Sovereign Wealth Funds: An Examination of the Rationale

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Abstract
This paper describes trends in Sovereign Wealth Funds (SWFs) and examines the rationale of establishing such funds. State capitalist development rather than the pursuit of return appears to be the overriding objective of SWFs. These funds reflect the increasing recognition by the state of the power of finance and their chief attraction remains the balancing of globalization and national sovereignty.

JEL Classification Codes: G15, P16

Key Words: Sovereign Wealth Fund, State Capitalism

I. INTRODUCTION

There are 48 Sovereign Wealth Funds (SWFs) in the world owning assets nearing 3 trillion US dollars. SWFs are government investment vehicles funded by foreign exchange assets which are managed separately from monetary authorities' foreign exchange reserves. Johnson (2007) defined SWFs as "assets held by governments in another country's currency". Foreign exchange reserves are maintained by the Treasury or the Central Bank of a country for exigencies of imports, national emergencies, and maintenance of stability of national currency. Although state enterprises and public pension funds may own investments in foreign exchange, SWFs seek riskier investments that offer a higher rate of return in foreign debt and equity markets. SWFs are also different from sovereign holding companies that have a domestic orientation.

Although Funds such as those of Abu Dhabi and Singapore have been around since the 1950s, about half of the SWFs have come to existence in the last few years. Eleven new SWFs were established in 2009 alone. The *Morning Star* suggested SWFs are "fashion accessories" for emerging nations rather than actual money makers. In fact, the recent global financial crisis has seriously eroded the already modest performance of the SWFs. It is worthwhile to examine why many small economies rushed to establish SWFs. Section II of the paper provides an overview of selected SWFs. The case for SWFs is examined in Section III while the case against is presented in Section IV.

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Section V offers a rudimentary discussion on management and performance of SWFs. State capitalist development rather than making money appears to be more overriding objective of SWFs. On this theme, an afterthought is presented in Section VI.

II. CHARACTERISTICS OF SOVEREIGN WEALTH FUNDS

Table 1 in the appendix shows data on selected sovereign funds. The seven largest SWFs have investments exceeding $100 billion each. UAE's Abu Dhabi Investment authority, Singapore's GIC and Tamasek Funds, Norway's Global Pension Fund, and SWFs from Kuwait, China, and Russia complete the top seven SWFs. The following features of SWFs are noteworthy:

1. Recently established funds are rather small with the exception of the funds of Russia, China, and Saudi Arabia. Some funds started with less than $5 billion. Among the biggest 20 SWFs, the average size is over 10 billion USD (Zhang, Wei and Hou, 2008). Once SWFs are set up, they grow by returns they earn and also by subsequent addition of surpluses to the funds[1].
2. The valuation of SWFs is difficult because of volatile investment results as well as possible secrecy of investment holdings. To illustrate, Chile's ESSF (Economic and Social Stabilization Fund) was constituted with an initial deposit of $6 billion in 2006, which according to the IMF, stood at $9.83 billion in assets at the end of July 2007. The SWF Institute estimates the assets of ESSF at $15.5 billion as of August 2008 and the *Morning Star* has yet another estimate.
3. Nearly two-thirds of the SWFs are funded by commodity exporting countries. UAE, Saudi Arabia, Kuwait, etc., have funded their SWFs by revenues from export of oil whereas funding of Chile's SWFs came from export of copper.

[1] Suppose foreign exchange reserves exceed a threshold level, such as a certain level of GDP, say 5%. The excess funds are used as an initial deposit for the SWF. Thereafter, reserves above 5% of GDP are added to the SWF.

Singapore, Korea, China, on the other hand, have funded their SWFs by export surpluses from a variety of manufacturing goods and services.

