Sovereign Wealth Funds
Some Frequently Asked Questions

THE CORNER HOUSE

If you've been reading the financial pages of the newspapers over the past few months, you will undoubtedly have come across reports describing how oil-rich, unaccountable and non-democratic governments have been aggressively buying up large portions of the world economy with their state-owned wealth funds. The stories have focused particularly on the multi-billion dollar investments that leading sovereign wealth funds (SWFs) from Asia made in beleaguered international banks in 2007 when the credit crisis began to emerge.

Paranoia is rampant in the reporting. "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 Citigroup banker. Another US-based observer remarked, "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 entitled, "Citi of Arabia,"[3] lamenting investments by the Abu Dhabi sovereign wealth fund in Citigroup, while in January 2008, *The Economist* ran a provocative cover story on "The invasion of the sovereign wealth funds."[4]

Much of the controversy has centred on overtly political issues rather than financial ones. Neo-liberal thinkers tend to be ideologically opposed to the very concept of state-owned funds and view them as fundamental challenges to free markets and private enterprise. Western policy makers, business leaders and commentators bemoan the SWFs' rapid rise on the grounds that the funds are pursuing strategic foreign and security policy objectives rather than commercial ones. They suspect that investments by sovereign wealth funds are aimed at securing control of strategically important industries, such as telecommunications and energy, for political ends. Others fear that countries will use their SWFs to destabilize financial markets, to protect national industries or to acquire technology.

These deep (but vague) fears have sparked a heated debate in the United States and Europe about the extent to which SWFs from other countries should be allowed to invest in national markets. A protectionist backlash against SWFs is fast emerging. The US, Canada, Australia and Germany have introduced substantial legislative changes in order to screen and restrict investments by SWFs and other state-owned entities.

Are such fears based on facts or fiction? Are sovereign wealth funds really invading? Do they pose a threat to global financial stability? Do they have hidden agendas? Are SWFs driven by political considerations? Are Asian governments using SWFs to pursue nefarious foreign policy objectives?

1. Quoted in Srinivas Srikanth, "Greed Versus Fear," *BusinessWorld*, 29 March 2008.
2. Patrick Mulloy, Washington representative of the Alfred P. Sloan Foundation, quoted in Dennis K. Berman, "The Deal Story of 2008: Will the U.S. Get LBOed?," *The Wall Street Journal*, 20 November 2007. In an LBO or Leveraged BuyOut, an investor borrows money (thereby incurring debt) to buy enough shares in a company to take control of it.
3. "Citi of Arabia", *The Wall Street Journal*, 29 November 2007.
4. "The invasion of the sovereign wealth funds," *The Economist*, 17 January 2008.

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Whatever the answers, one thing is certain: sovereign wealth funds cannot be ignored. Therefore it is imperative to understand their potential impact and implications in the rapidly changing environment of the global political economy.

What is a Sovereign Wealth Fund?

A sovereign wealth fund is a large pool of assets and investments owned and managed by a national or state government

Although "sovereign wealth fund" is now a catchphrase in the financial press, there is no single universally accepted definition of the term. It was coined only in 2005 by Andrew Rozanov of State Street Global Advisors, the fund management arm of the US custody bank, State Street Corporation,[5] who characterised SWFs as separate funds created out of foreign exchange reserves to meet specific purposes. Since then, everyone has defined a SWF in their own way, ranging from the International Monetary Fund (IMF) to banking firm Morgan Stanley to think-tank Peterson Institute for International Economics. Indeed, there are more definitions of a sovereign wealth fund than actual funds.

It is generally agreed, however, that a sovereign wealth fund is a large pool of assets and investments owned and managed (directly or indirectly) by a national or state government. It may be funded by foreign exchange (forex) reserves,[6] commodity exports, the proceeds of privatisations or fiscal surpluses.

To a large extent, SWFs have been set up to diversify and improve the return on a country's foreign exchange reserves or commodity revenues, and to protect the domestic economy from fluctuations in international commodity prices. Typically, a sovereign wealth fund, besides being state-owned and managed separately from official foreign exchange reserves, has:

- a high foreign currency exposure;
- no explicit individual liabilities (unlike pension funds);[7]
- a high-risk tolerance; and
- a long-term investment horizon.

It would be a mistake, however, to consider SWFs as a homogeneous group because their key characteristics – sources of funds, governance structures, operations, investment patterns, objectives, and legal and institutional structures – are hugely divergent. Many SWFs are not legally separate from their respective governments or central banks (such as Norway's Government Pension Fund) although some do operate under a separate legal entity (such as the Korea Investment Corporation), while Temasek Holdings of Singapore has been established as a private corporation governed by the country's company law. Like central banks, SWFs deploy surplus forex reserves; but since SWFs are set up to diversify investment, they undertake long-term investments 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 are the Main Types of SWFs?

Although SWFs are a heterogeneous group, and their policy objectives and investment strategies keep changing over time, they can be broadly divided into three main types based on their purposes:

5. Andrew Rozanov, "Who Holds the Wealth of Nations," *Central Banking Journal*, Vol. 15, No. 4, 2005, pp.52-57.
6. Official exchange reserves are a country's liquid external assets (foreign currency, foreign currency bonds and gold) held by the country's central bank that are used to back the country's liabilities, particularly the national currency. A central bank is a national government bank rather than a commercial, private, investment or retail bank. Its two main tasks, according to *The Economist*, are "preserving the health of the financial system and controlling inflation" ("The year of living dangerously", *The Economist*, 9 August 2008). It is usually responsible for a country's monetary and fiscal policy, controls the supply of money in the economy, sets interest rates, and issues national currency.
7. Pension funds have individual liabilities or claims upon them while the only liability or beneficiary of a SWF is a government and a nation's citizens but in a general rather than specific sense.

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

Savings Funds are set up by governments to create wealth over the longer term so as to meet future needs. Revenues from commodities or fiscal surpluses provide their initial basis. For commodity exporting countries, savings funds help to convert non-renewable assets (such as oil) into financial assets for the benefit of present and future generations. There are few withdrawals on these funds, which invest over a longer-term compared to stabilization funds. One prominent example of a savings fund is the Alaska Permanent Fund, whose money comes from the US state's oil revenues.

Pension Reserve Funds (PRFs) are set up with a specific mandate to finance future public pensions. Owned directly by the government, a pension reserve fund is often treated as a SWF. Pension Reserve Funds usually invest abroad in a wide range of assets. Some PRFs are not allowed to make any payouts for several 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 funds to support their development objectives, such as constructing infrastructure. Examples include Temasek Holdings of Singapore (*see* Box, p. AA), Khazanah Nasional Berhad of Malaysia and the National Development Fund of Venezuela.

The differences between SWFs and many other types of public funds may not be immediately clear. For instance, it is not easy to differentiate a SWF from a public pension fund such as The Netherland's Stichting Pension Fund (ABP) or the California Public Employees' Retirement System (CalPERS) (which despite its name is not a state-owned entity). Pension funds, however, are created to accumulate wealth whereas SWFs are created to manage wealth that has been accumulated through higher surpluses.

Some analysts have argued that other types of state-owned or managed investment funds such as government-employee pension funds (for instance, Japan's Government Pension Investment Fund), social security funds (such as the US Social Security Trust Fund), state-owned companies (for example, Russia's Lukoil) and state-owned development banks (such as the China Development Bank) should also be considered as sovereign wealth funds. There are certainly several common characteristics between SWFs and these entities, a major one being state ownership and control. But there are significant differences, too. For instance, most public pension funds are usually denominated and funded in local currency, whereas SWFs have a high foreign currency exposure. Similarly, the majority of state-owned companies do not substantially invest abroad (although some Asian companies have recently started to invest in foreign markets).[8]

Sovereign wealth funds aim to diversify and improve the return on a country's foreign exchange reserves or commodity revenues

Sovereign wealth funds are funded by foreign exchange reserves, commodity exports, privatisations or fiscal surpluses

Are SWFs a New Phenomenon?

The recent attention accorded SWFs might suggest that they are a new phenomenon, but SWFs have in fact been around for decades, if

8. This paper does not discuss other types of state-owned entities.

not centuries. Some claim that the first sovereign wealth fund was the Caisse des Dépots et Consignations, created by France in 1816 to restore trust in public finances after the 1803-1815 Napoleonic wars.

Sovereign wealth funds have been around for decades, if not centuries

It was in the early 1950s after the Second World War that the first wave of more recently established SWFs arose. The British colonial administration took the lead in setting up SWFs in its colonies. For instance, it set up the Kuwait Investment Board (which later became the Kuwait Investment Authority) in 1953 to invest the country's oil profits for future generations. Kuwait gained independence from Britain only in 1961.

The British colonial administration of the Gilbert Islands in the Pacific Ocean established the Kiribati Revenue Equalization Reserve Fund in 1956 to manage revenues from the export of phosphate deposits. At the time, phosphate exports accounted for almost 50 per cent of government revenue. The objective of this Revenue Equalization Reserve Fund was, again, long-term income generation and inter-generational wealth transfer. Over the years, several other sources (such as fiscal revenues) have contributed to the Fund, which now has assets of more than $500 million, almost nine times greater than the country's GDP. Since the country's independence in 1979, the Kiribati government has used income from the Fund for regular budgetary expenditure.

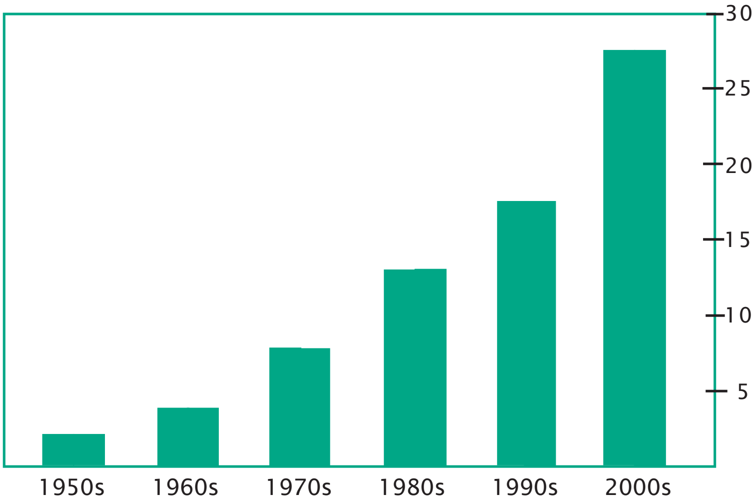
The British took the lead in setting by sovereign wealth funds in its colonies

The second wave of SWFs came in the 1970s and 1980s when a number of oil-producing countries established stabilization funds to accumulate current account and budget surpluses during the oil boom. The Abu Dhabi Investment Authority, now the largest SWF in the world, was formed in 1976, the Brunei Investment Agency in 1983, and the Norwegian Government Pension Fund–Global was set up in 1990.

Singapore was the first country in East Asia to establish a sovereign wealth fund. Its two large funds, Temasek Holdings and the Government Investment Corporation (GIC), were set up in 1974 and 1981 respectively. Other non-oil producers from East Asia have also established funds, largely in response to the 1997 Asian financial crisis.

Since 2005, more than 10 new SWFs have been established as a result of record commodity prices leading to 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 Investment Corporation (CIC) in 2007; and Russia's National Wealth Fund in 2008. In December 2008, Brazil announced the launch of its sovereign

Increase in Sovereign Wealth Funds since the 1950s



Source: Deutsche Bank and Morgan Stanley wealth fund with $6 billion raised from budget surplus. Also in December 2008, the Malaysian state of Terrengganu announced its plan to set up a $3 billion sovereign wealth fund based on the state's oil and gas revenue surplus. Other countries of the South including Bolivia, India, Japan and Thailand have also expressed interest in setting up a SWF in the near future.

For years, SWFs have invested overseas with little controversy or political attention. One of the few exceptions was the Kuwaiti SWF acquisition of a 22 per cent stake in British Petroleum (BP) in 1988 when the British government was selling off the last of its shares in the oil company. A subsequent review by the UK's Monopolies and Mergers Commission concluded that the Kuwaiti SWF could exercise considerable influence over BP; the Kuwaiti SWF later reduced its stake to 9.9 percent.[9]

It is only recently, however, that SWFs have attracted so much public and political attention prompted by their growing numbers, asset size and projected growth. In particular, it was SWF investments in distressed US and Swiss banks in mid-2007 as the sub-prime mortgage crisis began to unfold that brought them into the limelight.

What are the Main Sources of Funds of SWFs?

Of the world's top 20 sovereign wealth funds, 14 are funded from commodity revenues, predominantly from oil and gas exports but some from metals and minerals (such as Russia's Reserve Fund or Chile's Social and Economic Stabilization Fund). The revenues are generated in a variety of ways, including profits made by state-owned companies, commodity taxes and export duties.

Non-commodity SWFs are largely funded by transferring assets from official foreign exchange reserves, although some are based on fiscal surpluses, proceeds from the sale of state-owned enterprises to the private sector, and direct transfers from the state budgetary resources.

SWFs are one of many investment vehicles used to deploy surplus foreign exchange reserves earned from all these sources. To a large extent, SWFs act as recyclers of surplus funds just as Western banks recycled petrodollars in the 1970s and 1980s.[10]

Do SWFs Belong Exclusively to the South?

Although some of world's largest sovereign funds originate from Southern countries, a number of countries and states in the North have also set up sovereign wealth funds to serve their myriad policy objectives. The

9. BP and Kuwait have a long history. The Anglo-Persian Oil Company (APOC) was founded in 1908 following the discovery of a large oil field in Iran. APOC established the Kuwait Oil Company in 1934, which discovered oil in Kuwait (then a British protectorate) in 1938. APOC was renamed as the Anglo-Iranian Oil Company (AIOC) in 1935. When Iran nationalised its oil in October 1951 and reduced AIOC's involvement to just 40 per cent of the nationalised company, AIOC responded by increasing its oil production in Kuwait. In 1954, AIOC became British Petroleum (and then BP in 2000). In 1941, the UK took control of Kuwait (and Iraq), which obtained independence 20 years later in 1961. In 1975, Kuwait took over ownership of the Kuwait Oil Company.
10. In the mid-1970s, the price of oil rose dramatically because of rising inflation, crop failure in many countries, a falling dollar and oil embargoes. OPEC oil countries were suddenly choking on dollars from their oil sales that they could not use. They deposited the dollars with US and UK banks, which then lent them to Third World countries that needed dollars to pay for their oil imports. US Secretary of State at the time, Henry Kissinger, termed the process "recycling petrodollars". Hundreds of billions of dollars were recycled between OPEC, London and New York-based banks and back to Third World borrowing countries. The buildup of petrodollar debts by the late 1970s laid the basis for the Third World debt crisis of the 1980s. *See* Thomas D. Lairson and David Skidmore, *International Political Economy: The Power for Power and Wealth*, Wadsworth Publishing Company, 2002.

