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# Sovereign Wealth Funds - Size, Economic Effects and Policy Reactions

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# Sovereign Wealth Funds – Size, Economic Effects and Policy Reactions[1]

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**Abstract:**

The emergence of Sovereign Wealth Funds (SWFs) and some spectacular investments of these funds in recent years have caused widespread attention on international financial markets. Most SWFs are domiciled in Arabian countries, East Asia and Russia. Their low transparency led to concerns that SWFs could threat national security and the economic order of industrialised countries. This paper describes the growth and the investment strategy of SWFs, the impact of their investments on host and investing countries as well as policy reactions of selected countries. Several international organisations (European Union, OECD, the IMF together with the International Working Group of Sovereign Funds) have already undertaken initiatives that will help to improve the transparency and accountability of SWFs and to develop best practices for investing countries as well as for recipient countries. National policy reactions of several host countries, like the tightening of rules for cross-border investments in the United States and in Germany, were therefore rather counterproductive.

Keywords: Sovereign Wealth Funds, international financial markets, government policy, regulation

JEL: G32, G15, G38

[1] Extended version of a lecture at the University of Applied Sciences Amberg-Weiden in 2008.

**Deutscher Abstract:**

Das Wachstum und eine Reihe von spektakulären Investitionen von Sovereign Wealth Funds (SWFs) haben in den letzten beiden Jahren auf den internationalen Finanzmärkten für viel Aufsehen gesorgt. Aufgrund der geringen Transparenz vieler SWFs gab es Befürchtungen, dass diese Fonds, die überwiegend in arabischen Ländern, Ostasien und Russland angesiedelt sind, eine Bedrohung für die nationale Sicherheit und das Wirtschaftssystem von Industriestaaten sein könnten. In dem vorliegenden Beitrag werden das Wachstum und die Anlagestrategie von SWFs, die Auswirkungen ihrer Investitionen auf Empfänger- und Geberländer sowie die Politikmaßnahmen der betroffenen Länder beschrieben. Es zeigt sich, dass die nationalen Reaktionen der Empfängerländer, zum Beispiel die Verschärfung der Regelungen für grenzüberschreitende Investitionen in den Vereinigten Staaten und Deutschland, wahrscheinlich zu weit gingen, zumal auf supranationaler Ebene (Europäische Union, OECD und IWF zusammen mit einer Arbeitsgruppe von SWFs) bereits Initiativen auf den Weg gebracht wurden, die zu einer verantwortungsvollen und transparenteren Politik der SWFs wie auch der Empfängerländer von Investitionen beitragen.

## Sovereign Wealth Funds – Size, Economic Effects and Policy Reactions

### 1. Introduction

In 2007 Sovereign Wealth Funds (SWFs) entered the economic and political scene. For several decades these funds were largely unnoticed by a wide public. Rapid growth in recent years - fuelled by strongly rising commodity prices and large current account surpluses of several emerging market economies - and some spectacular cross-border investments brought them into the spotlight of the media around the globe. Within months countless articles in the financial press were released that dealt with the new phenomenon.[2]

Immediately, a heavy public debate about the effects of SWFs arose. Some commentators welcomed SWFs as a new kind of long-term and stable investors. Their large scale investments in distressed American and European financial institutions in the past 18 months were connected with the hope that SWFs can save global financial markets - what they did not and could not. On the other extreme SWFs were instantaneously identified as a major threat for national security and the economic order of Western countries - what they strongly denied. Nevertheless, the rise of SWFs provoked unusually quick and harsh policy reactions. Many recipient countries tightened their investment regimes whereas international institutions tried to stipulate best practices for SWFs and target countries to prevent a renewed wave of protectionism on international capital markets.

There is still a lot of confusion about SWFs. This article tries to summarize what is known about SWFs and how recipient countries, international organisations and home countries reacted to SWF investments. Section 2 defines SWFs and describes their size and investment strategy. Section 3 analyzes the possible impacts of SWFs on financial markets, home and target economies. Policy reactions of recipient and investing countries are reviewed in section 4. Section 5 concludes.

[2] With 3 million Google hits in mid December 2008 the term "Sovereign Wealth Fund" beat "Boris Becker" (1.7 million), the global sports icon.

## 2. Definition, Size and Investment Strategy of Sovereign Wealth Funds

### 2.1. What are Sovereign Wealth Funds and how do they arise?

There is no widely accepted definition of "Sovereign Wealth Funds" – a term that was used first only three years ago by Razanov (2005). But most institutions and researchers have agreed on some common characteristics of these funds.[3] SWFs are state-owned special investment funds that invest in foreign currencies and are separately managed from foreign exchange reserves of the central bank. They have no or only limited liabilities and therefore differ from sovereign pension funds. SWFs undertake long-term investments in search of commercial returns but they are not operating state owned companies (Beck and Fidora, 2008, p. 6, Fotak et al., 2008, p. 1).[4]

Based on their objectives the IMF (2008a) distinguishes five types of SWFs: (1) stabilization funds whose primary objective is the stabilization of government and export revenues against oil and other commodity price swings; (2) savings funds which aim to accumulate savings for future generations or other longer-term objectives by converting non-renewable assets into a more diversified portfolio of assets to avoid a Dutch disease effect; (3) reserve investment corporations that are established to increase the return on currency reserves that are separated from official reserves; (4) development funds that promote industrial policies or socio-economic projects in order to raise the potential output of the home economy; (5) contingent pension reserve funds which provide for unspecified pension liabilities of the government.

