

# The Impact of Sovereign Wealth Funds on the International Financial System

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Many emerging-market economies (EMEs) and commodity-exporting nations have recently experienced sustained capital inflows and an accumulation of substantial amounts of foreign exchange reserves. The management of these foreign reserves has increased the importance of a particular set of financial actors: sovereign wealth funds (SWFs). While SWFs have existed in one form or another since the 1950s, their recent rise to prominence has led to increased public scrutiny and debate. Much of this attention is due to the establishment of SWFs by major economies such as China and Russia, which has raised concerns about the role of state actors in global financial markets. In formulating policies for SWFs, the G-7 and G-20 have called on multilateral institutions such as the IMF and the OECD to identify best practices and codes of conduct, while reviewing legislation concerning state-financed cross-border investment.

This report focuses on the potentially stabilizing and destabilizing effects of SWFs on the international financial system. While challenges exist, we conclude that, on balance, SWFs will likely act to stabilize the international financial system. SWFs are long-term investors that can supply liquidity and reduce market volatility.

## STYLIZED FACTS ON SWFs

### Definition, sources, and objectives

There is not, as yet, a commonly accepted definition of sovereign wealth funds. Efforts to incorporate the varying sources, purposes, and management structure into one standard definition often render it unwieldy and vague. Fundamentally, SWFs are large pools of capital owned by sovereign governments. Other definitions stress that these funds are invested in a broad portfolio of risky assets, including equities. A key

defining characteristic is that these foreign reserves are managed independently from official reserves. Kimmitt (2008) defines SWFs as "government investment vehicles funded by foreign exchange assets and managed separately from official reserves."<sup>2, 3</sup>

SWFs differ based on the source of their funds and their ultimate policy objectives. Generally, all SWFs are financed by current account surpluses arising from two principal sources: (i) revenues generated by net commodity exports (typically oil); and (ii) revenues generated by a merchandise trade surplus. The largest SWFs are usually designed with one or more policy objectives in mind, including the stabilization of government revenue to smooth planned expenditures; the accumulation of a portion of windfall revenues to benefit future generations; and higher returns on foreign exchange holdings. SWFs can also be used for several ancillary objectives, such as debt repayment, funding for development projects, and exchange rate intervention. Table 1 presents an overview of several major SWFs, including the Alberta Heritage Savings Trust Fund.

### Relative size and projected growth rates

In 2007, there were approximately 40 SWFs, 20 of which have been established since 2000 (McCormick 2008). Assets under management of SWFs stood at an estimated US\$2 trillion to US\$3 trillion, which represented 2.5 per cent of global assets (Jen and Miles 2007).

1. For more detailed analysis, see Gomes (2008).

2. For the remainder of this report, Kimmitt's definition is used.

3. It is important to note that the CPP Investment Board and the Caisse de dépôt et placement du Québec are not included in the definition of SWFs used here because of characteristics that set them apart from SWFs as described above (e.g., they do not manage government money or, as with the Caisse, manage both public and private money). For details on the CPP Investment Board, see CPP Investment Board (2007). However, since the Alberta Heritage Savings Trust Fund is derived from revenues associated with government royalties on oil and natural gas, it is included in the definition used here.

**TABLE 1**

**Overview of Major Sovereign Wealth Funds**

| SWF: Country and date of establishment | Official name                                  | Size US\$ billions (% GDP) | Official reserves US\$ billions (% GDP) | Truman score <sup>a</sup> |
|--|--|----------------------------|---|---------------------------|
| United Arab Emirates (1976)            | Abu Dhabi Investment Authority                 | 875 (324%)                 | 60 (22%)                                | 0.50                      |
| Singapore (1981)                       | Government of Singapore Investment Corporation | 330 (171%)                 | 177 (92%)                               | 2.25                      |
| Norway (1990)                          | Government Pension Fund—Global                 | 369 (77%)                  | 50 (10%)                                | 23.00                     |
| Kuwait (1953)                          | Kuwait Investment Authority                    | 264 (165%)                 | 14 (9%)                                 | 12.00                     |
| China (2007)                           | China Investment Corporation (CIC)             | 200 (5%)                   | 1,684 (40%)                             | -                         |
| Russia (2004)                          | Stabilization Fund of the Russian Federation   | 192 <sup>b</sup> (11%)     | 555 (31%)                               | 9.50                      |
| Singapore (1974)                       | Temasek Holdings                               | 130 (67%)                  | 177 (92%)                               | 13.50                     |
| Qatar (2005)                           | Qatar Investment Authority                     | 50 (43%)                   | 13 (11%)                                | 2.00                      |
| Korea (2005)                           | Korea Investment Corporation                   | 30 (3%)                    | 258 (27%)                               | 9.00                      |
| Canada (1976)                          | Alberta Heritage Savings Trust Fund            | 16                         | -                                       | 19.50                     |

a. Truman (2007) compiles a “scoreboard” of major SWFs, ranking them on transparency, governance, accountability, and other measures. The score is based on 25 yes/no questions. A score for the CIC is not available at this time.

