Sovereign-Wealth Funds: Assuaging the Exaggerated Anguish about the New Global Financial Players*

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Abstract

The world of international finance is in the process of transformation. A new group of emerging market economies and members of GCC are emerging as major exporters of capital. Sovereign Wealth Funds (SWFs) are their instruments of interacting with the global capital markets. Although they are an instrument of enhancing liquidity and financial resource allocation in the international capital market, they have become a source of controversies and threaten an escalation in financial protectionism. SWFs are state-owned and managed and have started playing a decisive role in underpinning, sustaining, and expanding financial globalization. Popular and financial media did not begin copious discussions regarding the operations of the SWF until the last quarter of 2007, when they acquired considerable eminence due to their increasing operations. The sub-prime mortgage crisis in the US created severe credit crunch, which precipitously worsened to a crisis proportion in the third week of September 2008. This credit crunch became a window of opportunity for the SWFs. Total assets under management of the SWFs were on an increase. However, their state-ownership and lack of transparency has created considerable anxiety about their operations. The SWFs are being viewed as turning from creditors to owners.

Large and diversified portfolio investments by SWFs entail few risks for the international financial market; anxiety about them is exaggerated. Restrictions from host economies on SWFs activities would deprive the international financial markets of a cash-rich market player. Rise of financial protectionism would work as a barricade against the expanding globalization. Participation of the SWF in the international financial system can be improved by policy initiatives at three levels, namely, the SWF level, the host economy level and by the international institutions like the IMF, which needs to devise a set of best practices for the operations of the SWFs.

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Financial globalization has been accelerating. Over the last two decades the rate of increase of global cross-border investment was twice that of rate of growth of multilateral trade in goods and services, which in turn exceeded the rate of global GDP growth (Lane and Milesi-Ferretti, 2006). State-owned and managed, sovereign-wealth funds (SWFs), largely from the emerging-market economies (EMEs)\(^1\), have started playing a decisive role in underpinning, sustaining and expanding financial globalization. While they are not a new group of institutional investors, the term SWF was not in vogue until 2005. They are liquidity-rich funds supporting financial globalization and diversification. These behemoths of the global financial world have been investing in a wide range of asset classes. One problematical facet of SWFs’ investment is the backlash they are provoking from protectionists and nationalists. Threats of financial protectionism have been mounting with rising investment by these state-owned investment funds in the global private sector corporate assets. Although they are an instrument of enhancing liquidity and of financial resource allocation in the international capital market, they have also become a source of a challenging controversy and have threatened an escalation in financial protectionism. Both public and private sector policy conclaves are concerned about the necessary policy measures needed for keeping these ominous threats in check and promoting an open global financial system. SWF operations have emerged as the hottest theme of intellectual curiosity in the discipline of international finance. Their enlarged operations since the last quarter of 2007 raised some honest question-marks.

This article argues that the mistrust-tinged anguish regarding the large and diversified investments by SWFs is overdrawn. Thus far their operations have not caused risk for the international financial market operations. Restrictions on their operations are frequently contemplated and often implemented in the advanced industrial economies. They serve to deprive the global financial markets of cash-rich market players. These measures lead to financial protectionism as well as frustrate and decelerate expanding globalization in the financial markets. This article proposes a pragmatic plan for integrating these large financial operators into the fold international financial system. To participate more actively and integrate better in the international financial markets, the SWFs will need to proactively adapt and modify some of their operational patterns. Participation of the SWFs can be improved by policy initiatives at three levels, namely, the SWF level, the host economy level and by the international institutions like the

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\(^1\) Emerging-market economy is a term coined by Antoine W. van Agtmael of the International Finance Corporation in 1981. It is a sub-set of developing economies. See Das (2004), Chapters 1 and 2 for an explanation of what emerging-market economies (EMEs) are and how are they defined.
International Monetary Fund (IMF), which needs to devise a set of best practices for the operations of the SWFs. It also profiles various policy measures that are necessary at the present stage of operations of the SWFs. That being said, in most advanced industrial economies legislation and regulatory barriers for keeping foreign investors out are already in existence. The specter of unwelcome and objectionable intrusion by cash-rich SWFs in a country’s economic life is overly puffed up.