Most SWFs are either commodity based or non-commodity based. Commodity based funds are earning money directly through receipts from commodity exports or through taxes by the government. Resource-rich countries mainly from the Middle East as well as from Norway and Russia have established such funds. Non-commodity funds are financed by a transfer of official foreign exchange reserves by the central bank. These reserves are being accumulated in excess of what is needed for intervention or balance of payments purposes. The source of reserve accumulation is often the result of high current account surpluses and inflexible exchange rate regimes (Beck and Fidora, 2008, p. 6f). Most of these funds are based in East Asia.

[3] The IMF Committee on Balance of Payments is working on a precise and operational definition of SWFs.
[4] For an overview of different definitions of SWFs by government organizations, investment banks, private research organizations and international organizations see GAO, 2007, p. 46.

## 2.2. How big are SWFs and how strong will they grow in the future?

As many SWFs do not publish data on their size and due to different definitions there is a wide range of uncertainty with respect to the number and size of existing SWFs.[5] There are more than 50 such funds in more than 40 countries. Most of them have unique characteristics so “there is no such thing as an average SWF” (Economist, 2008b, p. 2). Some funds are new (like the China Investment Corporation which was established in 2007), some are very old (as Kuwait Investment Authority, founded in 1953). Some SWFs are very big (Abu Dhabi Investment Authority with assets of more than $500 billion) and some are very small in size (Sao Tome and Principe with assets of $20 million). Some are passive investors, while others are active investors (like Temasek Holdings).

Sovereign Wealth Funds have grown tremendously in recent years. Their growth reflects rising oil and non-oil commodity prices and fast growing current account surpluses of home countries. According to different estimates SWFs assets could have reached roughly $3.5 trillion at the end of 2007 compared to an estimated $0.5 trillion in 1990. A list of 20 SWFs with an estimated fund volume of more than $20 billion each in 2007/2008 can be found in table 1. Table 1 contains the size of the funds, their origin (commodity or non-commodity based), as well as the year of their inception.[6] The ten largest funds combined have a volume of $2.6 trillion or 70% of the total value of assets of SWFs. During 2008 SWFs were similarly hit by the financial market crisis like other large asset funds. According to estimates of the Deutsche Bank the value of the assets of SWFs could have fallen by nearly 17% during the past 12 months until the end of the third quarter of 2008 (FAZ 2008).

[5] Several institutions and other researchers have published various lists of SWFs and have estimated the assets of SWFs. These lists are not congruent as different definitions were used. Sometimes the names of various SWFs contribute to a lack of clarity. For example, some funds’ names include “pension” but they do not operate as pension funds (GAO, 2008, p. 46).

[6] Here we follow most commentators that include Norway’s Government Pension Plan into the SWF category because of its size, its unusual global asset allocation and its focus on profitability.

Table 1

**The world's largest Sovereign Wealth Funds 2007/08 ***

| Country | Fund name | C = Commodity<br>N = Non-Commodity | Size<br>($ billion) | Year<br>of inception |
|---|---|---|---|---|
| UAE (Abu Dhabi) | Abu Dhabi Investment Authority (ADIA) | C | 625-875 | 1976 |
| Norway | Government Pension Fund Global (GPFC) | C | 372 | 1990 |
| Saudi-Arabia | SAMA | C | 300 | 1952 |
| Singapore | Government Investment Corporation (GIC) | N | 215-330 | 1981 |
| Kuwait | Kuwait Investment Authority (KIA) | C | 213-250 | 1953 |
| China | China Investment Corporation (CIC) | N | 200 | 2007 |
| Hongkong (China) | Exchange Fund Investment Portfolio | N | 186 | 1998 |
| Russia | Reserve Fund | C | 130 | 2008 |
| Singapore | Temasek Holdings | N | 108 | 1974 |
| UAE (Dubai) | Investment Corporation of Dubai | C | 82 | 2006 |
| Australia | Australian Government Future Fund | N | 58 | 2006 |
| Qatar | Qatar Investment Authority | C | 40-60 | 2005 |
| Libya | Libya Investment Authority | C | 50 | 2007 |
| Algeria | Revenue Regulation Fund | C | 46 | 2000 |
| USA (Alaska) | Alaska Permanent Fund | C | 38 | 1976 |
| Brunei | Brunei Investment Agency | C | 30-35 | 1983 |
| Russia | National Wealth Fund | C | 33 | 2008 |
| Kazakhstan | National Fund | C | 26 | 2000 |
| South-Korea | Korea Investment Corporation | N | 20 | 2005 |
| Venezuela | National Development Fund | C | 21 | 2005 |

* Sources: United States Government Accountability Office (2008) and various financial institutions.

