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Jouko Rautava: Sovereign wealth funds arouse political passions

Global imbalances have remained a persistent topic in international economics in recent years. The concept refers to the large US current account deficit and counterbalancing large surpluses in Asian and oil-producing countries. These have boosted the foreign reserves of many surplus countries clearly beyond levels seen as necessary for securing their international liquidity. Consequently, decision-makers in the surplus countries are seeking to increase the return on their "excess" reserves by managing their foreign reserves more actively. For this purpose, they have established special sovereign wealth funds (SWF).

Over the past year, Arab countries and Asian surplus countries have invested USD 45 billion of their SWF funds in major Western banks. Despite the fact that this flow of finance is welcomed by banks hit by the financial crisis and is good for market stability, concern has been raised in the United States and Europe about the intentions of the sovereign wealth funds. What is this all about?

Sovereign wealth funds growing rapidly

There is no unambiguous definition of an SWF. However, they can be roughly divided into two categories: (i) Funds based on raw material revenues and (ii) funds built on asset transfers from ballooning foreign reserves. The latter are concentrated in Asia. In fact, growth of China's reserves and the reasons behind it are by themselves popular topics of policy debates. The objective of the funds is to stabilise economic and budgetary developments in countries where fluctuations in raw material prices and other factors often cause large disturbances. In many cases, the fund's operating horizon is very long, as sometimes reflected in the label pension fund. A common feature of the funds is that they invest largely in foreign instruments, selected more on return than liquidity considerations.

The first SWFs were established already in the 1950s, but their number has increased rapidly in this decade. At the moment, about 30 countries have at least one sovereign wealth fund, and the total number of the funds is over 40. Almost half of these have been established in this decade.

Value and market share of SWFs by country at the beginning of 2008*

	USD bn	% share
Oil producers	2,260	67.8
- UEA	875	26.3
- Norway	380	11.4
- Saudi Arabia	300	9.0
- Kuwait	250	7.5
- Russia	157	4.7
- Other oil producers	298	8.9
Raw material producers	27	0.8
- Chile	16	0.5
- Botswana	7	0.2
- Other raw material producers	4	0.1
Other SWFs	1,046	31.4
- Singapore	489	14.7
- China	200	6.0
- Hong Kong	163	4.9
- Others	194	5.8
Total	3,333	100.0

**Specific information is not available for every country.*
Source: www.swfinstitute.org and own estimates.

The assets held by the funds have grown rapidly, so that the assets under their management have almost doubled since the beginning of the decade to the present level of over USD 3,300 bn. At the end of last year, funds based on oil and gas revenues accounted for two thirds of the assets of the SWFs, but the proportion of non-raw material SWFs is increasing. As far as is known, at least Japan is considering establishing an SWF, and China seems to be investing an increasingly large proportion of its foreign reserves in higher-return (and risk) investments. Sovereign wealth funds are expected to grow rapidly in the coming years also due to high energy prices.

Despite their rapid growth, the amount of assets in sovereign wealth funds is still small relative to the size of the international financial markets. In comparison with the SWFs, the amount of foreign assets held by central banks alone is about twice as large, not to mention the fact that pension funds, management companies and insurance institutions combined hold more than twenty times the assets under SWF management. On the other hand, SWF assets exceed the assets of the recently much publicized hedge funds, estimated at USD 1,900 billion.

Concerns have a political background

From the point of view of operation of the financial markets, sovereign wealth funds do not involve special risks, although critics claim they can disrupt price formation in the markets. The objective of the funds is to achieve the best possible return on the investment assets, and it is hard to see why exactly these funds would be more problematic for financial market stability than other investors. No one has presented tangible evidence that SWF investments have caused market disruptions. Instead, many believe they help to stabilise the markets, since SWFs invest their own funds instead of debt capital.

Heated discussions in which the SWF question is often viewed from a very narrow perspective seem to overlook the big picture. In oil-producing countries and emerging markets, SWFs serve as buffers in stabilising cyclical fluctuations and economic developments. In light of the international financial crises over the past decades, the conservative financial policy and long-term approach reflected by the sovereign funds are welcome changes from the previous situation. From this viewpoint, the funds rather more increase stability than uncertainty in the markets.

Ultimately, the reasons for concerns relating to SWFs are political. With respect to the investments of oil-producing countries, the discussion could have remained a debate on individual investments, but the blossoming China and to an extent Russia seems to have raised the discussion to an entirely new level. The gist of the problem is that strong claims have been made in the United States and Europe that the investments by SWFs may not be based on financial factors, but may be guided by political motives and strategic objectives of governments. Naturally, countries owning these funds deny the accusations.

Clear rules benefit everyone

It seems that many of the Western countries' economic and political concerns about globalisation are erupting out of the SWF question. However, making the operation of the funds more difficult will not benefit anyone, since at their best the funds produce wellbeing for everyone concerned. Still, the political concerns are a fact of life and if they escalate, they will pose a threat to the operation of the funds. There is an ongoing discussion about the need for a clearer set of rules for the funds, so that they could continue operating without disruptions and without the need to establish an expensive and unnecessary mechanism for their supervision. Similarly, the idea of a specific SWF association to promote their cause seems unnecessary. At the same time, there is a desire to ensure that countries receiving investments do not engage in protectionism or prejudice in their own policies.

The Norwegian pension fund is exemplary in that the country's oil reserves have been converted into, in the long term, higher-return financial assets without raising political passions among external parties. What is key in the Norwegian model is transparency. The purposes of the fund have been made clear to the citizens of the country as well as outsiders, and there are clear guidelines on the investment policy and supervision of the fund.

Rules on transparency following the Norwegian model are being promoted within the IMF and OECD, albeit the difference in viewpoints between the investor and recipient countries is still wide. In March, the United States agreed bilaterally with Singapore and Abu Dhabi on principles focusing on economic foundations, transparency and equitability. Certain SWFs are also considering joining member associations of private equity funds, in which case they would commit to a code of conduct emphasising transparency.

At a general level, sovereign funds, even in their present form, are not a problem, although most of them have considerable room for improvement in terms of transparency. The debate on SWFs reflects heightened security concerns among Western countries amid the rise of emerging markets and China and Russia in particular as well as concerns about availability of resources and the drain of technology and jobs to competitor countries. The core of the problem is a fear of entangling political and economic decision-making in a manner inconsistent with developed market economy rules of the game. In this respect, however, e.g. Chinese and Russian state-owned companies are more important actors than those countries' funds. Nevertheless, to prevent the rise of protectionism, we need to tackle the SWF problem. A solution highlighting the transparency of investment policy in investor and recipient countries would also promote the development of rules on other fronts.

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