1. Definition and Concept

Although a universally accepted definition of a SWF does not exist, it can be functionally defined as a fund owned and run by the government of a sovereign nation that manages national savings, budget surplus and excess foreign exchange reserves by investing them globally into corporate stocks and bonds and other financial instruments. These foreign currency assets are managed separately from the official reserves of the monetary authorities. However, whether these foreign assets are a part of the reserve assets of a country is hitherto ambiguous. Thus viewed, an SWF is the investment vehicle of a sovereign government that holds foreign assets for long-term purposes.

Several export-oriented Asian economies steadily build up trade surpluses. On the one hand, the Asian EMEs, in particular China, have been increasing their trade surpluses. Progressively rising oil and gas prices on the other hand have increased the revenues of the Gulf Cooperation Council (GCC)\(^2\) and the Russian Federation and turned them into globally significant net investors. In this sub-group of economies, China has been the largest global investor, with almost twice as much foreign investment as the next largest EME, the Russian Federation and three times as much as the Republic of Korea (herein after Korea), the third largest investing EME. Economies that are Asia’s financial hub, namely, Hong Kong SAR, Singapore and Taiwan, have strengthened their bond with the EMEs of the region and they are expanding global investment rapidly. This wave of Asian financial integration has excluded Japan (MGI, 2008).

The source of the accumulated pool of resources of an SWF can be foreign currency deposits earned through recurrent balance of payment surpluses, or revenues earned from the exports of non-renewable natural resources like petroleum and gas, or exports of commodities. Gross official international reserves more than doubled between 2002 and 2006, reaching $5 trillion. This led to an unprecedented concentration of liquid forex resources in the official sector. Excess liquidity in the public sector can also be derived from the fiscal surpluses of the governments. Besides, a SWF can be a domestic pension fund, funded in

\(^2\) The Gulf Cooperation Council (GCC) was established in 1981. Its members are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE).
domestic currency, but it may diversify into making global investments. The two kinds of SWFs share many common characteristics and frequently are not distinguished from each other.

The rationale, objectives and investment behavior of SWFs are identical to other funds like trust, hedge, or private-equity funds. However, as the assets of SWFs belong to a sovereign nation, managed through an *ad hoc* fund, these funds are aptly christened sovereign-wealth funds. Although little is known about the nature and degree of government intervention in the operations of individual SWFs, majority of them are largely semi-autonomous, self-directed entities, dedicated to professional portfolio management. Enhancing risk-adjusted returns on investment is their overarching objective. They have slowly, steadily, silently, albeit not stealthily, grown into consequential financial players in the global markets.

Foreign exchange reserves of an economy, typically held in euros, dollars and yen, are the assets of the official sector and traditionally managed by the central banks with an explicit short-term objective of protecting and stabilizing the domestic currency and protecting banks during periods of crises as well as for liquidity management purposes. Several EMEs suffered from currency and banking crises during the decade of the 1990s and early 2000s. Since these reserves are intended for use during such exchange rate or financial emergencies, they were conventionally invested in assets that could be liquidated easily and quickly at the time of need. In managing reserves, the preference of the central banks has been for liquidity for balance of payment needs. The rate of return on investment was not an important consideration for them. Therefore, low-return investments in the United States (US) Treasury Securities and their equivalents were regarded as an acceptable mode of investment. Unlike these investments by central banks, for the most part, foreign assets held in SWFs are for long-term. They are illiquid and not readily available to monetary authorities for balance of payment purposes.

As a generalization, a large number of SWFs are an outgrowth of expanding foreign exchange reserves of the official sector. When the foreign exchange reserves grew substantially larger than what was regarded as necessary for serving the short-term objectives enumerated above, the mind-set of investing governments began to change. The new line of thinking was that as this was the surplus public wealth of the country, possibilities of higher-returns on them should be explored. The managing governments concluded that at least part of the growing foreign exchange reserves should be placed in high-yielding, high-risk, if less liquid, investments. With this new mandate in mind, some sovereign governments launched SWFs so that they could maximize risk-adjusted long-term returns on their accumulated liquid financial resources. Consequently, large amounts of state controlled liquidity began flowing into private assets globally.
Continual growth in sovereign assets has turned the official sector into an active and prominent investment group.

