Frequently Asked Questions

About

Sovereign Wealth Funds

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Billion is 1,000 million.
Trillion is 1,000 billion.
Dollars are US dollars unless otherwise specified.

Introduction

If you regularly read the international financial press, you must have come across numerous scare stories recently about how oil-rich, unaccountable and non-democratic regimes and their state-owned wealth funds are aggressively buying up large portions of world economy.

Across the Western world, politicians, business leaders and commentators are bemoaning the rapid rise of sovereign wealth funds (SWFs). Parliaments in Europe are introducing new regulations to curb the potential impact of SWFs on financial markets, corporate governance and security.

Much of the controversy on SWFs is centered on political questions. The Western policy makers fear that the operations of SWFs are largely influenced by strategic policy objectives rather than commercial interests. They suspect that investments by sovereign wealth funds are meant to secure control of strategically-important industries (such as telecommunications and energy) for political ends. These fears have sparked a heated debate within the developed world about the extent to which SWFs should be allowed to invest in national markets. A protectionist backlash against sovereign wealth funds is fast emerging in the developed world. Countries such as the US, Canada, Australia and Germany have recently introduced substantial legislative changes in order to screen and restrict investments by SWFs and other state-owned entities.

In particular, the paranoia is centered on the multi-billion dollar investments in international banks by leading SWFs from Asia, particularly from the Middle East and China, in the wake of credit crisis which began in mid-2007. "Have we handed over the keys of critical financial institutions to China and oil-rich Middle Eastern countries? Will this come back to bite us at some point in time?,"[1] asked an unnamed banker in Citigroup. Another US-based observer remarked that "We're moving to a sharecropper economy…the other guys (SWFs) are going to be owning, and we're going to be working for them."[2]

In November 2007, *The Wall Street Journal* wrote an editorial titled, "Citi of Arabia,"[3] lamenting investments by Abu Dhabi Investment Authority (ADIA) in Citigroup. In January 2008, *The Economist* ran a provocative cover story titled, "the invasion of the sovereign wealth funds."[4]

Are such fears based on facts or assumptions? Is the "invasion" of sovereign wealth funds real? Do SWFs pose a direct threat to financial stability? Do they have hidden agendas? Are SWFs driven by political considerations? Are governments really using SWFs to pursue nefarious foreign policy objectives? Should anyone fear about sovereign wealth funds?

On the other hand, the SWFs view them as saviors providing long-term investments and stability to ailing businesses and economies.

Irrespective of the view one holds, one thing is certain: sovereign wealth funds, as an investor class, are here to stay over the long haul. Therefore, it becomes imperative to understand the potential impact and implications of such funds in the rapidly changing environment of global political economy.

Unfortunately, the ongoing debate on sovereign wealth funds has shed more heat than light. This paper is an attempt to examine several questions surrounding the activities of SWFs.

What is a Sovereign Wealth Fund?

Despite becoming buzzwords, there is no single universally accepted definition of a sovereign wealth fund. The term, sovereign wealth fund, was first coined in 2005 by Andrew Rozanov[5] of State Street Global Advisors, the fund management arm of the US custody bank, State Street Corporation. He had characterized SWFs as separate funds which are created from foreign exchange reserves to meet specific purposes.

Subsequently this term has been used by different people to define different kinds of sovereign funds. From International Monetary Fund (IMF) to Morgan Stanley to Peterson Institute for International Economics, everyone defines SWFs in their own way. Indeed, there are more definitions of sovereign wealth fund than their actual numbers.

In simple terms, sovereign wealth funds are large pools of assets and investment funds owned and managed (directly or indirectly) by governments. They may be funded by foreign exchange reserves, commodity exports, the proceeds of privatizations and fiscal surpluses. The SWFs manage foreign exchange assets separately from official reserves.

To a large extent, SWFs are set up to diversify and improve the return on foreign exchange reserves or commodity revenue, besides protecting the domestic economy from fluctuations in international commodity prices.

Typically, sovereign wealth funds have the following six main characteristics:

- SWFs are state-owned funds;
- SWFs are managed separately from official foreign exchange reserves;
- SWFs have high foreign currency exposure;
- Unlike pension funds, SWFs have no explicit liabilities;
- SWFs have high-risk tolerance; and
- SWFs have long-term investment horizons.

However, it would be erroneous to consider SWFs as a homogeneous entity because their key characteristics (such as sources of funds, governance structures, operations, investment patterns and policy objectives) are hugely divergent. Across the world, SWFs follow different legal and institutional structures. For instance, many SWFs are not legally separate from their respective governments or central banks (such as Norway's Government Pension Fund) but some have a separate legal entity (such as Korea Investment Corporation). On the other hand, Temasek Holdings of Singapore has been established as a private corporation governed by country's company law. Therefore any blanket generalization about SWFs and their practices should be made with caution.

What are the Main Types of SWFs?

Since SWFs are a heterogeneous group and their policy objectives and investment strategies keep changing over time, they could be broadly divided into three main types on the basis of their purpose:

1. Stabilization Funds: These funds are usually set up by countries rich in natural resources to provide budgetary support as well as to insulate the national economy from volatile international commodity prices. These funds are commonly set up during the boom times and drawn upon when the commodity prices are lower or there is a shortage of reserves. The Reserve Fund of Russia is an example of stabilization funds.

2. Savings Funds: These funds are set up by governments for longer term wealth creation to meet future needs. The sources of these funds are commodity based or fiscal. For commodity exporting countries, savings funds help in transferring non-renewable assets (such as oil) into financial assets, thereby preserving the country's wealth for future generations. One prominent example of savings funds is Alaska Permanent Fund of US.

3. Pension Reserve Funds (PRFs): These funds are set up with a specific mandate to finance future public pension expenditures. Owned directly by the government, the pension reserve funds are often treated as SWFs. The PRFs substantially invest abroad in a wide range of assets. Some PRFs are not allowed to make any payouts for decades. Some prominent examples of PRFs include Norway's Government Pension Fund-Global, the Australian Future Fund, the New Zealand Superannuation Fund and the Irish National Pension Reserve Fund.

In addition, some governments have created wholly-owned development funds for supporting developmental projects, such as infrastructure, primarily at the national and regional level. These funds support the development policy objectives of their respective governments. Examples include Temasek Holdings of Singapore, Khazanah Nasional Berhad of Malaysia and National Development Fund of Venezuela.

The differences between SWFs and many other types of public funds are not very clear. For instance, it is not east to differentiate SWFs from public pension funds such as Netherland's Stichting Pension Fund (ABP) and US's California Public Employees' Retirement System (CalPERS) given many similarities among them.

Some analysts have argued that other types of state-owned or managed investment funds such as government-employee pension funds (e.g., Japan‘s Government Pension Investment Fund), social security funds (e.g., US's Social Security Trust Fund), state-owned companies (e.g., Russia's Lukoil) and state-owned development banks (e.g., China Development Bank) should also be considered as sovereign wealth funds. True, there are several common characteristics between SWFs and these entities. One major common element among them is their state ownership and control. But there are significant differences too. For instance, most public pension funds are usually denominated and funded in local currency. Similarly, majority of state-owned companies do not substantially invest aboard. Though some Asian companies have recently started investments in foreign markets.

In this paper, however, we are not discussing other types of state-owned entities as they are usually dealt separately in financial literature and policy circles.

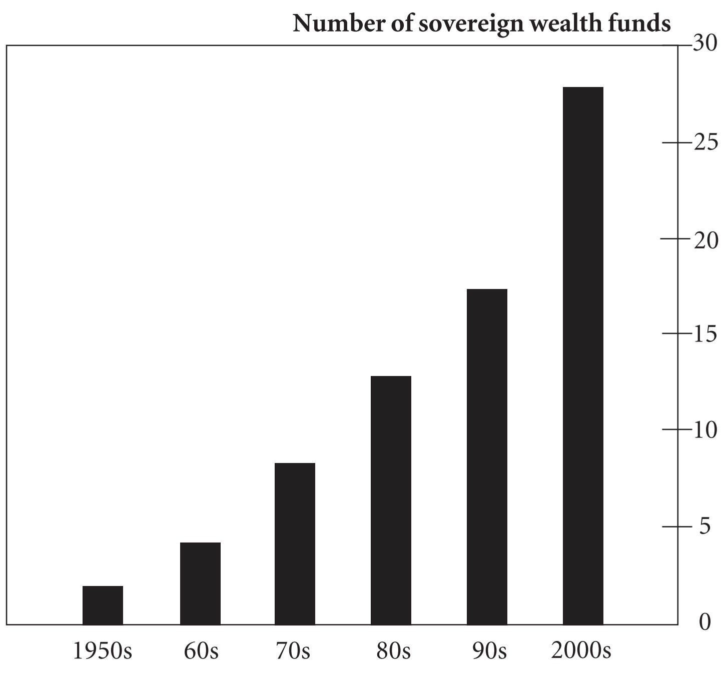
Are SWFs a New Phenomenon?

No. The SWFs have been around for decades. Some may claim that the first sovereign wealth fund in the world, Caisse des Dépots et Consignations, was created by France in 1816.

In the post-war period, the first wave of SWFs began in the early 1950s. In particular, the British colonial administration took the lead in setting up SWFs in its colonies. Kuwait established its SWF in 1953 when it was still a British territory. The Kuwait Investment Board, which later on became the Kuwait Investment Authority, was set up by British administration to invest country's oil profits for purposes of intra-generational wealth transfer.

In 1956, the Kiribati Revenue Equalization Reserve Fund was established by the British colonial administration to manage revenues from the export of Phosphate deposits. At that time, the phosphate export revenues accounted for almost 50 per cent of the government revenue. The objective of Revenue Equalization Reserve Fund was long-term income generation and inter-generational wealth transfer. Over the years, several other sources have contributed to the financing of the Fund. The Fund has currently assets worth more than $500 million, almost nine times greater than country's GDP. Income from the Fund has been used by the Kiribati Government for budgetary expenditure since independence in 1979.

Chart 1: Number of Sovereign Wealth Funds Since the 1950s



Source: Deutsche Bank and Morgan Stanley.

The next wave came in the 1970s and 1980s when a number of oil-producing countries established SWFs (mainly stabilization funds) as a means to accumulate current account and budget surpluses during the oil boom. The Abu Dhabi Investment Authority, the largest SWF in the world, was formed in 1976, the Brunei Investment Agency in 1983, while Singapore's two large funds, Temasek Holdings and the Government Investment Corporation (GIC), were set up in 1974 and 1981 respectively. The Norway's Government Pension Fund - Global was set up in 1990.

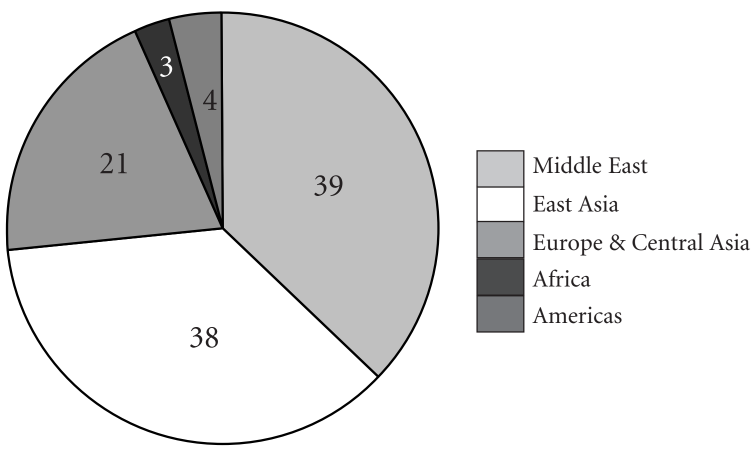
For years, SWFs have carried out international investments without much controversy and political backlash in the host countries. Perhaps the only exception was the acquisition of 22 per cent stake in the British Petroleum (BP) by Kuwaiti SWF in 1988. This led to the review by the U.K. Monopoly and Mergers Commission which decided that the Kuwaiti SWF would exercise considerable influence over BP. Following the Commission's decision, the Kuwaiti SWF reduced its stake to 9.9 percent.

Throughout the 1990s, there was hardly any political controversy surrounding the investments by the SWFs.

It is only recently that SWFs have attracted much public attention. What is particularly new about SWFs is their growing numbers, asset size and projected growth. In particular, SWFs investments in the US and Swiss banks in the aftermath of sub-prime mortgage crisis of 2007 brought them into the limelight.