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

SWFs and Estimated Assets under Management

Region	Fund Name	Assets ($bn)
North America and Canada	Alaska Permanent Fund (US)	39.8
	Alberta Heritage Fund (Canada)	16.6
	New Mexico State Investment Office Trust (US)	16
	Permanent Wyoming Mineral Trust Fund (US)	3.7
	Alabama Trust Fund (US)	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) WHERE IS FONDEN?	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)	NA
	Emirates Investment Authority (UAE Federal)	NA
Far East and Australasia	Government 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

Source: Compiled from media and industry reports. NA = Not Available

Alaska Permanent Fund was established by the US state of Alaska in 1976 to reinvest the state's oil profits (*see* Box, p. 35). Other US states, including New Mexico, Wyoming and Alabama, have also set up smaller SWFs. If Norway's Government Pension Fund–Global, Canada's Alberta Heritage Fund and Australia's Future Fund are included, Northern SWFs manage assets worth close to $600 billion (almost 20 per cent of total SWF assets) and invest heavily abroad. If government-employee pension funds (such as Japan's Government Pension Investment Fund) and social security funds (for example, the US Social Security Trust Fund) are also included, the SWF universe becomes dominated by funds based in the North. Such funds 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.

Many Southern SWFs in addition have made London and New York their base for their international operations. The Abu Dhabi Investment Authority, Kuwait Investment Office, Brunei Investment Authority and Temasek of Singapore all have representative offices in London, while Dubai's Istithmar World Capital has opened an office in New York. Moreover, many Southern country SWFs regularly hire US and UK-based management firms, investment banks and advisers for their risk management and managerial skills. For instance, the Korea Investment Corporation (KIC) has outsourced nearly three-quarters of its $20 billion investment portfolio to external fund management firms,[11] mostly from the North.

Sovereign wealth funds have invested overseas for years with little controversy or political attention

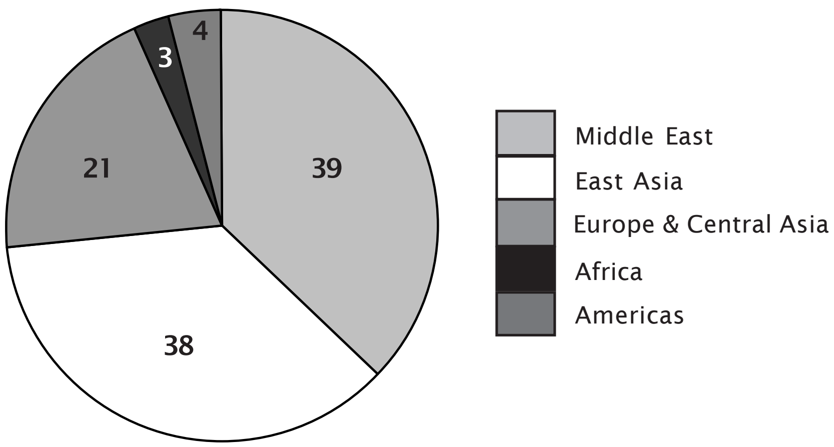
How Big are SWFs?

Estimating the size of the world's SWFs is no easy task because of their myriad definitions and classifications and their limited public disclosures. In certain instances, moreover, funds might be counted twice as some sovereign wealth funds are also recorded in official foreign reserves. Nonetheless, most private and official sources estimate that, at the beginning of 2008, SWFs across the world managed assets worth around US$3 trillion,[12] a figure equivalent to almost half the world's foreign exchange reserves. Back in 1990, SWFs managed only an estimated one-sixth of this: US$500 billion.

At present, there are more than 50 recognized SWFs in operation. According to JP Morgan Research, 39 per cent are located in the Middle East, and 38 per cent in East Asia. Much of the recent growth in

11. Internal managers refers to in-house expertise and staff who manage a fund, while external managers means that the fund hires a fund management firm, mostly based in the US or Europe, to carry out specific transactions.
12. A November 2008 report by investment bank Morgan Stanley suggests that losses of about 25 per cent during the year may have pushed their assets down to US$2.3 billion. http://www.morganstanley.com/views/gef/archive/2008/20081110-Mon.html#anchor7146
Risk consultant and author Satyajit Das thinks that the available pool of money in forex reserves and SWFs may, in fact be far less than assumed if the US dollar loses its favoured position in trade and as a reserve currency. *See* Satyajit Das, "Illusions Over Central Banks' Reserves Could Be Shattered", *Financial Times*, 22 October 2008, http://www.ft.com/cms/s/0/e9685bc4-9fd2-11dd-a3fa-000077b07658.html.

Geographical Distribution of Sovereign Wealth Funds



Source: JP Morgan Research 2008

Sovereign wealth fund investments in collapsing US and Swiss banks brought SWFs into the limelight

SWFs is attributed to the rapid increase in official foreign exchange reserves in Asian countries and the rising revenue gained by oil exporting countries. Market analysts estimate that SWF assets grew 18 per cent in 2007. Although commodity funds (based on mainly oil exports) still account for the bulk of global assets, their share is declining due to the rapid growth of non-commodity SWFs from the Asian region.

Approximately two-thirds of all SWF assets are still held by basic commodity exporting countries. 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 the world's sovereign wealth fund assets. Together, Middle Eastern and East Asian countries account for more than three-quarters of all SWF assets, and the top ten funds account for about 80 per cent of all SWF assets.

Some of the biggest sovereign wealth funds are the 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 that together manage $300 billion. China launched its SWF, the 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. The world's largest SWF, Abu Dhabi Investment Authority, alone accounts for about 27 per cent of total SWF assets.

In the wake of the global credit crisis, SWFs, particularly Asian and Middle Eastern ones, are estimated to have invested over $60 billion in distressed US and Swiss banks in return for minority stakes. GIC and Temasek Holdings of Singapore invested over $25 billion.

SWFs Market Share by Country

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

Source: 2007 estimates by SWF Institute and IFSL.

How Much Clout do SWFs Actually Have?

The influence of SWFs is relative. Their $3 trillion in assets is a lot of money compared to the gross domestic product (GDP) of poor countries such as Rwanda (US$13.7 billion estimated GDP in 2006) or Bangladesh (US$336.7 billion estimated GDP in 2006).

But comparing SWFs with other international funds and financial institutions gives a completely different perspective. In total, SWFs are relatively small players in international financial markets. According to the IMF, total global financial assets amounted to $190 trillion in 2006,[13] of which SWFs accounted for less than 2 per cent. Sovereign wealth funds represent less than 5 per cent of the combined assets of private pension, insurance and mutual funds put together. In May 2008, the total market capitalization of all publicly traded companies in the world was $57 trillion. Even in comparison with the GDP of the US ($12 trillion), assets managed by SWFs, while significant, are not spectacular. Indeed, the world's largest SWF, the Abu Dhabi Investment Authority, is no match for US-based mutual fund Fidelity Investments, which manages $1.5 trillion in mutual funds and another $1.9 trillion in brokerage assets.

13. IMF, *Global Financial Stability Report*, October 2007, p.139.

There is no denying, however, that SWFs do own more assets than those of two other financial entities much in the news recently: hedge funds and private equity (*see* Table 3). But even this comparison misses an important point: both hedge funds and private equity are heavily leveraged,[14] increasing their actual financial prowess. The hedge fund industry's gross investments in financial markets could be as high as $6 trillion.[15]

The IMF has projected that the assets managed by SWFs could reach up to $10 trillion by 2013.[16] Other estimates have put the figure at about $12 trillion.[17] But these scenarios assume continued high oil and commodity prices, a rapid increase in foreign exchange reserves, sustained growth of the world economy and adequate returns on investments.[18] Even accepting such optimistic projections, SWFs would at best account for just 4 to 5 per cent of the world's financial assets by 2012. Therefore, although they will remain important players,[19] any assumption that sovereign wealth funds will be dominant players in the world's financial markets in the next few years is way off the mark.

What is the Rationale Behind Setting up SWFs?

Sovereign wealth funds are set up to manage a country's surplus foreign exchange reserves and revenues. The recent increase in the number of SWFs reflects the large accumulation of such reserves, mostly by Southern countries. According to IMF statistics, global forex reserves tripled from $2.1 trillion to $6.2 trillion between 2001 and 2007, of which the South accounted for more than 80 per cent. Several countries, particularly in East Asia, are accumulating forex reserves especially rapidly. Asia now controls nearly two-thirds of the world's forex reserves, compared to a mere 5 per cent by Europe. China is the world's largest and fastest-growing holder of foreign exchange reserves; these were expected to reach $2 trillion by the end of 2008, reflecting China's current account surpluses from its exports.

Why are Southern countries accumulating such high forex reserves? They have several motives. First and foremost has been to protect their national economies from any sudden flight of capital, a phenomenon that triggered the Southeast Asian financial crisis back in 1997.[20] Thailand and Indonesia were particularly hard hit a decade ago; they discovered they had meagre reserves of their own to ward off the

14. Leverage is the use of borrowed funds (or debt) to enhance a positive (or negative) outcome.
15. McKinsey Global Institute, *The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets*, San Francisco, October 2007, p.22.
16. IMF, "*Sovereign Wealth Funds: A Work Agenda,*" IMF, Washington DC., February 2008. p.6.
17. Stephen Jen, *How Big Could Sovereign Wealth Funds Be By 2015*, Morgan Stanley Research Global, 3 May 2007.
18. A November 2008 report by investment bank Morgan Stanley suggests SWFs will accumulate assets at a less rapid pace in future because of lower oil prices, lower export growth rates, capital flight and new domestic fiscal needs. (http://www.morganstanley.com/views/gef/archive/2008/20081110-Mon.html#anchor7146)
19. Although SWFs represent just 4 per cent of global financial assets, they are, in the ongoing financial crisis, the only class of investor able to undertake large investments. All other classes of investor are facing redemption pressures, and no one else is willing to lend. In this context, the small SWF numbers and their relatively small assets become proportionally much larger, particularly when the overall investment size has shrunk.
20. During the early 1990s, many countries removed their controls over capital flowing in and out of their national economies. "Hot money" refers to capital flowing in or out of a country within a very short space of time. In 1997, a sudden reversal of investor sentiment in several countries for different reasons – concern about the current account deficit in Thailand, and short-term debt in South Korea – led to swift withdrawals of massive amounts of capital from Thailand, Indonesia and South Korea, triggering the 1997-1998 Asian financial crisis. Hong Kong, Malaysia, Laos and the Philippines were also affected. Although financial crises triggered by a sudden reversal of capital flows had happened before, the magnitude and speed of the reversal in Asia surprised most observers.

Largest Holders of Foreign Exchange Reserves

Rank	Country/ Monetary Authority	Forex Reserves ($ bn)	Date
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

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 optimisation	**Abu Dhabi** Investment Authority (ADIA) **Qatar** Investment Authority (QIA)	**Singapore**: Government Investment Corporation (GIC)	**Singapore:** Foreign managed by GIC **Korea:** Foreign reserves managed by KIC **China:** Foreign reserves managed by CIC

Source: JPMorgan, 2008.

speculative attacks on their currencies. This crisis strengthened the resolve among many central banks both within and outside Asia to build up their official foreign exchange reserves so as to protect their national economies from any future volatile capital flows and to prevent a reoccurrence of the Asian financial crisis.

Some Southern countries also built up large stocks of reserves to defend themselves against foreign investors, particularly to defend their economies from speculative attacks on their currencies. Others build up higher levels of forex reserves as an insurance policy against having to rely on IMF-supported bailout programmes that come with strict conditionalities, such as cuts in social spending and privatisation of state-owned companies.

Over the past decade, several Asian countries have now accumulated far more reserves than they need (according to conventional indicators) to protect their domestic economies from trade shocks and volatile capital flows; those most affected by the 1997-1998 crisis now have more than enough to cope with any repeat. IMF guidelines indicate that a country's forex reserves should be sufficient to meet three to four months of its imports, while the Greenspan-Guidotti rule states that they should be no less than its short-term debt.[21] Large forex reserves themselves pose new challenges and risks. They put pressure on a country's exchange rate so that the currency appreciates, negatively affecting the competitiveness of more expensive exports. Excessive reserves could induce asset price bubbles and higher inflation by way of an excessive money supply.[22] There are fiscal costs as well, as the authorities may lose control of monetary policy.

Central banks typically undertake short-term investments in low-yielding liquid assets such as US treasury bills and bonds; the financial returns on these money market instruments are meagre – approximately 1 per cent in the past 60 years, according to Deutsche Bank Research.[23] In contrast, the equivalent real return on a diversified portfolio of 60 per cent stocks and 40 per cent bonds has been until recently almost 6 per cent.[24] Since mid-2008, the sharp depreciation of the US dollar in relation to other major currencies has made investments in dollar-

21. Holding enough money in reserve to pay for 3-4 months of imports is considered reasonable when a country's balance of payments (its transactions with the rest of the world) is dominated by trade. But as many countries in recent years opened their economies up to more international trade and reduced their controls on capital flowing in and out of the country, cross-border flows of capital or financial assets began to dwarf trade flows. Thus an alternative or additional "rule of thumb" for reserve adequacy was suggested in 1999 by the former chair of the US Federal Reserve Board (the US central bank), Alan Greenspan, and a former deputy finance minister of Argentina, Pablo Guidotti. This rule recommends countries keep their reserves at a level to cover all short-term (one year) external debt or foreign liabilities. It is sometimes expressed as being able to live without new foreign borrowing for up to one year.
22. When a country's monetary base (the amount of money in the system) is larger than what an economy is producing, inflation is usually the result.
23. Steffen Kern, *Sovereign Wealth Funds: State Investments on the Rise*, Deutsche Bank Research, September 10, 2007, p.5.
24. Ibid.

denominated money market instruments even more unattractive. Hence state authorities and central banks are seeking alternative investment opportunities. Sovereign wealth funds have become an obvious choice for diversifying investments and maximising returns over the long run. By establishing SWFs, countries can also try to conserve some wealth for future generations (although as with all savings, they could also lose wealth and value if markets and/or economies collapse.)