In recent years many countries increasingly shifted assets from currency reserve holdings into SWFs so that their assets rose to approximately 45% of their foreign exchange reserves (Beck and Fidora 2008). Several countries started early to transfer reserves to SWFs. The United Arabian Emirates (UAE), Norway, Singapore and Kuwait, four of the largest SWF holders, have estimated combined assets in SWFs of $1.3 trillion, compared to official foreign exchange reserves of less than $200 billion. China and Russia were latecomers in this respect. Only recently they started to transfer currency reserves to SWFs. Therefore their official reserves of approximately $2 trillion are still 8-times higher than their assets in SWFs. The widespread fear in many industrialised countries against SWFs is caused by the expectation of a massive increase of the volume of Chinese and Russian SWFs that could give them the power to shop around in the Western corporate sector.

SWFs are expected to continue to grow strongly in coming years but estimates of the prospective growth of SWFs differ in a wide range. In spring 2008 the IMF projected a growth of SWFs to $6-10 trillion by 2013 (IMF 2008a) which would mean more than a doubling of SWFs funds volume within the next five years. Several financial institutions were even more optimistic with estimates ranging from $10-12 trillion until 2011-2013 (Johnson,

2007, and Jen, 2007). The forecasts on the growth of SWFs crucially depend on the future development of oil prices and current account surpluses of emerging economies in East Asia. The financial market crisis and its negative effects on oil prices and export expectations of many countries had slowed down the expected growth of SWFs. Nevertheless, SWFs will still grow further and could exceed official currency reserves within the next five years.

### 2.3. How do SWFs invest and why do they raise concerns in host countries?

In the past most SWFs did not disclose their assets and investment strategies. As far as it is known the majority of SWFs followed a rather conservative investment strategy and concentrated their assets in fixed income. Larger investments in publicly listed equities or in alternative asset classes were not widespread. SWFs therefore remained relatively unknown for a wider public until mid of this decade. In recent years and pushed by strongly rising fund volumes SWFs began to diversify their assets.

As some SWFs started to disclose their investments one can draw a clearer picture of their behaviour and strategy even if much remains in the dark (see section 3). SWFs are a very heterogeneous group of investors. Their asset allocation reflects their different objectives. Some SWFs invest solely in publicly-listed assets (bonds and equities) while others invest across all major asset classes including alternative investments like private equity, real estate and emerging market investments. SWFs assets are therefore more diversified than traditional reserve holdings and are comparable to private asset managers, in particular mutual funds (IMF 2008a, p. 9, Beck and Fidora 2008, p. 12).

According to a survey of the International Working Group of SWFs (IWG) one can classify the investment behaviour of SWFs into two groups. One group of SWFs, mostly those that are not separate legal entities, still have relatively traditional asset allocations – often limited to highly rated government securities - and only a few of these funds are investing in equity and taking on more credit risk (IWG 2008a, p. 15). The other group uses different asset classes whereby the share of the selected assets in the total volume of their portfolio varies considerably: equity (40-70%), fixed income (13-40%), private equity (4-10%), real estate (8-10%), infrastructure (2-5%) and commodities (2-5%).

Most cross-border equity investments of SWFs are portfolio investments that are driven by longer-term return motivations. The majority of SWFs prefer smaller equity stakes of less

than 10% or even less than 5% to diversify risks. Most SWFs do not seek control of the targeted companies for different reasons. Often they don't have the expertise or knowledge to run a company. Sometimes they don't want to be reviewed by government institutions of the recipient countries. Several transactions are known where SWFs abandoned voting rights when they had acquired larger stakes. Funds like the Norwegian "Government Pension Fund – Global" explicitly limit their investments in equity stakes to 5%. Since 2007 there was a wave of cross-border portfolio investments of SWFs, mainly in the financial sector of the United States and Europe. SWFs investments in United States and European financial institutions in 2007 and in the first half of 2008 amounted to $92 billion. These investments led to increased concentration risks in SWFs portfolios (Deutsche Bank Research 2008, p. 8).

Table 2

**Major cross-border equity investments of SWFs in the financial sector**

2007 - 2008, 1st quarter

| | | Transaction value | |
|---|---|---|---|
| Acquired company | SWF | $ billion | in % of firm value |
| UBS | GIC (Singapore) | 9.8 | 8.6 |
| Citigroup | ADIA (Abu Dhabi) | 7.6 | 4.9 |
| Citigroup | GIC (Singapore) | 6.9 | 4.4 |
| Morgan Stanley | CIC (China) | 5.0 | 9.9 |
| Merril Lynch | Temasek (Singapore) | 5.0 | 11.3 |
| Merril Lynch | KIA (Kuwait) | 3.4 | 7.0 |
| Barclays | China Development Bank | 3.0 | 3.1 |
| Blackstone | CIC (China) | 3.0 | 10.0 |
| London Stock Exchange | Investment Corporation (Dubai) | 3.0 | 28.0 |
| Merril Lynch | KIC (Kuwait) | 2.0 | 4.3 |
| Barclays | Temasek (Singapore) | 2.0 | 1.8 |
| London Stock Exchange | Qatar Investment Authority | 2.0 | 20.0 |
| Standard Chartered | Temasek (Singapore) | 2.0 | 5.4 |

