

# Sovereign Wealth Funds: A Critical Analysis

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## Abstract:

In recent months, sovereign wealth funds have received much attention and criticism on the world stage. This paper analyzes these funds from a multidimensional perspective, showing their relative size, origins, history, strategies, and what regulatory oversight they have. Next, it examines why countries create sovereign wealth funds, and the criticisms of these funds. Thirdly, it projects the likely behavior of sovereign funds in the near term, explaining that they will create more liquidity and lower costs of capital in emerging equity markets and raise the demand for the services of existing investment managers. These funds will not, however, contribute to higher interest rates in U.S. treasuries or cause direct confrontations between the U.S., the UAE, Russia, and China over fund holdings. These funds may, on the other hand, increase the volatility of developed and emerging markets and create greater demand for openness to foreign direct investment among sovereign wealth fund-holding countries.

*Keywords: sovereign wealth fund, international capital movement, Abu Dhabi Investment Authority, China Investment Fund, capital flows, Russian Stabilization Fund, open investment.*

## I. Introduction and Description of Sovereign Wealth Funds

In the last six months, the subject of sovereign wealth funds (SWFs) has created much discussion in the halls of the Treasury, the German Chancellery, and the Chinese Politburo. With over \$3 trillion in assets, these vehicles have the possibility of revolutionizing the financial services industry, and having strong influences on international capital flows. The formation of new funds in China and Russia, moreover, has sparked a heated debate in the West: some see these funds as an opportunity for additional foreign direct investment (FDI), capital formation, and ultimately, growth, while others see sovereign wealth funds as threats, where hostile, authoritarian regimes can perform “sneak attacks” of corporate espionage or economic turmoil to undermine open, democratic nations.

### *A. What are they?*

Sovereign wealth funds are defined by the U.S. Treasury as “government vehicles funded by foreign exchange earnings but managed separately from foreign reserves” (Lowery, 1). Along with financing, sovereign wealth funds also differ from other government vehicles in their objectives, terms, and holdings: while foreign reserves have historically invested in sovereign fixed income notes for the purpose of intervention on the foreign exchange market, SWFs typically take a longer-term approach, where international equities, commodities, and private fixed income securities are used to achieve the long-run strategic and financial goals of a sovereign.

It should be strongly noted that sovereign wealth funds are **not** the only vector through which sovereign entities make foreign private investments. Another way through which countries invest in foreign entities is through purchases by state-owned enterprises. Examples of this method include the attempted acquisition of the Peninsular and Oriental Steam Navigation Company (P&O) by the state-owned Dubai Ports World Corporation, and the purchase of IBM’s computing business by the Chinese government-controlled Lenovo Group. Additionally, governments can make foreign private investments directly through their existing foreign exchange stocks. For example, the governments of India, Thailand, and Indonesia have either investigated or implemented plans to diversify their foreign exchange holdings into private fixed income products or liquid international equity securities.

### *B. Is this a recent phenomenon?*

The first sovereign wealth funds were established alongside the initial oil strikes in the Persian Gulf states in the 1950s—the Kuwaiti Investment Board, for example, began in 1953 for the purpose of managing the “excess” oil revenues Kuwait was expected to garner in the coming years. The next wave

of funds was established during the oil boom of the 1970s. Oil exporters such as the United Arab Emirates, Saudi Arabia, and Alberta used their SWFs as a way to absorb excess liquidity that could potentially overheat their economies. Recently, another oil and natural resources boom—alongside a massive buildup of foreign exchange reserves among non-commodity exporters—has spurred a new group of countries to establish sovereign wealth funds. These countries, including South Korea, Venezuela, Iran, and Algeria, are much more geographically and economically diverse than their older counterparts. Many of these newer funds represent countries that are not commodity exporters, are not necessarily facing excessive financial liquidity, and are oftentimes still quite economically underdeveloped—a far cry from the “overabundance” scenarios that spurred the first two rounds of sovereign funds. Additionally, in the last ten years, the scope and size of all sovereign funds has changed. Although sovereign wealth funds are by no means a recent phenomenon, they have nearly doubled in size since 2000 from \$1.5 to \$3 trillion, and at their current rates of growth, look to surpass total foreign exchange reserve holdings in total size by 2011 (Davies, 4).