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 of converting non-renewable assets into financial assets for future generations.

The experience of these countries also plays a part. The oil price boom in the early 1970s encouraged many oil-exporting countries to increase their public expenditures, but they faced a painful adjustment when oil prices plummeted in the early 1980s. This boom-and-bust experience induced many commodity exporters (such as Russia) to establish stabilisation funds by saving some of the gains of the boom years (*see* Box, p. 30). In fact, international financial institutions (particularly the IMF) have encouraged commodity exporters to set up stabilisation funds rather than spending the money on fuelling domestic investment or consumption bubbles.

Southern economies have built up their foreign exchange reserves to protect themselves from speculative attacks on their currencies . . .

and to avoid IMF bailouts requiring social spending cuts and privatisation

Massive global imbalances in trade have also played an important role.[25] China, Japan, South Korea, Singapore and Hong Kong have been running persistent trade surpluses for many years as a result of their rapidly growing exports. Other countries, however, are running large current account deficits, particularly the US, UK, Italy and most Eastern European countries. The huge trade deficit of the US – $711 billion in 2007 – implies that the US effectively borrows almost $2 billion each day to finance its imports. The US economy also relies heavily on foreign investment to finance its spending. Japan, China and oil-exporting countries have been financing these US deficits by buying US treasury securities, agency bonds, and corporate debt and equity instruments. In 2006, Japan was the largest holder of long-term US treasury securities ($644 billion), followed by China with $350 billion. As of September 2008, however, China became the single largest holder of US treasuries with a total outstanding stock of $585 billion in September 2008. (China's total holdings of US securities, including agency bonds, are even higher.)

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

What are SWF Investment Patterns and Strategies?

Despite limited publicly-available information about SWFs, several broad trends in their investments have been observed:

- First, SWFs have undertaken substantial investments across national borders (although some funds invest predominantly in their domestic markets, such as Singapore's Temasek Holdings and Malaysia's Khazanah).
- Second, the overwhelming majority of sovereign funds are passive investors. In the rare cases where SWFs have made direct investments, they have not sought controlling interests or active roles in the management of invested companies, as private equity investors do.[26] Even the large-scale direct investments made by SWFs in US and

25. This argument is well emphasized in John Gieve, "Sovereign Wealth Funds and Global Imbalances," speech delivered at the Sovereign Wealth Management conference, London, 14 March 2008. http://www.bankofengland.co.uk/publications/speeches/2008/speech339.pdf .

26. Passive investors typically do not participate in the day-to-day management of companies in which they invest. They buy a stock and hold it for a longer period in the belief that long-term investments will be profitable. In contrast, direct investors or private equity funds buy a stake in a company with the purpose of actively managing the company firm and integrating it into their business model or strategy. *See* Kavaljit Singh, "Taking it Private: Consequences of the Global Growth of Private Equity", *Corner House Briefing* XX, September 2008, http://www.thecornerhouse.org.uk/summary.shtml?x=562660.

European banks during 2007-08 were minor in terms of bank ownership and did not come with any special rights or board representation. Some funds deliberately seek just a small ownership stake in companies in order to diversify their investment portfolio. Norway's Government Pension Fund-Global (GPF) is a prime example. Although GPF has invested in more than 7,000 companies worldwide, its stakes in each one are small, averaging less than 1 per cent. The Fund deliberately does not invest more than 10 per cent in any one company. The Foreign Direct Investment (FDI) component of all SWF investments is also minimal.[27] According to UNCTAD, FDI by SWFs was a mere $10 billion in 2007, accounting for just 0.2 per cent of total SWF assets and only 0.6 per cent of total global FDI flows.[28] In contrast, FDI by private equity funds, which are considered smaller than SWFs in terms of asset size, reached $460 billion in 2007.[29]

- Third, unlike hedge funds and private equity funds, SWFs typically are not highly leveraged institutions.
- Fourth, the bulk of SWF investments have been concentrated in developed countries; Southern countries (particularly in Asia) are a relatively new investment destination.
- Fifth, since SWFs have no explicit liabilities (meaning that no individual has a claim on their assets), they usually have a long-term investment horizon combined with a high tolerance for risk. They therefore tend to invest in illiquid and higher-yielding risky instruments property and securities that are not actively traded. Indeed, the share of risky assets in sovereign wealth funds' portfolios has been increasing over the years.

27. Foreign Direct Investment involves non-citizens of a country buying real assets in a country, such as property, factories or manufacturing plants, and equipment, and managing those assets.
28. UNCTAD, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge*, 2008, p.21.
29. Ibid.

Investment Patterns of Sovereign Wealth Funds

Fund	Foreign Investment	Equity Investment
Abu Dhabi Investment Authority	high	high
Government Pension Fund-Global (Norway)	high	medium
SAMA (Saudi Arabia Monetary Authority)	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
Fund for Future Generations (**Kuwait??**)	high	high
National Oil Fund (**Kazakhstan??**)	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 (Taiwan)	low	high
Government Future Fund (Australia)	medium	medium
Alaska Permanent Fund (US)	medium	medium
Alberta Heritage Fund (Canada)	medium	medium

Note: These are rough approximations. 'High' and 'low' indicate proportions above two-thirds and below one-third respectively. ***Source:*** European Central Bank, 2008.

Composition and Asset Allocation of Selected SWFs

Fund	Asset Allocation	Geographic Allocation
Global Pension Fund (Norway)	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, privateequity allocation as high as 5%	equity portfolio based on share of global GDP, slightly overweight Europe, underweight US.
Qatar I.A. (Investment Authority)	high private equity allocation	unknown breakdown
Dubai International Capital	mostly private equity	most reported purchases have been in UK, Eurozone, Middle East North Africa (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 split into reserve and future generation fund in Feb 2008)	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. Data as of December 2006.

- Sixth, SWFs are gradually moving towards a more diversified investment portfolio. At present, fixed income instruments such as government and agency bonds represent the biggest share of SWF assets, but several SWFs have decided to increase their allocation to equities and "alternative" assets, such as hedge funds and private equity. Norway's Government Pension Fund-Global, for instance, has decided to increase its equity allocation from 40 per cent to 60 per cent by 2010. Newer SWFs from the Middle East have recently increased their exposure to alternative assets, particularly private equity. They have set up dedicated, albeit small, funds to invest directly in private equity funds, and funds of funds. This development matches the rise of the domestic private equity industry in the Middle East and North Africa. Market observers estimate that investments (direct and indirect) by SWFs in private equity worldwide are currently in the range of $80 to $100 billion. SWFs often place their money with a consortium of private equity investors, although their use of leverage is minimal. Like large institutional investors such as pension funds, SWFs can indirectly influence the operations of companies in which they invest. Prominent examples of sovereign wealth funds investing in the private equity business include Qatar's Investment Authority, Abu Dhabi's Mudabala, Dubai's Istithmar and Dubai International

Capital. Some sovereign wealth funds have bought ownership stakes in leading private equity firms:

- In 2006, the Abu Dhabi Investment Authority took a 9 per cent stake in the US-based private equity firm, Apollo Management.
- In May 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.

Recent SWF Investments in International Banks*

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

Source: Complied from various media and industry sources.

* since 2006

In the ongoing credit crisis when banks are reluctant to lend, private equity firms are seeking out sovereign wealth funds to finance their leveraged buyouts. In February 2008, a leading private equity individual predicted that SWFs would "effectively replace Wall Street".[30] Joint deals between SWFs and private equity may take some time to come to fruition because of SWFs' lack of specialised skills and expertise, but could be anticipated nonetheless.

Although a shift in asset allocation will not happen overnight, it has been estimated that SWFs' share in total alternative markets will rise from 6 per cent currently to 10 per cent by 2012. Their real estate holdings may rise but their commodities' exposure is likely to remain small.

Financial services have emerged as one of the important SWF investment sectors, generating consternation among Western policy makers and others. Since the sub-prime mortgage crisis in the United States erupted in mid-2007, sovereign wealth funds have together invested more than $70 billion in the world's leading banks:

- China Investment Company invested $5 billion in Morgan Stanley;
- Abu Dhabi Investment Authority acquired a $7.5 billion stake in Citigroup;

30. Guy Hands of Terra Firma, quoted in Martin Arnold, "Wealth funds fill bank gap for buy-out groups", *Financial Times*, 28 February 2008.

- 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).

But these privately negotiated investments in the Western banking system were minor in terms of ownership stakes. They were not hostile investments (the banks' management knew about and welcomed the investments before they were made) and involved "convertible bonds" that would be changed into equity stakes only at some point in the future. They were made openly and transparently with the approval of the banking regulatory authorities in the host countries. Indeed, by injecting tens of billions of dollars into ailing banks, SWFs acted as a stabilising force in the international banking system (at least in the short-term).

Since banks became reluctant to lend, private equity firms have been seeking out sovereign wealth funds to finance their leveraged buyouts

Are Sovereign Wealth Funds Transparent?

Although the SWF investments in US and European banks were open and transparent, lack of transparency is a justified and frequently made criticism of SWFs. But not all SWFs are opaque: some sovereign wealth funds are very transparent and publicly disclose their asset size, investment portfolio and returns. Norway's Government Pension Fund-Global (GPF) and Canada's Alberta Heritage Fund are examples of transparent SWFs. GPF ranks first in the Linaberg-Maduell Transparency Index of the Sovereign Wealth Fund Institute; few non-SWF or institutional investors can match its high standards of governance, accountability and transparency. GPF publishes quarterly and annual reports that include a detailed disclosure of assets under management, the currency and asset class composition of the portfolio down to company level, and a standardised reporting of its performance against benchmarks. As part of its disclosure and governance standards, GPF published its voting records for 2007 for the first time.

Other SWFs, however, particularly those in the Middle East, do not publicly disclose their asset size, investment strategies or financial performance. A recent survey by the IMF's International Working Group on Sovereign Wealth Funds found that nearly one-fifth of the world's top 20 SWFs are not accountable to their domestic legislatures.[31] These varying degrees of transparency should be viewed in their specific national contexts. It is hardly surprising that opaque governments tend to operate opaque SWFs. Other investment funds and financial institutional in these countries are not transparent either. In some Middle Eastern countries, even basic national statistics are not made public.

A study by the US-based Peterson Institute for International Economics that ranked SWFs 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 terms of the quality of their legal systems and democratic accountability.[32] Similar patterns were observed in the Linaburg-Maduell Transparency Index of the Sovereign Wealth Fund Institute.[33]

Contrary to popular perception, however, the Russian sovereign wealth funds have higher standards of transparency and governance than many other SWFs. The Ministry of Finance that administers the funds publishes a monthly report on their asset size, accumulation and investment positions.

31. International Working Group on Sovereign Wealth Funds, "Sovereign Wealth Funds: Current Institutional and Operational Practices," 15 September 2008.
32. Edwin M. Truman, "Sovereign Wealth Funds: The Need for Greater Transparency and Accountability," *Policy Brief*, Peterson Institute for International Economics, Washington, DC, August 2007.
33. The Sovereign Wealth Fund Institute based in California, USA, describes itself as an impartial organization designed to study sovereign wealth funds and their impact on global economics, politics, financial markets, trade, and public policy. Its two founders are Carl Linaburg and Michael Maduell. http://www.swfinstitute.org/research/transparencyindex.php

Given the lack of transparency and governance of many US and European financial institutions, their calls for SWF transparency lack credibility

Many of the newly launched SWFs have also adopted relatively high standards of transparency and governance. Many have hired 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 (*see* Box, p. 26).

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

In addition, Western governments have recently undertaken several international initiatives to enhance SWF transparency and governance standards. In February 2008, the European Union (EU) suggested a slew of measures, including disclosure of size and sources of funds, annual disclosure of investment positions, asset allocation and currency composition.[34] 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,

34. Commission of the European Communities, "A Common European Approach to Sovereign Wealth Funds," provisional document, Brussels, 27 February 2008.

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. 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 ADIA, which is managed by a Board of Directors appointed by the President.

The main sources of ADIA funds are oil exports, and the investments are managed by both internal and external managers.

ADIA is the second most important institution in Abu Dhabi's economy after the Supreme Petroleum Council (SPC). The current UAE oil minister and key officials in other Abu Dhabi ministries have come from ADIA.

ADIA operates under the Abu Dhabi Investment Council, which also owns a number of state owned firms. The Abu Dhabi Investment Corporation (ADIC) is ADIA's executive arm. In 1984, ADIA created the International Petroleum Investment Company (IPIC) to invest in the energy sector. IPIC is an important player in international oil markets and has made large-scale investments in East Asia, Europe and North Africa.

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

Traditionally, many of its investments have been in equities and fixed income instruments, but market analysts believe that ADIA has now added a diverse range of assets to this mix including real estate, hedge funds and private equity. They estimate that ADIA invests 60 per cent of its funds in equities, 25 per cent in fixed income and the remaining 15 per cent in alternative assets. About 80 per cent of its portfolio is externally managed.

ADIA was one of the SWFs that hit the headlines in 2007 when it purchased large-scale stakes in the ailing Citigroup and Apollo Management (a US-based private equity firm). In May 2007, ADIA also acquired an 8 per cent stake in EFG-Hermes, an Egyptian investment bank. ADIA also maintains close ties with the Abu Dhabi's state-owned Mubadala Development Corporation, which bought a stake in The Carlyle Group (the US-based private equity firm), Ferrari (the Italian carmaker) and Advanced Micro Devices (the US-based chip maker) in 2007.

under the aegis of the IMF, released a set of voluntary principles to enhance SWF transparency and disclosure standards (*see* p.32ff).