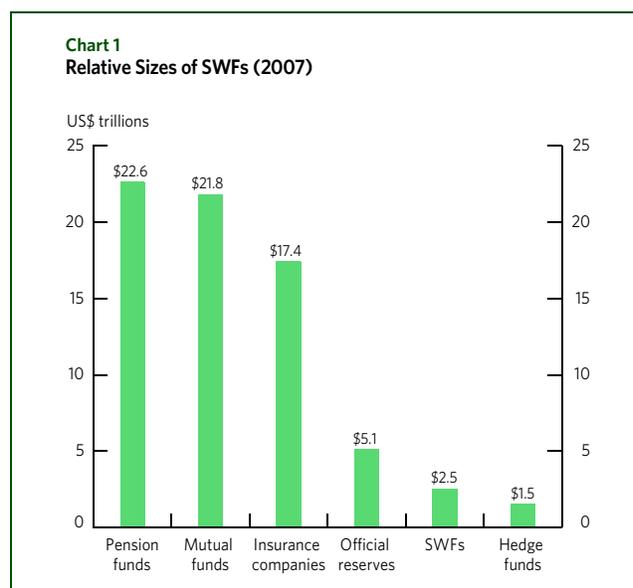
b. The Stabilization Fund was split into two separate funds in February 2008: the Reserve Fund and the National Prosperity Fund. This figure represents the sum of both funds.

Note: The figures cited here represent the most recently available data; sizes are approximate when not disclosed by authorities. GDP data are IMF estimates for 2008. Reserves data are for 2008Q2, except for China, which is 2008Q1.

Sources: Truman (2007), IMF International Financial Statistics, Ministry of Finance of the Russian Federation, Sovereign Wealth Fund Institute

Chart 1 shows that, while large in size, the assets under management of SWFs are still relatively modest compared with pension funds and mutual funds; they are, however, concentrated in the hands of a few players.

Despite incurring paper losses because of the financial crisis, the assets of SWFs are projected to grow markedly over the next decade or so. Jen and Andreopoulos (2008) estimate that SWFs could grow to as much as US\$9.7 trillion by 2015 and will exceed the world’s total holdings of official reserves in 2014. Kern (2007) estimates that, over the next decade, the asset allocations of SWF portfolios could lead to a gross capital inflow of over US\$3 trillion into global equity markets and US\$4.5 trillion into global debt markets.



## STABILIZING EFFECTS OF SWFs

SWFs can prove to be a stabilizing force in several ways. At the country level, they have allowed states to manage capital inflows, while addressing long-run structural issues, thus providing a basis for sustained economic growth in certain EMEs. At the international level, by virtue of their size and long-term investment strategies, SWFs can be liquidity providers and contrarian investors that support global markets in times of financial stress. These aspects are examined below.

### Managing capital inflows

SWFs can aid in the macroeconomic management of large current account surpluses. By transferring excess revenues into investment funds, states can alleviate inflationary pressures arising from capital inflows that place upward pressure on nominal exchange rates, thus reducing demand for exports and slowing growth. By investing capital inflows offshore, SWF states can maintain a stable exchange rate in the face of large shocks. However, offshoring capital inflows may become unsustainable or suboptimal, especially when perpetuated indefinitely.

### Addressing longer-horizon structural issues

Investing excess revenues strategically can provide SWF states with a means to address structural weaknesses in their economies. Savings funds facilitate intergenerational transfers, allowing future generations to benefit from current favourable economic conditions. Additionally, investing abroad allows SWF states to import knowledge and technical expertise to develop local industries and domestic infrastructure and provide a basis for sustained growth. As such, strategic investment can help SWF states reduce both macroeconomic and financial vulnerabilities that may lead to instability in the future.