*C. What countries have sovereign wealth funds? How big are they?*

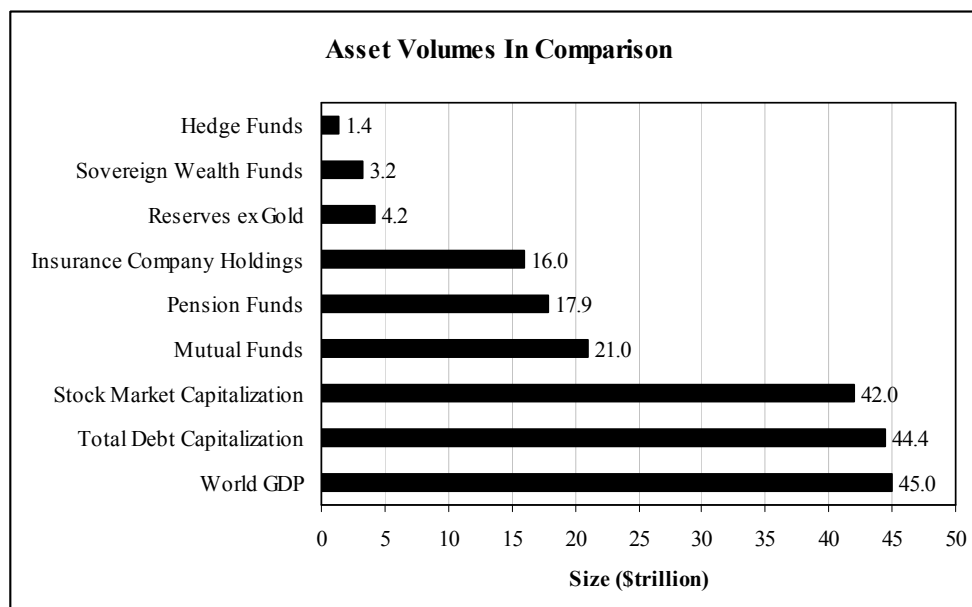
The twenty largest funds, according to Morgan Stanley and the Peterson Institute, are listed on the next page in Figure (1). As you can see, sovereign wealth funds hold approximately \$3.19 trillion, while the top five SWFs account for over 90% of total holdings. Additionally, the world’s largest sovereign wealth fund—the Abu Dhabi Investment Authority—is over twice the size of its closest peer, accounting for 27% of total sovereign wealth fund assets. In addition to what is listed below, Taiwan, Libya, Ireland, Nigeria, Chile, Botswana, Azerbaijan, East Timor, Uganda, Angola, and Papua New Guinea hold the remaining 10% of total fund assets, with fund sizes ranging between \$200 million and \$4 billion. In coming years, Japan, and Bolivia also look to join the sovereign wealth fund community through the establishment of their own funds.

Figure 1: Largest Sovereign Wealth Funds

Country	Fund(s)	Assets (\$billion)	Year Formed
UAE	Abu Dhabi Investment Authority	875	1976
Singapore	Government of Singapore Investment Corporation, Temasek Holdings	430	1981, 1974
Norway	The Government Pension Fund of Norway	308	1996
Saudi Arabia	Saudi Arabia's "menagerie" funds	300	N/A
China	State Foreign Exchange Investment Corporation	300	2007
Kuwait	Kuwait Investment Authority	234	1953
Russia	Stabilization Fund of the Russian Federation	122	2003
Qatar	Qatar Investment Authority	50	2005
Algeria	Revenue Regulation Fund	43	2000
US (Alaska)	Alaska Permanent Fund	42	1976
Australia	Australian Government Future Fund	40	2004
Brunei	Brunei Investment Agency	30	1983
South Korea	Korea Investment Corporation	20	2006
Malaysia	Kazanah Nasional BHD	18	1993
Kazakhstan	National Oil Fund	18	2000
Venezuela	National Development Fund	15	2005
Canada	Alberta Heritage Savings Trust Fund	14	1976
Iran	Oil Stabilization Fund	12	2000
New Zealand	Superannuation Fund	10	2001
All Sovereign Wealth Funds Total		3,190	

When put into perspective, though, it can be seen that sovereign wealth funds are **not** the dominant capital holders in the world economy. While SWFs are twice the size of total hedge fund assets, they are one-twentieth the size of total private holdings and account for just a fraction of total world GDP. As seen by Figure (2), sovereign wealth funds are dwarfed by the holdings of the world's insurance companies, pension funds, and mutual funds. On the other hand, as compared to other public financial transactions, sovereign wealth funds dwarf inter-country flows of official aid. For example, if the Marshall Plan were quoted in today's dollars, it would only amount to \$100 billion—a small sum when compared to the \$3 trillion size of sovereign wealth fund holdings.