Source: ECB (2008), p. 11

A relatively new phenomenon is the growing interest of SWFs in investments in larger equity stakes that give them the opportunity to exert control of the target countries. Foreign direct investment (FDI) in the form of cross-border M&As of SWFs provoked fears that SWFs not only will follow economic but also political and strategic goals. FDI of SWFs is still very low compared to FDI of strategic investors and private equity and hedge funds. But the number of cross-border M&A deals recently increased strongly, from only 1 in 1987 to 20 in 2005, and 30 in 2007. During the past three years from 2005-2007 FDI of SWFs amounted to $31

billion compared to only $8 billion during the period from 1987 to 2004. Ten of the largest FDI cases of SWFs can be found in table 3. Unctad's database of SWFs cross-border M&As shows that FDI by SWFs is largely concentrated in some sectors and regions. About three quarters of SWFs investments were made in developed countries, mainly in the United Kingdom, the United States and Germany. A specific feature of these investments has been their concentration in business services (24%) with much less going to the primary and manufacturing sector (Unctad 2008, p. 21f.). The major investors are SWFs that are domiciled in the United Arab Emirates followed by those of Singapore.

Table 3

**Large FDI cases by Sovereign Wealth Funds (1995-2007)**

| Year | Value ($ million) | Acquired company (target country) | Acquiring SWF or entity established by SWFs | Acquired share (%) |
|---|---|---|---|---|
| 2005 | 2359 | Kuckwang Petrochemical Co Ltd (Taiwan Province of China) | International Petroleum Investment Co (IPIC) (UAE) | 20 |
| 2006 | 2313 | Tunisie-Telecoms (Tunisia) | Investment Corporation of Dubai (UAE) | 35 |
| 2005 | 1691 | Borealis A/S (Denmark) | Abu Dhabi Investment Authority (UAE) | 50 |
| 2005 | 1495 | Tussauds Group Ltd (UK) | Dubai International Capital LLC (UAE) | 100 |
| 2006 | 1270 | Travelodge Hotels Ltd (UK) | Dubai International Capital LLC (UAE) | 100 |
| 2006 | 1241 | Doncasters Plc (UK) | Dubai International Capital LLC (UAE) | 100 |
| 2005 | 1222 | CSX World Terminals LLC (USA) | Dubai Ports International (UAE) | 100 |
| 2006 | 1200 | 280 Park Ave, N.Y. (USA) | Istitihmar PJSC (UAE) | 100 |
| 2007 | 1160 | Mauser AG (Germany) | Dubai International Capital LLC, UAE | |
| 1995 | 1135 | Mediaset SpA (Italy) | Saudi-Arabia | 18 |

Source: Unctad (2008), p. 24

## 3. Impact of SWFs on global financial markets, home and host countries

### 3.1. What are the possible effects of SWFs on global financial markets?

The assets of SWFs had reached roughly $3.5 trillion at the end of 2007. Compared to the total volume of global capital markets of an estimated $190 trillion SWFs seem quite small. They are also relatively small compared to assets under management of mature market

institutional investors ($57 trillion at the end of 2007) (IMF 2007). Compared to private equity funds and hedge funds SWFs assets are larger. But, these funds have highly leveraged their investments so that their influence on capital markets is bigger. Nevertheless one should not neglect the importance of SWFs which will rapidly grow during coming years.

The growing importance of SWFs has provoked some hopes and many fears. On the one hand there are fears that the investment behaviour of SWFs could have detrimental effects on world capital flows, interest rates and exchange rate stability. As we have seen SWFs opt for a higher return and less liquidity oriented portfolio allocation compared to traditional currency reserves holders. This could cause strong capital outflows out of traditional reserve currencies, an increase in their interest rates and a depreciation of their exchange rate.

In a recent study Beck and Fidora (2008) have calculated the possible effects of a transfer of foreign exchange reserves to SWFs. They have estimated that excess reserves of major emerging markets could exceed $3 trillion. Actually these reserves are invested nearly exclusively in the US and the European bond markets (with shares of roughly 60% and 29%). If SWFs follow a portfolio strategy like private fund managers that is reflected in global market capitalisation shares one can expect a considerable capital outflow out of the US and European capital markets (of $500 billion and $230 billion respectively). In both regions massive capital outflows from the bond market would be partially offset by an inflow of capital into equity markets (Beck and Fidora 2008, p. 14 ff.). In contrast, Japan and many fast growing developing countries in Asia could attract strong capital inflows into the bond and equity markets which would reflect the large weight of these countries in global capital markets and their negligible role as reserve countries. Even in this extreme scenario a complete shift of excess reserves out of the traditional markets would not have a destabilizing effect on world capital markets. For the United States a capital outflow of $500 billion is equivalent to only 2.5% of the $20 trillion outstanding US debt. One could also expect that such a shift would take a longer time to avoid market disruptions and capital losses.

The IMF (2008) has calculated the effects of a shift of newly available foreign currency inflows into SWFs. The most significant effects would result on the US markets if countries diversify away from dollar holdings. Capital inflows into the United States could decline by around 0.25-0.50% of US GDP per year on average. As a result the US real interest rate would increase by 10 to 20 basis points, the US dollar would depreciate by 2-5% and the US

current account deficit could improve by 0.25-0.5% (IMF, 2008a, p. 30ff.). These are not minor effects but they would not disrupt the functioning of international capital markets.