4. Non-oil exporting country's funds use a small portion of the country's foreign exchange reserves for SWFs. Oil exporting nations maintain small reserves and the funds used for SWFs are a large portion of their foreign exchange reserves.
5. Although most SWFs are from developing countries and they invest in developed financial markets in stocks and bonds, the SWFs can easily diversify into emerging economies, and into hedge funds and private equities. Such tendencies have recently become apparent.
6. SWF may emanate from both democratic and autocratic societies. The budgetary processes in democracies may provide public trust in government ownership and management of the funds.
7. Fund types vary by their main objective. Whereas stabilization and sterilization are the most common, some emphasize saving and development while others are preventive and strategic. Funds may have a mix of objectives as well.

III. THE CASE FOR SOVEREIGN WEALTH FUNDS

In this Section we discuss the rationale of setting up SWFs. The advantages of SWFs are many, although not all need apply for each country at any given time.

Increased Foreign Currency Reserves

The primary reason for SWFs comes from sustained increase in a country's foreign exchange reserves. China ($2.4 trillion), Russia ($447 billion), India ($279 billion) and South Korea (273 billion) have substantial reserve accumulation in recent years. Singapore, Hong Kong, Malaysia, Brazil - all have reserves exceeding $100 billion[2]. The availability of large surpluses creates strong incentives to establish SWFs.

[2] Figures are as of March 2010, International Financial Statistics, International Monetary Fund, Washington DC.

Yield

Primary commodity exporters with trade surpluses used to passively invest funds in western banks that recycled the funds. Petrodollars in the 1970s were recycled when banks lent funds to developing countries. In the 1980s and 1990s, surpluses were invested in short term, low-risk US treasury bonds. When interest rates dropped on US treasuries in the 2000s, developing countries became anxious to augment foreign exchange reserve returns. One way they did this was by using SWFs to invest in foreign equity markets, thus reducing the opportunity cost of reserve holdings.

Stabilization

With volatile commodity prices, establishing SWFs for stabilization of revenues is appealing. Most commodity exporters have such an objective. Funds are removed from the state budget when revenues are high and are put back to the budget when revenues are down. These processes are not symmetric. The later may be complicated by liquidity and marketability of the SWF assets as well as the monetary authority's legal right to call upon the assets for meeting balance of payment needs.

Combating Inflation

Trade surpluses tend to increase domestic prices[3]. SWFs remove funds from the current budget and can soak up excess liquidity and reduce inflation. Facing inflationary

[3] According to the classical *Specie-Flow-Mechanism*, trade surpluses induce inflow of gold. This increases the supply of money, which, in a gold standard system, is tied to the reserve of gold. The increase in the supply of money causes inflation, *a la* the quantity theory of money. Even in a fiat money system, trade surpluses work in a similar fashion, causing an inflow of currency into a country, thus raising both money supply and inflation.

pressure, governments may desire to remove foreign exchange from the hands of the public. The government issues bonds and uses bond proceeds to purchase foreign exchange from the central bank. To make bonds attractive they offer marginally higher interest on them, incurring sterilization costs. Higher interest, however, attracts hot money from abroad, further swelling foreign currency reserves and raising sterilization costs. Goldman Sachs estimated China's sterilization costs at $500 million a year.

Development

Sovereign funds provide savings for economic development and facilitate savings and intergenerational transfer of surplus funds. Earmarking funds for specific developmental goals such as education, health, pension, infrastructure, and banking development is common. China's Investment Corporation (CIC) is committed to banking development and initially made investments in China Development Bank ($20 Billion), Agricultural Bank of China ($40 Billion), and smaller amounts in China Everbright Bank and China Construction Bank (Martin, 2008). Chile set up the Economic and Social Stabilization Fund (ESSF) to provide "funding for public education, health, and housing initiatives", and the Pension Reserve Fund (PRF) to fund the government's pension obligations (Kristian, 2007). Reform and long term investment in education or services can make an economy more competitive internationally.

Diversification

Depending on holdings, SWFs may bring diversification of a government's assets. The economies of primary commodity exporters are often dependent on the export of one or two products. SWFs permit the country to diversify its investment and risks.