Figure 2: Total Asset Volumes by Type



*D. Where did all the money come from?*

Sovereign wealth funds are funded through three strategies. First, natural resource-exporting countries typically fund their SWFs through revenues on commodities owned or taxed by the government. Examples of funds held by natural resource-exporting countries include Norway's Government Pension Fund and the United Arab Emirates' Abu Dhabi Investment Authority. The second route through which countries finance their SWFs is the transfer of assets from foreign exchange reserves. Non-natural resource exporting countries such as Singapore, China, and South Korea are the primary users of this second route. The massive reserve buildup in recent years has made reserves transfers especially popular—80% of all reserves are now held by only 20 countries, 18 of whom have established sovereign wealth funds or plan to establish a SWF in the next five years. Third, all sovereign wealth funds are at least partly financed by the disbursement of sovereign debt on international markets. Typically, if a sovereign does not spend all the capital it raised from international sources, the remaining funds are given to its foreign reserve or sovereign wealth fund holdings.

*E. Why do countries establish sovereign wealth funds?*

Sovereign wealth funds are established for four principal reasons. Firstly, most funds held by natural resource exporters act as intergenerational transfer mechanisms, where future government pensions, asset liquidity, and fiscal revenues are guaranteed by today's export earnings. When the country's natural resources are exhausted, therefore, future generations can continue to live prosperously using the earnings of their forefathers. Next, most sovereign wealth funds of all country types are created to diversify a country's income so that it can respond to shocks to the country's comparative advantages. When a country is faced with a competitiveness crisis, it can call on its sovereign wealth fund assets to reinvest in new sectors of the economy that can revive the country's competitive advantages. Thirdly, countries establish sovereign wealth funds to increase the return on assets held in their central bank reserves. By investing in securities other than U.S. or European sovereign bonds, they can raise returns above the 3-5% annual returns garnered by most foreign exchange reserve holdings. With rapidly expanding foreign exchange stocks in many emerging markets and the decline of the U.S. dollar—and thus lower returns on dollar-denominated debt—this desire has become increasingly prevalent in recent times.

Some sovereign wealth funds, whether in word or practice, also seek to promote investment from multinational corporations and technological transfer to domestic industries. To accomplish this goal, a fund would have to acquire a majority stake in a company or form a coalition with other shareholders.

With its voting power, the SWF can appoint corporate board members that could direct a company to invest in the SWF's home country, and especially, establish research and development facilities there. On the tech transfer end, these research and development facilities could produce new technologies under the intellectual property regime of the SWF-holding country, allowing it to tailor its patent laws to favor the dissemination of newfound knowledge to domestic firms. On the other hand, due to the political implications of such a strategy, this practice is far from universal. Only those countries seen as "allies" of the United States—Taiwan, South Korea, and Singapore—have invested in foreign companies to promote technological innovation in domestic industries, and have avoided major investments in U.S. technology firms. Furthermore, only Singapore's sovereign wealth fund has actually acquired corporations for this aim.

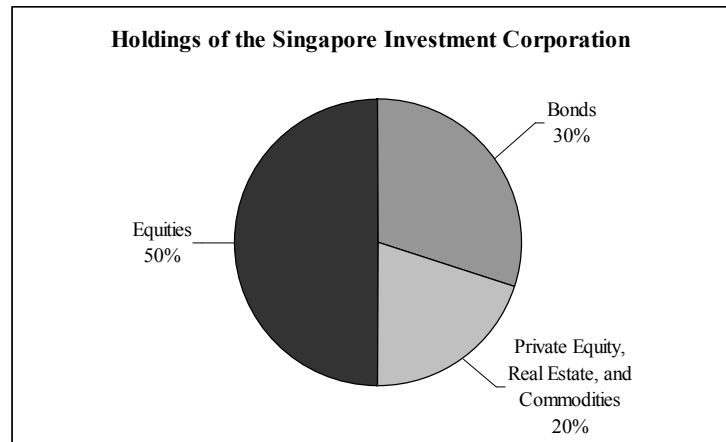
On the other hand, no SWF to date has invested in a company for reasons of political "blackmail" or espionage. Some funds, including the Abu Dhabi Investment Authority, have a stated policy to avoid majority stakes in companies due to the possibility that such "blackmail" could occur. China and Russia, in addition, have both communicated to the Treasury their intention to avoid strategic purchases in the next five years (Lowery, 3). Furthermore, all of the top ten SWFs save the Singapore Investment Corporation and Temasek Holdings have stated that they do not wish to invest in sensitive sectors such as oil, gas, telecommunications, and national airlines. This, again, is to avoid any concerns that SWFs are looking to make investments for reasons of political positioning. China is even more sensitive in this regard—in its \$3 billion agreement to take a minority stake in The Blackstone Group, it reassured American critics of the deal by waiving its shareholder voting rights. After the Dubai Ports and Unocal debacles, it can thus be seen that SWFs have been quite careful to stay out of the public limelight in the United States and across the world's developed economies. Finally, although SWFs are very secretive in their investments, there is no record of SWFs investing in the economies of "obvious" enemies. As an example, Saudi Arabia has made it policy not to invest in Iran, while China has privately stated that it will not invest in Taiwan.