On the other hand SWFs can play a stabilizing role on international financial markets. In contrast to many investors with a shorter-term investment horizon like private equity funds and hedge funds SWFs are long-term investors with no immediate call on their assets. Their investments are normally unleveraged and they have an interest in pursuing portfolio reallocations gradually to limit adverse price effects of their transactions (IMF 2008a, p. 12f.). During the recent financial market crisis SWFs acted as a stabilizing force by investing heavily in distressed American and European banks. Investing in stakes of globally operating banks when their stock prices are falling could indicate a mean-reverting investment strategy of SWFs (Beck and Fidora 2008, p. 12). However, the stabilising effect was short-lived as stock prices plummeted later on during the aggravation of the financial crisis in the second half of 2008 which also led to massive losses of SWFs investments (see section 3.2.).

### 3.2. What are the motivations for setting up SWFs?

The rise of Sovereign Wealth Funds in recent years has provoked fears in host countries that these funds have political motives and could be a threat to national security or that they could follow strategic goals by using industrial espionage. In section 4 we will discuss how realistic such a scenario is and what the appropriate response could be. But, there is no need to draw a completely pessimistic picture as there are several other obvious reasons for setting up SWFs (Reisen 2008).

For resource rich countries, like the Arabian oil producers or countries in Africa and Latin America, SWFs can raise national welfare. Extracting oil or other commodities leads to capital depreciation unless the receipts are fully invested in financial, physical or human capital (Hartwick Rule). A Sovereign Wealth Fund can help these countries to transform commodity receipts in wealth rather than being consumed like in the 1970s (Griffith-Jones and Ocampo 2008, p. 7). This seems necessary from a development perspective. The World Bank (2006) has shown that many oil exporting countries and other countries that are exporters of non-renewable resources have negative “genuine” savings. SWFs can therefore contribute to the smoothing of consumption and the preservation of wealth for future generations (Griffith-Jones and Ocampo 2008, p. 7).

Countries with large current account surpluses and high currency reserves, like China and Singapore, can also profit by setting up a SWF. By transferring foreign exchange reserves to SWFs a country can improve the risk and return profile of its assets. In the longer run the yield on the investments of SWFs is higher than the yield on government bonds (mostly US government bonds). The rationale for setting up SWFs is connected with the question of the rationale of reserve accumulation. There is a vast literature on the subject of the optimal level of foreign exchange reserves. Economists disagree if the Asian surplus countries already have reached the optimal level of foreign exchange reserves. There are two motives that can relatively easy explain why it made sense for these countries to accumulate reserves in past years. According to the competitiveness motive countries can raise price competitiveness by maintaining a stable and weak exchange rate. The gains of the resulting export surpluses can be higher than the costs of the inevitable reserve accumulation (Griffith-Jones and Ocampo 2008). The self-insurance motive states that the accumulation of foreign exchange reserves is a rational response of each country to self insure against the risks of a deepening financial integration that poses the risk of a sudden large capital outflow. The accumulation of reserves was therefore a natural reaction of several Asian countries to the Asian crisis in 1997/98 and makes sense from the perspective of the individual countries.[7]

If it makes sense to set up SWFs there is the question of how to investment the funds. The main fear of SWFs comes from rising investments in the form of FDI. Investments on the international bond markets and portfolio investments on equity markets that have a longer tradition did not provoke similar reactions. For SWFs investments in the form of FDI has several advantages. By FDI countries can reduce resource dependence through vertical and horizontal diversification. They can transfer technology to the home country by investing abroad, and they can benefit from networks or clusters.

### 3.3. What are the possible effects of SWFs investments on target countries?

The rise of SWFs and their increasing investments in North American and European companies initiated a heavy public debate in the summer of 2007 that continued in 2008. Transactions like the $3 billion investment by China Investment Corporation in shares of the American private equity firm Blackstone or the acquisition of a 3% stake in the European aircraft producer EADS by Dubai International Capital in July 2007 raised concerns. In the

[7] From another standpoint it is argued that the currency reserves of several Asian countries are excessive, that they had arisen from artificially low exchange rates and that they contribute to global imbalances. (Griffith-Jones and Ocampo 2008).

United States Hillary Clinton argued that one need to have a lot more control over what SWFs do and how they do it (Economist 2008a). The French President Nicolas Sarkozy claimed that innocent French managers should be protected against "extremely aggressive" SWFs. Roland Koch of the ruling Christian Democrats in Germany emphasized that SWFs seek political power (Koch 2007).

Target countries fear that investments of SWFs could be driven by political motivations. If governments manage SWF investments in pursuit of political objectives they are a threat for national security or the market-based economic system. More specifically, non-democratic countries like China and Russia could use their SWFs to get control of defence related sectors and firms in Western countries. Until now there are no documented cases of abuse of power by any SWF (Cohen 2008, p. 6). This could be a sign that SWFs are not interested in provoking reactions or that the already large barriers that are manifested in national laws are a protective shield against attempts of SWFs. Indeed, there is much evidence that existing national laws are adequate to deal with potential security threats.