Debt Management

SWFs allow alteration of debt structure. Excess funds can pay down debt, upgrading the country's debt profile. Brazil's SWF has this as its primary objective. Its SWF uses its proceeds to pay off Brazilian private sector debt, which, in turn, invests abroad.

Industrial Policy

SWF lending is an alternative to industrial incentives such as export financing or bond insurance. This bypasses World Trade Organization rules as such regulations do not extend to SWFs. Further, a country may try to keep its currency undervalued to boost exports and employment. Increasing reserves create pressure for foreign exchange rate to rise. Removal of reserves through SWFs reduces such pressure.

Covert Intervention in Foreign Exchange Markets

SWFs make it more difficult to trace central bank intervention in foreign exchange market. Conventional means of intervention are complex and small central banks will have small ability to intervene. However, interventions through SWFs and their subsidiaries would be immensely more complex.

Political Influence

Some developing nations flex their muscles in the international finance arena and use SWFs to enhance political influence abroad. SWFs may be used to acquire key foreign infrastructure and use ownership of such assets as a foreign policy tool. China, as the strongest emerging nation, draws political attention when it obtains infrastructure

and raw material sources in remote countries. The *Financial Times* (Sep 12, 2008) claimed China's state administration of foreign exchange "convinced" Costa Rica to switch ties from Taipei to Beijing.

Intangibles

Partnering with foreign companies may provide opportunities for gaining knowledge and developing expertise in unrelated areas tapping into networks where connections are the key to deal making. Even if China's $3 billion investment in Blackstone does not make money, collaboration with Blackstone may bring opportunities to participate in the private equity market. Such opportunities may otherwise be expensive to achieve.

State Capitalism

The state acts as a capitalist when it uses government controlled funds to acquire strategic assets around the world. Developing countries have taken charge of capitalist development in the post-colonial era. Such development is often thwarted by public sector inefficiencies, center-periphery relationships, socioeconomic inequities, the neocolonial world order and other reasons. Globalization and liberalization in the 1990's restricted national autonomy. Empowered by the rise of a financier class within their economies and vast public sector holdings of foreign exchange reserves, some states find SWFs can influence capitalist development. Clark and Monk (2010) suggest SWFs provide an attractive middle path between globalization and autonomy of nation states. SWFs enable states to alleviate the adverse impact of globalization on their domestic economies without entirely giving up its benefits. State capitalism can work through many vehicles[4], but SWFs are one of them.

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[4] The principal actors of state capitalism are: "national oil corporations, state-owned-enterprises, privately owned national champions, and sovereign wealth funds" (Bremmer, 2009).

IV. THE CASE AGAINST SOVEREIGN WEALTH FUNDS

Whereas many goals of SWFs are laudable, SWFs may not be the best vehicle to achieve those goals. SWFs have drawn criticisms from developed countries as well as domestically on several grounds. The main criticisms are:

Excessive Government Ownership and Management

SWFs give governments command over massive amount of wealth. Some believe the state may not be more efficient in utilizing such funds than the private sector and states should return surpluses to their people by national tax holidays. SWFs reduce government control and management of surplus funds when SWFs are managed by private entities. In practice, however, management of SWFs is entrusted to the country's central bank or entities whose independence from government is questionable.

Too Much Power to the States of the South

SWFs are largely investment vehicles of developing countries in the developed world's financial markets. There are concerns in both the United States and Europe on the potential influence on the Western financial system. SWFs are viewed as large, influential, and lacking in transparency. Their management objectives and investment strategies are often unknown. The US Congress held hearings on SWFs and the G-7 asked the IMF to develop guidelines to monitor SWF investment activities. SWFs, on the other hand, justify covertness for fear of protectionist response to their investment propositions.