*F. What do SWFs do with their money?*

Due to the aforementioned objectives of sovereign wealth funds, the vast majority—including those of China, the United Arab Emirates, and Singapore—structure their holdings to maximize investment

returns. An example of a “model” fund is the Government of Singapore Investment Corporation (GSIC)—many newer SWFs have consulted the GSIC during the initiation of their investments. Its holdings are outlined in Figure (3). As seen to the right, approximately 50% of the GSIC’s portfolio is invested in equities, 30% of total assets are held in bonds, and 20% of assets are held in other forms of investment, including private equity, real estate, and commodities.

Figure 3: GSIC Investments



Although the GSIC shows a “typical” SWF portfolio, there is much variation over the *types* of equity, bond, and other investments involved in a country’s sovereign wealth fund. To meet the objective of “smoothing out” pension fund obligations and government revenues, for example, countries tend to invest countercyclically, taking stakes in industries and countries that perform best when the SWF-holding country’s economy is performing poorly. Examples of this strategy include the holdings of Norway and Saudi Arabia, where investments are primarily made in banking, technology, and industrial companies, and natural resource investments are discouraged. On the other side of the countercyclical strategy is Singapore and Malaysia: they tend to invest strongly in natural resource plays. Also, smaller “stabilization” funds oftentimes seek higher allocations of lower-risk equities and bonds because it is likely that they will be called upon during times of worldwide economic slumps—because only low-risk securities hold their value during global slumps, investments in high-risk assets are of little use to these funds. Additionally, countries such as Singapore and South Korea that are seeking to develop specific industries and encourage the transfer of technology to native firms target the equity of companies that can carry out their goals.

A second difference in SWF holdings involves the farming out of assets: while South Korea allows 75% of its sovereign wealth fund assets to be managed by outside investment managers, the Abu Dhabi Investment Authority employs a staff of thousands and manages all its assets in-house. This difference

is due to a number of factors, including the demand for transparency and independence in a SWF and the on-hand technical expertise a country possesses. For example, if a country wants its SWF to be both free of corrupt appointees and political patronage, and if the financial waste of the SWF can be determined due to its relative transparency, it is likely that more of its holdings will be invested by third-party managers. On the other hand, if there is little accountability of the SWF to the country's citizens and there is little information available to determine what waste exists within the investments and bureaucracy of the sovereign wealth fund, it will tend to invest nearly all its assets directly.

*G. What have SWFs been up to recently?*

Recently, a number of deals have been announced between sovereign wealth funds and major international corporations. Following their aforementioned investment strategies, most SWFs have only made strategic investments—and not outright acquisitions—in firms. Even more importantly, the vast majority of outright acquisitions have been made in the developing world, and SWFs have been seen to avoid such purchases in the U.S., E.U., and Japan. Nevertheless, several high-profile deals have been negotiated between Western companies and SWFs. As seen by Figure (4), the largest sovereign wealth funds—China's Foreign Exchange Investment Corporation, the UAE's Abu Dhabi Investment Authority, Qatar's Investment Authority, and Singapore's Investment Corporation—have all negotiated deals in the last year to take minority stakes in large American, British, Australian, and European firms. It is also apparent that financial firms dominate the list of recent deals. This is due to the fallout of the subprime crisis, where SWFs have seen a buying opportunity in undervalued global banks, and banks such as Morgan Stanley, UBS, and Barclay's have welcomed SWFs as a source of cheap financing while they repair their tattered balance sheets. Additionally, SWFs have taken a strong investment role in the Chinese economy, as seen by the stakes of Qatar, the UAE, and Singapore in Chinese firms.