Besides security related goals in a narrower sense SWFs could also aim to gain other strategic political advantages. If SWFs could get control over certain economic sectors that are vital for the functioning of the economy they would be able to exert political pressure on the governments of the host countries. Investments in strategic sectors like the financial sector, telecommunications and logistics, energy supply or railway and postal services pose a risk. In network industries, for example, SWF could gain a monopolistic position by large cross-border acquisitions which could lead to political pressure. Despite large-scale privatizations and deregulation since the 1980s competition in the energy supply sector is still limited in many European countries. If a SWF could acquire a major stake in one of the large players of the European energy markets it could probably misuse a dominating market position. Driven by its home government a SWF could announce price hikes or a stop of energy supply to exert political pressure on target countries. But, the relevant question is now: Is the potential threat of this scenario an argument for a general tightening of rules for foreign investments? Or, wouldn't it be better to further privatize in such markets or to install more powerful regulatory institutions (Haucap 2007)?

As was described in the second section SWFs concentrated their cross-border investments during the past 18 months in the US and European financial sector. These investments

provoked mixed feelings. On the one hand they were welcomed as they contributed to the recapitalisation of several distressed banks in North America and Europe. On the other hand some observers argued that SWFs could get control of worldwide capital flows. Gilson and Milhaupt (2008) wondered about SWFs rapid infusion of capital into U.S. commercial and investment banks whereas few other investors from industrialised countries provided capital. They speculated that if the investment opportunity was attractive in purely economic terms why were SWFs the principal investors? They suggested that SWFs perhaps got something more than a purely financial investment. It seems that these fears are not justified. In contrast to some network industries, like the European energy sector, there is enough competition in the financial sector to prevent that institutions that are controlled by SWFs could exert a dominating influence. As we have seen (section 2) most SWF investment in the US and European banking sector were smaller than 10 % stakes and in many cases the funds do not exercise their voting rights.

Another issue that was raised first by Larry Summers in a Financial Times article is that SWFs could symbolise a “rise of state capitalism” (Economist 2008b). The past quarter century has seen a sharp decline in the extent of direct state ownership in favour of private investors. SWFs through their cross-border investments accumulate now various kinds of stakes in what were once purely private companies. This redistribution from private to public hands implies a decision-making orientation that is at variance with the traditional private sector, market oriented framework (Trumann 2008, p. 2). What’s the problem with state-owned companies and do we have to feel uncomfortable with that situation? State-owned companies often have no clear goals, are not under the pressure to reduce costs and are not controlled by financial markets. Therefore they act under soft budget constraints. With regard to SWFs this doesn’t seem a problem for the target countries of SWF investments as these inefficiencies are financed by the foreign governments that are the owners of SWFs (Haucap 2007, p. 12f).

Economically one has to differentiate between macroeconomic and microeconomic effects of SWF investments in the target countries. From the macroeconomic perspective cross-border investments of SWFs have positive effects on the target countries as they contribute to an internationally efficient allocation of capital. Several countries with larger current account deficits, like the United States, profit from capital inflows that allow a financing of these deficits.

Fotak et al. (2008) in a first study on the microeconomic effects have measured the impact of SWFs investments on the performance of the targeted companies. In an event study of 212 SWF acquisitions of equity stakes in publicly traded companies they found negative abnormal returns over a period of two years following the SWF investment. The negative impact on firm profitability could come from additional agency costs that are larger than the potential benefits related to a better monitoring of target firms by a significant shareholder. In the short run around the announcement date SWF investments led to positive abnormal returns which signals that SWFs – in contrast to the public opinion - were mostly welcomed as investors.

## 4. Policy reactions to Sovereign Wealth Funds

Many SWFs lack a reasonable degree of transparency and accountability. The rise of SWFs has therefore provoked policy reactions of recipient countries despite efforts of international organisations to prevent new protectionist measures on international capital markets. This section gives an overview of the current status of transparency of SWFs, it describes and analyses recent policy reactions of major recipient countries as well as the work of international organisations and it discusses the "Santiago principles", the response of the International Working Group of Sovereign Wealth Funds in collaboration with the IMF.

### 4.1. How transparent are SWFs?

Increased cross-border investments of SWFs in Western countries have caused public unease about possible detrimental effects of these investments. The main point of critique is that many SWFs act in the dark. In several areas such as institutional structure, risk management, transparency and accountability not very much is known about SWFs which contributes to uncertainty.