Sovereign Wealth Funds are Unsuitable for Many

Criticisms of SWFs include claims that many countries are not prepared for SWFs. Countries with surplus funds should not rush to establish SWFs until urgent needs of the economy have been met first. For example, countries with poverty, unemployment, and current account deficits should not rush into SWFs just because they have foreign exchange surpluses. In many instances the foreign exchange reserves are not "earned" reserves but are "borrowed" reserves[5]. To the extent excess reserves are hot money inflows from abroad which can be withdrawn in short notice, SWF may not be sustainable. India is a case in point. India has large foreign exchange reserves but its trade balance shows a modest deficit, it has a high proportion of people below the poverty line, and much of its foreign exchange reserve is hot money from abroad. India's central bank, the Reserve Bank of India, pursued and shelved the idea of establishing a SWF.

Creates Policy Conflicts

Concerns have been expressed that operations of the SWFs, when not integrated with other economic policies of the government, may undermine the later. The policies of a country's SWF may interfere with the policies of the country's central bank.

Despite repeated Congressional hearings in the United States on SWFs and protectionist alarmism, there is growing awareness SWFs do not threaten the western financial system. As a writer in *Foreign Policy* notes, "Worried about oil-rich foreigners taking over your economy? You shouldn't be. In reality, it is citizens of unaccountable, paternalistic regimes who stand to lose most when rulers play games with their national wealth" (Ashlund, 2007).

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5 One estimate puts as much as 37% of India's foreign exchange reserves as "hot money".

V. MANAGEMENT AND PERFORMANCE OF SOVEREIGN WEALTH FUNDS

Management responsibility of SWFs rests with the country's Ministry of Finance, or the central bank, or a state appointed board that hires private sector financial managers for fund management. Even when professional managers are utilized, government influence is evident. For example, Singapore's *Temasek* fund, although managed privately, was headed by the wife of the country's Prime Minister.

One consequence of employing professional money managers is SWFs tend to hold portfolios with different risk profiles, time horizon, and asset classes than central bankers who traditionally kept their holding in highly liquid government securities, agency debts, money market instruments and bank deposits. Although SWFs pursue higher return by bearing higher risk, many SWFs are managed quite conservatively. For example, Chile's initial investments had 30% in money market funds. This they intend to reduce, yet the new targets are 15% stock and 20% corporate bonds (Flyvholm, 2007). It may be noted Chile's SWFs are managed by the country's central bank. There seems to be a reluctance to hold cash by SWFs. Cash earns little yield, and defeats the purpose of SWFs which was, in part, to reduce the opportunity cost of holding reserves. Regarding the investment pattern of SWFs, it has been noted that very large share of SWF investment (half of the total investment) went into financial sector and the US financial market received half the funds (Bortolotti *et al*, 2010). China has shifted its emphasis from dollar denominated assets in financial firms to investment in commodities and real estate. Recently, CIC (China Investment Corporation) invested $850 million in Singapore-based Nobel Group (Financial Times, Sep 21, 2009).

There is very little published information on the SWF performance. Singapore's GIC claimed since its inception a long term rate of return of 6.49% through the end of 2007. The report was published before the recent financial crisis which inflicted heavy losses

on most SWFs. Temasek sold off, at a huge loss, its stake in Bank of America it had acquired through investment of $4.4 billion in Merrill Lynch, the Abu Dhabi investment authority lost most of its $7.5 billion investment in Citibank preferred shares, and China's CIC lost much of its $3 billion in Blackstone. Some of these SWF stand at one-half to one-third their value estimated in 2007. Gamal (2009) reports that the Kuwait Investment Authority (KIA) lost $30 billion in the last 9 months of 2008. Temasek lost 31% of its portfolio value during the same period (Wassener, 2009). The SWFs regained some of the losses as the markets turned around.

"Poor long-term stock performance" by SWFs is established by formal studies of SWFs performance. Bortolotti et al. (2010) found abnormal return of 802 acquisitions of stakes in publicly traded companies by 33 SWFs resulted in significant negative returns in the two year holding period following the investment. In the case of 355 acquisitions, they find SWFs acquired seats in the boards in 53 (14.9%) of the target firms. The authors concluded SWFs would be unable to exercise monitoring because they would be unwilling to antagonize local management.