Figure 4: Recent Major Acquisitions by Sovereign Wealth Funds

SWF Origin	Company	Size of Stake	Total Cost (\$bln)	Sector	Country
China	The Blackstone Group	10%	3.0	Private Equity	U.S.
	China Railway Corporation		0.1	Construction	Hong Kong
	Morgan Stanley	10%	200.0	Financials	U.S.
	ANZ		0.6	Financials	Australia
	Barclay's	3%		Financials	U.K.
UAE	EADS	3%		Aerospace	France, Germany, U.K.
	Citigroup		7.5	Financials	U.S.
	China Development Bank	3%		Financials	China
Qatar	London Stock Exchange	20%		Financials	U.K.
	J. Sainsbury	25%	1.5	Supermarkets	U.K.
Singapore	UBS		10.0	Financials	U.K.
	Barclay's	5%	19.0	Financials	U.K.
	China Construction Bank	4%		Construction	China



Outside of these large acquisitions, considerable investments have also been made in emerging markets. For example, 16% of the Abu Dhabi Investment Authority's assets are currently invested in countries outside the OECD, including India, China, and South Africa. Also, China has invested roughly \$4 billion in Nigerian oil and gas companies, African telecommunications firms, and Latin American commodity exporters. Singapore, likewise, has invested heavily in Indian banks and Russian hydrocarbon producers. This exposure is thought to be typical of most large sovereign wealth funds, where, as explained earlier, total asset holdings are large enough to take chances in high-return markets without endangering the core missions of each Fund.

#### *H. Who regulates them?*

Regulatory and oversight structures vary widely between the sovereign wealth funds examined in this study. In short, the transparency of each fund is directly related to the openness of the country's political system: while funds in democratic countries such as Norway, Canada, the United States, and Australia are very open, accountable, and transparent, those of authoritarian countries such as the United Arab Emirates, Saudi Arabia, and Qatar are not. Norway, for example, publishes monthly return figures for its Government Pension Fund and reveals its holdings on a quarterly basis. Its managers are directly accountable to Norway's legislature, and therefore, the Norwegian people. On the other hand, the Abu Dhabi Investment Authority is extremely secretive in its operations, and has never publicly announced its size, holdings, or even the names of its top managers. Because this sovereign wealth fund is only accountable to the unelected Sheikh of Abu Dhabi, it has significant leeway in both its investments and its transparency. Viewing the list of the holders of sovereign wealth funds—where approximately 65% are undemocratic—it can be seen that SWFs, on average, are highly opaque and have both loose oversight and lax domestic regulatory structures. This, in addition, creates great uncertainty over simple assessments such as the size of each fund—this summer, Kuwait's Investment Authority publicized its size for the first time in thirty years; its figure of \$234 billion was only one-half the size of most analysts' projections.

Among developed countries receiving direct investment, a much more comprehensive and strong regulatory regime is present. In the United States, a regulatory agency called the Committee on Foreign Investment in the United States (CFIUS) has the right to review all foreign investments, including those of SWFs, demand stipulations on foreign investments, impose fines if a foreign entity is in violation of such stipulations and, if necessary, block or shut down a foreign investment into the U.S. Because of the far-reaching powers of CFIUS, sovereign wealth funds have sought to negotiate in

advance with CFIUS to prevent a potentially long review of their investments. An example of this is the announcement that the Chinese Investment Corporation would forfeit its voting rights in the Blackstone Group—in advance of the Blackstone deal’s announcement, Chinese authorities consulted several CFIUS members and agreed to the forfeit action as a way to speed up the deal’s approval. Also, a July 2007 reform has strengthened the power of CFIUS, allowing it to block investments that may cause technology transfers from U.S. companies to foreign owners and punish foreign investors who do not comply with the U.S.’s international sanction laws. Moreover, the reform reaffirmed CFIUS’s role as the sole negotiator of foreign investments into the U.S.—not even Congress can overturn its rulings. Therefore, CFIUS has the power to end stakes by outside sovereign wealth funds in the U.S. if they are seen to engage in anticompetitive activities or make acquisitions in industries vital to national security. Also, if it desires, CFIUS can force sovereign funds to reveal their holdings to outside authorities.