But any attempt to push a single, time-bound framework for transparency, accountability and governance may not yield the desired results given the varying degrees of ownership and governance norms practised by the SWFs. Moreover, the demand by the West for increased SWF transparency lacks credibility given the poor levels of transparency and governance standards amid their own 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 adopted by Western policy makers, and suggests hidden or other motives. In principle, all financial institutions (public or private) should be transparent.

Overlooking the secrecy and unaccounability enjoyed by hedge funds, private equity and investment banks exposes Western policymakers' double-standards

SWFs need to become more transparent and accountable to their legislatures, public institutions and citizens in their home countries. Increased transparency may also help to remove fears in the countries in which they invest; opponents often cite secrecy as an excuse to shun SWFs. Indeed, more transparency could enhance public participation in the management of funds. As Norway's Minister of Finance, Kristin Halvorsen, pointed out:

> "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."[35]

But improvements in transparency, governance and accountability will occur gradually and organically rather than overnight.

Do Sovereign Wealth Funds Destabilise Financial Markets?

To date, there is no empirical evidence to support the charge that sovereign wealth funds destabilise financial markets. Those opposed to SWFs, however, argue as follows: since SWFs hold large positions in financial markets, any sudden shift in their asset or currency allocation could have significant price impacts, causing higher volatility in prices and triggering "herd behaviour" (whereby investors follow others in rushing to get in or out of a market), which in turn could pose a potential threat to the entire financial system.

It is true that a large position held by any financial institution poses a potential threat to market stability. But unlike hedge funds, SWFs have not tended to shift their investment portfolios rapidly (even if they use hedging techniques to safeguard their underlying currency exposures). And, as with transparency or lack of it, the phenomenon of herd behaviour is not restricted to sovereign wealth funds, but is common to many, if not most, of the big institutional players. Once again, the way that SWFs are singled out for criticism suggests other motives at work.

Furthermore, the SWF share of global financial markets is too small to destabilise them. SWFs currently account for just three per cent of the global equity market.[36]

Even if one accepts optimistic projections of their future asset size, SWFs will still remain small players in equity markets. By 2012, their share of the global equity market has been estimated to be less than 5

35. Kristin Halvorsen, *Financial Times*, 15 February 2008.
36. Large SWFs presently have considerable exposure to equities that they will not increase further. Smaller SWFs might enhance their equity portfolio but doing so would not affect markets overall. Individual funds would have more impact on individual stocks, transactions, and mergers and acquisitions. This type of SWF investment did increase when SWFs bailed out ailing US and European banks, helping to stabilise the overall banking system at the time. More SWF investments in private equity would allow private equity funds to undertake large deals, but the impact would be more in terms of individual buyout transactions rather than the overall direction of the underlying markets. In the case of real estate, SWF transactions may drive up property prices in certain locations but would not distort property markets overall.

China Investment Corporation

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

To raise funds for CIC, the Chinese government issued special treasury bonds (which were bought by the central bank, Agricultural Bank of China, other banks, financial institutions and state-owned vehicles) and used the proceeds to buy foreign reserves from the central bank. CIC is expected to earn a return that exceeds the annual interest that the government pays out on these special treasury bonds. The Chinese government may well increase CIC's asset base in future by issuing more treasury bonds.

The ultimate responsibility and accountability of CIC lies with the State Council, (China's chief administrative authority that is largely synonymous with the Chinese government), which also appoints a Board of Directors.

Although its investment processes are not publicly known, it is well established that CIC is modelled on Singapore's government Investment Corporation (GIC) and Temasek Holdings. Up to $90 billion of its funds are estimated to 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 is believed to be invested in domestic banks and financial institutions. CIC recently made a $100 million investment in the China Railway Group during its initial public offering (IPO) on the Shanghai stock exchange.

To date, CIC has made several investments in the financial sector overseas. In May 2007, CIC made a $3 billion pre-IPO investment (with non-voting rights) in the US-based private equity firm, The Blackstone Group, before the firm's official launch on the New York Stock Exchange. In December 2007, it invested $5 billion in banking firm Morgan Stanley in the form of mandatory convertible securities.

In early 2008, CIC agreed to launch a $4 billion private equity fund with private equity group JC Flowers & Co focusing primarily on financial assets in the US. This would be CIC's first private equity fund; CIC is expected to provide about 80 per cent of the fund with JC Flowers with other general partners providing the rest.

With the spread of the credit crisis during 2008, the value of CIC investments in international banks and private equity firms has declined significantly. 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 Northern countries (particularly the US) about CIC's lack of transparency, CIC issued a brief publication giving information about its operations, but not detailed information about its investment strategy, decision-making processes or structures. Senior CIC management has declared that their fund will act as a "good corporate citizen" and will not invest in companies that damage the environment, waste energy or produce tobacco. Given the suspicion in Western policy circles over the motives of Chinese investment, CIC may well avoid strategic direct investments and acquisitions for some time.

The State Administration of Foreign Exchange (SAFE) is another Chinese sovereign wealth fund and 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, however, SAFE has become an active investor with greater exposure to equities worldwide. In April 2008, SAFE purchased a $2.8 billion stake in the French oil firm, Total. It has also recently bought stakes in Australian banks and is contemplating investment in private equity and other alternative assets.

per cent. It is hard to accept the claim, therefore, that sovereign funds could build up large positions in financial markets and destabilise them.

Norway's Government Pension Fund-Global (GPF), which follows a policy of negative screening and divestment on ethical grounds, has intentionally designed its divestment process so as to avoid any downward price pressure and market instability. When GPF divested from US retailer Wal-Mart and mining company Vedanta Resources, its exit had no negative impact on company share prices or market capitalisation (*see* p.25).

That said, there is no denying that increased SWF financing of private equity funds and hedge funds poses potential market risks. But the same argument also applies to the far bigger pools of capital that have to date provided the bulk of money to such players. SWFs as a group are also relatively small players in other alternative markets, such as property and commodities.

Far from destabilising financial markets, a number of factors suggest that sovereign wealth funds could in fact exert a potentially stabilising influence:

- In contrast to hedge funds, SWFs do not use excessive leverage to amplify their positions and returns.
- SWFs are typically patient investors with long-term investment horizons. Since they have no explicit liabilities, they can remain committed to their investments in the hope of booking higher returns in the future.
- SWF investment portfolios are well diversified, unlike central banks that tend to concentrate on government and agency bonds.
- SWF funding sources tend to be fairly stable, which makes them less sensitive to market volatility.
- SWFs are not prone to withdrawals by investors that could force them to liquidate their positions quickly. In contrast, investors in hedge funds and mutual funds can quickly withdraw their money.
- Given their stable funding sources, SWFs are able to 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.
- SWFs contribute to economic stability in their home countries by acting as a buffer against volatile commodity prices and mitigating "Dutch disease"[37] effects.

Sovereign wealth funds could act as a stabilising force in the international financial system

Despite all these stabilising factors, concerns have been raised over the implications of large SWF investments in the financial sector in the aftermath of the sub-prime mortgage crisis in the US. This is despite the fact that these investments are minor in terms of ownership stakes and grant no special rights of ownership or board representation. The investments involved convertible bonds that would be converted into equity stakes in the future and were made in a transparent manner with the approval of banking regulatory authorities. SWFs invested at a time when the banks were facing a severe liquidity crisis. They bought stakes in UBS, Citigroup, Merrill Lynch and Credit Suisse when credit default swap (CDS) spreads[38] were very high. The higher the CDS spread, the higher the perceived risk. By injecting billions of dollars into ailing banks, SWFs acted as counter-cyclical investors and enabled banks to continue their business.

In fact, SWFs have suffered significant paper losses on their investments in Western banks and private equity funds, because the value of their stakes has plummeted as the credit crisis has spread globally. Media reports suggest that sovereign wealth funds have lost $38 billion in value as banks plunged deeper and deeper into trouble in mid-2008.[39] The *Financial Times* reported that they were "shell-shocked about their losses". One commentator noted:

> "They aren't exactly saying they were fleeced but they know they went in early with Citi and Merrill Lynch and Morgan Stanley. They are licking their wounds."[40]

The pain is made worse by the fall in their investments in private equity firms (which was one avenue of minimising the public backlash against their investments in the West). The China Investment Corporation paid over $29 per share for its non-voting $3 billion stake in The Blackstone Group in 2007, but by October 2008, Blackstone's share price was trading at just $8.83. According to a Bloomberg report, Stable Investment Corporation, an affiliate of the China Investment Corporation, has invested as much as $5.4 billion in Reserve Primary Fund, the US money market fund.[41]

37. The term "Dutch disease" was coined to describe the sharp decline in Dutch exports of manufactured goods and lowered national economic growth in The Netherlands after the country discovered natural gas in the 1960s in the North Sea, which led to the appreciation of the country's currency. The theory is that an increase in national revenues and a large inflow of foreign currency from sales of exported natural resources raises a country's exchange rate, and thereby makes other sectors of a country's economy, such as manufacturing, less competitive internationally (even though a decreasing manufacturing sector may be due to other factors as well.) In the past two decades, these effects have been noticed in commodity exporting countries. *See* "The Dutch Disease" *The Economist*, 26 November 1977, pp.82-83. WEB
38. A credit default swap (CDS) is a derivative (an asset whose value depends on or is "derived from" the price of another underlying asset) that provides cover if a loan or a bond defaults. Although often described as "insurance", CDSs are in effect bets on the credit-worthiness of a company. For more information, *see* Nicholas Hildyard, "A (Crumbling) Wall of Money: Financial Bricolage, Derivatives and Power", The Corner House, October 2008. http://www.thecornerhouse.org.uk/summary.shtml?x=562658
39. Victoria Stewart and Hugo Duncan, "Sovereign Funds lose £22bn on Bank Bets," *Evening Standard,* 13 October 2008.
40. Henry Sender, "Sovereign funds go cold on rescue finance", *Financial Times*, 10 November 2008.
41. Miles Weiss and Belinda Cao, "China's CIC May Have $5.4 Billion Frozen in Money-Market Fund," *Bloomberg*, 13 October 2008.

SWFs from the Middle East, however, have experienced the biggest paper losses. The Qatar Investment Authority suffered losses from the 70 per cent drop during 2008 in the share price of the London Stock Exchange in which the Authority has a 15 per cent stake. The Kuwait Investment Authority has lost $270 million on its January 2008 $3 billion investment in Citigroup, whose share price has since fallen two-thirds and which is being propped up by a $326 billion rescue package from the US government. Sovereign wealth funds from Middle East are therefore believed to be changing their investment strategies after losing billions of dollars in Western banks. Several funds have reportedly shifted their assets to support domestic markets instead, which have fallen sharply in the wake of global financial crisis. The Kuwait Investment Authority has shifted $4 billion from US and European markets into its own stock market while the Qatar Investment Authority has started bailing out local banks. Media reports suggest that the Abu Dhabi Investment Authority is also retreating to domestic markets and bailing out local banks. The Norwegian government, meanwhile, has decided to use a portion of the Government Pension Fund-Global to pump-prime the domestic economy, particularly public investments in schools, hospitals and infrastructure.

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

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

There is a widespread suspicion in Europe and the US that foreign state-owned entities (particularly those belonging to China, Russia and the Middle East) are trying to acquire stakes in strategic industries (such as energy, infrastructure and high technology) and iconic domestic companies (for example, aviation company EADS) mainly for non-commercial and strategic purposes. Such suspicions have often fuelled protectionist sentiments.

To date, however, there is no clear evidence of SWFs having such objectives nor of their home governments interfering with specific investment decisions or using SWFs to pursue narrow political and strategic objectives. The involvement of governments in most sovereign wealth funds is restricted to determining their overall objectives, investment frameworks and governance structures, and determining any ethical investment guidelines and their implementation (except in the case of the Norwegian SWF).

Protectionist fears about SWF investments have been bolstered by reports in the Western media about several high-profile investment proposals and projects involving other investors from the South including:

- The takeover in May 2005 of IBM's personal computer business by the Lenovo Group, China's largest personal computer manufacturer;[42]
- The proposal in 2005 by the China National Offshore Oil Corporation (CNOOC) to acquire the US-based Unocal Oil Company;[43]

42. Lenovo was founded in 1984 by 11 engineers of a Chinese government agency, the Chinese Academy of Sciences and incorporated on the Hong Kong stock exchange in 1988. Its largest shareholder is the Chinese Academy of Sciences, which has provided financial and technical backing throughout its history. Three leading private equity firms (Texas Pacific Group, General Atlantic LLC and Newbridge Capital LLC) have owned some 6-7 per cent of its shares since 2005.
43. On 23 June 2005, the China National Offshore Oil Company Ltd. (a subsidiary of the state-owned China National Offshore Oil Corporation) announced a bid to buy Unocal for cash. Its bid was opposed as a threat to US security. In July 2005, the US House of Representatives voted for President George W. Bush to review the bid on these grounds. That same month, Unocal's board recommended that its shareholders accept a lower bid from US oil company Chevron. CNOOC withdrew its offer at the beginning of August 2005, and Unocal became a wholly owned subsidiary of Chevron.

- The Dubai Ports World's acquisition in March 2006 of the UK-based P&O container terminals and ferries operator, which included DPW taking over the operations of six US sea ports;[44]
- The purchase in August 2006 of a 5 per cent stake in European Aeronautic Defence and Space (EADS) company by a Russian bank, Vneshtorgbank (VTB, known in Russian as OAO) that was state-owned at the time (it was privatised in 2007);[45] and
- Growing investments, particularly in the extractive industries, by the China Development Bank and China EXIM Bank in Africa and Latin America (which raise US and European fears of losing their long-standing control over markets in Africa and Latin America).

None of these investments has involved sovereign wealth funds, although they have included state-owned corporations or banks that have completely different motives. Unlike SWFs, state-owned companies acquire foreign companies in order to manage them actively and integrate them into their global business operations, much like a privately-owned company. State-owned development banks and financial institutions from East and West, North and South, all provide concessional loans for infrastructure and other projects at both national and international levels. Concerns about direct acquisitions by state-owned corporations should not be confused with passive investments by SWFs.[46]

So far not a single instance of a hostile takeover attempted by a SWF has come to public attention. In cases where SWFs do undertake direct investments, they do not seek controlling interests.