Although SWFs are not a new class of institutional investors, professional and academic interest in them had in general remained subdued for a long time. The SWFs had operated in the international capital markets since the early 1950s. Although the term SWF is of recent vintage (section 1), the first fund making international investments on behalf of sovereign governments operated since 1953, when the Kuwait Investment Authority (KIA) was launched. It invested the substantial petroleum revenues of the state of Kuwait. The second such venture was the Kiribati Revenue Equalization Reserve Fund, which was created by the British administration of the Gilbert Islands in 1956. A levy on the export of phosphates from Kiribati resulted in rich revenues, creating an investment pool of over half a billion dollars. Some of the other older state investment funds include Temasek Holdings of Singapore and Alaska Permanent Fund, which began operating in 1974 and Mubadala Development Company of Abu Dhabi and Alberta Heritage Fund of Canada, which began operating in 1976.

In spite of large volume of their operations, the SWFs had managed to remain by and large low-keyed and obscure for a long while. Only occasionally in the last three or four years, they became a source of argumentative debate, even sour controversy, when they tried to make a large and conspicuous acquisition in the industrial economies. Popular and financial media did not begin copious discussions regarding the operations of the SWF until the last quarter of 2007, when they acquired considerable eminence. The Financial Times and The Wall Street Journal have begun covering SWFs extensively and a new class of SWFs experts has emerged. Esteemed institutions like Deutsche Bank, Morgan Stanley and Standard Chartered began publishing well-researched pieces on SWFs. In rapidly globalizing financial markets, the growing role and activities of SWFs also began attracting a great deal of attention of the central bankers and finance ministers in the industrial economies. In the Group-of-Seven (G-7) meeting, held in October 2007, leaders of industrial economies had expressed concern about the investments made by the SWFs, in particular they had disapproved of the lack of transparency in their operations. The Senate Banking Committee in the United States (US) heard lengthy and repeated hearings on the SWFs in October and November 2007. In mid-November, the IMF convened its first annual roundtable

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3 This G-7 meeting was hosted by the US Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben S. Bernanke in Washington DC, on October 22. Aside from the U.S., members of the G7 include Japan, Germany, France, Britain, Italy and Canada.

4 Several noted scholars including Kenneth Rogoff, Patrick Mulloy and Edwin Truman participated in these hearings. Christopher Cox, the Chairman of Securities and Exchange Commission, expressed his concern regarding the operations of the SWFs in a speech at the Harvard University on October 24, 2007.
on sovereign assets. For the first time, the US Treasury discussed SWF operations in its *Semi-Annual Report on International Economic and Exchange Rate Policies*, published in June 2007.

The sub-prime mortgage crisis in the US, that began in August 2007, resulted in daunting losses in the banking industry and a credit crunch ensued. Increase in seriously delinquent sub-prime mortgages, which amounted to an additional $34 billion in troubled loans, disrupted the $57 trillion US financial system (Dodd, 2007). Large US financial institutions sustained heavier losses than previously visualized. It paradoxically became a window of opportunity for the SWFs. In an increasingly globalized economy, the SWFs played a notable salvaging role in the aftermath of this crisis. They rose to prominence during the credit crunch and the following financial crisis. It brought them into public eye and attracted a great deal of market and academic attention to them. Resourceful and enterprising SWFs took initiative and became active even before the monetary authorities of the industrialized countries stunned the global financial markets with a dramatic joint plan to ease the liquidity squeeze. This synchronized central bank policy action was taken on the 12th of December. The Federal Reserve Board, the European Central Bank (ECB), the Bank of Canada and the Swiss National Bank were its initiators, while the central banks of Japan and Sweden stood by to step in and act as necessary. In an ambiance of severe credit crunch, some of the largest financial institutions like the Citicorp, Union Bank of Switzerland (UBS), Merrill Lynch, needed infusion of fresh liquidity. The SWFs stepped in like chivalrous white knights and came to their rescue. The Abu Dhabi Investment Authority (ADIA) provided emergency capital injection of $7.5 billion to the Citigroup, Singapore’s Government Investment Corporation (GIC) provided SFr 11 billion to the UBS and Temasek Holdings of Singapore helped Merrill Lynch enhance its capital position by $6.2 billion. By January 2008, SWFs from Kuwait, Korea, and Singapore had invested $21 billion in Citigroup and Merrill Lynch, two heavy-weight financial institutions, because of serious losses in the credit crisis (*The Economist*, 2008). High-profile participation in these leading investment activities helped SWFs in emerging as large investors of global significance. They contributed to the stability of the international financial markets, presented a matured image and have begun to be regarded as a prominent segment of the global financial system. To an extent, this