Since 2005, more than 10 new SWFs have been established. A number of countries have set up sovereign funds in the light of record commodity prices and rapid accumulation of foreign reserves. South Korea launched its SWF in 2005 with $20 billion in assets. Australia's Future Fund was established in 2006, China's CIC was established in 2007 and Russia's National Wealth Fund in 2008. Many developing countries including Bolivia, Brazil, India and Thailand have also expressed their interest in setting up a SWF in the near future.

Chart 2: Geographical Distribution of Sovereign Wealth Funds



Source: JPMorgan Research, 2008.

Do SWFs Belong Exclusively to the Developing World?

Not really. Though some of world's largest sovereign funds originate from the developing countries but a number of developed countries have also set up sovereign wealth funds to serve their myriad policy objectives. The US-based Alaska Permanent Fund was established way back in 1976 to reinvest oil profits. Though smaller in size, SWFs are also owned by the states of New Mexico, Wyoming and Alabama. Some other examples of SWFs belonging to the developed world include Norway's Government Pension Funds – Global, Canada's Alberta Heritage Fund and Australia's Future Fund. Together, such SWFs manage assets close to $600 (almost 20 per cent of the total assets) and invest heavily abroad.

If one considers a wider definition of SWFs and thereby include government-employee pension funds (e.g., Japan's Government Pension Investment Fund) and social security funds (e.g., US's Social Security Trust Fund), then the universe of the SWFs would be dominated by the developed world.

Interestingly, the SWFs belonging to the developed world are growing rapidly. The Future Fund of Australia is a case in point. Its assets grew from $14 billion in 2006 to $49 billion as of February 2008.

It is important to note that many SWFs belonging to the developing world have made London and New York as a base for their international operations. A number of large SWFs such as Abu Dhabi Investment Authority, Kuwait Investment Office, Brunei Investment Authority and Temasek of Singapore have set up their representative offices in London. Dubai's Istithmar World Capital has opened an office in New York.

In addition, many developing countries SWFs regularly hire US and UK-based management firms, investment banks and advisers for risk management and managerial skills. For instance, the Korea Investment Corporation (KIC) has outsourced nearly three-fourths of its $20 billion investment portfolio to external fund management firms, mostly from the developed world.

How Big are SWFs?

Estimating the true size of the world's SWFs is not an easy task due to their myriad definitions and limited public disclosures. In certain instances, there could be double counting as some sovereign funds are recorded in official foreign reserves.

Most private and official sources estimate that SWFs across the world currently manage assets around $3 trillion, almost half of the world's foreign exchange reserves at $6 trillion. In 1990, they managed an estimated US$500 billion.

At present, there are more than 50 recognized SWFs in operation.

According to JP Morgan Research, 39 per cent of sovereign wealth funds are located in the Middle East. While East Asia accounts for 38 per cent (*See* Chart 2).

Table 1: List of SWFs and Estimated Value of Assets under Management

Region	Fund Name	Assets ($ bn)
North America and Canada	Alaska Permanent Fund (US – Alaska)	39.8
	Alberta Heritage Fund (Canada)	16.6
	New Mexico State Investment Office Trust (US – New Mexico)	16
	Permanent Wyoming Mineral Trust Fund (US – Wyoming)	3.7
	Alabama Trust Fund (US – Alabama)	3.1
South and Central America	National Development Fund (Venezuela)	17.5
	Social and Economic Stabilisation Fund (Chile)	15.5
	Oil Income Stabilisation Fund (Mexico)	6.2
	Pension Reserve Fund (Chile)	1.4
	FIEM (Venezuela)	0.80
	Macroeconomic Stabilisation Fund (Venezuela)	0.79
Western and Central Europe	Government Pension Fund – Global (Norway)	396.5
	Reserve Fund (Russia)	162.5
	National Welfare Fund (Russia)	125
	National Pensions Reserve Fund (Ireland)	30.8
	State Oil Fund (Azerbaijan)	3.3
Middle East	Abu Dhabi Investment Council (Abu Dhabi)	875
	SAMA Foreign Holdings (Saudi Arabia)	300
	Kuwait Investment Authority (Kuwait)	250
	Qatar Investment Authority (Qatar)	60
	Brunei Investment Agency (Brunei)	30
	Kazakhstan National Fund (Kazakhstan)	21.5
	Dubai International Capital (Dubai)	13
	Oil Stabilisation Fund (Iran)	12.9
	Istithmar World (Dubai)	12
	Mubadala Development Company (Abu Dhabi)	10
	Mumtalakat Holding Company (Bahrain)	10
	Public Investment Fund (Saudi Arabia)	5.3
	State General Reserve Fund (Oman)	2.0
	RAK Investment Authority (UAE – Ras Al Khaimah)	1.2
	Palestine Investment Fund (Palestine)	0.89
	Investment Corporation of Dubai (Dubai)	N. A.
	Emirates Investment Authority (UAE – Federal)	N. A.

(Cont...)

Far East and Australasia	Government of Singapore Investment Corporation (Singapore)	330
	SAFE Investment Corporation (China)	311.6
	China Investment Corporation (China)	200
	Hong Kong Monetary Authority Investment Portfolio (China – Hong Kong)	163
	Temasek Holdings (Singapore)	159
	Australian Future Fund (Australia)	58.5
	Korea Investment Corporation (South Korea)	30
	Khazanah National Berhad (Malaysia)	25.7
	National Stabilisation Fund (Taiwan)	15
	New Zealand Superannuation Fund (New Zealand)	13.8
	Timor-Leste Petroleum Fund (East Timor)	3.0
	State Capital Investment Corporation (Vietnam)	2.1
	Revenue Stabilisation Fund (Kiribati)	0.4
Africa	Libyan Arab Foreign Investment Company (Libya)	50
	Revenue Regulation Fund (Algeria)	47
	Libyan Investment Authority (Libya)	40
	Excess Crude Account (Nigeria)	11
	Poverty Action Fund (Uganda)	0.35
	National Fund for Hydrocarbon Reserves (Mauritania)	0.3
	Reserve Fund for Oil (Angola)	0.2
	National Oil Account (Sao Tome)	0.02
Caribbean	Heritage and Stabilisation Fund (Trinidad & Tobago)	0.5
	Revenue Stabilisation Fund (Trinidad & Tobago)	0.5

N. A. = Not Available.

Source: Compiled from media and industry reports.

Much of their recent growth is attributed to rapid increase in official foreign exchange reserves of Asian countries and rising revenue from oil exporting countries. Market analysts estimate that assets of SWFs grew 18 percent in 2007. Though commodity funds (based on mainly oil exports) still controls the bulk of global assets but their share is declining over the years due to rapid growth of non-commodity SWFs from the Asian region.

The largest funds belong to the Middle East, Norway, Singapore, China and Russia. Six Gulf States – Abu Dhabi, Dubai, Kuwait, Oman, Qatar and Saudi Arabia – account for nearly half of the world's sovereign wealth fund assets. The Middle East and East Asian countries together account for more than three quarters of all SWF assets.

Some of the biggest sovereign wealth funds are Abu Dhabi Investment Authority ($875 billion), Norway's Government Pension Fund – Global ($390 billion), Singapore's Government Investment Corporation ($330 billion) and Saudi Arabia's various holdings which together manage $300 billion. China launched its SWF, China Investment Corporation, in 2007 with $200 billion in its kitty. Russia's National Welfare Fund, established in 2008, currently has over $125 billion in assets. Table 1 provides a list of leading SWFs with estimates of total assets under management.

The assets managed by SWFs are highly concentrated. The top ten funds account for about 80 per cent of all SWF assets. The world's largest SWF, Abu Dhabi Investment Authority, alone accounts for about 27 per cent of total SWF assets (*See* Table 2). Further, approximately two-thirds of all SWF assets are held by commodity exporting countries.

In the aftermath of global credit crisis, SWFs are estimated to have invested over $60 billion in return for minority stakes in the US and Swiss banks. Much of this investment came from Asian and Middle Eastern SWFs. In particular, GIC and Temasek Holdings of Singapore invested over $25 billion in distressed US and Swiss banks.

Isn't $3 Trillion a Lot of Money?

Well, it depends on how you look at it. Certainly, it is a lot of money if one compares asset size of SWFs with the gross domestic product (GDP) of poor countries such as Rwanda and Bangladesh. But placing SWFs with other international funds and financial institutions, one gets a completely different perspective.

In totality, SWFs are relatively small players in the international financial markets. Here are some statistics. According to the IMF, the global financial assets were $190 trillion in 2006.[6] It means that SWFs are less than 2 per cent of global financial assets. In comparison with other funds, sovereign wealth funds are less than 5 per cent of the combined assets of private pension, insurance and mutual funds (*See* Table 3).

In May 2008, the total market capitalization of all publicly traded companies in the world was $57 trillion. In this respect, $3 trillion is not much. In contrast to the GDP of US at $12 trillion, assets managed by SWFs may appear significant but not spectacular.

Table 2: SWFs Market Share by Country, 2007 (in %)

United Arab Emirates	27
Singapore	15
Norway	12
China	11
Saudi Arabia	10
Kuwait	8
Russia	5
Others	13
Total	**100**

Source: Estimates by SWF Institute and IFSL.

The largest SWF in the world, ADIA, is no match to US-based mutual fund, Fidelity Investments, which manages $1.5 trillion in mutual funds and another $1.9 trillion in brokerage assets.

No denying that SWFs own more assets than hedge funds and private equity combined (*See* Table 3). But such comparison misses an important point that both hedge funds and private equity are heavily leveraged[7] institutions. If one includes leverage, the hedge fund industry's gross investments in the financial markets could be as high as $6 trillion.[8] In the case of private equity funds, their actual financial prowess would be significantly higher due to excessive reliance on leverage.

The IMF has projected that the assets managed by SWFs could reach up to $10 trillion by 2013.[9] More aggressive estimates have put the figure at about $12 trillion.[10] However, such optimistic scenarios would be dependent on a number of factors including high oil and commodity prices, rapid increase in foreign exchange (forex) reserves, sustained growth of world economy and adequate returns earned by SWFs on their investments. Even if one accepts such optimistic projections, SWFs, at best, could reach only 4 to 5 per cent of world financial assets by 2012. Therefore, any assumption that sovereign funds would become the dominant players in the world financial markets in the coming years is off the mark.

What are the Main Sources of Funds of SWFs?

Commodity-based SWFs are funded predominantly from oil and gas exports. Some funds are also based on revenues generated from metals and minerals (e.g., Chile's Social and Economic Stabilization Fund). Of the world's top 20 sovereign wealth funds, 14 are funded from commodity revenues. The commodity revenues are generated through a variety of sources including profits made by state-owned companies, commodity taxes and export duties.

Non-commodity SWFs are funded by transfer of assets from official foreign exchange reserves. In certain cases, funds are based on fiscal surpluses, proceeds from privatization and direct transfers from the state budgetary resources.

It is important to note that SWFs are one of many investment vehicles to deploy surplus foreign exchange reserves earned from above-mentioned sources. To a large extent, SWFs act as recyclers of surplus funds just like Western banks recycled petrodollars in the 1970s and 80s.

Table 3: The Size of SWFs and other Funds

Assets under Management ($ trillion, 2007)

Pension Funds	28.0
Mutual Funds	24.6
Insurance Funds	18.5
Sovereign Wealth Funds	3.0
Hedge Funds	2.1
Private Equity Funds	0.8

Source: Complied from various reports.

In many respects, the SWFs cannot be differentiated from central banks which also deploy surplus forex reserves. However, one major factor which distinguishes SWFs from central banks is their investment pattern. Since SWFs are set up to diversify investments, they undertake long-term investments and that too in illiquid and risky assets. Whereas central banks typically undertake short-term investments in low-yielding liquid assets such as government securities and money market instruments.

What is the Rationale behind Setting up SWFs?

As noted above, sovereign wealth funds are essentially set up to manage surplus foreign exchange reserves and revenues.

