerging market countries to accumulate large stockpiles of international reserves by running persistent current account surpluses (see Aizenman 2007). Many of these countries now hold more reserves than needed for prudential reasons. Attempts to diversify these reserves into potentially higher-yielding assets entail transferring them from the control of the central bank to the treasury or to quasi-public entities with the mandate to pursue financial strategies aiming at higher long-run returns.

Current estimates suggest that funds derived from oil and gas export revenues account for some two-thirds of the total assets held by SWFs, with the rest consisting of funds mainly controlled by Asian surplus exporters (Jen 2007). The four main Persian Gulf investment funds (Abu Dhabi Investment Authority, Kuwait Investment Authority, Qatar Investment Authority, and Dubai International

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Capital), launched in the 1970s, now have a combined asset value of over $1 trillion. Norway's Government Pension Fund - Global (previously called the Petroleum Fund of Norway) was established in 1990 and now holds over $300 billion. Russia's Oil Stability Fund, established in 2003, currently has over $100 billion in assets. (All of Saudi Arabia's oil surplus funds are managed by the central bank together with its reserves.)

In Asia, Singapore's two government investment funds—the Government Investment Corporation (GIC) and Temasek—have combined assets of over $200 billion. Korea's Korea Investment Corporation was launched in 2005 with $20 billion in assets. China recently set up the China Investment Corporation with assets worth $200 billion to manage more aggressively a portion of its over $1.2 trillion in foreign reserves.

Investment strategies

Central banks generally invest their foreign exchange reserves conservatively in safe and marketable instruments that are readily available to monetary authorities to meet balance of payments needs. SWFs typically seek to diversify foreign exchange assets and earn a higher return by investing in a broader range of asset classes, including longer-term government bonds, agency and asset-backed securities, corporate bonds, equities, commodities, real estate, derivatives, and foreign direct investment. They have access to and frequently make use of professional private fund managers and consultants.

SWFs differ in their strategies for investing abroad. Unfortunately, not much is known about the activities of individual sovereign funds, since very few publish information about their assets, liabilities, or investment strategies.

The Norwegian Government Pension Fund, the most transparent large SWF, invests in a wide set of foreign industrial and emerging market securities, with significant portions under external management. It generally has not sought out management control of its investments, tending to have only small ownership shares in companies.

Singapore's GIC was set up in 1981 to manage the bulk of Singapore's foreign exchange reserves and operates along lines similar to most private investment management companies, investing government reserves across a range of asset classes and regions, including foreign equities, bonds, and property. The International Monetary Fund has urged the GIC to be more transparent by publishing broad details of its accounts, a suggestion that Singapore has yet to accept.

Temasek, the Singapore government's strategic investment arm, was established in 1974. It takes long-term stakes in local and foreign companies and tends to take a more activist approach to its investments. Temasek has released some information about its financial performance since 2004. But the available information has been confined to consolidated accounts that do not disclose flows between subsidiary investments and omits historical financial data before 2001. Other countries invest through intermediaries; for example, China's new SWF just bought a $3 billion stake in Blackstone Group, a U.S. private equity firm.

Implications and concerns

By definition, the sum of all current accounts adds up to zero. Hence, the growing current account surpluses of commodity exporters and Asian countries are the mirror image of the growing current account deficits of other countries, primarily the U.S. in recent years. Short of aggressive and potentially destabilizing curtailment of current account deficits and surpluses, the challenges introduced by the growth of SWFs are here to stay. While some view these developments as the desirable outcome of deeper financial globalization, there have been growing concerns that the size of SWF portfolios may ultimately destabilize the global financial system. These concerns reflect the view that size matters and that sovereign management may be motivated by nationalistic considerations, deviating from conventional wealth maximization.

Apprehension about the size effect of funds is not new, reflecting the possibility that a large fund may use its market power strategically, potentially leading to greater financial instability, and occasionally benefiting large players. An example of these concerns is the alleged role of large private hedge funds in coordinating speculative attacks on the British pound and other currencies participating in the European exchange rate mechanism in the early 1990s. The extra dimension added by SWFs is the possibility that sovereign investors may use their strategic leverage for narrow nationalistic objectives (Summers 2007). The concern is that financial globalization has reached the point where the sheer size of foreign savings may distort sovereigns' incentives, shifting them from beneficial diversification toward zero-sum game policies. These may include supporting domestic "national champion" firms, buying controlling positions in foreign firms with proprietary knowledge, or increasing control of financial and tangible infrastructure abroad (telecommunication, energy, ports, etc.).

Such developments may also lead to the proliferation of capital controls and financial protectionism, ultimately risking international trade in goods and services. Already, globalization, despite its benefits, has raised sensitivities around the world. In particular, there is rising opposition in many countries to the control or major stakes that state-controlled SWFs are taking in foreign private companies. The adverse political reaction to efforts by China's state-owned oil enterprise CNOOC to acquire the U.S. oil firm Unocal in 2005 and by the United Arab Emirates' DP World to acquire several major U.S. ports are well known. The Abu Dhabi Investment Authority's recent $7.5 billion investment in Citigroup prompted less concern, in part because of the Authority's assurances that it would not seek any control or active management. Emerging markets also at times have expressed sensitivity to certain investments by other emerging markets. Temasek's purchase of a controlling stake in the Thai telecom firm Shin Corp. from the family of then-Prime Minister Thaksin Shinawatra in January 2006 sparked off a political crisis in Thailand.

As a result of these concerns, a range of policies have been proposed. Some observers call for imposing stringent transparency requirements on SWFs, well above the present requirements on private financial funds (Truman 2007). In this connection, the U.S. Treasury has suggested that the International Monetary Fund and World Bank play an oversight role to limit the systemic risks of unregulated SWFs, including the formulation of best practice guidelines.

Others have proposed greater scrutiny of foreign government entities seeking operational control of companies in which they invest, particularly if they choose to exercise the voting rights of their equity shares. Accordingly, some have advocated that SWFs should be allowed to invest only in nonvoting equity shares (Buiter 2007). In addition, some call for restricting SWFs' operations to reciprocal arrangements, where the ability of a country to buy foreign assets would be conditioned on granting similar access to foreign funds (*Economist* 2007).

Further insight into this issue is gained by noting that economic theory suggests that the diversification benefits associated with increased globalization can be obtained best by buying a share of a "global fund," composed of all the traded assets of all countries. This suggests that the expanding role of SWFs may be best accommodated by their purchasing shares of a fund composed of the indexes of all the countries forming the global financial system. Such diversification provides the best mechanism for eliminating idiosyncratic risks. Short of engaging in potentially destabilizing zero-sum speculation, large players approaching the size of SWFs should not expect to get more than the gains associated with holding such wide "country funds."

Taking the insight provided by this benchmark seriously, a policy of encouraging SWFs to invest in well-diversified index instruments, such as the S&P 500, Wilshire 5000**,** Dow Jones Wilshire Global Total Market Index, etc., has the advantage of providing a workable solution to challenges associated with SWFs. The requirement for stringent transparency tests of SWFs may be unrealistic, due to costly monitoring and collection of information. Channeling the activities of SWFs into widely diversified country funds offers diversification gains to investors, while minimizing the exposure of a given country to strategic "cherry picking," that is, selectively buying control in entities due to narrow nationalistic objectives. One may also view it as a stepping stone towards deeper global diversification, as it may encourage the proliferation of country indexes in countries that are interested in gaining from financial globalization. Such a policy could be implemented either with the guidance of international financial institutions or as the outcome of bilateral negotiations between SWFs and potential recipient countries.

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