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5 The subprime mortgage financial crisis of 2007 entailed a precipitous increase in home foreclosures. Although it started in the US during the fall of 2006, it began affecting the global economy in 2007, which became a gloomy year for some of the largest financial institutions in the world.
wave of sizeable investments by the SWFs was driven by the boom in petroleum prices.6

That being said, operations of the SWFs are unprecedented, even atypical, in several respects. First, they are huge, cash-rich funds, and are presently managing assets almost twice as large as the hedge funds segment of the international financial market. Second, a large majority of them are owned by developing economies, or to be more precise the EMEs. Third, states conventionally invested their excess foreign exchange reserves in low-risk, high-grade, investment vehicles like the US Treasury Securities, but by investing through SWFs, states moved towards riskier assets like equities and corporate bonds, in the process significantly enhancing liquidity in the global financial markets. Fourth, SWFs changed the character and composition of investments made by states. For the first time, SWFs enabled states to diversify their portfolios. Like any prudent investors, taking advantage of the increasing financial globalization, they began to diversify their holdings and look for higher risk-adjusted returns. Fifth, the foreign ownership of SWFs became a source of concern for the host economies, particularly because they are owned by sovereign governments. This exposed them to accusations of their investments being motivated by strategic and political considerations not economic considerations or profit maximization. The reason for this indictment is that in case of SWFs it is the governments that are regarded as the decision-maker of their large investments and governments are not business entities. Therefore, it is believed that maximization of risk-adjusted return on investment and shareholders’ wealth may well take a lower priority for the SWFs. Sixth, as more SWFs buy into prestigious firms and business corporations in the MIEs, an uncomfortable scenario of share croppers is conjured up, where foreign-owned firms employ the local high-skill workforce in the MIEs.

2. Market Size and Growth Dynamics

The SWFs have proliferated after 2000 and so has their global investment. The banking and financial sector has been one of their favored areas of interest. By January 2008, they invested close to $69 billion on recapitalizing some of the largest financial institutions in the MIEs. As alluded to above (Section 3), majority of SWFs publish little operational details, market has scanty knowledge about them. Going by what is available, Deutsche Bank Research (DBR, 2007)

6 During 2007, the supply-demand fundamentals for crude oil were in clear deficit. Towards the end of September 2007, average petroleum spot price (APSP) of benchmark West Texas Intermediate (WTI) shot up to $83.90 per barrel and in early November it topped $99. This was 65 percent increase in petroleum prices in one year. The global consumption of oil has been growing at an average annual rate of 1.9 percent; 2007 was the sixth consecutive year of oil price increases.
compiled basic statistical data on SWFs. According this compilation, the ADIA of Abu Dhabi is the largest SWF having $875 billion of AuM and the GIC of Singapore the second largest with $330 billion worth of AuM. Norway’s Government Pension Fund-Global (GPFG) comes next with $322 billion of AuM. The fourth in this reckoning is the SWFs of Saudi Arabia with $300 billion of AuM. KIA, the first SWF to be launched, comes fifth with $250 billion in AuM and China’s recently established CIC is the sixth largest with $200 billion in AuM. Hong Kong Monetary Authority Investment Portfolio manages assets worth $140 billion and is the seventh largest, followed by the Stabilization Fund of the Russian Federation (SFRF) with $127 billion in AuM. The ninth position is held by Temasek Holdings of Singapore with $108 billion in AuM and the tenth by the Central Hujin Investment Corporation of China, with $100 billion in AuM.