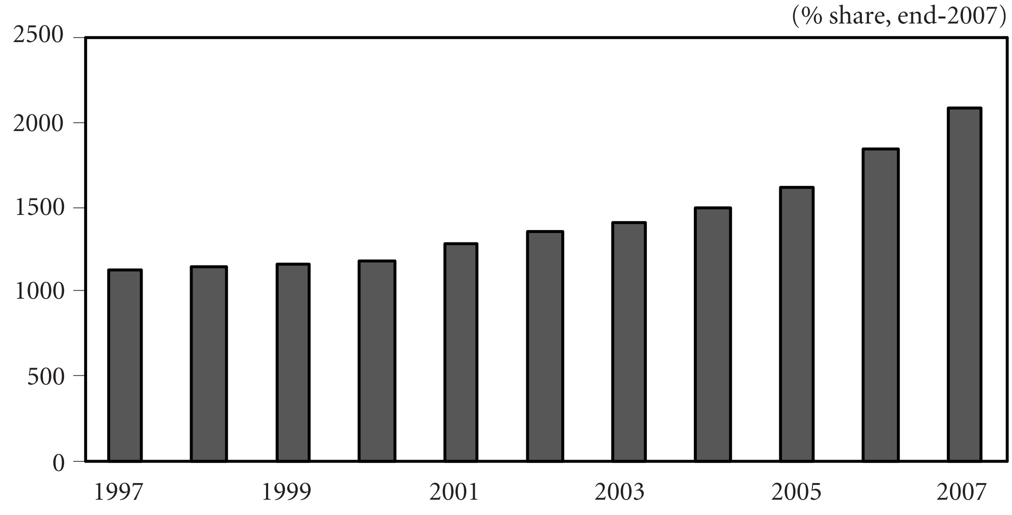
The recent increase in the number of SWFs is the reflection of large accumulation of foreign exchange reserves, mostly by the developing countries. According to the IMF statistics, global forex reserves tripled from $2.1 trillion to $6.2 trillion between 2001 and 2007. The developing countries accounted for more than 80 per cent of global reserve accumulation during this period. Several countries, particularly in East Asia, are accumulating forex reserves more rapidly. Asia controls nearly two-thirds of world's forex reserves, compared to mere 5 per cent by Euro area.

China is the world's largest and fastest growing holder of foreign exchange reserves (*See* Table 4). China's foreign exchange reserves are expected to reach $2 trillion by the end of 2008. China's huge reserves reflect its current account surpluses based on higher exports.

Why developing countries are accumulating higher forex reserves? There are several motives. The biggest motive is to protect economy from sudden flight of capital. The Southeast Asian financial crisis of 1997 strengthened the thinking that developing countries need to build up higher official foreign exchange reserves to protect from volatile capital flows. In particular, Thailand and Indonesia experienced severe financial crisis as they had meager reserves to fight speculative attacks on their currencies. In order to prevent reoccurrence of Asian financial crisis,

Chart 3: Oil Exporting Countries' Assets in SWFs

(% share, end-2007)



Source: IFSL estimates, McKinsey & Company.

many central banks (within and outside Asia) started accumulating higher reserves. In fact, higher reserves became the policy response to meet the challenges posed by financial liberalization. Some developing countries also built up large stocks of reserves to dispel the fears of foreign investors.

Additionally, the negative fallout of IMF-supported bailout programs with strict conditionalities in crisis-hit Asian countries also dissuaded the developing world to seek out IMF and other international financing in an event of a financial crisis. Instead, each country preferred to build up higher levels of forex reserves as a part of "self-insurance" policy against financial crises. This trend has been more visible in the Asian countries which are particularly vulnerable to external shocks.

However, several Asian countries have accumulated more reserves than needed to protect their domestic economy from trade shocks and volatile capital flows. As per IMF guidelines, the forex reserves of a country should be sufficient to meet 3-4 months of its imports. The Greenspan-Guidotti rule states that the forex reserves of a country should be no less than the short-term debt of the country. In many Asian countries, foreign exchange reserve levels far exceed these conventional indicators.

However, large forex reserves also pose new challenges and risks. They put pressure on its exchange rate thereby negatively affecting the competitiveness of exports and other sectors. Excessive reserves could induce asset price bubbles and higher inflation. There are fiscal costs as well. The authorities also lose control of monetary policy.

Since central banks typically undertake short-term investments in low-yielding liquid assets such as US treasury bills and bonds, the financial returns on such money market instruments are meager. According to Deutsche Bank Research, the real return on such money market instruments has been approximately 1 per cent in the past 60 years.[11] In contrast, the equivalent real return on a diversified portfolio of 60 per cent stocks and 40 per cent bonds is almost 6 per cent.[12]

Table 4: Largest Holders of Foreign Exchange Reserves

Rank	Country/ Monetary Authority	Forex Reserves ($ bn)	Figures (as of)
1	Mainland China	1905	September 2008
2	Japan	995	September 2008
3	Russia	546	October 2008
	Eurozone	563	March 2008
4	India	283	October 2008
5	Taiwan	281	September 2008
6	South Korea	239	September 2008
7	Brazil	205	October 2008
8	Singapore	172	August 2008
9	Hong Kong	153	August 2008
10	Algeria	149	September 2008

Source: Wikipedia, 2008.

Of late, the sharp depreciation of the US dollar vis-à-vis other major currencies has made investment in dollar-denominated money market instruments further unattractive. Hence, state authorities and central banks are seeking out alternative investment opportunities. The sovereign wealth funds become the natural choice for diversifying investments and maximizing returns over the long run. By establishing SWFs, countries can also preserve the wealth for future generations.

From the perspective of commodity exporting countries, SWFs act as a buffer against volatile commodity prices. Since oil, gas, copper and other commodities are non-renewable and finite, commodity exporters also view SWFs as a means to transfer non-renewable assets into financial assets, thereby preserving the country's wealth for future generations.

The oil price boom in the early 1970s encouraged many oil-exporting countries to increase public expenditures but they faced a painful adjustment when the oil prices plummeted in the early 1980s. This boom and bust experience has induced many commodity exporters (such as Russia) to establish stabilization funds by saving a share of the gains made during the boom periods.

In fact, international financial institutions (particularly IMF) have encouraged commodity exporters to set up stabilization funds to stabilize volatile commodity revenues rather than fueling domestic investment and consumption bubbles.

The massive global imbalances in trade have also played an important role.[13] China, Japan, South Korea, Singapore and Hong Kong have been running persistent trade surpluses on account of rapidly growing exports for many years.

Table 5: Examples of SWF Sources and Purposes

Purposes/Sources	Commodity Revenues	Fiscal Sources	Foreign Reserves
Revenue stabilization	Russia: Reserve Fund Kuwait: Reserve Fund Mexico: Oil Stabilization Fund		
Future generations / public pensions	Russia: National Welfare Fund Norway: Government Pension Fund - Global	Australia: Future Fund New Zealand: Super Fund	
Management of government holdings	Mubadala	Singapore: Temasek Malaysia: Khazanah	China: Bank holdings managed by CIC
Wealth or risk/return optimization	Abu Dhabi Investment Authority (ADIA) Qatar Investment Authority (QIA)	Singapore: Government Investment Corporation (GIC)	Singapore: Foreign reserves managed by GIC Korea: Foreign reserves managed by KIC China: Foreign reserves managed by CIC

Source: JPMorgan, 2008.

On the other hand, a number of countries are running large current account deficits. This includes the US, UK, Italy and most countries of Eastern Europe. The trade deficit of the US was $711 billion in 2007. This huge deficit implies that the US effectively borrows almost $2 billion each day to finance its deficits. The US economy also relies heavily on foreign investment to finance its deficit budget spending.

Japan, China and oil-exporting countries are financing the US deficits by buying treasury securities, agency bonds and corporate debt and equity instruments. In 2006, Japan was the largest holder of long-term treasury securities ($644 billion), followed by China with $350 billion.

In the absence of any international policy coordination, massive current account imbalances are likely to persist in the coming years.

Box 1

Abu Dhabi Investment Authority (UAE)

Constituted in 1976, the Abu Dhabi Investment Authority (ADIA) is the largest sovereign wealth fund in the world with an estimated $875 billion in assets. The ADIA is wholly-owned by the Abu Dhabi Government, the largest and richest member of the oil-rich United Arab Emirates (UAE). Each Emirate has sovereign rights over its natural resources. The President of UAE, Sheikh Khalifa Bin Zayed Al Nahyan, chairs the ADIA. The ADIA is managed by a Board of Directors appointed by the President. The main sources of funds of ADIA are oil exports. The investments are managed by both internal and external managers.

The ADIA is the second most important institution in Abu Dhabi's economy next to the Supreme Petroleum Council (SPC). The current UAE oil minister and key officials in various ministries in Abu Dhabi have come from ADIA. The ADIA operates under the Abu Dhabi Investment Council which also owns a number of state owned firms. The Abu Dhabi Investment Corporation (ADIC) is the executive arm of ADIA. The ADIA created the International Petroleum Investment Company (IPIC) of Abu Dhabi in 1984 to invest in energy sector. The IPIC is an important player in the international oil markets and has made large-scale investments in East Asia, Europe and North Africa.

Throughout its history, the Authority has never disclosed its exact asset size, investment portfolio and returns. Until 2006, investments by ADIA were exclusively in foreign assets. Nowadays, ADIA invest both within and outside Abu Dhabi. Apart from international investments, ADIA is the largest shareholder in two of UAE's largest banks, National Bank of Abu Dhabi and Abu Dhabi Commercial Bank.

Traditionally, much of its investments were in equities and fixed income instruments. The market sources believe that ADIA currently invests in a diverse range of assets including equities, fixed income, real estate, hedge funds and private equity. In recent years, however, its investment portfolio has shifted towards real estate and financial sectors. The market sources estimate that ADIA invests 60 per cent of its funds in equities, 25 per cent in fixed income and the rest 15 per cent in alternative assets.

The ADIA came into news recently when it purchased large-scale stakes in the ailing Citigroup and Apollo Management (a US-based private equity firm). In May 2007, ADIA acquired 8 per cent stake in EFG-Hermes, an Egyptian investment bank. The ADIA also maintains close ties with state-owned Mubadala Development Corporation which bought a stake in Carlyle (the US-based private equity firm), Ferrari (the Italian carmaker) and Advanced Micro Devices (the US-based chip maker) in 2007.

Should India Establish a Sovereign Wealth Fund?

Ever since India's foreign exchange reserves reached over $200 billion, a debate has begun in the official circles on how to deal with this embarrassment of riches. One much-talked policy proposal is to set up an Indian SWF.

This proposal has received strong backing of the powerful Prime Minister's Council on Trade and Industry which consists of leading Indian industrialist. In its meeting held on December 18, 2007, the Council suggested setting up setting up of a sovereign wealth fund of $5 billion to "begin with for financing acquisition of companies abroad."

With foreign exchange reserves at $310 billion in March 2008, the proponents argue that a SWF would help in maximizing higher returns as in the case of other Asian countries.

However, it would be erroneous to equate India with other Asian countries which are rapidly accumulating forex reserves on account of higher oil prices and current account surpluses. Unlike East Asian countries such as China and Singapore, India has been running persistent current account deficits barring a small surplus for a few years. India's current account deficit touched $17 billion in 2007-08 as against $9.8 billion in 2006-07 largely due to higher oil import bill. The merchandise trade deficit increased from $63 billion in 2006-07 to $90 billion in 2007-08, more than 7 per cent of the GDP.

It is important to note that the country's current account deficit is widening despite steady growth in software services exports and substantial rise in workers' remittances from overseas Indians. India's persistent current account deficits have been financed by large capital inflows.

Unlike Middle East countries which have established SWFs on strong commodity exports, India does not have any dominant exportable commodity (oil or gas) that can generate significant surpluses. India remains a huge net importer of oil and gas. India's oil imports climbed up 40 per cent from $48 billion in 2006-07 to $68 billion in 2007-08.

For decades, India has remained vulnerable to shocks on account of surge in oil and food prices. Besides, India also runs a perennial fiscal deficit.

The ongoing credit crisis in the US has led to fall in India's foreign exchange reserves from $ 310 billion in March 2008 to $271 billion in September 2008.

Much of India's foreign exchange reserves have been accumulated through large capital inflows in the form of portfolio investments and other short-term flows that are prone to capital flight. In 2007-08, net inflow under capital account was $ 109 billion against $46 billion in 2006-07, largely due to surge in portfolio investments, commercial borrowings and short-term debt.

True, the foreign direct investment (FDI) component of capital inflows has increased in recent years. But a substantial part of FDI flows is related to acquisitions of domestic firms, rather than greenfield investments.

Additionally, India also has a negative international investment position (IIP) with liabilities far exceeding assets. According to the official statistics, as on March 2007, India's international investment position showed a net liability at $45 billion with assets at $243 billion and liabilities at $288 billion.