In Europe and Japan, regulatory structures similar to CFIUS exist, but their powers and oversight missions are much less well-defined. Germany, Italy, the United Kingdom, and France all protect their vital industries and corporations through “blacklists,” where foreign investors are prohibited from making acquisitions in a specific list of companies. On the other hand, only the governments of France and Japan have active oversight agencies like CFIUS to analyze existing foreign investments in vital areas of the economy or in companies that are not on their “blacklists.” Moreover, France, Germany, and the United Kingdom have never interfered in a direct investment by foreign entities in recent history. On the other hand, Chancellor Merkel, in response to growing awareness of the power of sovereign wealth funds, has championed a CFIUS-like entity to oversee and regulate foreign investments in the German economy (Truman, 11).

Among emerging market economies that have seen investment by SWFs, regulatory responses have been lackluster and laws regulating foreign sovereign wealth funds are quite lax. This is a product of their bad bargaining positions: many of these emerging market countries desperately need foreign investment, and a lack of large “star” corporations necessarily creates a “race to the bottom” where sovereign wealth funds, due to their indifference between emerging market economies, choose to enter those countries with the least amount of regulation that could hinder a SWF’s activities.

## II. Criticisms

The first major criticisms of SWFs deal with their effectiveness. As shown by a 2007 IMF study on sovereign wealth funds in natural resource-exporting countries, there is little evidence to show that sovereign wealth funds have achieved the goal of “smoothing out” liquidity, government expenditures, and pension obligations between times of strong and weak natural resource prices. Furthermore, the IMF reported that countries possessing SWFs found it difficult to coordinate fund operations with fiscal policy, where investments by companies held by SWFs did not occur in concert with government programs intended to develop new high-tech industries. Very few SWFs have ever been asked to draw down their holdings for the greater, “national” well being, and, in general, the IMF found that SWFs acted as independent bodies, disconnected from their governmental superiors and concerned with only one principle mission: self-preservation (Kern, 17). Additionally, the IMF found an interesting paradox in the relation between SWFs and their home countries—the more reliant a country is on one commodity, the less effective its SWF is in achieving its goals (Ibid, 16).

A second argument against the existence of SWFs pertains to those funds that are not funded by commodity earnings. In this case, sovereign wealth funds can only grow in size through sterilized currency intervention, and thus must garner returns higher than the bonds it disbursed during sterilizations. Because many non-commodity SWFs exist in countries with existing or potential high interest rate environments, and because sterilization instruments are not backed by natural resource earnings, the high interest rates of sterilizing bonds create a difficult return environment for sovereign wealth funds. These high rates may spur SWFs to participate in excessive risk taking, creating an environment where a country could become insolvent not because it was experiencing a scarcity of funds, but instead because it could not effectively manage financial plenty.

The third major criticism of sovereign wealth funds is that their goal of building a financial base that can be used to respond to shocks in comparative advantages is misguided. Simply put, it makes much more sense to invest now to diversify a country’s economy and protect against possible comparative advantage shocks than to create an “endowment” to rebuild an economy once a shock occurs.

Fourthly, international observers criticize sovereign wealth funds for their secrecy and lack of transparency. Some, including Chancellor Merkel of Germany, worry that SWFs will use third party proxies to disguise their holdings in major corporations, thereby allowing sovereign wealth fund-holding countries to enact surreptitious policies that ultimately enrich themselves at the expense of developed countries. Moreover, commentators in the U.S. are also concerned with the national security

implications of SWFs—although there is little evidence of SWF-led corporate espionage, the Dubai Ports debacle has ignited new worries in the U.S. that China’s SWF will use its corporate power to steal knowledge from U.S. companies, and that Iran’s SWF could be used to smuggle potential terrorists into the United States. On the other hand, both the concerns of Germany and the U.S. do not imply that both countries will shut themselves off from SWF investments—these threats, however unlikely, can be effectively managed by CFIUS-style institutions, allowing each country to enjoy the upside of sovereign wealth fund investments: increased human and physical capital formation.