Present (2007) estimates of total assets under management (AuM) have been provided in Section 3. Although their global operations are larger than those of hedge funds ($1.4 trillion), SWFs account for less than one-eighth of global investment fund industry, which has $21 trillion worth of AuM. Another revealing comparison can be made with the assets held by the global banking sector ($63.5 trillion). The SWFs hold only 5 percent of the total assets held by the global banking sector (DBR, 2007). Thus, at present SWFs are much smaller in size when compared to the other large institutional investors. However, their importance and weight in the global financial market will continue to grow steadily. According to the projections made by the IMF (2007a), the SWFs will continue to accumulate global assets at the rate of $800 billion to $900 billion annually. This rate of expansion can bring the aggregate foreign assets under SWFs management to approximately $12 trillion by 2012. Growth in international reserves in the EMEs would be the principal factor buttressing this growth dynamics.

In the recent past, petroleum revenue growth in economies of Latin America and the Middle East has been aided by a sharp oil price spike. Also, increasing competitiveness and improving official reserves situation in the EMEs of Asia, particularly in China, Hong Kong SAR, Korea, Singapore and Taiwan will contribute the expansion of aggregate foreign asset managed by the SWFs. The weight of this country group in global official reserves has markedly increased in the recent past. The SWFs of EMEs of Asia and the Middle East seem set to lead the foreign asset accumulation process in the foreseeable future, with that the global operations of the SWF will pari passu expand.

According to the projections made by Morgan Stanley, SWFs are to grow rapidly in the medium term, both in absolute terms and relative to the total stock of global official foreign currency reserves. By 2010, they are projected to rise to

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7 See Table 4, DBR (2007).
$5 trillion and further to $10 trillion in 2014. By 2015, they are projected to touch $12 trillion mark. By 2011, SWFs should reach $6.5 trillion, surpassing the official foreign exchange reserves (Jen, 2007a). Two reasonable assumptions made while making these projections are that a large segment of incremental balance of payments surpluses will be added to SWFs and that the return on investments by SWFs is higher than that on sovereign bond holdings by central banks.

3. Ramifications of a Group of Large Institutional Investors

Advent of a group of cash-rich institutional investors, particularly those with a penchant for making large-volume long-term investments, is a wholesome development for the equity markets and other segments of the international financial markets. They play a positive role in enhancing market liquidity and financial resource allocation. Therefore, as a purveyor of capital, SWFs should be greeted, particularly by those business corporations and financial institutions that are in the financial market for long-term capital. Accumulation and channeling of financial capital to productive firms are indeed constructive and welfare-enhancing functions of the SWFs and they benefit the global economy. Large amounts of capital flows will have a bearing on global asset allocation and prices. According to estimates made by Jen (2007b), capital flows from SWFs should have a far-reaching impact. They would raise the “safe” bond yields by 30 to 40 basis points over the next ten years. They would also drive down the average return on equities by 50 to 70 basis points and reduce the equity premium by 80 to 110 basis points.

If so, why the SWFs have generated so much of anxiety, essentially in the political and legislative circles and among the business leaders? The SWFs are being viewed as turning from creditors to owners. The public debate on them has unmistakable negative overtones. Financial protectionism has raised its head from time to time. For Truman (2007) the very fact that the EMEs have accumulated “a vast amount of international assets” raised “profound questions about the structure and stability of international financial system in the first decade of the 21st century”, which seems a tad unconvincing. However, when SWFs try to acquire substantive stakes in large business corporations and banks that are at the forefront of a country’s commercial life, strong protectionist backlash can justifiably arise. The key trigger for concern was SWFs taking stakes in high-profile US and European corporations, some of which are listed in Section 2. With escalating financial wherewithal, the global investments of SWFs are bound to record an upsurge. What would be the macroeconomic and strategic implications of SWFs’ increasing investment in global corporate assets and
occasional takeover in the medium- and long-term is a question perplexing the professional and policy-making communities.