As far country's external debt is concerned, it has been rising steadily for the past few years on account of higher borrowings by the Indian companies and short term credit. The external debt reached $221 billion in March 2008, as compared to $169 billion in March 2007.

Given the overwhelming presence of volatile capital flows in the foreign exchange reserves, it would be erroneous to consider country's foreign exchange reserves as a position of strength. Hence, any policy move towards establishing an Indian SWF should proceed cautiously.

Nevertheless, a portion of country's reserves could be prudently used in the improvement of infrastructure, education and health services particularly in rural India rather than financing "acquisition of companies abroad."

Table 6: Investment Patterns of Sovereign Wealth Funds

Fund	Foreign Investment	Equity Investment
Abu Dhabi Investment Authority	high	high
Government Pension Fund - Global	high	medium
SAMA	high	low
Kuwait Investment Authority	high	high
Investment Corporation of Dubai	high	high
Qatar Investment Authority	high	high
Libya Investment Authority	high	high
Brunei Investment Agency	high	high
Government Pension Fund - (Norway)	low	medium
Future Generations Fund	high	high
National Oil Fund	high	low
Khazanah Nasional Berhad (Malaysia)	low	high
China Investment Corporation	high	high
Government Investment Company (Singapore)	high	high
Temasek Holdings (Singapore)	medium	high
Korea Investment Corporation	high	high
National Stabilisation Fund	low	high
Government Future Fund (Australia)	medium	medium
Alaska Permanent Fund (US)	medium	medium
Alberta Heritage Fund (Canada)	medium	medium

Notes: Figures are only rough approximations. "High" and "low" refer to shares above two-thirds and below one-third respectively.

Source: European Central Bank, 2008.

What are the Investment Patterns and Strategies of SWFs?

Despite limited information, several broad trends about the investments of SWFs have been observed. First, SWFs undertake substantial investments across the borders though some funds (e.g., Temasek Holdings and Khazanah) predominantly invest in their domestic market.

Second, the overwhelming majority of sovereign funds are passive investors. In rare cases where SWFs undertake direct investments, they do not seek controlling interests or active roles in the management of invested companies. Even the large-scale direct investments made by SWFs in the US and European banks during 2007-08 are minor in ownership with no special rights or board representation. Some funds such as Norway's Government Pension Fund (GPF) deliberately seek a small ownership stake in companies in order to diversify investment portfolio. Though the GPF has invested in more than 7000 companies globally but its stakes are small. The average ownership stake is less than 1 per cent. The Fund deliberately does not invest more than 10 per cent in each company to underscore its role as a financial investor.

The FDI component of the total investments made by SWFs is very minimal. According to the UNCTAD, FDI by SWFs was merely $10 billion in 2007, accounting for a mere 0.2 per cent of their total assets and only 0.6 per cent of total global FDI flows.[14] In contrast, FDI by private equity funds, which are considered smaller in asset size than SWFs, reached $460 billion in 2007.[15]

Third, unlike hedge funds and private equity funds, SWFs typically are not highly leveraged institutions.

Fourth, the bulk of investments made by SWFs are currently concentrated in the developed countries. However, developing countries (particularly in Asia) are becoming the new investment destination of SWFs.

Fifth, since SWFs have no explicit liabilities, they usually have a long-term investment horizon coupled with a higher risk tolerance. The share of risky assets in sovereign wealth funds' portfolios is increasing over the years. In particular, savings funds tend to invest in illiquid and higher-yielding risky instruments.

Sixth, SWFs are gradually moving towards a more diversified investment portfolio. At present, the biggest share of SWF assets are invested in fixed income instruments such as government and agency bonds. Several SWFs have decided to increase their allocation to equities and alternative assets. However, the shift in the asset allocation would not happen overnight. For instance, Norway's Government Pension Fund-Global has decided to increase its equity allocation from currently 40 per cent to 60 per cent by 2010. It has also proposed investments in some alternative assets.

Of late, newer SWFs from the Middle East region are increasing their exposure to alternative assets, particularly private equity. They are setting up dedicated funds (though small in size) to invest more directly in private equity funds. This development is in sync with the rise of local private equity industry in the Middle East and North Africa (MENA) region. The market observers estimate that investments (direct and indirect) by SWFs in the global private equity industry currently are in the range of $80 to $100 billion. Such funds often invest with a consortium of PE investors. But their usage of leverage is minimal. Like large institutional investors, such funds can influence the operations of companies in which they invest. The prominent examples of such sovereign funds include Qatar's Investment Authority, Abu Dhabi's Mudabala and Dubai's Istithmar and Dubai International Capital.

In addition, some sovereign funds have recently bought ownership stake in the leading private equity firms. In 2006, the Abu Dhabi Investment Authority took a 9 per cent stake in US-based

Table 7: Composition and Asset Allocation of Selected SWFs (December 2006)

Fund	Asset Allocation	Geographic Allocation
Global Pension Fund	40/60 equity/fixed income, equity to increase to 60%, may add Private equity, property	Equity: 50% Europe, 35% Americas/Africa and 15% Asia, Fixed income: 60% Europe, 35% Americas/Africa and 5% Asia
Abu Dhabi Investment Authority	high equity ratio, perhaps 50%, some private equity, property	unknown breakdown
Kuwait Investment Authority	high equity allocation, private equity allocation as high as 5%	Equity portfolio based on share of global GDP, slightly overweight Europe, under-weight U.S.
Qatar I.A.	high private equity allocation	unknown breakdown
Dubai International Capital	mostly private equity	Most reported purchases have been in UK, Eurozone, MENA
Kazakhstan National Fund	25/75 Equity/Fixed Income split	fixed income: 45% US, 30% eurozone, 10% UK 10% Japan 5% Australia
Brunei I.A.	assumed significant equity portion	Unknown
Russian Stabilization Fund	Low-risk, liquid fixed income, fund to be split into reserve and future generation fund as of Feb 08	Fixed Income: 45% US, 45% EU, 10% UK
Saudi Arabian Monetary Authority	as of December 2006, over 80% foreign securities, 20% deposits with foreign banks	Unknown

Source: Brad Setser and Rachel Ziemba, "What Do We Know About the Size and Composition of Oil Investment Funds?," RGE Monitor, April 2007, p.10.

private equity firm, Apollo Management. In 2007, China Investment Corporation bought a 9.9 per cent non-voting stake in the Blackstone Group. In September 2007, Abu Dhabi's Mubadala bought a 7.5 percent stake in the Carlyle Group. In November 2007, Dubai International Capital bought a 10 per cent stake in Och-Ziff, a US-based alternative asset management firm.

In the aftermath of credit crisis, private equity firms are seeking money from sovereign wealth funds to finance leveraged buyouts. The financing for leveraged buyouts may take some time due to lack of specialized skills and expertise at SWFs but joint deals between SWFs and private equity could be expected.

It has been estimated that SWFs' share in total alternative markets will rise from 6 per cent currently to 10 per cent by 2012. The real estate holdings of SWFs may rise while commodities exposure is likely to remain small.

The financial services has emerged one of the important investment sectors of SWFs. Since the beginning of the US sub-prime crisis in mid-2007, sovereign wealth funds have together invested more than $70 billion in world's leading banks. Table 8 provides details of these major investments by SWFs in the banking and financial sector. Some major investments are listed below:

- China Investment Company invested $5 billion in Morgan Stanley;
- Abu Dhabi Investment Authority acquired a $7.5 billion stake in Citigroup;
- Korea Investment Corporation, together with Kuwait Investment Authority, invested $5.4 billion for an equity capital stake in Merrill Lynch; and
- GIC of Singapore acquired a $9.8 billion stake in the Union Bank of Switzerland (UBS).

Table 8: Recent Investments by Sovereign Wealth Funds in International Banks

SWF	Bank	Value ($bn)	Stake (in %)
Government of Singapore Investment Corp	Citigroup	6.8	4.4
Kuwait Investment Authority		7.7	4.1
Abu Dhabi Investment Authority		7.6	4.9
Korean Investment Croporation	Merrill Lynch	2.0	4.3
Temasek Holdings		5.0	11.3
Kuwait Investment Authority		3.4	7.0
Government of Singapore Investment Corp.	UBS	9.8	8.6
Saudi Arabia Monetary Agency		1.8	2.0
China Investment Corporation	Morgan Stanley	5.0	9.9
Temasek Holdings	Barclays	2.0	1.8
Qatar Investment Authority	Credit Suisse	0.6	1.0

* Since 2006.
Source: Complied from various media and industry sources.

It needs to be emphasized here that these privately negotiated investments in the Western banking system were minor in ownership stakes. Moreover, these investments were not hostile in nature and involved convertible bonds which would be converted into equity stakes in the future. Furthermore, these investments were made in a transparent manner with the approval of banking regulatory authorities in the host countries. By injecting tens of billions of dollars into ailing banks, SWFs acted as a stabilizing force in the international banking system.

Are Sovereign Wealth Funds Transparent?

The lack of transparency in the universe of SWFs is a fair concern. But it would be erroneous to conclude that all SWFs are opaque. Some sovereign wealth funds are very transparent and publicly disclose their asset size, investment portfolio and returns.

The Norway's Government Pension Fund-Global (GPF) and Canada's Alberta Heritage Fund are the shining examples of transparent SWFs. As per Linaberg-Maduell Transparency Index of the Sovereign Wealth Fund Institute, the GPF ranks first among the SWFs in terms of transparency. There are very few non-SWFs and institutional investors in the world which can match up to the high standards of transparency, governance and accountability of the GPF. The GPF publishes quarterly and annual reports which include a detailed disclosure of assets under management, the currency and asset class composition of the portfolio down to company level and a standardized reporting of its performance against a benchmark. As part of its higher disclosure and governance standards, the GPF, for the first time, published its voting records for 2007 which provides the basis for its voting decisions.

On the other hand, some SWFs, particularly belonging to the Middle East, do not publicly disclose their asset size, investment strategies and financial performance.

A recent survey by the International Working Group on Sovereign Wealth Funds found that nearly one-fifth of world's 20 SWFs are not accountable to their domestic legislatures.[16]

The varying degrees of transparency among the sovereign wealth funds have to be viewed in their specific national context. It is hardly surprising that opaque governments tend to operate opaque SWFs. It is not that all other investment funds and financial institutional (barring SWFs) are transparent in these countries. Though both Saudi Arabia and Norway operate SWFs but their transparency, governance and accountability standards are hugely different. These differences have more do to with their distinct historical, cultural, political, legal and institutional contexts. In some Middle East countries, even basic national statistics are not made public.

A study by US-based Peterson Institute for International Economics in which SWFs were ranked according to their structure, governance, transparency and accountability found a systematic pattern whereby SWFs with low transparency are associated with economies with low scores in quality of the legal system and democratic accountability.[17] Similar patterns have also been revealed in the Linaberg-Maduell Transparency Index of the Sovereign Wealth Fund Institute.

Contrary to popular perception, the Russian sovereign wealth funds have adopted higher

Box 2

China Investment Corporation

With $200 billion as seed money, the state-owned China Investment Corporation (CIC) was established on September 29, 2007. The CIC was set up to diversify investments of foreign-exchange reserves and to seek better returns from overseas markets. Another objective of the CIC is to strengthen domestic financial system through recapitalizing domestic banks.

To raise funds for the CIC, the Chinese government issued special treasury bonds and used the proceeds to buy foreign reserves from the central bank. The CIC is expected to earn a return that exceeds the annual interest cost of the special treasury bonds. It is expected that the Chinese government would increase the asset base of the CIC by issuing more treasury bonds.

The ultimate responsibility and accountability of CIC lies with the State Council, which also appoints a Board of Directors. Though its investment processes are not publicly known but it is well established that the CIC is modeled on Singapore's GIC and Temasek Holdings. It is estimated that up to $90 billion of its funds could be invested in international financial markets in a diverse portfolio consisting of equity, fixed income, real estate, private equity and other alternative assets. Another significant portion of CIC's assets could be invested in domestic banks and financial institutions. The CIC has recently made $100 million IPO investment in China Railway Group.

Till now, CIC has made investments in the financial sector in the overseas markets. In May 2007, before its official launch, CIC made a $3 billion pre-IPO investment (with non-voting rights) in Blackstone Group, the US-based private equity firm. In December 2007, CIC invested $5 billion in Morgan Stanley in the form of mandatory convertible securities.