Although the industrialized countries of the world have been more vocal in their worries over SWFs, developing countries are the most threatened by sovereign wealth funds. Because of lax oversight of foreign inflows and the relatively weak military, economic, and diplomatic power of developing countries, sovereign wealth funds are much less careful to avoid taking strategic stakes and making acquisitions in these countries’ natural resource, infrastructure, defense, and telecommunications sectors. If a sovereign wealth fund does indeed become bellicose, the lack of institutional strength in emerging markets could allow SWFs to perform untraceable corporate espionage and economic blackmail, giving the SWF’s home country a new bargaining chip with which it can destabilize its enemies. This worry is quite palpable among the countries that were once part of the Soviet Union: the Ukraine, the Baltic States, and Georgia have all expressed publicly their worry that Russia’s sovereign wealth fund will be used to “sabotage” their energy independence.

### **III. Implications**

Numerous scholars have attempted to predict the implications of sovereign wealth funds in the world economy, in international politics, and within financial markets. The number of opinions in the SWF debate is almost as great as its diversity of predictions—while some anticipate that sovereign wealth funds will help usher in a more calm and stable international economy, other see SWFs as divisive “bargaining chips” in world politics. This section looks analyze what will happen, what may happen, and will not happen as a result of the growth and formation of sovereign wealth funds.

#### *A. What Will Happen*

1. More liquidity and lower costs of capital in equity markets, and especially in emerging markets.

Because sovereign wealth funds inject capital into equity markets that would otherwise be channeled into debt markets, companies listed on the world’s equity exchanges will see a higher demand for their stock, and thus, larger markets, more liquidity in individual stocks, and ultimately, higher equity prices.

Higher equity prices, in turn, will allow companies to more easily raise capital through the selling of common stock. Because SWFs have stated their intent to invest in emerging markets, and because emerging markets are currently much more illiquid than larger, developed exchanges, the enhanced liquidity and lower costs of capital created by SWFs will be most prevalent in the Mumbai, Singapore, Mexico City, Sao Paulo, Hong Kong, Seoul, and Johannesburg exchanges.

## 2. Increased demand for the services of investment managers.

Because of the relative inexperience of newer sovereign wealth funds, many will turn to third-party investment managers to manage at least some of their assets. Companies like State Street Global Advisors, T. Rowe Price, Barclay's Bank, and Fidelity Investments will therefore likely see large inflows of capital into their funds. Also, it is likely that fund managers will see increased demand for their services as countries such as China poach the best advisors to manage their sovereign wealth funds.

## 3. A small change in the risk/reward tradeoff.

Because sovereign wealth funds will take on more risky assets than managers of foreign exchange reserves, *ceteris paribus*, riskier firms will find it easier to raise capital, but less risky corporate and government entities will find it harder to raise capital relatively cheaply. Therefore, the global allocation of capital will be somewhat skewed by sovereign wealth funds to more risky opportunities. On the other hand, because SWF capital flows in the coming years will be dwarfed by those of larger pension funds, insurance companies, and mutual fund managers, it is unlikely that this adjustment in the risk/reward tradeoff will be very large.

### *B. What Won't Happen*

#### 1. A Spike in the Interest Rates of U.S. Treasuries.

Although sovereign wealth funds will allow countries to diversify their holdings of foreign securities away from U.S. government bonds, future global reserve growth *apart* from the growth of sovereign wealth funds is more than adequate to absorb the anticipated disbursement of U.S. government bonds at their current prices in the next five to seven years.

#### 2. Confrontations between the U.S., the UAE, Russia, and China over SWF holdings.

The UAE, China, and Russia have all stated that they will avoid sensitive industries and acquisitions of U.S. firms in the near term. Moreover, in the case of the UAE, the Abu Dhabi Investment Authority

has a stated policy that it does not make strategic acquisitions as part of its investment strategy and avoids, at all costs, highly visible holdings. In the case of China, it is modeling its sovereign wealth fund after Singapore's Investment Corporation and is recruiting top managers from the private sector to manage its SWF, showing that it will maximize total returns above all else and favor a private sector approach to the SWF's management rather than one based upon national security interests. Also, in the wake major losses in its Blackstone investment, China has repositioned two-thirds of its sovereign wealth fund to recapitalize domestic banks, with the other one-third of its fund aimed primarily toward short-term instruments and a buyout of other government-owned investment management corporations. In a way, therefore, China has "neutered" its SWF to a point where it will not have the capital to make any serious impact in the U.S. economy.