Moreover, some sovereign wealth funds have explicit policies against the fund seeking a controlling interest in the firms in which they invest, Norway's Government Pension Fund–Global being a case in point. Indeed, most SWFs behave just like any other large institutional investor (such as pension funds and insurance funds) and the threats they pose are not so different from those thrown up by these funds.

Another major concern often expressed is that SWFs could be used by their home governments to put political pressure on the host countries or to cause economic hardship.[47] In the words of US trade and finance professor and one-time investment banker 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."[48]

Such concerns are misplaced on two counts. First, since many Asian central banks own large holdings of government securities in the US (and other developed countries), they could potentially harm the US and other economies at any moment by rapidly selling off securities in the financial markets. Why should home governments use SWFs to buy minority stakes in individual companies in the host country with no special rights and board representation to do so? To date, Asian central banks have treaded cautiously to minimise their impact on prices. To a large extent, it is not in their interest or that of SWFs to sell off securities rapidly in the markets because they would suffer losses as prices dropped steeply because of the heavy selling.

Second, most US and European countries already have domestic laws to block any foreign investments that may are perceived as potentially threatening national security. Take the case of the Exon-Florio provision in the US, which allows the potential acquisition by a foreign entity to be stopped if it is deemed to be a national security threat. This provision is implemented by the Committee on Foreign Investment in

44. Dubai Ports World (DPW) is a subsidiary of Dubai World, which is owned by the government of Dubai in the United Arab Emirates. In March 2006, DPW bought P&O, once the world's largest shipping operator and at the time the world's fourth largest ports operator. These ports included those of New York, New Jersey, Philadelphia, Baltimore, New Orleans, and Miami. The Committee on Foreign Investment in the United States (CFIUS) approved the deal, but members of Congress expressed concern over its potential negative impact on port security. By the end of 2006, Dubai Ports World had agreed to sell P&O's US operations to Global Investment Group, the asset management division of the now troubled insurance firm, American International Group, in order to allay concerns about US national security.
45. The VTB bank sold its stake in December 2007 to Vnesheconombank (VEB), whose Russian name translates as "External Economy Bank" but is commonly called the Russian Development Bank (although it refers to itself as the "Bank for Development and Foreign Economic Affairs"). The Russian government uses the VEB to support and develop the Russian economy, and to manage Russian state debts and pension funds. In January 2008, VEB said it would swap its stake in European Aeronautic Defence and Space (EADS) for a holding in Russia's aircraft maker United Aircraft Corp (UAC), which was 90 per cent state-owned at the end of 2008.
46. Even the concerns about the activities of state-owned companies and banks from outside Europe and US seem to hinge more on ideological beliefs in the superiority of privately-owned and -run entities over state-owned ones, and issues about their geographical place of origin (even though Western and US companies have been buying up companies in other countries for decades and opening up other countries to financial and market liberalisation.) One long-standing critique of developing countries within the WTO negotiations has been that developed countries have worked to prise open other countries to Western imports while protecting their own economies, particularly in the area of US agriculture. The hypocrisy at work thus suggests that even 'national security' concerns should be viewed with caution as well.
47. *See*, for instance, David J. Lynch, "Secretive Global Funds May Hurt Treasuries Market," *USA Today*, 21 June 2007; Lawrence Summers, "Sovereign Funds Shake the Logic of Capitalism," *Financial Times*, 30 July 2007; Jeffrey Garten, "We Need Rules for Sovereign Funds," *Financial Times*, 7 August 2007; and David R. Francis, "Will Sovereign Wealth Funds Rule the World?," *The Christian Science Monitor*, 26 November 2007.
48. Jeffrey Garten, "We Need Rules for Sovereign Funds," *Financial Times*, 7 August 2007, http://www.ft.com/cms/s/0/1a968284-44fd-11dc-82f5-0000779fd2ac.html?nclick_check=1

Several institutional investors pursue non-commercial objectives -- ethical investment encourages them to do more

the United States (CFIUS), an inter-agency committee chaired by the US Secretary of the Treasury. In the light of the growing concern in the US over several proposed high-profile foreign investments, the US Congress passed the Foreign Investment and National Security Act (FINSA) in 2007, which strengthens further the ability of CFICUS to screen potential acquisitions by overseas investors. FINSA authorizes CFIUS 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 what they perceive to be a threat to their national security from foreign investors. Furthermore, all investors, including SWFs, have to abide by domestic legal, corporate governance, disclosure and competition rules in the host countries.

The charge that SWFs have non-commercial investment motives rasies other questions. Several institutional investors are actively engaged

Temasek Holdings (Singapore)

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

During the past three decades or so, most of Temasek's investments have been within Singapore. But over the years, it has increased its overseas investment exposure although largely within the Asian region. As of March 2007, Temasek's exposure within Singapore was only 38 per cent.

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

Temasek made its financial accounts public in 2004 in response to statutory requirements for issuing bonds. It has recently introduced certain disclosure and governance norms. Temasek publishes an annual report, *Temasek Review*, and runs a comprehensive website outlining its investments and investment policies. Temasek has earned average annual returns of 18 per cent since its inception in 1974. Temasek earned a record profit of S$18 billion (US$12 billion) for the financial year ending March 2008.

Unlike Singapore's other sovereign wealth fund, GIC, Temasek's investment decisions have provoked controversies. In many instances, Temasek has taken a more activist investment approach, similar to that of a private-equity fund or strategic buyer (and thus the exception among passive SWFs). It has bought substantial stakes in foreign companies, particularly within Asia. For instance, Temasek's purchase of a 96 per cent stake in Thailand's Shin Corporation in 2006, the country's largest telecom group, led to public protests against Thaksin Shinawatra, the then Thai prime minister, whose family controlled the company. The public protests were centred on the $1.9 billion tax-free profits made by the Shinawatra family as a result of the deal and violation of foreign ownership regulations. Mr. Thaksin was later ousted from the Thai premiership in a military coup in September 2006 and his family earnings from the company's sale were seized by the authorities. Civil strife continues today between Thaksin's opponents and supporters. Temasek says that Thaksin's non-payment of capital gains tax on the deal is a domestic issue that Thaksin, the Thai government and the Thai people should deal with. It says that it followed all the Thai and Singaporean tax rules while buying the Shin Corporation.

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

Geographic Allocation of Temasek's Investments (i%)

	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

Government Investment Corporation (GIC)

Of the non-commodity based SWFs, the Government Investment Corporation (GIC) of Singapore is the largest in the world with assets worth $330 billion under management. Established in 1981, GIC was set up to manage exclusively Singapore's foreign exchange assets on behalf of the government and monetary authority of Singapore. Singapore's forex reserves sharply increased from 1970 onwards as a result of higher private savings and fiscal surpluses.

GIC acts purely as a financial investor. Unlike Temasek, it has always mainly invested abroad in a diverse range of assets. GIC relies heavily on non-Singaporean managers and has set up offices in London, New York, San Francisco, Beijing and Tokyo.

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, however, GIC published its first annual report containing information about its investment portfolio, governance structure and returns.

GIC funds are managed by three different entities, each with their own separate Board and management teams:

- GIC Asset Management looks after investments in public markets;
- GIC Real Estate manages investments in property; and
- GIC Special Investments invests in private equity, venture capital, infrastructure and other assets.

The bulk of GIC assets are invested in public equity, followed by fixed income and alternative assets. It employs both internal and external managers.

Set up with a wealth enhancement objective, GIC's investment horizon is long-term. It uses several international benchmarks (for instance, Morgan Stanley Capital International World Equity Index for equities) to measure its investment performance. Over its two decades of operations, GIC has 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 the sub-prime crisis in 2007, GIC made large investments in the financial sector, such as an $11 billion stake in the Swiss bank, UBS (making it the bank's single largest shareholder) and a $7 billion stake in the US banking group, Citigroup. GIC has also invested heavily in UK property markets.

in issues that go beyond profit motives. Many pension funds, for instance, (including CalPERS, the largest public pension fund in the United States) have taken strong stands on human rights, democracy and environmental issues. They have withdrawn their investments from several countries (including Thailand and Malaysia) on such moral and political grounds. The public pension fund of the US state of Montana, the Montana Board of Investments, sold its stake in French companies following France's refusal to support the 2003 US and UK-led invasion of Iraq.

Norway's Government Pension Fund-Global excludes a company from its investments if the company systematically breaches ethical norms governing human rights and the environment. Sweden's AP Funds (national buffer funds) have ethical policies of engaging with the management of the companies in which they invest to address compliance with ILO (International Labour Organisation) core labour standards and international human rights. Some sovereign wealth funds from the Middle East and Asia have a specific mandate not to invest in alcohol, gambling or tobacco companies.

Many civil society and ethical investment goals involve encouraging financial institutions to pursue non-commercial objectives. One of the clearest examples was the campaign to persuade foreign investors to withdraw from apartheid South Africa. Ongoing international campaigns to get China to divest from the Sudan and Burma are other clear examples. In April 2008, World Bank President Robert Zoellick proposed that SWFs should invest one per cent of their assets in Africa in order to bring $30 billion worth of investments to the continent,[49] illustrating that "non-commercial objectives" can mean whatever one wants. Indeed, such proposals are aimed at encouraging SWFs to seek out investments on non-commercial grounds.

49, World Bank Group press release 2008/255/EXC, http://go.worldbank.org/50LXBPOUM0.

Is Norway's SWF a "Model" Fund?

Few institutional investors can match Norwegian governance and ethical standards

The Norwegian economy is a model of welfare capitalism, a mixed economy combining both free market activity and government intervention. Norway is rich in natural resources such as oil, hydropower, fish, forests and minerals. Oil and gas account for one-third of its exports; only Saudi Arabia and Russia export more oil. The government controls key economic sectors, such as oil, through large-scale state enterprises.

Norway's Government Pension Fund–Global (GPF), the world's second largest SWF with assest of over $390 billion, was created in 1990 by an act of the Norwegian Parliament.[50] It is a savings fund, set up to manage Norway's surplus wealth from its oil sector (mostly revenue from taxes and licensing agreements) so as to meet future pension and social expenditures, and to stabilise the foreign exchange rate. Returns on GPF's investments are added to the Fund's capital, meaning that there are no transfers to the government budget. Thanks to the rapid rise in international crude oil prices in recent years, GPF is now bigger than Norway's annual gross domestic product (GDP), which tood at $360 billion in 2007 (down to $350 billion by September 2008 following the global market meltdown).

The Norges Bank Investment Management (NBIM), an investment branch of Norway's central bank, manages GPF as well as most of the central bank's foreign exchange reserves. NBIM uses both external and internal investment managers while day-to-day operational management is handled by Folketrygdfondet, a state entity specifically created to manage the Fund. Ultimate management responsibility 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. Its current exposure to equities is 40 per cent of its assets with the remaining 60 per cent being devoted to fixed income instruments such as bonds and government securities.[51]

To date, this Norwegian fund has remained a low-profile, non-strategic financial investor. It has invested in more than 7,000 companies globally but takes small stakes averaging less than one per cent of a company's shares. The Fund deliberately does not invest more than 10 per cent in each company. 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.

GPF's institutional structure is certainly considered as a model in terms of transparency and accountability. Of all the world's SWFs, it is the most transparent: it publishes quarterly and annual reports that include a detailed disclosure of assets under management, the currency and asset class composition of the portfolio down to company level, and standardised reporting of its performance against a benchmark.

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

In 2004, an Advisory Council on Ethics was established for the Fund while the Ministry of Finance went on to introduce ethical guidelines

50. Until January 2006, the fund was known as the Government Petroleum Fund. It now comprises the Government Pension Fund–Global and the Government Pension Fund–Norway, which was formerly known as the National Insurance Scheme Fund.
51. In 2007, a segment for equities in companies with a small market capitalisation was included in the benchmark portfolio. A small cap company has a relatively small market capitalization of between $300 million and $2 billion (the amount varies from country to country). Small-cap stocks enable an investor to beat institutional investors, such as mutual funds, many of which have restrictions limiting the proportion of shares they can buy in any one company and thus do not bother with small companies.

    GPF is also contemplating investments in "alternative" assets (such as hedge funds, private equity or property) in the future. Norwegian labour unions, however, have protested strongly against proposed investments in hedge funds and private equity funds. The General Workers' Union, Fellesforbundet, and the Food and Allied Workers' Union (NNN) have demanded that existing restrictions on investments in private equity and hedge funds should remain.

within GPF's regulatory framework. These ethical guidelines are meant to promote sustainable development and to minimise the risk of complicity in serious human rights and environmental violations. The guidelines cover humanitarian principles, human rights, anti-corruption and environmental damage. They established two policy measures to meet these ethical goals: the exclusion of companies, and active ownership.

The Advisory Council on Ethics has broad powers to recommend company exclusions[52] from GPF's investment portfolio where the Council believes that there is an unacceptable risk of complicity in gross or systematic breaches of ethical norms within the areas of human rights and the environment. The first basis for excluding a company is if the company produces "weapons that through their normal use may violate fundamental humanitarian principles."[53] The Council can also issue a recommendation if it believes a company's acts or omissions to act constitute an unacceptable risk of the Fund contributing to:

- "Serious or systematic human rights violations, such as murder, torture, deprivation of liberty, forced labour, the worst forms of child labour and other forms of child exploitation;
- Serious violations of individuals' rights in situations of war or conflict;
- Severe environmental damage;

52. The exclusions are through "negative screening" when GPF is considering a new investment and through selling shares in companies in which it has already invested.
53. Ethical Guidelines, Government Pension Fund – Global, Oslo, 22 December 2005, available at http://www.regjeringen.no/en/sub/Styrer-rad-utvalg/ethics_council/Ethical-Guidelines.html

Divestments on Human Rights and Environmental Grounds

Growing concern over human rights violations and environmental destruction led Norway's Government Pension Fund-Global (GPF) to exclude from its investment portfolio mining companies Freeport-McMoRan in 2006 and Vedanta Resources in 2007.