As majority of SWFs make little information available about their operations and investment strategy, there is widespread perception in “countries with liquid and efficient capital markets that SWFs are intransparent if not incalculable participants in global financial markets” (DBR, 2007). In terms of secretiveness, SWFs rank even below the most secretive hedge funds. Majority of them reveal little regarding their basic philosophy, investment strategy, portfolio composition, disclosure of operations and return on investments. This opacity has created misgivings regarding their motives and mistrust in their operations. Angst regarding their ability to destabilize market were also candidly expressed.

Another obvious and understandable cause of anxiety is the state-ownership of the SWFs. It is commonly observed that governments in the developing economies, including the EMEs, are more actively involved in international investment decisions than those in the MIEs. Although these controls have been loosening in the recent years, they still exist. While so far SWFs have not given any evidence of any “mischievous behavior”, this legitimately intensifies the apprehension in the MIEs of government intervention in resource allocation decisions (The Economist, 2008). Besides, large private sector corporate assets in the hands of foreign governments “are at sharp variance with today’s general conception of a market-based global economy and financial system”, in which commercial decisions are made by individual entrepreneurs based on profit maximizing motives (Truman, 2007). State-ownership of SWFs runs counter to the grain of capitalist thought and neo-classical economic philosophy. There is no gainsaying this fact.

However, it cannot be refuted that notwithstanding their state-ownerships, investment operations of the SWFs are fairly identical to those of other private sector investment funds in terms of motivation and management. Like them, SWFs look for the highest risk-adjusted returns. Their investment activities and mode of operation do not seem strikingly different from those of large pension funds, both in private and public sectors. That SWFs essentially have a good deal of autonomy in their operations has been noted in section 2. Therefore, apprehensiveness caused by mere state-ownership may well be exaggerated, if not misplaced.

4. Squaring the Policy Circle

The scale and scope of the SWFs operations has grown large and they can indeed move markets. However, experience thus far shows that large and diversified portfolio investments by them entail few risks of destabilizing international financial market. Those who regard investments by SWFs as a risky source of
destability need to carefully reassess the accuracy of their stance. As stated above (Section 6.1), there is little evidence of unwarranted, undesirable or offensive conduct by the SWFs. If anything, investment flows by the SWFs should be supported and welcomed by the host country governments. Long-term investment horizon for a large majority of them and lack of interest in speculative activity should make them a strong stabilizing force in the international financial market. Arbitrary restrictions from the host economies on their activities would deprive the international financial markets of a cash-rich group of market players. Rise of financial protectionism would work as an effective barricade against expanding globalization. Besides, erecting barriers to foreign investment from the EMEs on the premise that the SWFs may possibly abuse their position, while demanding open access to their economies is patently hypocritical. That said, participation of the SWF in the international financial system can be decisively improved by policy initiatives at the SWF level, the host economy level and by the international institutions like the IMF.

Arguably the thorniest policy issue is regarding investment by SWFs that sometimes enables them to take on management stakes. A knee-jerk reaction of analysts and policy makers in the recipient economies is to limit the stakes that SWFs can have in certain category of industries and keep it below a prescribed proportion. Both the industries and the limit can be determined by the regulatory authorities of the host country. However, this resolution is not easy to implement. It is prickly in that how to identify an investor or a fund that should be subjected to such restrictions. Besides, some host country corporations and pension funds may well be averse to such limitations on the SWFs.

One policy resolution of this prickly issue could be allowing SWFs only non-voting shares in specified sectors of the domestic economy. Care should be taken in specifying the industrial sectors for this purpose. Keeping J. Sainsbury from the hands of QIA did not seem rational. Grocery business was not so strategic for the British economy that decisions made by a SWF could adversely influence the economic wellbeing of the people, or even that line of business activity. Some SWFs have begun taking lessons from the Dubai Ports World experience and CNOOC bid for UNOCAL. They have started taking a pragmatic approach in this regard. They have voluntarily begun opting for non-voting shares. The CIC declared their willingness for taking non-voting stakes, although they might take positions on boards.