In the case of Russia, a similar outlook also supports the evidence that shows that it will not use its SWF to confront the United States. Firstly, the country is still accumulating funds to launch its own sovereign fund, making speculation on the strategy of its SWF a mute point until it is ready in 2011. After the fund is launched, it is likely to be return-driven because the Duma has given itself the power to withdraw yearly an amount from the fund equal to or less than 3.7% of the country's GDP for national spending or debt servicing priorities. With much of the Russian state hinging on populist programs, this power also looks to inhibit the ability of Russia to use its SWF to influence other countries.

### *C. What May Happen*

#### 1. Increased Market Volatility

Although sovereign wealth funds should invest for the long haul if they wish to maximize returns, their opacity and secrecy may create speculative "herding" behavior in financial markets. Due to a lack of information, market actors may interpret a sovereign wealth fund's withdraw or purchase of positions in a financial market as a signal of the long-term fundamental viability of various equities. Therefore, any portfolio repositioning undertaken by an opaque SWF could create large swings in individual and market-wide asset prices. On the other hand, though, there is a likelihood that, due to the relatively small size of sovereign wealth funds versus larger global asset managers, this effect on volatility may be quite muted.

## 2. A Slowdown in the Growth of Sovereign Wealth Funds

Because a significant portion of sovereign wealth fund growth in the last ten years has been experienced by funds held by non-commodity exporting countries, a move to floating currencies by most non-oil exporters would serve to dry foreign exchange reserves growth, and thus, the funding sources of sovereign wealth funds. Especially in the case of China, Singapore, and South Korea, a move toward a floating currency would end the funding of their SWFs, thus sapping the future effectiveness of these funds.

## 3. Greater Demands for Reciprocity in Openness to Foreign Direct Investment

With increased visibility and oversight of SWFs among the larger Western economies, it is possible that they will use the presence of direct investment by SWFs in Western firms as a bargaining chip to demand greater openness in the domestic economies of sovereign wealth fund holders. China, for example, limits foreign stakes in its domestic companies to 25%, while the Gulf states, Singapore, and Russia protect their telecommunications, transportation, and finance industries from foreign investment. Moreover, the vast majority of large sovereign wealth fund holders are listed by the OECD as the *most* restrictive economies in the world. Therefore, there is considerable room for opening in the economies of SWF holders, and with increased scrutiny of the current account surpluses of countries such as China and South Korea, legislators in the United Kingdom, U.S., Germany, and France may demand greater access to foreign markets if they allow sovereign wealth funds to have continued access to Western firms.

## 4. Engagement of SWFs by International Organizations

While there has been some talk of regulation, especially by the U.S. Treasury, there appears to be little chance that the World Bank or the IMF will exert transparency or regulatory demands on SWFs. Such a change in the mission of either international organization would have to be approved by the very donors who have sizable sovereign wealth funds. On the other hand, the World Bank and the IMF are establishing best practice guidelines for sovereign wealth funds, and may attempt to engage these funds in an advisory role with the eventual goal of promoting transparency and openness within all SWFs.

## 5. Squabbles Within Countries Over their Sovereign Wealth Fund Holdings

As shown by the case of China, decisions made by a sovereign wealth fund may have strong political implications in its home government. In 2007, China's 60% loss of its \$3 billion investment in the Blackstone Group created heated fights within the Chinese Communist Party that eventually led to the sacking of several

central bank ministers and party leaders. In this way, therefore, market movements or financial mismanagement could cause major squabbles within a country's ruling classes if the performance of its sovereign wealth fund does not meet expectations. As seen in the case of Thailand, such squabbles could even help contribute to a military coup!

#### **IV. Conclusion**

In the last year, sovereign wealth funds have erupted onto the world stage, but, in many ways, have been grossly misunderstood by the international financial press. These funds, although large, are dwarfed by other major sources of capita flows, are not a recent or new phenomenon, and do not, for the most part, pose a threat to the national security of the West. Rather, they seek to maximize investment returns and invest in ways similar to private investment managers. On the other hand, sovereign wealth funds cannot be considered as wholly benign. Firstly, serious questions arise over the effectiveness and even the prudence of such investments. Moreover, sovereign wealth funds have the potential of posing a threat to smaller, emerging market economies due to the lack of proper regulatory frameworks and "star" companies in these capital-hungry countries. Finally, sovereign wealth funds could spark an increase in capital market volatility and even power struggles within the home government of a fund. Therefore, a comprehensive, detailed knowledge of the practices and goals of sovereign wealth funds is needed if a country is to reap the foreign investment benefits of these funds without suffering from the less desirable drawbacks of the emergence of SWFs.



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