In early 2008, CIC agreed to launch a $4 billion private equity fund with JC Flowers & Co focusing primarily on financial assets in the US. This would be the first private equity fund started by the CIC since its inception. The CIC is expected to provide about 80 percent of the fund while JC Flowers and other general partners would provide the rest of funding.

With the spread of credit crisis, the value of its investments in the international banks and private equity firms has declined significantly. The media reports suggest that CIC may have as much as $5.4 billion frozen in a US money-market account.

In the wake of growing criticism from the developed countries (particularly the US), the CIC brought out a brief publication which gives information about its operations but detailed information about its investment strategy, decision-making processes and structures are not available. The senior management of CIC has declared that their fund would act a "good corporate citizen" and not invest in companies that damage the environment, waste energy or produce tobacco. Given the hostility, the CIC may avoid strategic direct investments and acquisitions for some time.

The State Administration of Foreign Exchange (SAFE) is another sovereign fund of China which operates under the jurisdictions of the central bank. For years, SAFE has been managing China's foreign exchange reserves and investing largely in US treasury bills and bonds. Of late, SAFE has become an active investor with greater global equity exposure. In April 2008, SAFE purchased a $2.8 billion stake in the French oil firm, Total. Besides, it has recently bought stakes in Australian banks and is contemplating investment in private equity and other alternative assets.

standards of transparency and governance. Since the funds are administered by the Ministry of Finance, the Ministry publishes a monthly report on their asset size, accumulation and investment positions. The Ministry of Finance reports to the Government on accumulation, investment and spending of the capital of the funds both on a quarterly and annual basis. Asset allocation norms and investment guidelines are also made public. As per investment guidelines approved by the Russian state authorities, the assets of the funds are to be invested in a narrow list of investment opportunities, mainly in low-yielding, low-risk sovereign bonds of selected developed countries and their state agencies. The eligibility of foreign debt securities is decided by the Government. There are several other conditions (such as currency allocation and time horizon) attached to the investment guidelines of the funds.

It has been observed that the newly-launched SWFs have adopted relatively higher standards of transparency and governance. Many of them hire external managers, regularly publish financial information and are accountable to their national legislatures. The Korea Investment Corporation and Chile's Social and Economic Stabilization Fund are notable examples of this trend. Since its inception, the Korea Investment Corporation has disclosed its asset size, sources of funds, major foreign and domestic investments and hiring of external managers for fund management.

Under growing pressures, some older SWFs are also becoming more transparent and accountable. A significant number of them are conducting both internal and external audits. Since 2004, Temasek is disclosing information related to its financial performance. In July 2007, for the first time, the Kuwait Investment Authority revealed its asset size and financial performance. In September 2008, GIC made public its first annual report containing information about its investment portfolio, governance structure and financial returns. The Abu Dhabi Investment Authority has also disclosed its broad asset allocation in October 2008.

However, improvements in the transparency and governance will come gradually and organically. Therefore, one should not expect that all SWFs to adopt higher standards of transparency, governance and accountability overnight.

Several international initiatives have been undertaken recently by the Western governments and institutions to enhance the transparency and governance standards of the SWFs. In February 2008, the European Union (EU) has suggested a slew of measures to improve the transparency and governance standards of SWFs.[18] The proposed measures include disclosure of size and sources of funds, annual disclosure of investment positions, asset allocation and currency composition. On governance, it called for a clear separation of responsibilities between the SWF and home governments, operational autonomy and issuance of risk-management policies. At the multilateral level, the International Working Group on Sovereign Wealth Funds under the aegis of IMF released a set of voluntary principles to enhance transparency and disclosure standards of SWFs.

Any attempt to push a single time-bound framework for transparency, accountability and governance may not yield result given the varying degrees of ownership and governance norms practiced by the SWFs.

The demand for increased transparency of SWFs by the West lacks credibility in the light of poor levels of transparency and governance standards of big private investors. Singling out SWFs for their opaqueness but overlooking similar (or even greater) levels of secrecy and unaccountability enjoyed by hedge funds, private equity funds and investment banks exposes the double-standards the Western policy makers. In principle, all financial institutions (public or private) should be transparent. Why single out sovereign wealth funds?

There is no denying that SWFs should become more transparent and accountable to their legislatures, public institutions and citizens in their home countries. Increased transparency may also help in removing fears in the host countries as opponents often use secrecy of SWFs as an excuse to shun them. Indeed, more transparency would enhance public participation in the management of funds. As pointed out by Kristin Halvorsen, Norway's Minister of Finance, "We believe transparency is a key tool in building trust. Domestically it helps build public support and trust in the management of Norway's petroleum wealth. Openness about the fund's management can contribute to stable financial markets and exert a disciplinary pressure on managers."[19]

Do Sovereign Wealth Funds Destabilize Financial Markets?

Till date, there is no empirical evidence to support the popular perception that sovereign funds destabilize financial markets.

The argument of the opponents goes as follows. Since SWFs have large positions in the markets, any sudden shift in the asset or currency allocation could result in significant price impacts, higher volatility and herd behavior which, in turn, could pose a potential threat to the entire financial system. True, large positions by any financial institution could pose a potential threat to market stability. As discussed earlier, unlike hedge funds, SWFs do not shift their portfolios rapidly. Also the phenomenon of herd behavior is not restricted to sovereign wealth funds. There are many big players which can trigger herd behavior. Why single out SWFs?

Further, the share of SWFs in the global markets is too small. The SWFs currently account for 3 per cent of the global equity market. Even if one accepts optimistic projections on the future asset size of global SWFs, they will still remain a small player in the global equity markets. By 2012, the share of SWFs in the global equity market would not be more than 5 per cent. Therefore, it is hard to accept the claim of the opponents that sovereign funds could undertake large positions and destabilize financial markets.

Even in the case of Norway's Government Pension Fund which follows a policy of negative screening and divestment on ethical grounds, the process of divestment is intentionally designed to avoid any downward price pressure and market instability. When the GPF divested from Wal-Mart and Vedanta Resources, it had no negative impact on the share prices and market capitalization of divested companies.

No denying, increasing involvement of SWFs in the financing of private equity funds and hedge funds poses potential market risks but the same applies to the bigger pools of capital in the West which provide bulk of money to such players. The SWFs, as a group, are also relatively small players in the other alternative markets such as property and commodities.

On the contrary, a number of factors suggest that sovereign wealth funds could exert a stabilizing

Box 3

Temasek Holdings (Singapore)

With $120 billion in assets, Temasek Holdings is the second largest SWF of Singapore. Temasek was incorporated in 1974 as an investment holding company under the Singapore Companies Act. Despite fully state-owned, the Government of Singapore has no influence in its investment and management decisions which are guided by commercial interests with an independent Board.

Traditionally, most of investments of Temasek were located in Singapore. Over the years, it has increased its overseas investment exposure but largely within the Asian region. As of March 2007, Temasek's exposure to Singapore was 38 per cent. In certain investments, Temasek acts an active investor and exercise its shareholder rights to protect its commercial interests.

Sectorally, the majority of investments by Temasek Holdings are in financial services, telecoms and media. Some of its prominent investments include Standard Chartered (UK), Barclays (UK), Merrill Lynch (US), ICICI Bank (India), INX Media (India), Bank of China, Mitsui Life (Japan) VTB Bank (Russia). Domestically, Temasek owns 28 per cent DBS Bank.

Temasek made its financial accounts public in 2004 in response to statutory requirements for issuing bonds. It has recently also introduced certain disclosure and governance norms. Temasek publishes annual report (*Temasek Review*) and runs a comprehensive website outlining investments and investment policies. Temasek has earned average annual returns of 18 percent since its inception in 1974. Temasek earned a record profit of S$18 billion for the Financial Year ended March 2008.

Unlike GIC, investment decisions by Temasek have provoked controversies. In many instances, Temasek has taken a more activist investment approach, similar to a private-equity fund or strategic buyer. It has bought substantial stakes in foreign companies, particularly within Asia. For instance,

Geographic Allocation of Temasek's Investments (in %)

	2005	2007
Singapore	49	38
North Asia (China, Taiwan, S. Korea)	8	24
OECD economies (excluding S. Korea)	30	20
Asean* (excluding Singapore)	9	12
Others	4	6

Temasek's purchase of 96 per cent stake in Shin Corporation of Thailand in 2006, country's largest telecom group, led to public protests against Thaksin Shinawatra, then prime minister, whose family controlled the company. The public protests were centered on $1.9 billion tax-free profits made by Shinawatra family and violation of foreign ownership regulations. Mr. Shinawatra was later ousted in a military coup in September 2006 and his family earnings from the company's sale were seized by the authorities.

In Indonesia, Temasek was accused of violating anti-monopoly laws by making investments in country's two mobile operators. But Temasek has repeatedly claimed that its investments are purely commercial in nature and it does not direct operational decisions of its portfolio companies.

influence on global financial markets. First, in contrast to hedge funds, SWFs do not use excessive leverage to amplify positions and returns. Second, SWFs are typically patient investors with long-term investment horizons. Since sovereign funds have no explicit liabilities, they can remain committed to their investments in the hope of booking higher returns.

Third, the investment portfolios of SWFs are well diversified unlike central banks which tend to concentrate on government and agency bonds.

Fourth, the funding source of SWFs is fairly stable which makes them less sensitive to market volatility. Fifth, SWFs are not prone to withdrawals by investors which could force them to liquidate their positions quickly. In contrast, investors in hedge funds and mutual funds can quickly withdraw their money.

Sixth, given stable funding source, SWFs could go against market trends as witnessed during the credit crisis of 2007. There are very few investors in the global markets who can provide liquidity when it is most needed.

Seventh, the SWFs contribute to the economic stability in their home countries by acting as a buffer against volatile commodity prices and mitigating "Dutch disease"[20] effects.

Box 4

Government of Singapore Investment Corporation (GIC)

Among the non-commodity based SWF, the GIC is the largest in the world with assets worth $330 under management. Established in 1981, GIC was set up to exclusively manage Singapore's foreign exchange assets. The GIC essentially manages funds on behalf of the government and Monetary Authority of Singapore. The forex reserves of Singapore witnessed sharp increase in the post-1970 period due to higher private savings and fiscal surpluses.

It acts as purely financial investor. Unlike Temasek, GIC mainly invest abroad in a diverse range of assets. The GIC relies heavily on non-Singaporean managers to manage the funds and has set up offices in London, New York, San Francisco, Beijing and Tokyo.

The GIC is ultimately accountable to the Ministry of Finance to whom it reports on a regular basis. For many years, GIC did not publicly disclose its financial statements. The authorities refused to make GIC as transparent as Temasek Holdings on the grounds that such disclosures could make it vulnerable to currency speculators. In September 2008, GIC made public its first annual report containing information about its investment portfolio, governance structure and returns.

The funds of GIC are managed by three different entities with their separate Board and management teams. The GIC Asset Management looks after investments in public markets. The GIC Real Estate manages investments in property and GIC Special Investments carry out investments in private equity, venture capital, infrastructure and other assets. The bulk of its assets are invested in public equity, followed by fixed income and alternative assets. It uses both internal and external manages for fund management.

Set up with a wealth enhancement objective, the investment horizon of GIC is long-term. It uses several international benchmarks (for instance, Morgan Stanley Capital International (MSCI) World Equity Index for equities) to measure its investment performance. Over its two decades of operations, the GIC achieved an annual return of 9.5 per cent, exceeding the benchmark returns. Market sources estimate that about 80 per cent of its investments are in the US, Europe and Japan.

In the aftermath of sub-prime crisis in 2007, the GIC has made large investments in financial sector such as $11 billion stake in UBS and $7 billion stake in Citigroup. The GIC is the single largest shareholder in the UBS. The GIC has also invested heavily in the UK property markets.

Concerns have been raised over the implications of large investments made by SWFs in the financial sector in the aftermath of sub-prime mortgage crisis in the US. As discussed earlier, these investments in the Western banks were minor in ownership stakes with no special rights of ownership and no board representation. Moreover, the investments were not hostile in nature and involved convertible bonds which would be converted into equity stakes in the future. Further, these investments were made in a transparent manner with the approval of banking regulatory authorities in the host countries. The investments in these banks were made at time when they were facing a severe liquidity crisis.

The stakes in UBS, Citigroup, Merrill Lynch and Credit Suisse were bought when their credit default swap (CDS) spreads were very high. The higher the CDS spread, the higher the perceived risk. By injecting billions of dollars into ailing banks, the SWFs acted as counter-cyclical investors and enabled banks to continue their business.