### Investor profile: Large-scale, long-term investors

One commonly cited advantage of SWFs is that, given their large scale and long investment horizons, they are able to inject liquidity into global capital markets, thereby supplying capital to those who require it. SWFs have an explicit mandate of long-term investment and, thus, can withstand short-term fluctuations, allowing them to act as contrarian investors, investing in times of market distress. This function was clearly exhibited in 2007, when SWFs invested more than \$85 billion in financial institutions in developed economies, helping them to recapitalize after incurring substantial losses associated with the U.S. subprime-mortgage market. Moreover, since SWFs are not subject to specific capital requirements, they are less likely to liquidate rapidly when markets deteriorate, thus potentially contributing to financial stability.

Because traditional reserve managers seek to preserve the value of their holdings, reserve assets are typically safe, liquid investments offering low returns. SWFs, however, have a different objective: they aim to earn higher returns on their holdings by diversifying across currencies and asset classes. Most notably, this implies a high allocation towards equities. Depending on the size of the SWF (especially relative to official reserves), this can represent a significant shift and increase in investment earnings.

To secure higher returns, SWFs are effectively accepting a higher level of risk. By diversifying their foreign exchange earnings, SWFs aim to spread the risk in their portfolios across a variety of assets and currencies. Moreover, since SWFs represent an additional source of revenue for governments, this reduces their reliance on any one macroeconomic output (such as oil) at the margin.

## POTENTIAL RISKS TO INTERNATIONAL FINANCIAL STABILITY

While SWFs may provide benefits to the international financial system, they may also present several potential risks.

### Triggering "herding" behaviour

With SWFs, large sums of capital are concentrated in the hands of a limited number of major players that have a relatively high tolerance for risk, compared with traditional foreign exchange reserve managers, such as monetary authorities. In the absence of SWFs, these surpluses would be distributed among domestic citizens, who can be assumed to be distributed along a continuum of risk preferences.

The presence of such large players can induce herding behaviour that could lead to a negative outcome, thus reducing market efficiency. The size of the impact depends on the information content of the move and the signal being sent to the smaller traders (Corsetti et al. 2004).

While the possibility of SWFs inducing "herding" behaviour does exist, the risk that they would deliberately seek to destabilize or manipulate markets is minimal. SWFs are typically committed to diversifying their portfolios, rather than investing in one specific asset class.

### Lack of transparency, non-economic objectives, and financial protectionism

As Truman (2007) shows, SWFs run the gamut from full, open disclosure and high standards of governance (e.g., Alberta and Norway) to providing little to no information (e.g., the Gulf SWFs), which could raise short-term volatility in markets. In particular, transparency regarding investment objectives is

strikingly absent from many of the major SWFs. This has raised concerns in many policy-making circles that SWFs will be motivated by non-commercial objectives, and thus attempt to invest in sensitive industries that may compromise national and economic security.

Investing for strategic reasons could lead to price distortion if SWFs are willing to pay prices above market value for specific assets, thus undermining market efficiency. Another consideration is the response of states receiving SWF investments. While not a risk inherent to SWFs, some observers are concerned about a protectionist backlash against SWFs that would restrict cross-border investment and slow economic growth. The reaction of Western economies to SWF investment may lead to the adoption of barriers, preventing the free movement of capital. This policy response would not only affect SWFs but might also ensnare other institutional investors, such as national pension funds.

Virtually all countries already have legislation in place that protects national and economic security; additional measures may impede the efficient allocation and free flow of capital, undermining the advances made thus far in liberalizing capital flows.

## CONCLUSION

On balance, SWFs should contribute to stability in the international financial system by facilitating the efficient functioning of international financial markets. Although the risk of politically motivated actions does exist, and non-economic behaviour is always possible, global investment is a repeated game, and SWF states are vulnerable to retaliatory tactics, even if such behaviour leads to suboptimal outcomes.

The OECD and the IMF have encouraged both SWF states and recipient states to engage in open dialogue. The IMF in particular has provided a secretariat for the International Working Group of Sovereign Wealth Funds that have recently agreed on a voluntary set of guiding principles and practices for SWFs. The adoption of best practices and greater transparency regarding investment strategies and risk management would facilitate the efficient allocation of excess savings and encourage the flow of capital to where it is most needed, as well as alleviating any concerns about the non-commercial motivations. Ultimately, the prudent management of SWFs is in the best interests of SWF states. This is an opportunity for developing nations to acquire the financial and human capital required for institutional development and productivity gains, thus promoting domestic and global growth while contributing to the stability of financial markets.

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