One strategic measure that SWFs need to take is increasing transparency and accountability of their own accord. It will certainly result in reduction of risk of reflexive financial protectionism, or at least in containing its expansion. Legitimate concern regarding their motivation will be alleviated if SWFs become more transparent. For supporting smoothly operating international capital markets on the one hand and active participation of SWFs on the other, transparency is
indispensable. *A la* Truman (2007) it is needed for advancing horizontal accountability among the participants and stakeholders as well as vertical accountability along the policy-making process.

Example of GPFG of Norway is frequently given for having exemplary levels of disclosure and being a paragon of transparency. The Permanent Reserve Fund of Alaska (US) and Alberta Heritage Savings Trust Fund of Alberta (Canada) are also regarded as highly transparent, followed by the Temasek Holdings. The Khazanah Nasional BHD of Malaysia is also regarded as fairly transparent. In case SWFs do not voluntarily adopt high standards of transparency, they can indeed be internationally coaxed to publish audited information about their balance sheets, annual reports and quarterly reports as well as provide necessary information regarding their rationale, basic philosophy and objectives, portfolio composition, investment strategy and return on investment. Those SWFs that are averse to comply with calls for high standards of voluntary disclosure and transparency may be restricted to purchasing a pre-specified level of non-voting shares in the recipient economies. In fact, given the scale and scope of SWFs’ operations, it seems in order to make higher norms of disclosures mandatory.

International financial institutions like the IMF can initiate the third line of policy action. International investment operations of sovereign governments warrant “collective effort to establish an internationally agreed standard to guide the management of their cross-border investments” (Truman, 2007). Therefore, recognizing the positive liquidity enhancing and financial resource allocation roles of SWFs, policy makers at the international level have begun deliberations on how to forestall financial protectionism so that an open global financial system and be promoted and buttressed. What code of conduct the SWFs need to follow has become a legitimate issue for the international financial community.

The International Monetary and Financial Committee (IMFC) of the IMF have charged the IMF with analyzing the relevant policy issues from the perspective of both investors and recipients of SWF flows. The IMFC has stressed on the imperative need for a candid dialogue on identifying best practices so that rising financial protectionism can be nipped in the bud. In the November 2007 roundtable of the IMF (Section 2.2), which was attended by the senior level delegates from central banks, ministers of finance, and sovereign asset managers from 28 countries, it was decided that the IMF will taken into consideration the viewpoints of the two sides and identify sound practices to be followed in the management of SWFs. Dominique Strauss-Kahn, the Managing Director of the IMF, emphasized the imperious need for SWFs to function “in ways that are consistent with global financial stability” (IMF, 2007). To be sure, an agreed upon set of best practices could go a long way in maintaining an open global financial
system and discourage the host countries from imposing unilateral restrictions on SWF operations.

For some time, the MIEs have had legislation and regulatory barriers for keeping those foreign investors out whose investments are not welcome. At present, SWFs taking stakes or ownership in important commercial enterprises against the popular will in the business corporations in the forefront of commercial life is not feasible. Therefore, the specter of unwelcome and objectionable intrusion by cash-rich SWFs is over-blown. The US government is the best equipped for prohibiting or suspending any unwelcome foreign investment. Since 1950, it has Exon-Florio Amendment in place, which is a part of the Defense Production Act. In addition, the Committee on Foreign Investment (CFI) has also been active in identifying and blocking any foreign takeovers that it regards as injurious to the US commercial or strategic interests. It was able to stop UNOOC in its tracks.

Japan, the second largest economy, has had stringent limits on inward foreign investment for a while. In several industrial sectors, Japan can also suspend investments by foreign controlled enterprises. Similarly, German Foreign Trade and Payments Act, amended in 2006, is capable of restricting investment transactions of foreigners. Its focus of protection is defense related German companies. The present regime wants to be extra cautious in allowing SWFs from China and the Russian Federation to take stakes in defense related German firms. It has proposed a CFI like body for vetting investment proposals from SWFs. Such a protective law in the United Kingdom (UK) makes use of “golden shares. It is more potent and versatile than the German law. Golden shares are nominal shares that are able to outvote all the other shares under certain specified circumstances. The UK also has a 29.5 percent cap on foreign shareholdings in what it regards as strategic industries. The golden share concept is a practicable and no-non-sense one. The on-going deliberations in the European Commission (EC) seem to favor it because they can prevent outright takeover of strategic holdings as well as politically and economically sensitive commercial assets.