Truman (2007a) has pointed to the need for greater transparency and accountability of SWFs. To underpin his arguments he developed a scoreboard for SWFs that covers four basic categories and 25 subcategories (2007b). Each SWF is evaluated on the extent to which those elements are associated with its structure and operation. The categories are (1) structure, (2) governance, (3) transparency and accountability, and (4) behaviour. The subcategories cover relevant questions like "Is the SWFs objective clearly communicated?", "Is the role of the government in setting the investment strategy of the SWF clearly established?" or "Does the SWF have in place and public available guidelines for corporate responsibility that it follows?" The results indicate that SWFs differ largely and many funds lack basic

characteristics of transparency and accountability. New Zealand's Superannuation Fund scored 24 points of a maximum of 25 points followed closely by Norway's GPFG with 23 points. Both funds can therefore be considered as a kind of a "gold standard" for transparency and governance of SWFs (Unctad 2008). On the other hand some SWFs have a very low standard in this respect. Abu Dhabi Investment Authority and Corporation (ADIA) only scored 0.5 points and clearly missed international standards of best practices. Another 12 of a total of 32 evaluated SWFs only scored less than a quarter of the maximum of 25 points (Truman 2007b, p. 12).

Table 4

**Transparency Rankings of selected Sovereign Wealth Funds**

| Country | Sovereign Wealth Fund | Truman Scoreboard 0-25 | SWF Institute Index 1-10 |
|---|---|---|---|
| New Zealand | Superannuation Fund | 24.0 | 10 |
| Norway | GPFG | 23.0 | 10 |
| Timor-Leste | Petroleum Fund | 21.75 | 6 |
| Canada | Alberta Heritage Savings Trust Fund | 19.50 | 9 |
| United States | Alaska Permanent Fund | 18.00 | 10 |
| Australia | Future Fund | 17.00 | 9 |
| Azerbaijan | State Oil Fund | 16.50 | 9 |
| Chile | Economic and Social Stabilization Fund | 15.50 | 7 |
| … | … | … | … |
| Russia | Stabilization Fund | 9.5 | n.a. |
| China | Central Hujin Investment Company | 6.0 | n.a. |
| Iran | Oil Stabilization Fund | 5.5 | 1 |
| Oman | State General Reserve Fund | 5.0 | 1 |
| Algeria | Revenue Regulation Fund | 4.5 | 1 |
| UAE | Mubadala Development Company | 3.5 | 7 |
| Brunei | Brunei Investment Agency | 2.5 | 1 |
| Singapore | Singapore Investment Corporation | 2.25 | 6 |
| Qatar | Qatar Investment Authority | 2.00 | 5 |
| UAE | ADIA | 0.50 | 3 |

Sources: Truman (2007b) and Sovereign Wealth Fund Institute (2008).

The Sovereign Wealth Fund Institute (2008) is publishing another index that reflects transparency of SWFs according to ten principles. Each principle adds one point to the total score. The institution claims a minimum rating of 8 points for an "adequate" transparency standard. Its method differs from the more sophisticated scoreboard of Truman but it shows similar results for SWFs originating in different regions[8]: Only 11 SWFs of 46 SWFs have scored a minimum of 8 points or more. Eight of these are based in OECD countries and only

[8] The index is an ongoing project. The current ranking is published on the website of the institution (swfinstitute.org).

three are from emerging market economies or countries in transition (South Korea, Singapore and Azerbaijan). In contrast most SWFs that originate in Russia, China and Arabian countries (West Asia) have a low standard of transparency and accountability (see table 4).

**4.2. Policy reactions of recipient countries – did they make sense?**

The lack of transparency and the fear that SWFs could follow political rather than mere economic goals led to reactions of recipient countries. In principle it was acknowledged that the rise of SWFs should not cause the building up of new barriers to international capital flows and FDI. This view was repeatedly stated in various declarations. In October 2007 the Group of Eight declared that “SWFs are increasingly important participants in the international financial system and our economies can benefit from openness to SWF investment flows” (Group of Eight 2008). The European Commission in February 2008 urged a common European approach to SWFs that should strike the right balance between addressing concerns about SWFs and maintaining the benefits of open capital markets. Specifically it pointed out that SWFs do not operate in a legal vacuum today. Rather, SWFs had to comply with the same EU national and economic legislation that all other investors had to respect. The European Union at the community level and the single member states already had adequate powers to deal with public security issues. It indirectly criticised that several EU members in 2007 and 2008 started to “explore” applying exceptions to the application of the principles of free movement of capital (Commission of the European Communities 2008). In June 2008 the ministers of OECD countries stated that recipient countries should not erect new protectionist barriers to foreign investments and that they should not discriminate among investors. Additional investment restrictions should only be considered in the case of legitimate national security concerns if other policies of general application to both foreign and domestic investors are inadequate (OECD 2008a).

In contrast to these views at least eleven major countries - which together received more than 40% of global FDI inflows in 2006 - have approved or are seriously planning new rules to restrict certain types of FDI or expand government oversight of cross-border investments (Marchick and Slaughter 2008, p. 2). In the United States the “Foreign Investment and National Security Act” (FINSA) became effective in October 2007. FINSA amends section 721 of the Defense Production Act of 1950, the so-called Exon-Florio amendment. FINSA was stimulated by the massive public resistance against the planned acquisition of the British “Peninsular & Oriental Steam Navigation Company” that controlled several U.S. ports by

“Dubai Ports”, a government owned entity based in the United Arab Emirates. The US Committee on Foreign Investments (CFIUS) that was responsible for Exon-Florio approved the transaction which caused resistance in the U.S. congress. Under the new law CFIUS must consider several additional factors in conducting reviews and investigations. CFIUS is now explicitly charged with considering whether the transaction is a foreign government-controlled transaction and whether it would result in control of critical infrastructure (GAO 2008, p. 33f.)