It needs to be emphasized here that SWFs have suffered losses on their investments in the Western banks and private equity funds. The value of stakes of most sovereign wealth funds have plummeted with the spread of credit crisis. The media reports suggest that sovereign funds have lost $38 billion in value as banks plunged deeper into trouble in mid-2008.[21] The biggest losses have been suffered by SWFs from the Middle East. The Qatar Investment Authority has also suffered losses investing in the London Stock Exchange.

The China Investment Corporation paid over $29 per share for its non-voting $3 billion stake in Blackstone in 2007. In October 2008, Blackstone's share was trading at $8.83. According to a Bloomberg report, Stable Investment Corporation, an affiliate of China Investment Corporation, got as much as $5.4 billion frozen in Reserve Primary Fund, the US money market fund.[22]

Do SWFs Pursue Non-Commercial, Political and Strategic Motives?

There is a widespread suspicion in the host countries that foreign state-owned entities (particularly those belonging to China, Russia and Middle East) are acquiring stakes in strategic industries (such as energy, infrastructure and high technology) and iconic domestic companies mainly for non-commercial and strategic purposes. Quite often, such suspicions have fueled protectionist sentiments that go beyond legitimate security concerns.

Till date, not a single incident of such behavior has been reported. There is also no clear evidence of home governments interfering with the individual investment decisions of their SWFs or using them to pursue narrow political and strategic objectives. The involvement of governments in most sovereign wealth funds is usually restricted to determining the overall objectives, investment frameworks and governance structures of the funds. Except in the case of Norwegian SWF, the government also determines ethical investment guidelines and their implementation.

In the media, a number of high-profile investment proposals and projects involving investors from the developing world are often cited in support of protectionist fears. Some of these investments include:

- The takeover of IBM's personal computer business by China's Lenovo Group;

- The proposal by China National Offshore Oil Corporation (CNOOC) to acquire the US-based Unocal Oil Company;
- The Dubai Ports World's acquisition of UK-based P&O which would have led to takeover of operations of six US sea ports;
- The purchase of 5 per cent stake in European Aeronautic Defence and Space Company by Russia's GAO Bank; and
- Growing investments, particularly in the extractive industries, by China Development Bank and China EXIM Bank in Africa and Latin America.

However, none of the above-listed projects involved investments by any sovereign wealth fund. These and many other investment activities are carried out by state-owned corporations and banks. The motives of SWFs and state-owned corporations are completely different. Unlike SWFs, state-owned companies acquire foreign companies in order to actively manage and integrate them into their global business operations. The state-owned development banks and financial institutions provide concessional loans for infrastructure and other projects at both national and international levels. Therefore, concerns related to direct acquisitions by state-owned corporations should not be commingled with passive investments by SWFs.

So far there is not a single instance of hostile takeovers attempted by SWFs has come into public notice. The overwhelming majority of sovereign funds are passive investors. In cases where SWFs undertake direct investments, they do not seek controlling interests.

Some sovereign funds have explicit policies against seeking controlling interest in invested firms.

Box 5

Korea Investment Corporation

The Korea Investment Corporation (KIC) was officially launched in July 2005 with a corpus of $20 billion provided by Bank of Korea and the Ministry of Economy and Finance's Foreign Exchange Stabilization Fund. It is essentially a foreign exchange stabilization fund meant to achieve sustainable return on foreign-currency assets and other public assets provided by the state authorities. Another stated objective of the KIC is to develop domestic asset management industry in the country. The KIC is expected to receive $30 additional funds by 2009.

The KIC has a separate legal entity. The management of KIC is independent of the government and discloses its annual financial positions and investment strategies regularly. The KIC Act emphasizes and ensures KIC's independence with regard to its organization and investment management. KIC discloses annual financial statements and accounting standards.

The KIC manages funds on behalf of various state authorities and carries out investments in consultation with such entities. It extensively relies on external managers. Nearly three-quarters of KIC's $20 billion portfolio is outsourced to external fund managers.

Currently, the bulk of its assets are invested overseas (particularly OECD countries) in both in fixed income and public equity. It is expected that KIC will venture into hedge funds, private equity, real estate and commodities in the near future. In January, 2008, KIC made an equity investment of $2 billion in Merrill Lynch.

The Government Pension Fund – Global is a case in point. Though the Fund has invested in more than 7000 companies globally but its stakes are small. The average ownership stake is less than 1 per cent. The Fund deliberately does not invest more than 10 per cent in each company to underscore its role as a financial investor.

Indeed, most SWFs behave like other large institutional investors (such as pension funds and insurance funds). Therefore, the threats posed by SWFs are not much different from such other funds.

Another major concern expressed is that the SWFs could be used as a tool by their home governments to put economic hardship or political pressure on the host countries.[23] In the words of Jeffrey Garten, " These funds are going to have the ability to buy any global company, to create panic in markets if they move too precipitously, even to dwarf the political clout of international financial institutions."[24] Such concerns are misplaced on two counts. One, since many Asian central banks own large holdings of government securities in US (and other developed countries), they could potentially harm the host economy by rapidly selling off securities in the markets. Why should home governments use SWFs to buy minority stakes in individual companies in the host country, that too with no special rights and board representation? Till date, Asian central banks have treaded cautiously to minimize their impact on prices.

Two, the host countries have domestic laws to block any foreign investments that may potentially threaten national security. Take the case of the Exon-Florio provision in the US. The Exon-Florio allows the blocking of an acquisition by a foreign entity in case of a national security threat. The Exon-Florio provision is implemented by the Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee chaired by the US Secretary of Treasury. In the light of growing concern over several high-profile foreign investments, the US Congress passed the Foreign Investment and National Security Act (FINSA) in 2007 which further strengthens the screening of foreign acquisitions by the CFICUS. The FINSA authorizes CFIUS

Table 9: Top Foreign Buyers of US Securities in First Four Months of 2008
(in $ bn)

China	76.7
Japan	56.3
Hong Kong	39.2
Brazil	22.7
Norway	16.6
Mexico	14.8
Canada	13.9
Singapore	12.3
South Korea	6.3
Germany	5.6

Source: US Treasury Department.

to review “any merger, acquisition or takeover…by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States.”

Many other developed countries including the UK, Germany and France have stringent legal provisions at their disposal to ward off any threat to national security from foreign investors.

Furthermore, all investors have to abide by domestic legal, corporate governance, disclosure and competition rules in the host countries. It is hard to understand that why SWFs would not follow domestic rules in the host countries.

The time has also come to define what is meant by non-commercial investment decision. In the present world, a number of institutional investors are actively engaged in issues which go beyond profit motives. Many pension funds (including CalPERS of the US) have taken strong stands on issues ranging from human rights, democracy and environment. They have withdrawn investments in several countries on such moral and political grounds. Not long ago, the US-based public pension fund, Montana Board of Investments, sold its stake in French companies following France’s refusal to support 2003 invasion of Iraq.

Norway’s GPF excludes a company from its investments if there are systematic breaches of ethical norms within the areas of human rights and the environment. Like GPF, Sweden’s AP Funds (national buffer funds) have ethical engagement policies with the management of invested companies with regards to compliance with ILO core labor standards and international human rights.

Some sovereign wealth funds from Middle East and Asia have a specific mandate not to invest in liquor, casino and tobacco companies.

The ongoing international campaigns to force divestment from China over Darfur and Burma are examples of pursuing non-commercial objectives. In April 2008, the World Bank President, Robert Zoellick, proposed that SWFs should invest 1per cent of their assets in Africa in order to bring $30 billion worth of investments to the continent.[25] Irrespective of the fact whether the SWFs invest in Africa or not, such proposals seek investments on non-commercial grounds.

Is Norway’s Government Pension Fund a “Model” Fund?

The Government Pension Fund – Global (GPF) of Norway is the second largest SWF in the world with assets over $390 billion. The fund was created in 1990 by an act of the Norwegian Parliament. Until January 2006, it was known as Government Petroleum Fund. Now the Fund comprises of the Government Pension Fund – Global and the Government Pension Fund – Norway (formerly National Insurance Scheme Fund).

The GPF invests surplus wealth produced by Norway’s petroleum sector, mostly revenue from taxes and licensing agreements. The return on the GPF is added to the Fund’s capital and therefore there are no transfers to the government budget. Thanks to rapid rise in international crude oil prices in recent years, the Fund has now become bigger than Norway’s annual gross domestic product (GDP) at $360 billion in 2007.

The Norwegian economy is a model of welfare capitalism and mixed economy, combining both free market activity and government intervention. In particular, the government controls key areas, such as the vital petroleum sector, through large-scale state enterprises. The country is rich in natural resources such as oil, hydropower, fish, forests, and minerals. Oil and gas account for one-third of country's exports. Only Saudi Arabia and Russia export more oil than Norway.

Created as a savings fund for future generations, the GPF has been set up to manage Norway's petroleum wealth in a sustainable manner, helping to meet the challenge of rising pensions and social expenditures in the future besides stabilizing the exchange rate. The Norges Bank Investment Management (NBIM), an investment branch of Norway's central bank, manages this Fund as well as most of the central bank's foreign exchange reserves. The NBIM uses both external and internal managers for investment purposes. The day-to-day operational management of the GPF is handled by Folketrygdfondet, a state entity specifically created to manage the Fund. The ultimate responsibility of the management of the GPF lies with the Ministry of Finance which issues guidelines for its investments.

The Ministry of Finance has defined a benchmark portfolio for the Fund's asset allocation. The GPF's current exposure to equities is 40 per cent and the rest 60 per cent is devoted to fixed income instruments such as bonds and government securities. In 2007, a small-cap segment in the benchmark portfolio for equities was included. The GPF is also contemplating investments in some alternative assets in the future.

Till date, the Norwegian fund has remained a low-profile non-strategic financial investor. Though the Fund has invested in more than 7000 companies globally but its stakes are small. The average ownership stake is less than 1 per cent. The Fund deliberately does not invest more than 10 per cent in each company to underscore its role as a financial investor.

The GPF has invested in non-Norwegian financial instruments (bonds, equities and money market instruments), spread over 42 developed and emerging equity markets and 31 fixed-income markets.

The institutional structure of GPF is considered as a benchmark in terms of transparency and accountability. Among all the world's SWFs, GPF is considered to be the most transparent as it regularly publishes its assets, investment portfolio and earnings. The GPF publishes quarterly and annual reports which include a detailed disclosure of assets under management, the currency

Table 10: Strategic Benchmark Portfolio of GPF (in %)

Asset class	Overall strategic benchmark	Europe	Americas/ Africa	Asia/ Oceania
Fixed income	60	60	35	5
Equities	40	50	35	15

Source: Norges Bank.

and asset class composition of the portfolio down to company level and a standardized reporting of its performance against a benchmark.

Apart from domestic considerations, the Norwegian authorities adopted two important mechanisms to address the impact of its international investments. In 2001, an Environmental Fund was created within the structure of the existing fund with the sole aim of investing in equities in companies based in developed countries which have very limited negative impact and consequences on the environment. The Environment Fund also used to follow certain environmental reporting and certification requirements.

Later on, the Norwegian authorities expanded the scope of ethical guidelines for the Fund's investments. In 2004, an Advisory Council on Ethics was established by the Fund and subsequently the Ministry of Finance introduced ethical guidelines in the regulatory framework of the Fund. The ethical guidelines are meant to promote sustainable development and to minimize the risk of complicity in serious human rights and environmental violations. The guidelines cover humanitarian principles, human rights, corruption and environmental damage. The guidelines established two policy measures to meet the ethical obligations: active ownership and the exclusion of companies.

The Council on Ethics has been given broad power to make recommendations for exclusion from its investment portfolio (through negative screening and disinvestment) of companies where there is an unacceptable risk as an owner of complicity in gross or systematic breaches of ethical norms within the areas of human rights and the environment. The first basis for exclusion of a company is for "production of weapons that through their normal use may violate fundamental humanitarian principles." In addition, the Council can issue a recommendation because of acts or omissions that constitute an unacceptable risk of the Fund contributing to:

- Serious or systematic human rights violations, such as murder, torture, deprivation of liberty, forced labor, the worst forms of child labor and other forms of child exploitation;
- Serious violations of individuals' rights in situations of war or conflict;
- Severe environmental damage;
- Gross corruption;
- Other particularly serious violations of fundamental ethical norms.