Mac Freeport-McMoRan Copper & Gold

Freeport is a well-known transnational mining corporation operating the world's largest gold mine and one of the largest copper mines, Grasberg, in West Papua on the island of New Guinea (the easternmost part of Indonesia). The mine uses a natural river system to dispose of close to 230,000 tonnes of waste each day, which release large quantities of sediment and heavy metals into the water. This has caused serious damage to the river system, nearby ecosystems and the livelihoods of indigenous peoples living in the area.

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

GPF's Advisory Council on Ethics carried out its own investigations and concluded that the environmental damage caused by the mining operations is extensive, long-term and irreversible. The Council found no inclination on the part of Freeport to manage the waste in a better way.

Based on its assessment, the Council on Ethics concluded that the Government Pension Fund-Global was running an unacceptable risk of contributing to severe environmental damage by investing in Freeport.

In May 2006, the Ministry of Finance announced that it would disinvest Freeport from the Fund's investment universe under the Fund's ethical guidelines. In September 2008, the Fund also decided to divest from the international mining company, Rio Tinto, which had a joint venture partnership with Freeport in this mining project.

Vedanta Resources

The Norwegian fund had an investment of about $14 million (an equity ownership of 0.16 per cent) in mining and metals group Vedanta Resources, which is listed on the UK's London Stock Exchange but conducts most of its mining activities in India. In November 2007, the Fund dropped Vedanta from its investment portfolio because of concern about environmental and human rights abuses in India.

Local people and groups have been opposing Vedanta's proposed $850 million aluminium refinery and bauxite mining project in the remote Niyamgiri hills of the eastern Indian state of Orissa. The mining, they say, would lead to a substantial loss of local people's livelihoods and traditional culture.

Having carried out investigations into Vedanta's four Indian subsidiaries, the Council on Ethics submitted its report to Norway's Ministry of Finance on 15 May 2007 stating that:

> "The allegations levelled 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 its stake in Vedanta. On 6 November 2007, the Ministry announced the completion of the sale on its website.

- Gross corruption
- Other particularly serious violations of fundamental ethical norms."[54]

GPF's ethical guidelines conform with other international frameworks such as the UN Global Compact, the OECD Guidelines for Corporate Governance and for Multinational Enterprises, and ILO Conventions. The Advisory Council on Ethics initiates its own investigations to find out whether its portfolio companies are abusing any of its ethical guidelines. Having completed its investigations, the Council shares its findings with the management of the concerned company and invites their comments. The Council can make recommendations only, the final decision to exclude companies resting with Norway's Ministry of Finance. Both recommendations and decisions are subsequently made public, however.[55]

On the recommendations of the Council, the Finance Ministry has disinvested from a number of companies within the Fund's investment portfolio. In June 2006, for instance, GPF sold its holdings in the world's largest retailer, the US-based Wal-Mart, for "serious and systematic violations of human rights and labour rights" and in the US-based mining company, Freeport-McMoRan Copper & Gold, for "complicity in serious damage" to the environment in New Guinea (*see* Box, p.25).[56] Other prominent companies excluded because their activities are held to breach the ethical guidelines include:[57]

- Alliant Techsystems Inc (US) for producing components for cluster munitions;[58]
- BAE Systems Plc. (UK) for producing components for nuclear missiles for the French Air Force;[59]
- Boeing Company (US) for maintaining inter-continental ballistic missiles (ICBMs) for the US Air Force;[60]
- DRD Gold Limited (South Africa) for serious environmental damage;[61]
- GenCorp Inc (US) for producing nuclear weapons.[62]

GPF's divestment process is intentionally designed, however, to avoid causing any downward price pressure in order to minimize GPF losses from divestment. Such divestments have been based on non-economic motives but had no adverse impact on GPF's financial returns.

As part of its higher disclosure and governance standards, GPF

54. Ethical Guidelines, Government Pension Fund – Global, Oslo, 22 December 2005, available at http://www.regjeringen.no/en/sub/Styrer-rad-utvalg/ethics_council/Ethical-Guidelines.html
55. For more information on the Advisory Council on Ethics, *see* http://www.etikkradet.no
56. "Two companies – Wal-Mart and Freeport – are being excluded from the Norwegian Government Pension Fund–Global's investment universe", press release 44/2006, Norwegian Ministry of Finance, 6 June 2006.
57. For a full listing, *see* "Companies Excluded from the Investment Universe", Ministry of Finance, http://www.regjeringen.no/en/dep/fin/Selected-topics/andre/Ethical-Guidelines-for-the-Government-Pension-Fund—Global-/companies-excluded-from-the-investment-u.html?id=447122.
58. The Council identified seven companies producing cluster weapons components: Alliant Techsystems Inc., EADS Co., General Dynamics Corp., L3 Communications Holdings Inc., Lockheed Martin Corp., Raytheon Co., and Thales S.A. *See* Advisory Council on Ethics, "Recommendation on Exclusion of Cluster Weapons from the Government Petroleum Fund", Oslo, 16 June 2005.
59. The Council identified seven companies producing nuclear weapons components: BAE Systems Plc., Boeing Co., Finmeccanica Sp.A., Honeywell International Inc., Northrop Grumman Corp., United Technologies Corp. and Safran SA. *See* Advisory Council on Ethics, "Recommendation of September 19, 2005 on the exclusion of companies that are involved in production of nuclear weapons", 19 September 2005.
60. "Recommendation on exclusion", Advisory Council on Ethics, Oslo, 19 September 2005,
61. "Mining company excluded from the investment universe of the Norwegian Government Pension Fund–Global", Ministry of Finance, Oslo, 11 April 2007.
62. "One producer of cluster munitions and two producers of nuclear weapons excluded from the Government Pension Fund–Global", Ministry of Finance, Oslo, 11 January 2008.

Korea Investment Corporation

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

KIC is a separate legal entity from the South Korean government and its management is independent of government. It discloses its annual financial positions and statements, investment strategies and accounting standards regularly. The legislation that brought KIC into existence emphasizes and ensures KIC's independence with regard to its organization and investment management.

KIC manages funds on behalf of various state authorities and invests in consultation with these entities. It relies extensively on external managers and management firms (rather than relying on in-house fund managers or departments): nearly three-quarters of KIC's $20 billion portfolio is outsourced to external fund managers.

Currently, the bulk of KIC assets are invested overseas (particularly in OECD countries) in both fixed income and public equity instruments. KIC is expected to 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 the beleaguered US bank, Merrill Lynch.

published for the first time in 2007 its voting records on shareholder resolutions within its portfolio companies. These reveal that the Fund highlighted global warming, labour standards and freedom of access to the Internet as part of its active ownership approach. For instance, it voted in favour of shareholder resolutions at ExxonMobil and the Ford Motor Company calling for the companies to adopt carbon emission reduction goals. (The resolutions were, however, defeated by majorities of 93 per cent and 86 per cent respectively.) At fast-food giant McDonalds, the Fund used its share ownership to vote in support of a resolution calling for the company to adopt the "declaration of fundamental principles" under the International Labour Organisation (but again, this resolution was defeated).

The Norwegian government has initiated a review of the Fund's ethical policy, as part of which it circulated a consultation paper seeking comments from various stakeholders. The scope and mechanisms of the ethical guidelines may well be expanded further to cover other corporate abuses. For instance, the Fund has made child labour a priority concern, developing the NBIM Investor Expectations on Children's Rights in order to prevent child labour and promote children's rights. The Fund is particularly pressing a number of agricultural multinational corporations to improve their record on child labour.

These ethical guidelines have attracted the attention of several other SWFs (notably from Asia), international institutions, academics and NGOs. Undoubtedly, GPF has opened up new avenues for grassroots' activists and groups to influence corporate behaviour. Negative publicity generated by the Fund's disinvestments also helps to create further awareness of the issues involved. For instance, in November 2007, when India's Supreme Court was deliberating whether or not to give Vedanta permission to open cast mine bauxite in the forested Niyamgriri hills in the eastern Indian state of Orissa, it took note of GPF's decision to exclude Vedanta from its portfolio for violating human rights and labour laws, barred the company and laid down new conditions for the mining project to go ahead.[63]

Very few institutional investors have similar governance and ethical standards to this Norwegian fund, which is, in many ways, an exception in the global financial markets. It remains to be seen whether other sovereign wealth funds, pension funds and other institutional investors will adopt similar ethical guidelines. Given the emphasis on pluralism, diversity and democracy within Norwegian society and politics, some elements and processes within the ethical guidelines may take years for other countries (in both the South and North) and institutional investors to emulate. Nevertheless, GPF's ethical guidelines and governance standards act as a valuable reference point.

All financial institutions should be strictly regulated and supervised in both home* and *host countries

Shouldn't Sovereign Wealth Funds be Regulated?

All financial institutions, both private- and state-owned, should be subject to stringent regulation and supervision in both home and host countries. Many of the policy concerns raised about the governance, financial stability and market integrity of sovereign wealth funds apply equally to other market players. Should there be special rules for SWFs that do not also apply to hedge funds and private equity funds?

As the ongoing financial crisis shows, hedge funds pose a greater systemic risk to the global financial system than sovereign wealth funds. Unlike SWFs, hedge funds use extensive leverage and engage

63. The Court was not opposed to the mining project in principle, however. It proposed that a Special Purpose Vehicle should be set up involving the Orissa state government, the state mining company and Sterlite Industries India Ltd, an associate company of Vedanta Resources. In August 2008, the Supreme Court gave the go-ahead for the bauxite mine, despite being aware of the close association between Sterlite and Vedanta.

National Development Fund (Venezuela)

Venezuela's National Development Fund (El Fondo de Desarrollo Nacional – FONDEN) was set up by the Hugo Chavez government in September 2005 as part of reforms of the charter of the Central Bank of Venezuela. FONDEN is wholly owned by the Venezuelan government.

Most of the Fund's money, an estimated $27 billion, comes from excess forex reserves and national oil companies' profits. The Fund will also receive substantial money from an oil windfall profit tax approved in April 2008. The state authorities view the Fund as a vehicle for redistributing the oil income throughout the country.

The bulk of FONDEN'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 the country's external debt liability and to support "special situations". In 2006, it was used to repurchase $4.7 billion of Venezuela's external debt, including Brady bonds (dollar denominated bonds issued by Latin American countries in the 1980s, named after then US Treasury Secretary Nicholas Brady).

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 the 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 provides financial information to the wider public through the mass media.

In 2007, FONDEN and the China Development Bank created a joint development fund of $6 billion to invest in various development projects in both countries.

Several years before FONDEN was set up, Venezuela had established a Fund for Investment of Macroeconomic Stabilization in 1999, managed by the Central Bank of Venezuela. Its main sources of funds are from oil companies, and its purpose is to protect the domestic economy from the volatility of crude oil revenues.

in speculative trading in stocks, currencies, commodities and derivatives. Hedge funds are usually short-term investors and more sensitive to volatility in financial markets. They not only invest at a breathtaking speed but can also pull their money out quickly if performance or market conditions deteriorate. Additionally, the majority of hedge funds are registered in offshore tax havens (such as the Cayman Islands or Bermuda) to avoid regulation and tax liabilities.

In contrast to SWFs, hedge funds can easily gain large positions in financial markets with the help of leverage and derivatives. According to 2007 data from a US-based consulting firm, Greenwich Associates, hedge funds were the biggest source of trading volume in interest-rate derivatives accounting for 30 per cent of total US trading volume.[64] Hedge funds also constitute 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.[65]

Such large positions pose risks not only to investors but also to the stability of the financial system and the real economy. Some prominent recent examples of hedge fund failures include Long-Term Capital Management (LTCM) in 1998, Amaranth Advisors in 2006 and two in-house Bear Stearns funds in 2007. The collapse of LTCM brought the Russian financial crisis to the doors of Wall Street. With a capital base of $4 billion, LTCM had balance sheet assets worth $125 billion, a leverage of more than 30 times. Its off-balance sheet exposure had a notional value of $1.2 trillion.[66]

Regulation is also needed of the complex and opaque $516 trillion market in derivatives.[67] US investor Warren Buffett famously described credit derivatives in 2002 as "financial weapons of mass destruction."[68] The $55 trillion credit default swaps (CDSs) market has been operating for years with no public disclosure or legally enforced reporting requirements.[69] The regulation and supervision of highly-leveraged financial institutions such as hedge funds and opaque financial instruments including CDSs is all the more important in the light of the

64. Greenwich Associates, "In US Fixed Income, Hedge Funds are the Biggest Game in Town," 30 August 2007.
65. Ibid.
66. Long-Term Capital Management (LTCM) was a US hedge fund considered to be "the Rolls Royce of hedge funds". It was set up in 1994 and had returns of over 40 per cent in its initial years. By 1998, it had built up an investment exposure of some US$900 billion mostly in Northern capital markets. During one month in 1998, however, it suffered a 44 per cent fall in its net asset value when the financial markets unravelled after Russia defaulted on its debt. Its near collapse triggered financial problems in the well-known and established financial institutions that had lent to LCTM. The knock-on effect of a collapsing pyramid of deals considerably reduced the share prices of banks and industrial companies and damaged their credit ratings. Profits, jobs and growth were all affected. To stop the cascade, other financial institutions stepped in to bail out LCTM. The fund folded in early 2000. *See* Lowenstein, R., *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, Fourth Estate, London, 2002.

    The Russian financial crisis, which started in August 1998, was one of the most dramatic economic breakdowns of the last decade. It was exacerbated by the Asian financial crisis that had started in July 1997 (*see* footnote 20). and that triggered a decline in world commodity prices, which affected countries heavily

footnote continued on next page . . .

structural weaknesses of the global financial architecture that have been thoroughly exposed by the current credit crisis.[70]

As for SWFs, demand for their regulation should originate in their home countries rather than being externally imposed. After all, state-owned sovereign wealth funds are managing money that is ultimately owned by their citizens who have most to gain or lose from their investments. The citizens of these countries have a legitimate right to demand greater disclosure of the investments made by their national and sub-national funds and to ask: what developmental and other objectives are being served by these funds and for whom? Increased participation by domestic stakeholders would help to build public support for how sovereign wealth funds are managed. Indeed, since some SWFs explicitly manage wealth for future generations, there is in many cases a greater need for checks and balances at the domestic level.