The tightening of the US investment regime was welcomed by many commentators and some went even further. Gilson and Milhaupt (2008) for example proposed the suspension of voting rights of SWFs for portfolio investments that are not subject to the CFIUS review process. On the other hand the new rules can be criticised as they discriminate between private and public investments, as they cause investor uncertainty and as they are too far reaching. In fact the number of CFIUS reviews conducted increased sharply in 2006 and 2007 (113 and 147 cases respectively compared to an annual average of 51 cases in the period from 2001 to 2005). There were also more second-stage investigations in 2006-2007 than in the previous 15 years combined.

In Germany the government has approved a draft amendment to the Foreign Trade and Payments Act and its implementing regulations. According to the planned new law the Federal Ministry of Economics and Technology reviews a foreign investment and it can suspend or prohibit transactions that threaten to impair public security or public order (Bundesrat 2008). The screening is applicable to investors from outside the EU and EFTA that seek to acquire a 25 percent or greater stake of a German company. It is not limited to well-defined sectors or to the size of the target firm. To facilitate the process it is not mandatory for investors to “signal” an acquisition. Rather the ministry initiates a review process within a period of 3 months after the conclusion of the treaty if it recognizes a potential threat.

The draft of the planned change of the German Foreign Trade and Payments Act was heavily criticised. First of all, there are no criteria defined to judge if a potential foreign investment threatens national security or public order. The inclusion of the term “public order” in addition to “public security” is causing confusion (OECD 2008b). The German council of economic advisors emphasized very early that the lack of definite criteria is a problem and

that the first disputed case will make it necessary to cope with that problem (Sachverständigenrat 2007, p. 431). Second, it can be criticised that the review process is not limited to certain sectors and firms which could cause uncertainty for all foreign investors. The Federal Ministry of Economics and Technology emphasized that a broad based approach for a potential review process is justified as a threat to public order and public security is not indicated by certain sectors or companies of a specified size (Bundesministerium für Wirtschaft und Technologie 2008, p. 8). The German government estimated that only ten potential investments per year will be reviewed (Bundesrat 2008, p. 2). But it is possible that a larger number of foreign investors will use the possibility to signal a potential acquisition to be sure that their investments will not be reviewed in a progressive stage of their investments. The German industry federation criticized that the new rules are against European law (BDI 2008). This will push the European Commission to review the new law when it is final in order to assure its legal basis (OECD 2008b).

### 4.3. How did Sovereign Wealth Funds react? – The Santiago Principles

Investor countries owning SWFs reacted to the critique and the policy reactions of recipient countries. The fear of a further increase in discriminatory measures that was already under way led to the establishment of the International Working Group of Sovereign Wealth Funds (IWG) on May 1, 2008. With the help of the International Monetary Fund (IMF) which facilitated and coordinated their work IWG members in October 2008 agreed on Generally Accepted Principles and Practices (GAPP) – the so-called Santiago Principles. The GAPP seek to ensure that SWFs bring economic and financial benefits to home countries, recipient countries and the financial system. The 24 principles are covering (1) the legal framework, objectives and coordination with macroeconomic policies, (2) the institutional and governance structure and (3) the investment and risk management framework of SWFs (IWG 2008b).

If quickly adopted by SWFs this voluntary code of best practices could provide assurance that SWFs will invest apolitically abroad (Rose 2008). The European Union therefore reacted very positive to the Santiago Principles. Joaquin Almunia, the European Commissioner for Economic and Monetary Affairs, welcomed the completion of the Generally Agreed Principles and Practices and acknowledged the major effort of the International Working Group of Sovereign Wealth Funds and the IMF. “The principles and practices of the GAPP amount to a global public good that can help foster trust and confidence between sovereign wealth funds, their originating countries, and the recipient countries” (Almunia 2008).

Similarly the OECD acknowledged the Santiago Principles. Shortly after their publication the OECD Secretary General stated that the Santiago principles are a clear sign that SWFs intend to behave like other investors – maybe even better (OECD 2008c), which could mean that they are trying to become much more transparent than investors like hedge funds or private equity funds.

## 5. Summary and outlook

Sovereign Wealth Funds are now important investors on international financial markets. The rise of SWFs led to concerns in Western countries that these funds could be a threat for national security or the economic order of the recipient countries because most of these funds are domiciled in countries and regions that lack full democracy or where the governments exert a significant influence on the economy. Until now there is no documented case of misbehaviour of SWFs in recipient countries. Existing national economic laws and a competitive environment should guarantee that companies owned by SWFs cannot follow strategic political goals. Existing national laws allow government interventions to block investments if there is a threat for national security. The efforts of international organisations and the Santiago Principles are also a good basis for a trustful cooperation between SWFs and recipient countries. SWFs investments of excess currency reserves can help these countries to reach development goals and recipient countries profit from the recycling of petrodollars and reserves stemming from current account surpluses. Therefore, the policy reactions of several countries to the emergence of SWFs were rather counterproductive, often driven by myopic domestic political motives to calm public opinion.

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