The ethical guidelines of GPF are in conformity with other international frameworks such as UN Global Compact, the OECD Guidelines for Corporate Governance and for Multinational Enterprises, and ILO Conventions.

The Council on Ethics initiates investigations on its own to find out whether any abuse of its ethical guidelines is taking place in its portfolio companies. After completing its investigations, the Council shares its findings with the management of the concerned company and invites their comments.

Though the Council can only make recommendations, the final decision to exclude companies

Box 6

Divestments by GPF on Human Rights and Environmental Grounds

Due to growing concern over human rights violations and and environmental destruction, the GPF has excluded Mac Freeport in 2006 and Vedanta Resources in 2007 from its investment portfolio. A brief account on these two exclusions is given below.

Mac Freeport-McMoRan Copper & Gold

Freeport is a well-known transnational mining corporation operating one of the world's largest copper mines in the island of New Guinea in Indonesia. The corporation uses a natural river system to dispose of close to 230,000 tonnes of wastes each day, thereby releasing large quantities of sediments and heavy metals into the water. This has led to serious damage on the river system and close by ecosystem besides affecting the indigenous people living in the area.

A number of local and international NGOs have been active in raising awareness about the negative consequences of this mining project on the environment and indigenous people. As of 31 December 2005, the Government Pension Fund – Global had invested about $22 million in Freeport.

The Council on Ethics of the Norwegian fund carried out investigations into these matters and found that the environmental damage caused by the mining operations is extensive, long-term and irreversible. The Council found no inclination by the company to manage waste in a better way.

Based on its assessment, the Council on Ethics concluded that the Government Pension Fund – Global runs an unacceptable risk of contributing to severe environmental damage by investing in the company.

In May 2006, the Ministry of Finance announced the disinvestment of Freeport from the Fund's investment universe under the Fund's ethical guidelines.

Vedanta Resources Plc

The Norwegian fund had an investment of about $14 million (an equity ownership of 0.16 percent) in British mining and metals group Vedanta Resources. In November 2007, the Fund dropped Vedanta Resources from its investment portfolio due to concern over environmental and human rights abuses in its mining companies in India.

The local people and groups have been opposing a proposed $850 million aluminum refinery and bauxite mining project belonging to Vedanta Resources as they assert that the project would lead to a substantial loss of local people's livelihoods and traditional culture.

After carrying out investigations in Vedanta's four Indian subsidiaries, the Council on Ethics submitted its report to Norway's Ministry of Finance on May 15, 207. The report said in part: "The allegations leveled at the company regarding environmental damage and complicity in human rights violations, including abuse and forced eviction of tribal peoples, are well founded."

Based on the council's advice, the Norwegian Finance Ministry ordered the fund to sell off its stake in Vedanta. On November 6, 2007, the ministry announced the completion of sale at its Web site.

from Fund's investment portfolio rests with Norway's Ministry of Finance. These recommendations and decisions are made public later on.

On the recommendations of the Council, the Finance Ministry has removed a number of companies from the Fund's investment portfolio. In June 2006, for instance, the Fund sold its holdings in US-based Wal-Mart, the world's largest retailer, for "serious and systematic violations of human rights and labor rights" and US-based Freeport-McMoRan Copper & Gold for "complicity in serious damage" to the environment in New Guinea. Some other prominent companies which have been excluded due to activities in breach of its ethical guidelines are following:

- Alliant Techsystems Inc. (US): For production of components to cluster munitions.
- BAE Systems Plc. (UK): For production of nuclear missiles to the French Air Force through the company.
- Boeing Company (US): For maintenance of ICBMs to the US Air Force.
- DRD Gold Limited (South Africa): For serious environmental damage.
- GenCorp Inc (US): For production of nuclear weapons.
- Vedanta Resources (UK): For serious environmental damage and human rights violation.

The divestment process of the GPF is intentionally designed to avoid any downward price pressure in order to minimize the losses from divestment.

What is interesting to note is that such divestments based on non-economic motives by the GPF had no negative impact on its financial returns.

As part of its higher disclosure and governance standards, the Norwegian fund, for the first time, published its voting records for 2007 which provides the basis for its voting decisions. The voting records reveal that the Fund fought for several important issues such as global warming, labor standards and freedom of access to the internet, as part of its active ownership approach. For instance, the Fund voted its shares in favor of shareholder resolutions at ExxonMobil and Ford Motor Co, calling for the companies to adopt carbon emission reduction goals. However, the resolutions were defeated by majorities of 93 per cent and 86 per cent respectively.

At McDonalds, the Fund voted its shares in support of a resolution calling for the company to adopt the "declaration of fundamental principles" under the International Labour Organisation. Again, this resolution was also defeated.

The Norwegian government has initiated a review of the Fund's ethical policy which is expected to be published in later 2008. It has circulated a consultation paper for seeking comments from various stakeholders. It is likely that the scope and mechanisms of its ethical guidelines may be further expanded to cover other abuses committed by companies. Of late, for instance, the Fund has made child labor as an important priority of concern. The Fund has recently developed the NBIM Investor Expectations on Children's Rights in order to prevent child labor and promote children's rights. In particular, the Fund is pressing a number of multinational corporations in the agricultural sector to improve their record on child labor.

It is interesting to note is that these guidelines have attracted the attention of several other SWFs (notably from Asia), international institutions, academics and NGOs. However, it remains to be seen how other sovereign wealth funds, pension funds and other institutional investors would adopt such ethical guidelines. Given the peculiar characteristics of Norwegian society and politics with its emphasis on pluralism, diversity and democracy, there are certain elements and processes of the ethical guidelines which may take years to emulate by other countries (both developing and developed) and institutional investors. Nevertheless, the ethical guidelines and governance standards adopted by the GPF could act as a valuable reference point.

Undoubtedly, the GPF has opened up new avenues for grassroot activists and groups to influence corporate behavior. The negative publicity generated by the Fund's disinvestment also helps in creating awareness about the issues involved. For instance, the Supreme Court in India, while deciding up on the case against Vedanta, took note of the decision of the GPF to exclude Vedanta for violation of human rights and labor laws.

However, there are very few institutional investors which have similar governance and ethical standards. In many ways, the Norwegian fund is an exception in the global financial markets.

Shouldn't Sovereign Wealth Funds be Regulated?

Well, all financial institutions (private or state-owned) should be subject to regulation and supervision in both home and host countries. Many of the policy concerns related to governance, financial stability and market integrity of sovereign funds are equally valid to other market

Box 7

National Development Fund (Venezuela)

With an estimated $27 billion in its kitty, National Development Fund (FONDEN) was set up by the Hugo Chavez government in September 2005 as part of reforms to the charter of the Central Bank of Venezuela. FONDEN is wholly owned by the Venezuelan government.

Most of the Fund's money comes from excess reserves and national oil companies. The state authorities view Fund as a vehicle to redistribute the oil income in the country. It will receive substantial money from the oil windfall profit tax approved in April 2008.

The bulk of Fund's money is invested domestically in "real, productive" sectors and public projects such as roads, ports, energy, housing and hospitals. The Fund also has a mandate to manage external debt liability and to support "special situations." In 2006, the Fund was used to repurchase $4.7 billion of country's external debt, including Brady bonds. According to JP Morgan Research, the Venezuelan sovereign fund had invested in US$6.2 billion credit-linked notes written by foreign investment banks, most of which were linked to sovereign credit risk of a number of Latin American countries.

The Fund presents an annual report to the Permanent Finance Committee of the National Assembly. Occasionally, it also provides financial information to wider public through media.

In 2007, National Development Fund and China Development Bank together created a joint development fund (with a corpus of $6 billion) which will invest in various development projects in both countries. Long before the creation of National Development Fund, Venezuela had established Fund for Investment of Macroeconomic Stabilization in 1999. The purpose of this fund is to protect domestic economy from the volatility of income generated by crude oil. This fund is managed by the Central Bank of Venezuela. The main sources of this fund come from oil companies.

players. Why special rules for SWFs alone? What about the regulation of hedge funds and private equity funds? Shouldn't hedge funds be regulated? Why double standards?

The hedge funds pose a greater systemic risk to the global financial system. Unlike SWFs, hedge funds use extensive leverage and engage in speculative trading in stocks, currencies, commodities and derivatives. The hedge funds are usually short-term investors and more sensitive to volatility in financial markets. The hedge funds invest at a breathtaking speed but can pull out their money quickly if performance or market condition deteriorates.

Additionally, the majority of global hedge fund industry is domiciled in off-shore tax havens (such as Cayman Islands and Bermuda) to avoid regulation and tax liability.

There is greater case for regulation of hedge funds since they can gain large positions in markets with the help of leverage and derivatives. According to Greenwich Associates (a US-based consulting firm), hedge funds are the biggest source of trading volume in interest-rate derivatives, accounting for 30 per cent of total US trading volume.[26] The hedge funds also constitutes approximately 30 per cent of all US fixed-income security transactions; 55 per cent of US activity in derivatives with investment-grade ratings; and more than 40 per cent of US leveraged loan trading volume.[27]

Such large positions not only pose risks to investors but to the stability of the financial system and the real economy. Some of the prominent recent examples of hedge funds failures include Long-Term Capital Management (LTCM) in 1998, Amaranth Advisors in 2006 and Bear Sterns in 2007. The collapse of LTCM brought the Russian financial crisis to the doors of Wall Street. On a capital base of $4 billion, the assets of LTCM built up a balance sheet of assets worth $125 billion, a leverage of nearly 30 times. The LTCM also had off-balance sheet exposure with a notional value of $1.2 trillion.

What about the regulation of complex and opaque $516 trillion derivatives market? Not long ago, Warren Buffett called them "financial weapons of mass destruction." The $55 trillion credit default swaps (CDSs) market has been operating for years with no public disclosure or legally enforced reporting requirements.

The regulation and supervision of highly-leveraged financial institutions (e.g., hedge funds) and opaque financial instruments (e.g., CDSs) becomes more important in the light of structural weaknesses of the global financial architecture thoroughly exposed by the credit crisis of 2007.

The demand for regulation of SWFs should primarily originate in home countries, rather than externally imposed. However, it does not mean that host countries should not have a regulatory framework for SWFs. After all, the state-owned sovereign wealth funds are managing money which is owned by their citizens. It is the citizens of home countries who ultimately gain or lose from the investments made by the SWFs.

An increased participation by domestic stakeholders would help in building public support in the management of sovereign wealth funds. Since some SWFs manage wealth for future generations, there is a greater need for checks and balances at the domestic level.

True, many home countries lack democratic institutions and norms to seek public accountability of SWFs. Therefore, it becomes more important that strategies for greater democratic control of SWFs should be a part of wider project for democratic renewal in such countries.

Since, in principle, sovereign wealth funds are ultimately accountable to the citizens of their countries, a portion of these funds could be prudently used in the improvement of infrastructure, health, education and other services. In many developing countries having SWFs, some basic human needs are not accessible to their poor and marginalized citizens.

Some analysts have also proposed that a small portion of SWFs assets could be allocated to initiate monetary cooperation mechanisms among the developing countries and to create regional development banks which could lend money to the developing and the poor world on concessional terms.[28]

Box 8

Oil Stabilization Funds of the Russian Federation

The Stabilization Fund was established in 2004 by the Ministry of Finance. In February 2008, the Fund was split into two funds: The $125 billion Reserve Fund (which invests primarily abroad in low-yield securities) and the $32 billion National Welfare Fund (which invests in more risky high-yield securities).

Both sovereign wealth funds get their money from the oil export custom duties and mineral extraction tax. The objectives of both funds are to absorb excessive liquidity, reduce inflationary pressure and insulate the Russian economy from volatile commodity export earnings.

Till now, the funds have maintained a prudent asset allocation and acted purely as a portfolio investor. As per investment guidelines approved by the Russian authorities, the assets of the funds are to be invested in a narrow list of investment opportunities, mainly in low-yielding, low-risk sovereign bonds of selected developed countries and their state agencies. The eligibility of foreign debt securities is decided by the Government. The investment guidelines specifically mention the list of countries in which the funds can buy sovereign debt securities. Further, the issuers of debt should have AAA/Aaa long-term credit rating from at least two of the three main international rating agencies. There are several other conditions (such as currency allocation and time horizon) attached to the investment guidelines of the funds. For instance, the currency allocation is 45 per cent US dollar, 45 per cent Euro and 10 per cent Pound. Till now, the funds have not invested in global equities or companies.