In those home countries that lack democratic institutions and norms to hold SWFs publicly accountable, it is all the more important that strategies for greater democratic control of SWFs are part of a wider project for democratic renewal. Moreover, since sovereign wealth funds are in principle accountable to the citizens of their countries, some of their money could prudently be used to improve infrastructure, health, education and other services within the country. In many Southern countries that have SWFs, poorer and marginalised citizens do not have access to basic human needs.

Some analysts have also proposed that a small portion of SWF assets could be allocated to initiate monetary cooperation mechanisms among Southern countries and to create regional development banks that could lend to poorer and Southern countries on concessional terms.[71]

Should India Establish a Sovereign Wealth Fund?

When India's foreign exchange reserves reached over $200 billion in early 2007, debate began in official circles on how to deal with this embarrassment of riches. One suggestion was to set up an Indian SWF, a proposal that received strong backing from the powerful Prime Minister's Council on Trade and Industry comprising leading Indian industrialists. In its meeting of 18 December 2007, the Council suggested setting up a US$5 billion sovereign wealth fund "for financing acquisition of companies abroad." By March 2008, foreign exchange reserves stood at $310 billion, and SWF proponents were arguing that a SWF

dependent on the export of raw materials. Petroleum, natural gas, metals and timber accounted for more than 80 per cent of Russian exports. But there are generally considered to be several underlying structural and institutional causes to this crisis in Russia, a country undergoing a transition to a market economy and highly dependent at the time on foreign capital, which precipitated its debt and currency crisis.

Amaranth Advisors LLC managed some US$9 billion in assets, when it collapsed in September 2006 after losing some US$6 billion in one week on natural gas futures – the Amaranth trader had bet half the firm's assets that prices would continue to rise, but they didn't. Amaranth's cash losses were significantly larger than the $4 billion lost when LCTM went bust in 1998, but it had not borrowed as much, meaning that its collapse had less impact on other financial institutions.

67. A derivative is an asset whose value depends on, is based on or is "derived from" the price of another underlying asset, such as a security, stock, share, commodity, money, interest rate or exchange rate. There are three basic types of derivatives:

i) a ***future***, which is a tradable agreement to buy or sell a specified asset at a specified price and date in the future;

ii) an ***option***, which confers the right (but not the obligation) to buy or sell an asset in the future at an agreed price in return for a small down payment, known as a premium; and

iii) a ***swap***, which is an agreement to exchange assets (for example, different foreign currencies) at agreed prices on some specified date in the future.

In all three types, the value of the derivative depends on the future price of the underlying asset that is to be exchanged. When investors purchase derivatives, they are betting on the future direction of the market in a particular asset – will prices for the asset go up or down? – but without actually owning the tangible asset involved. They are speculating on the price, say, of frozen orange juice without actually owning the orange grove from which the juice is made.

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Khazanah Nasional (Malaysia)

Incorporated in September 1993, Khazanah Nasional is the investment holding arm of the government of Malaysia. This wholly owned state fund was created to manage the investments authorised by the Malaysian government. Its initial funding came from the privatisation of state companies, but subsequently Khazanah has raised money from issuing domestic and Islamic bonds. Indeed, Khazanah is active in Islamic finance, issuing in October 2006 the world's first tradable 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. It 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 neighbouring countries of 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.

would generate higher returns than leaving the money in US treasury and other government bonds. They pointed to other Asian countries as examples.

But India should not be equated with countries that are rapidly accumulating forex reserves because of higher oil prices and current account surpluses. Unlike China and Singapore, India has been running persistent current account deficits,[72] which are still growing despite steady growth in exports of software services and a substantial rise in workers' remittances from overseas Indians.

In addition, unlike Middle Eastern countries that have established SWFs on the back of strong commodity exports, India does not have any dominant exportable commodity that could generate significant surpluses. The country remains a huge net importer of oil and gas; its oil imports climbed 40 per cent from $48 billion in 2006-07 to $68 billion in 2007-08. For decades, India has remained vulnerable to surges in oil prices. Moreover, India also runs a perennial fiscal deficit, spending more than it earns.

Oil Stabilisation Funds of the Russian Federation

Russia's Stabilisation Fund was established in 2004 by the Ministry of Finance. In February 2008, it was split into two: the $125 billion Reserve Fund (which invests primarily abroad in low-yielding securities); and the $32 billion National Welfare Fund (which invests in more risky high-yielding securities).

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

To date, the funds have allocated their assets prudently and acted purely as a portfolio investor. Following investment guidelines approved by the Russian authorities, assets are 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 government decides which foreign debt securities are eligible.

The investment guidelines specifically list those countries in which the funds can buy sovereign debt securities. Further, the issuers of such debt should have AAA/Aaa long-term credit rating from at least two of the three main international rating agencies. The guidelines also set out currency allocations: 45 per cent in US dollars, 45 per cent in Euros and 10 per cent in UK sterling. The funds have not yet invested in global equities or companies.

Currently, these Russian funds are largely invested in bonds from government-linked authorities in the US, UK, Germany, France and The Netherlands. Market analysts expect that the National Welfare Fund will begin to make long-term investments in public equity, private equity and other alternative assets from early 2009 onwards. It is also anticipated that a portion of investments will be channelled to emerging markets.

Contrary to many media reports, these funds maintain high standards of transparency. Their investment strategy is based on a strict investment policy framework established by the Ministry of Finance. The funds publish reports on their assets, investment patterns and spending. The Ministry of Finance publishes a monthly report on the Funds' accumulation, spending and balance. It also reports to the government on a quarterly and annual basis on the Funds' accumulation, investment and capital spending. Their asset allocation norms and investment guidelines are also made public.

The ongoing credit crisis led to India's foreign exchange reserves falling from $ 310 billion in March 2008 to $271 billion in September 2008. Many of these reserves had been accumulated through large capital inflows (which financed the persistent current account deficits) in the form of portfolio investments and other short-term flows; these inflows are the very ones prone to capital flight. In 2007-08, the net inflow under the capital account was $109 billion against $46 billion in 2006-07, largely due to a surge in portfolio investments, commercial borrowings and short-term debt.[73]

India also has a negative international investment position (the value of domestic assets held by foreigners is much higher than the value of foreign assets held by domestic residents) and its liabilities (debt and equity) far exceed its assets. According to official statistics, as of March

For more information, see Nicholas Hildyard, "A (Crumbling) Wall of Money: Financial Bricolage, Derivatives and Power", The Corner House, October 2008, http://www.thecornerhouse.org.uk/summary.shtml?x=562658

68. "Warren Buffet on Derivatives", http://www.fintools.com/docs/Warren%20Buffet%20on%20Derivatives.pdf

2007, India's assets stood at $243 billion but its liabilities were $288 billion, indicating a net liability at $45 billion.

India's external debt has been rising steadily for the past few years due to higher borrowings by Indian companies and short-term credit. External debt reached $221 billion in March 2008, compared to $169 billion in March 2007.

Given the overwhelming presence of volatile capital flows in foreign exchange reserves, it would be a mistake to think of India's foreign exchange reserves as indicating a position of strength. Any policy move towards establishing an Indian SWF should therefore proceed cautiously.

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

Why Has France Just Established a New SWF?

On 21 October 2008, French President Nicolas Sarkozy proposed that European countries should create their own sovereign wealth funds to protect national companies from foreign "predators". (As *Financial Times* journalist Philip Stephens points out, "For foreign we should presumably read Arab or Asian."[74]) He told members of the European Parliament:

> "I'm asking that we think about the possibility of creating, each one of us, sovereign funds and maybe these national sovereign funds could now and again coordinate to give an industrial response to the crisis."[75]

Two days later, addressing business leaders in France, President Sarkozy announced that France would establish a SWF to support French companies of national strategic importance. "I will not be the French president who wakes up in six months' time to see that French industrial groups have passed into other hands," he remarked.[76]

One month later, on 20 November 2008, President Sarkozy officially launched the new €20 billion ($25.1 billion) fund, known as the National Strategic Investment Fund, financed by the government and a state-owned lender and managed by the country's existing sovereign fund, the Caisse des Dépots et Consignations (CDC).[77] The new fund's purported objective is to protect France's strategically-important industries (such as nuclear power company Areva or tyre manufacturer Michelin) from foreign takeover. President Sarkozy has said it will be "more active, more offensive, more mobile"[78] in defending French industrial assets.

President Sarkozy's rationale for a new French SWF (and his proposal for new other European SWFs) is flawed on many counts. The objective conditions for establishing a SWF – higher current account surpluses and strong basic commodity exports – are missing in Europe. Unlike China and Singapore, the overwhelming majority of European countries are running persistent large current account deficits (such as the UK, Italy, Spain and most countries of Central and Eastern Europe) while a number are also running large fiscal deficits (such as Italy, Hungary and Romania). Most European countries (barring Norway, The Netherlands and the UK) do not have any dominant exportable basic commodity (such as oil or gas) that by itself generates significant surpluses.

69. Credit Default Swaps are contracts between two parties that require one party to step in and pay the other's obligations if the second party cannot pay them. They act like insurance policies. The CDS "buyer" in the contract is the party that is buying protection against not being able to pay its oblgation; the CDS "seller" is the other party that is selling protection against such default. The buyer pays the seller a premium for this protection; the seller pays to the buyer only in case of a default. The CDS premium rises if the risk associated with the underlying obligation increases. Since the early 1990s, the CDS market has become a major component of global financial markets, but lack of transparency over who holds what CDSs poses systemic risks as the ongoing credit crisis has amply demonstrated.
For more information, *see* Nicholas Hildyard, "A (Crumbling) Wall of Money), The Corner House, October 2008, http://www.thecornerhouse.org.uk/summary.shtml?x=562658
70. These include information asymmetries, there being no official lender of the last resort, corrupt practices of rating agencies, and inadequate regulation of investment banks and CDS markets – to name a few.
71. *See*, for instance, Stephany Griffith-Jones and José Antonio Ocampo, "Sovereign Wealth Funds: A Developing Country Perspective," paper prepared for the workshop on Sovereign Wealth Funds organized by the Andean Development Corporation, London, 18 February 2008.
72. In 2007-08, the current account deficit touched $17 billion, up from $9.8 billion in 2006-07, largely the result of a higher oil import bill. The trade deficit increased from $63 billion in 2006-07 to $90 billion in 2007-08, more than 7 per cent of the GDP.
73. The foreign direct investment (FDI) component of capital inflows has increased in recent years, but a substantial portion relates to acquisitions of domestic firms, rather than new investments.
74. Philip Stephens, "Globalism and the new nationalism collide", *Financial Times*, 24 October 2008.
75. "Nicolas Sarkozy calls for European Sovereign Wealth Funds to tackle the economic and industrial crisis", 21 October 2008, available at http://www.premier-ministre.gouv.fr/en/information/latest_news_97/nicolas_sarkozy_calls_for_61450.html
76. "Measures to support the economy; Speech by M. Nicolas Sarkozy", 23 October 2008, available at http://www.ambafrance-uk.org/President-Sarkozy-s-Argonay-speech.html
77. The CDC was established almost 200 years ago in 1816. With €60 billion (US$ 78 billion at October 2008 interbank lending rates) of funds and €400 billion of assets at the end of 2007, it invests in local development projects, equity markets, real estate and private equity.
78. Ben Hall, "Sarkozy plans fund to fend off 'predators'", *Financial Times*, 24 October 2008, http://www.ft.com/cms/s/0/8b739400-a164-11dd-82fd-000077b07658.html?nclick_check=1.

The main policy rationale behind setting up a sovereign wealth fund has not been to bail out or protect domestic companies, but to diversify and improve the return on foreign exchange reserves or commodity revenue, while insulating the domestic economy from volatile international commodity prices. That is why the overwhelming majority of sovereign wealth funds invest globally, not domestically. Establishing sovereign wealth funds to protect domestic companies clearly has a political motive. It may also reflect the basic misunderstanding or bias prevalent in the North that SWFs are about "aggression" as well as "defence of private companies". President Sarkozy has in effect set up a new fund to fulfill strategic, political and non-commercial motives – the very accusation levelled at sovereign wealth funds from Asia and the Middle East.

Will the new €20 billion sovereign fund be effective? It is too soon to judge, but €20 billion is not enough to "protect" France's strategic industrial assets – unless they become very cheap.

What Have Been Policy Responses to the Rise of SWFs?

A wide range of policy proposals and initiatives have been taken at various levels in response to the rise of sovereign wealth funds. At the multilateral level, the G-7 group of countries,[79] led by the US, persuaded the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) to develop voluntary "best practices" for SWFs; the IMF was asked to develop a common set of voluntary codes for SWFs and the OECD to focus on a code for recipient countries.

These policy initiatives got underway the day after a meeting of G-7 finance ministers and central bank governors on 19 October 2007, when the IMF's International Monetary and Financial Committee gave the IMF the go-ahead to start work on the codes and to set up an International Working Group of Sovereign Wealth Funds (IWG) to carry the work forward. A year later, on 11 October 2008, the IWG presented some voluntary codes, known as Generally Accepted Principles and Practices (GAPP), to the International Monetary and Financial Committee. GAPP contains 24 principles covering SWFs' legal framework, governance structure, investment policies and risk management. They are broad in nature and repetitive, but transparency and public disclosure cut across them all, while guarding against market instability and non-commercial motives underlie most of them. Since the principles are voluntary, their actual implementation will depend on each SWF and home country. The IWG also proposed that a Formation Committee be set up to explore whether a permanent international body on SWFs should be created.[80]

The OECD, meanwhile, released its report, *Sovereign Wealth Funds and Recipient Country Policies*, in April 2008, outlining broad voluntary principles for recipient countries of SWF investments.[81] The report emphasises that it found no instances of sovereign wealth funds acting to further political objectives. The OECD called upon national authorities to determine what action is needed to protect national security as far as foreign investments are concerned without using national security as an excuse to engage in broader protectionist policies. The OECD's principles were adoped by OECD members on 8 October 2008.[82] Some World Bank analysts have advocated bringing oversight of SWFs within the World Trade Organisation.[83]

79. The G-7 is a meeting of the finance ministers from seven industrialized nations (Canada, France, Germany, Italy, Japan, United Kingdom, and USA) that takes place several times a year to discuss economic policies.
The G-8 is the annual meeting of the heads of government of these countries plus that of Russia.
The G-20 is a group of finance ministers and central bank governors from 20 economies: 19 of the world's largest national economies (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States) and the European Union. The IMF and World Bank also participate in G-20 meetings.
The G-77 refers to a group of developing countries, originally 77 in 1964 when the group was formed and now numbering 130. Its original aim was to improve joint negotiating capacity within the United Nations.
80. Generally Accepted Principles and Practices (GAPP), also known as the Santiago Principles: http://www.iwg-swf.org/pubs/gapplist.htm. IWG's October 2008 report: http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf. *See also* http://www.iwg-swf.org/index.htm
81. http://www.oecd.org/dataoecd/34/9/40408735.pdf
82. OECD Guidance on Sovereign Wealth Funds, http://www.oecd.org/document/19/0,3343,en_2649_34887_41807059_1_1_1_1,00.html
83. Aaditya Mattoo and Arvind Subramanian, "Currency Undervaluation and Sovereign Wealth Funds: a New Role for the World Trade Organization," *Policy Research Working Paper Series 4668*, World Bank, 2008.