VI. THE RATIONALE FOR SOVEREIGN WEALTH FUNDS - AN AFTERTHOUGHT

The rapid decline of SWF investments in the face of recent financial crisis raises doubt about the viability of the idea of developing countries participating profitably in developed world's financial markets for augmenting return and managing risks of their economies. With globalization and increasing financial market integration in the1990s, companies from emerging nations raising funds in developed country financial markets, increasing commodity prices generating a modest surplus for some developing economies, hopes were high that participating further in the world financial markets would benefit the emerging nations. The recent global financial crisis has lowered such expectations. A financial crisis is not mere fluctuation of fortunes, but often a permanent destruction of value. The losses of SWFs suggest that developing country enterprises in the developed markets are sharecroppers who stand a chance to gain only when it rains

well in the developed markets. Evidently SWFs regained much of the losses they suffered during the financial crisis of 2008, as the stock markets turned around and especially the financial stocks rebounded. This led the NY Times to write that the SWF "reaped huge gains from bailing out financial institutions . . . even as ordinary investors have been pummeled by billions of dollars of losses" (Dash, Dec 07, 2009). This however cannot happen unless the financial institutions had special deals with SWFs which allow them to sell at high prices that ordinary investors can't obtain. Notwithstanding populist cries in the developed country press, such recovery is modest and in line with stock market gains in general. The picture of SWFs recovering losses is quite mixed; Singapore's GIC gained from the market rebound, but Tamasek did not.

SWFs are state enterprises which emulate the behavior of late nineteenth century private portfolio capital that moved around the globe in search of higher return. Such mobility of capital helped capitalist development worldwide. Emerging country states are trying to promote the same at home by acting as monopoly capitalists. For the purpose of capitalist development, aggressive pursuit of return should be the objective of SWFs. Instead, these funds are being promoted in the name of social goals of education, health and retirement while their financial performance has remained modest. Until SWFs are successful in reaping significant financial returns, emerging nations may be better off investing surplus funds in removing production bottlenecks at home. Internationally, the rise of SWFs would not indicate any shift of power from western financial establishments to the emerging nations. SWFs however reflect increasing acceptance of the power of finance by developing countries and the chief attraction of SWFs is to balance globalization and national sovereignty.

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APPENDIX

TABLE 1: Selected SWFs in the World

Fund (Country)	Inception	Assets (*bn US $*)	Source of Fund	SWF-Forex Reserve Ratio
Abudhabi Inv Authority (UAE)	1976	875	Oil	29.5
Emirate Inv. Authority	2007	NA	Oil	
Pension Fund Global (NOR)	1990	396.5	Oil	7.1
Sama Foreign Holding (Saudi Arabia)	NA	365	Oil	NA
Singapore Inv. Corp	1981	330	Non-Commodity	1.9
Tamasek	1974	134	Non-Commodity	0.9
China Investment Corp.	2007	200	Non-Commodity	0.1
SAFE Inv. Company	X	311	Non-Commodity	0.2
National Social Security Fund	2000	74	Non-Commodity	n/a
Kuwait Inv. Authority	1963	264	Oil	12.7
Algeria Rev. Reguln. Fund	2000	47	Oil	3
US-Alaska Perma. Fund	1976	39	Oil	.5
Wyoming Mineral Trust	1974	3.9	Minerals	Nil
Alabama Trust Fund	1986	3.1	Gas	Nil
New Mex State Inv Office	1958	16	Non-Commodity	0.2
South Korea	2005	30	Non-Commodity	0.1
Chile ESSF	2006	15.5	Copper	0.9

Oil & Gas	$2381 billion
Others	$1448 billion
TOTAL	$3834 billion

Source: Morgan Stanley, April 2007.