Currently the funds are largely invested in bonds from government linked authorities in the US UK, Germany France and the Netherlands. The market analysts expect that the National Welfare Fund would begin long-term investments to public equity, private equity and alternative assets from early 2009. It is also anticipated that a portion of investments would be channeled to the fast-growing emerging markets.

Contrary to popular belief, the funds maintain higher standards of transparency. Their investment strategy is based on a strict investment policy framework established by the Ministry of Finance. The funds also publish reports on the assets, investment patterns and spending of the funds. The Ministry of Finance publishes a monthly report on the Fund's accumulation, spending and balance. The Ministry of Finance reports to the Government on accumulation, investment and spending of the capital of the funds both on a quarterly and annual basis. Asset allocation norms and investment guidelines are also made public.

What are Policy Responses to the Rise of SWFs?

A wide range of policy proposals and actual initiatives have been undertaken at various levels in response to the rise of sovereign wealth funds.

At the multilateral level, the G-7, led by the US, persuaded the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) to develop voluntary "best practices" for the SWFs. The IMF was asked to develop the voluntary codes for the SWFs while the OECD was asked to develop a code for the recipient countries. What is surprising is that these policy initiatives took place soon after the meeting of G-7 Finance Ministers and Central Bank Governors on October 19, 2007. The very next day, the International Monetary and Financial Committee endorsed the IMF to start work on developing a common set of voluntary codes for SWFs. The International Working Group of Sovereign Wealth Funds (IWG) was set up to carry forward the work.

The voluntary codes, also known as Generally Accepted Principles and Practices, were presented to the International Monetary and Financial Committee on October 11, 2008. The GAPP contains 24 Principles covering a wide range of issues from legal framework to governance structure to investment policies and risk management of SWFs. Since the Principles are voluntary in nature, their actual implementation would be dependent on member-countries. The IWG has also proposed the establishment of a Formation Committee which would explore the creation of a permanent international body on SWFs. The guidelines are very broad in nature and repetitive. One major issue which cut across every Principle of GAPP is transparency and public disclosure. The other two major issues underlying the GAPP pertain to market instability and non-commercial motives of the SWFs.

Box 9

Khazanah Nasional Berhad (Malaysia)

Incorporated in September 1993, Khazanah Nasional is the investment holding arm of the Government of Malaysia. The wholly-owned state fund was created to manage the investments delegated to it by the Government of Malaysia. Its initial funding came from the privatization of state companies but subsequently Kazanah has raised money from issuing domestic and Islamic bonds. Khazanah is active in Islamic finance. In October 2006, it issued the world's first tradeable Sukuk (Sharia-compliant bond) for $750 million.

Khazanah manages $17 billion in assets and invests in a range of sectors including utilities, finance, media, communications and infrastructure, both domestic and overseas. Khazanah makes strategic investments in selected sectors and markets with a long-term view as an active stakeholder.

The bulk of its investments (close to 90 per cent) are in Malaysia but increasingly Khazanah is investing abroad. Much of its overseas investments are concentrated in the neighboring countries such as Indonesia and Singapore. Khazanah specializes in undertaking strategic investments in new sectors with a long-term perspective.

Khazanah maintains a relatively high level of transparency in terms of its structure, governance and investments. It regularly publishes its total fund size, returns and investment holdings.

Meanwhile, in April 2008, the OECD released a report containing very broad voluntary principles for recipient countries. In its report titled, “Sovereign Wealth Funds and Recipient Country Policies,” the OECD found no instances where sovereign wealth funds have acted to further political objectives. The report called upon national authorities to determine what is necessary to protect its national security.

Some analysts have advocated bringing SWFs under the preview of the World Trade Organization.[29]

In addition to multilateral initiatives, the European Commission has proposed a common EU approach to deal with issues of transparency and accountability of SWFs. The Commission has called upon SWFs to disclose investment positions, asset allocation, currency composition, size and sources of funds, overall objectives, internal governance structures and risk management policies. The EU has also extended support to the voluntary guidelines prepared by the IMF and the OECD.

In the US where much of the political controversy is centered on foreign state-owned companies (such as CNOOC proposed buyout of Unocal in 2006), the Congress passed the Foreign Investment and National Security Act of 2007 that mandates additional scrutiny and higher-level clearances for investments by foreign state-owned entities. In March 2008, the US Treasury signed an agreement with the governments of Singapore and Abu Dhabi on 5 principles guiding the investments by sovereign wealth funds. The three countries also laid down principles for countries receiving SWF investment.

In addition, the President’s Working Group on Financial Markets is reviewing the activities of

Box 10

Permanent Reserve Fund (Alaska)

The $40 billion Alaska Permanent Fund was set up in 1976 for purposes of inter-generational wealth transfer and equity for all residents of Alaska, US. Owned by the State of Alaska, the fund’s regulatory framework allows State legislature to spend only its investment income. The principal amount cannot be spent without a vote.

By and large, the Fund functions like pension funds and makes annual dividend payments to the residents of Alaska who have resided in the state for at least one calendar year. In 2007, the Fund paid $1654 to each Alaskan resident. The constitutionally established fund is owned by the state of Alaska and operates as a public trust. The Alaska Permanent Fund Corporation manages the assets of the Fund.

The Fund receives 25 per cent of sale proceeds from oil, gas and other minerals from Alaska. Its investment goal is to earn a real rate of return of 5 per year. The Fund has a diversified investment portfolio consisting of domestic and global equities, bonds and real estate. Of late, the Fund has allocated assets to global private equity industry. The Fund is expected to reach $46 billion by 2012.

It publishes annual and monthly reports with information on its asset size, holdings and returns. Many of these reports are available at its website for wider public dissemination. There is a strong popular support to the Fund among the local population.

the sovereign wealth funds. Besides, there are ongoing discussions in the US policy circles to bar SWFs from voting rights and removing tax exemptions on investments made by the SWFs.

Concerned primarily over a Russian bank gaining a 5 per cent stake in EADS, Germany enacted a new legislation in August 2008 which allows the authorities to review and prohibit a non-EU company from acquiring German companies “on grounds of public policy or public security.” The legislation would come into application where the foreign investor seeks to acquire directly or indirectly 25 per cent or more of the voting rights in a German company.

Some European governments are considering the use of “golden shares.”[30]

In early 2008, the Australian government introduced new guidelines to enhance the screening of investments made by foreign state-owned entities. The guidelines contain six principles by which investments by foreign state-owned entities will be measured. One of these principles states that the country will consider whether “an investor’s operations are independent from the relevant government.” In particular, direct investments by foreign state-owned governments or entities (which include sovereign wealth funds) are required to be notified irrespective of their size.

It is too early to judge the real impact and implications of all these developments on the activities of the sovereign wealth funds. However, some SWFs have strongly objected to these initiatives. “Sovereign wealth funds have been found guilty before being proven innocent,” stated Muhammad al-Jasser, the Vice Governor of the Saudi Monetary Agency.[31] The Kuwait Investment Authority has criticized the initiatives to establish voluntary codes. The China Investment Corporation has also publicly expressed its displeasure for treating sovereign wealth funds unfairly. In the words of Gao Xiqing, President of China Investment Corporation, “Some think we are from a Cold War area and Red China...We are still regarded very much by many countries as a potential threat…We are trying to get financial returns. If there is too much political pressure and too much unpredictability, you just go away…Fortunately, there are more than 200 countries in the world. And fortunately, there are many countries who are happy with us.”[32]

If the protectionist sentiments remain strong in the West, the SWFs would move to other markets, particularly debt and equity markets of Asia. Some SWFs, particularly from the Middle East, have started allocating funds to domestic asset markets and banks in order to provide stability.

Does the Rise of SWFs Represent a Structural Shift in the International Financial System?

There are several parallel developments which indicate a shift in the balance of economic power with the comparative decline of West (particularly the US) and the growing financial clout of the developing world that were, until recently, minor players in the global financial system.

The developments indicate a gradual move towards a multipolar international financial system over the long haul. However, the actual shift would be dependent on a host of factors including the interplay of money and power at both national and international levels.

According to conventional economic theory, capital is supposed to flow from rich countries (e.g., US) to poor countries (e.g., China and India). Even a common person on the street also thinks that rich countries invest or lend money to the poor countries. But nowadays the reverse is happening. Currently capital is flowing "uphill" from poor to rich countries. The US alone accounts for as much as 60 per cent of global capital imports.

In the mid-1990s, a number of Asian countries were running a current account deficit. Nowadays these countries are running huge current account surpluses and have become net exporter of capital. China is the leading net exporter of capital, despite lower per capita income than its Asian peers.

In 1998, Russia sought bailout from IMF, World Bank and other Western lenders in the wake of a severe financial crisis. Thanks to higher international oil and gas prices, the country fully repaid all its foreign official debt of $42 billion by 2006. As on November 2007, Russia's foreign exchange reserves reached $463 billion. When Iceland faced a currency and financial crisis in September 2008, it first approached Russia (rather than US or IMF) to provide loans to tackle the crisis.

The transformation of emerging market countries, as a group, from debtors to creditors within a short span of time is not an insignificant development. However, it needs to be emphasized here that despite growing financial clout, emerging market countries have little or no participation in the designing and management of the policy framework of the international financial system. The international economic policy arena is still dominated by the Western financial institutions and agencies such as IMF and Bank for International Settlements (BIS).

Currently a substantial part of capital exports from emerging markets is channeled through their own central banks and sovereign wealth funds. This is in sharp contrast to the 1970s and 80s when Western banks were the prime players in the recycling of petrodollars.

Box 11

Future Fund (Australia)

Established in April 2006, the Future Fund intends to meet the unfunded public sector superannuation liabilities of the Australian Government. Its stated aim is to reach A$140 billion by 2020 so as to fully cover the future superannuation liabilities.

Though the fund is wholly owned by the Government of Australia, it is supervised by an independent Board of Guardians. The Board of Guardians is responsible for all investment decisions and is accountable to the Government. The investments are managed by external investment managers. In May 2007, the Board selected US-based Northern Trust Corporation to manage its funds.

The bulk of fund's money comes from fiscal surpluses and privatization proceeds. The Future Fund also manages the Higher Education Endowment Fund.

The Future Fund has invested in a diversified range of assets including domestic equities and bonds, foreign equities and bonds, real estate and commodities.

The Future Fund publishes an annual report which contains information about its asset size, investment portfolio and financial performance. The report is tabled in Parliament. Its financial statements are audited by Australian National Audit Office.

The direct investment by emerging markets is also being undertaken by non-state entities. Since 2003, the private corporations from emerging markets are expanding their global presence by investing in developed countries. The buyout of IBM by Lenovo and Corus Steel by Tata are recent examples of this trend. Besides, institutional investors and banks from emerging markets are also increasing their cross-border investments.

The rise of SWFs also represents a marked shift away from market capitalism to state capitalism model. The return of state capitalism has to be seen in the wider context of several Latin American countries (such as Venezuela and Bolivia) along with Russia and China increasing state control over strategic resources, particularly oil and gas. State capitalism is also making a comeback in the developed world with the large-scale bailout of big banks and financial institutions across the US and Europe since 2007.

At the ideological level, the rise of state-owned SWFs fundamentally challenges the ideological underpinnings of the free-market policies promoted under the banner of Washington Consensus. It questions the Anglo-Saxon economic model based on minimal state intervention and promotion of private enterprise. This is very significant because since the 1980s the international economic order was deeply embedded in the Anglo-Saxon economic model. It is in this wider context the phenomenon of sovereign wealth funds needs to be situated.

What are the Main Sources of Information on SWFs?

As of October 2008, there is not a single book on the sovereign wealth funds. It is expected that some books would be published soon given the sudden spurt in the interest on the activities of SWFs.

Most of information available in the public domain is scattered in the form of official documents, industry reports, research papers, studies, journal articles and newspaper reports.

Though most sovereign wealth funds run websites but there is varying degrees of information available on their websites. Following are some websites and blogs containing a wide range of information on SWFs:

Deutsche Bank Research: www.dbresearch.com

ExcessLiquidity.org: http://sovereignwealthfunds.wordpress.com

Financial Times: www.ft.com/indepth/sovereignfunds

http://blogs.ft.com/wolfforum/2007/07/sovereign-funds.html#more

International Monetary Fund: www.imf.org

McKinsey & Company: www.mckinsey.com/mgi

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Sovereign Wealth Fund Institute: http://swfinstitute.org

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