Besides these multilateral initiatives, the European Commission has proposed a common EU approach for SWF transparency and accountability. It has called upon SWFs to disclose their 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 its support to the IMF's voluntary guidelines and the OECD's principles.

In the US, where much of the political controversy has been centred on foreign state-owned companies buying US companies (such as the 2006 proposal by the China National Offshore Oil Corporation to acquire the US-based Unocal Oil Company), Congress passed the Foreign Investment and National Security Act in 2007, which mandates additional scrutiny and higher-level clearances for proposed investments by foreign state-owned entities. In March 2008, the US Treasury signed an agreement with the governments of Singapore and Abu Dhabi on five principles guiding the investments by SWFs. The three countries also laid down principles for countries receiving SWF investments (*see* Box below). In addition, the US President's Working Group on Financial Markets is reviewing the activities of the sovereign wealth funds. There are also ongoing discussions within US policy circles to bar SWFs from having voting rights in the companies in which they invest and removing tax exemptions on their investments.

Germany, in the meantime, alarmed at a Russian bank gaining a five per cent stake in aviation company EADS, passed new legislation in August 2008 allowing the authorities to review and prohibit a non-EU company from acquiring German companies "on grounds of public policy or public security." The legislation applies in cases where a foreign investor seeks to acquire directly or indirectly 25 per cent or more of the voting rights in a German company. Other European governments are considering the use of "golden shares."[84] In October 2008, Italy announced a 5 per cent ceiling on investments by SWFs in local Italian companies.

84. A "golden share" is a type of share that gives its shareholder power of veto over other shareholders in certain circumstances. The practice started in the 1980s to enable the British government under Prime Minister Margaret Thatcher to sell off public companies and industries while still protecting what the government perceived to be national (often political) interests, such as preventing a foreign investor from taking over a key energy or defence company. The function of a golden share is to prevent perceived dangers from being realised rather than allowing politicians to control a business. The share has either no time limit or is for a specified period only after which it expires. The idea of a golden share spread from the UK to many countries in Western Europe, and to developing and transition economies, such as Ghana, Russia and Bulgaria. European courts have ruled, however, that the golden shares held by the UK, Spain and France in certain specified companies (BAA, UK; Telefonica, Repsol, Endesa, Argentaria and Tabacalera, Spain; Elf, France) are illegal under EU commercial law. EU rules allow governments to keep a hold on private firms only if there are strong security reasons.

US-Singapore-Abu Dhabi Agreement on SWFs

In March 2008, the three countries agreed five policy principles for Sovereign Wealth Fund investments:

1. SWF investment decisions should be based solely on commercial grounds rather than the geopolitical goals of the controlling government.
2. Greater information disclosure by SWFs, in areas such as purpose, investment objectives, institutional arrangements, and financial information - particularly asset allocation, benchmarks, and rates of return over appropriate historical periods - can help reduce uncertainty in financial markets and build trust in recipient countries.
3. SWFs should have in place strong governance structures, internal controls, and operational and risk management systems.
4. SWFs and the private sector should compete fairly.
5. SWFs should respect host-country rules by complying with all applicable regulatory and disclosure requirements of the countries in which they invest.

The countries also agreed four policy principles for countries receiving SWF investment: by SWFs. The three countries also laid down principles for countries receiving SWF investments

1. Recipient countries should not erect protectionist barriers to portfolio or foreign direct investment.
2. Recipient countries should ensure predictable investment frameworks. Inward investment rules should be publicly available, clearly articulated, predictable, and supported by strong and consistent rule of law.
3. Recipient countries should not discriminate among investors. Inward investment policies should treat like-situated investors equally.
4. Recipient countries should respect investor decisions by being as unintrusive as possible, rather than seeking to direct SWF investment. Any restrictions imposed on investments for national security reasons should be proportional to genuine national security risks raised by the transaction.

Source: *US Treasury press release*, hp-881, 20 March 2008, http://www.ustreas.gov/press/releases/hp881.htm,.

Future Fund (Australia)

Established in April 2006, the objective of Australia's Future Fund is to meet the unfunded public sector worker pension liabilities of the Australian government. Its stated aim is to reach A$140 billion (US$98 billion) by 2020 so as to cover fully the future superannuation liabilities.

Although the fund is wholly owned by the government of Australia, it is supervised by an independent Board of Guardians, which is responsible for all investment decisions and is accountable to the government. External managers look after the investments. In May 2007, the Board selected the US-based Northern Trust Corporation to manage its funds.

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

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

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

In February 2008, Australia introduced new guidelines to enhance the screening of investments made by foreign state-owned entities. These guidelines contain six principles by which investments by foreign state-owned entities will be measured.[85] One of these principles states that the country will consider whether "an investor's operations are independent from the relevant government." Direct investments by foreign state-owned governments or entities (including SWFs) are required to be reported to the Australian authorities, irrespective of their size.

It is too early to judge the impact and implications of all these initiatives on the activities of sovereign wealth funds, but some have already voiced strong objections. "Sovereign wealth funds have been found guilty before being proven innocent," stated Muhammad al-Jasser, the Vice Governor of the Saudi Monetary Agency.[86] The Kuwait Investment Authority has criticized the initiatives to establish voluntary codes. As its managing director Bader al-Sa'ad put it:

> "Recipient countries are placing handcuffs on sovereign wealth funds in the form of regulations termed – in the best tradition of George Orwell's Newspeak – 'codes of conduct' or 'principles of operation' or 'best practices'. These regulations will not solve or prevent any future financial crises."[87]

The China Investment Corporation (CIC) also expressed publicly its displeasure at unfair treatment of sovereign wealth funds. In the words of CIC's President, Gao Xiqing:

> "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."[88]

If protectionist sentiments remain strong in the West, SWFs will no doubt move to other markets, particularly the debt and equity markets of Asia. Some SWFs, particularly from the Middle East, have already started allocating their funds to domestic asset markets and banks in order to provide financial stability. After suffering considerable losses in US and European markets, China's CIC began to make investments in local banks and financial institutions as part of larger stimulus package announced by China to mitigate the impact of the global slowdown on the country's economy. The Agricultural Bank of China, the

85. Australia's six guidelines to assess investment from a state-owned entity based abroad are:
    1. An investor's operations are independent from the relevant foreign government.
    2. An investor is subject to and adheres to the law and observes common standards of business behaviour.
    3. An investment may hinder competition or lead to undue concentration or control in the industry or sectors concerned.
    4. An investment may impact on Australian Government revenue or other policies.
    5. An investment may impact on Australia's national security.
    6. An investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community.

    See Treasurer of Australia, "Principles guiding consideration of foreign government related investment in Australia", media release, 17 February 2008, http://www.treasurer.gov.au.
86. Quoted in Carter Dougherty and Katrin Bennhold, "Sovereign Wealth Funds on the Defensive," *International Herald Tribune*, 25 January 2008.
87. Quoted in Tony Barber, "Plan for sovereign wealth fund code criticised", *Financial Times*, 9 April 2008, http://www.ft.com/cms/s/0/834fd8a0-05cf-11dd-a9e0-0000779fd2ac.html
88. Quoted in Kevin Lim, "Sovereign Wealth Funds set Code of Ethics Goal," *International Herald Tribune*, 8 July 2008.

country's third-largest bank, received a $19 billion cash infusion from the CIC and the government in October 2008.

Free marketers in the West are also concerned that caution over SWFs "could spill over into ever-broader restrictions on foreign investment in general", especially given that "foreign investment is still a subject that is easily exploited by demagogues from the US to France to India."[89]

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

Several parallel developments indicate an ongoing shift in the balance of economic power in the world with the comparative decline of the West (particularly the US) and the growing financial clout of actors in the South that were, until recently, minor players in the global financial system. These developments suggest a gradual move towards a multipolar international financial system over the long term. But the actual shift will depend 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 richer countries such as the United States to poorer ones like China and India. Even the "average person in the street" thinks that richer countries invest in or lend money to poorer countries. But the reverse is happening today. Capital is currently flowing "uphill" from poorer to richer countries. The US alone accounts for as much as 60 per cent of global capital imports, largely from China, Japan, Saudi Arabia and a host of Asian and Middle Eastern countries, which have transformed themselves within the space of a decade or so from debtors to creditors.

In the mid-1990s, a number of Asian countries were running a current account deficit. Today, they are running huge current account surpluses and have become net exporters of capital. China is the leading net exporter of capital, despite having a lower per capita income than its Asian peers. In 1998, Russia was in dire financial straits as well; it sought a bailout from the IMF, World Bank and other Western lenders in the wake of its severe financial crisis.[90] But thanks to higher international oil and gas prices, the country fully repaid all its foreign official debt of $42 billion by 2006. As of November 2007, Russia's foreign exchange reserves reached $463 billion. When Iceland faced a currency and financial crisis in September 2008, it first approached

The growing economic power of Southern actors suggests a multipolar international financial system in future

89. Gideon Rachman, "Do not panic over foreign wealth", *Financial Times,* 29 April 2008. http://www.ft.com/cms/s/0/df23012a-1538-11dd-996c-0000779fd2ac.html

90. *See* footnote 66.

Permanent Reserve Fund (Alaska)

The $40 billion Alaska Permanent Reserve Fund was set up in 1976 as a public trust to transfer wealth and equity between all residents of Alaska and future generations. Owned by the US State of Alaska, the Fund's regulatory framework allows the Alaskan State legislature to spend only its investment income. The principal cannot be spent without a vote. The Alaska Permanent Fund Corporation manages the Fund's assets.

By and large, the Fund functions like a pension fund; it makes annual dividend payments to residents of Alaska who have lived in the state for at least one calendar year. In 2007, the Fund paid $1,654 to each Alaskan resident.

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

The Alaska Permanent Reserve Fund publishes annual and monthly reports providing information on its asset size, holdings and returns. Many of these reports are available at its website for wider public dissemination. There is strong popular support for the Fund among the local population.

Russia to provide loans to deal with its crisis rather than the US or the IMF.

This transformation of emerging market countries as a group from debtors to creditors is not an insignificant development.[91] But despite their growing financial clout, emerging market countries have little or no participation in the design or management of the policy framework of the international financial system, which is still dominated by Western financial institutions and agencies such as the IMF and the Bank for International Settlements (BIS).[92]

The rise of SWFs represents a marked shirt towards state capitalism

Currently, a substantial portion of the capital exports from emerging markets is no longer channelled through Western banks and financial institutions, as it used to be, but through their own central banks and sovereign wealth funds. This is in sharp contrast to the 1970s and 1980s when Western banks were the prime players in recycling petrodollars from these countries into risky loans to the Third World and received little criticism (at the time) for doing so. Now that emerging countries are recycling their own surpluses, disapproval and angst emerges, even though (or perhaps because) Western countries (and their banks) desperately need Asian money

Non-state entities from emerging market countries are also undertaking direct investment overseas. Since 2003, private corporations from emerging market countries have been expanding their global presence by investing in developed countries. The buyout of IBM's personal computer business by the Chinese company Lenovo in 2005 and of the UK's Corus Steel and Jaguar Land Rover by Indian industrial giant Tata in 2007 and 2008 respectively are recent examples of this trend. In addition, 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 towards state capitalism. This trend should be seen in the wider context of several Latin American countries (such as Venezuela and Bolivia), Russia and China increasing state control over strategic resources, particularly oil and gas. State capitalism is also making a comeback of sorts 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 the Washington Consensus.[93] It questions the Anglo-Saxon economic model based on minimal state intervention and promotion of private enterprise. But as the ongoing credit crisis has amply demonstrated, the Anglo-Saxon model of unrestrained markets has failed. Apart from market meltdown with serious negative consequences for peoples' livelihoods and savings, this model has now lost any attraction it had. This is highly significant because the international economic order has been deeply embedded in this economic model since the 1980s. It is in this wider context that the phenomenon of SWFs needs to be situated.

91. This trend may reverse depending on how the current financial crisis unfolds, but these countries are still running current account surpluses. Moreover, the current engines of economic growth are primarily located in emerging markets (particularly China and India, both of which are less globally integrated financially than their peers) while most developed nations are undergoing or facing imminent recession.
92. The Bank of International Settlements, based in Basel, Switzerland, is an international organisation that "fosters international monetary and financial cooperation" among central banks and other agencies in pursuit of monetary and financial stability. It serves as a bank for central banks". *See* http://www.bis.org/
93. The term "Washington Consensus" initially referred to reforms promoted in developing countries by Washington DC-based institutions such as the International Monetary Fund (IMF), World Bank and the US Treasury Department, but came to be associated more generally with market fundamentalism, particularly an expanded free market and constraints upon the state.

Sources of Information on SWFs

Most sovereign wealth funds run websites, but they provide varying degrees of information. The following websites and blogs contain 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

OECD: www.oecd.org

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

Sovereign Wealth Funds Review: http://www.sovereignwealthfundsreview.com

SWF Radar: www.swfradar.com

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Most publicly available information on sovereign wealth funds is scattered throughout official documents, industry reports, research papers, studies, journal articles and newspaper reports. In addition to reports, papers and articles mentioned in the footnotes, the following also provide information and analysis on myriad aspects related to the SWFs.

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