However, there is a downside to it, that is, golden shares may be abused to protect European companies. Among the members of the European Union (EU) there is disagreement so far on whether there should be a collective policy on restricting the SWFs, or individual member economies should devise their own policies. While France and Germany strongly favor a EU-wide stand, enthusiasm in the UK is not so high. Ireland follows open investment regime and may be wary of an EU-led policy regime, albeit it might accept a code of conduct for the SWFs. The French and German governments agree on not allowing SWFs uncontrolled access to stakes in their business firms. Although unequivocal in their demand for transparency, they have shown preference for laying down a code of conduct instead of rigid regulations. Canada has legislation restricting

http://www.bepress.com/gej/vol8/iss4/5
foreign ownership to minority shares in a long list of industries. Without discouraging investments by SWFs, it has recently demanded more transparency in their operations and declared that scrutiny of takeovers by them will be higher. Unlike these Group-of-Seven (G-7) economies, Australia and New Zealand have been far more welcoming to SWFs. Therefore, Asian SWFs and those from oil-exporting economies have large investments in these two economies. SWFs from Singapore have more commercial assets in Australia than the Government of Australia. The SWFs invest in the EMEs as well, whose concern regarding transparency and ownership of stocks in the sensitive sectors is not different from those of MIES. If anything, they many be more restrictive than the governments in the MIEs. Temacek Holdings was recently asked to reduce its holdings in the Shin Corporation of Thailand.

The SWFs are going to be active in the foreseeable future and will not disappear as long as surpluses and deficits in the economies continue. One plausible short-term change in this setting that is likely is that as the domestic financial sector liberalization in the Asian and Middle-Eastern economies continues, its citizenry will play a more active role in making foreign investment than its bureaucrats. This will reduce, albeit not eliminate, the stigma of state ownership of foreign investment that the SWFs represent.

Summary and Conclusions

This article focuses on the concept of SWFs and the recent spurt in their activities and significance. Although they are an instrument of enhancing liquidity and financial resource allocation in the international capital market, they have become a source of controversies and threaten an escalation in financial protectionism. SWFs are state-owned and managed and have started playing a decisive role in underpinning, sustaining, and expanding financial globalization. They are a fairly old group of large, liquidity-rich, funds supporting financial globalization and diversification. They manage national savings, budget surplus and excess foreign exchange reserves by investing them into corporate stocks, bonds and other financial instruments.

In spite of large volume of their operations, the SWFs had managed to remain by and large obscure. Over the last three or four years they often became a source of controversy. Consequently began to draw negative public attention. Popular and financial media did not begin copious discussions regarding the operations of the SWF until the last quarter of 2007, when they acquired considerable eminence. The sub-prime mortgage crisis, and the credit crunch created by it, brought the operations of the SWFs to the forefront of the global financial operations.
They are often regarded as ironic entities because it is normal for the MIEs to invest in the developing economies or the EMEs because they by definition are the capital rich group of economies. However, through SWFs this relationship is reversed and the developing economies become investors in the MIEs. Several categories of SWFs have emerged. They can be categorized according to their sources of wealth as well as policy objectives.

Total assets under management (AuM) of the SWFs have been estimated at around $2.5 trillion at present. Their future rate of expansion is likely to be rapid and by 2015 they have been projected to rise to $12 trillion. Growth in international reserves in the EMEs would be the principal factor buttressing this growth dynamics. For the most part, advent of a group of cash-rich of institutional investors, particularly those with a penchant for making large-volume long-term investments, is a wholesome development for the international equity markets and other segments of the international financial markets. However, their state-ownership and lack of transparency has created considerable anxiety about their operations. The SWFs are being viewed as turning from creditors to owners. When SWFs try to acquire substantive stakes in large business corporations and banks that are at the forefront of a country’s commercial life, strong protectionist backlash can justifiably arise.

References


