Notes on Sovereign Wealth Funds

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Seminar on New Trends in Reserve Management

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G7 Communiqué, 19 October 2007

"Cross-border, market-based investment is a major contributor to robust global growth. In this context, we agreed that sovereign wealth funds (SWFs) are increasingly important participants in the international financial system and that our economies can benefit from openness to SWF investment flows.

We see merit in identifying best practices for SWFs in such areas as institutional structure, risk management, transparency and accountability. For recipients of government-controlled investments, we think it is important to build on principles such as nondiscrimination, transparency, and predictability.

We are committed to strengthening our dialogue with countries involved and look forward to discussing these issues at our Outreach Dinner later this evening.

We ask the IMF, World Bank, and OECD to examine these issues. We will explore opportunities to enhance investment flows between our economies and continue our discussions on mutual recognition of comparable securities regimes".

Sovereign Wealth Funds: An ubiquitous notion

- Key figures (IMF):
  - Current outstanding 1.9 to 2.9 Trn$
  - Potential of reallocation out of 5.6 Trn$ foreign exchange reserves
  - Up to 12 Trn$ in 2012
- Key features
  - Standalone or dedicated within the central bank
  - Investment of (sometimes commodity-related) current account surpluses
  - Long-term-oriented investment
- Pitfalls:
  - Substitution between FX reserves / SWFs / State-owned enterprises blurs notion of SWF
  - Confusion in public debate between SWF and other, government-sponsored investment

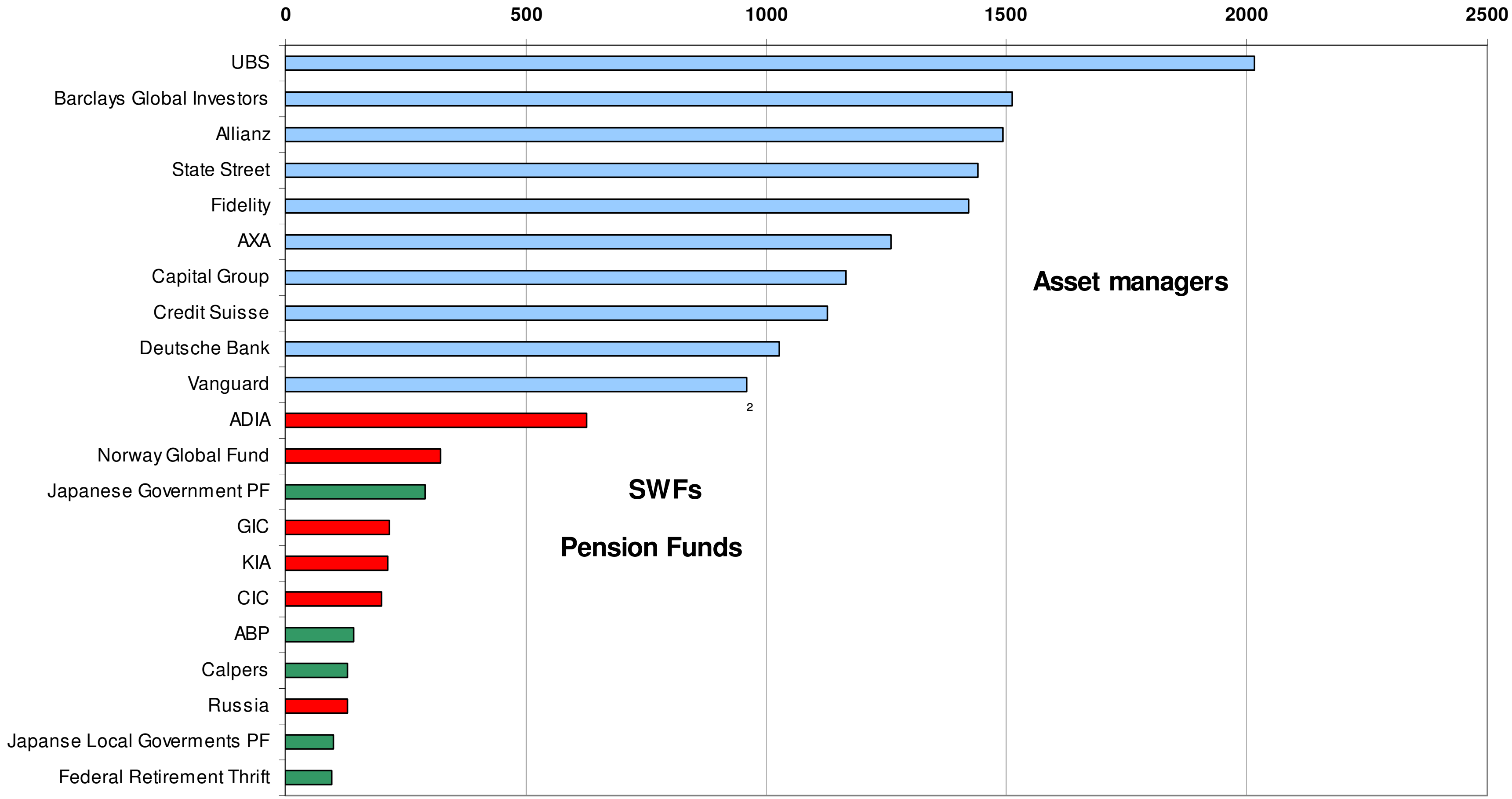
Source of funds	**Top 20 SWFs**
Commodities	Abu-Dhabi (ADIA), Kuweit, Alaska, Brunei, Alberta, Chile, Oman, Norway, Venezuela, Russia, Kazakhstan, UAE (Dubai) (Isithmar and DIC)
Non-commodities	Singapore (GIC and Temasek), China, Taiwan, South Korea, Malaysia

SWFs are rooted in history

Country	Name		$Bn	% GDP 2006
UAE (Abu Dhabi)	ADIA	1976	625	520.7%
Norway	Government Pension Fund - Global	1990	322	102.6%
Singapore	GIC	1981	215	169%
Kuweit	KIA	1953	213	268.7%
China	CIC	2007	200	8%
Russia	Stabilization Fund	2004	127.5	14.2%
Singapore	Temasek	1974	108	84.9%
Qatar	QIA	2005	60	185.3%
USA (Alaska)	Permanent Reserve Fund	1976	40.2	0.3%
Brunei	BIA	1983	30	309.4%
Korea	KIC	2005	20	2.2%
Malaysia	Khazanah Nasional BHD	1993	17.9	12.3%
Venezuela	Fonden	2005	17.5	10.5%
Canada (Alberta)	Alberta Heritage Savings Trust Fund	1976	16.4	1.3%
Taiwan	National Stabilization Fund	2001	15.2	4%
Kazakhstan	National Fund	2000	14.9	15.6%
Chile	Economic and Social Stabilization Fund	2006	9.7	7.6%
UAE (Doubai)	Isthitmar	2003	8	6.7%
UAE (Doubai)	DIC	2004	6	4%
Oman	General Reserve Fund	1980	6	16%
Total			2072	

Source: Oxford Analytica

Small among the giants



Source : Oxford Analytica, Watson Wyatt.

A positive role for international capital allocation

- SWF are the by-product, not the cause of global imbalances and insurance-seeking by emerging market countries
- Excess savings are better invested in the real economy than in Treasuries
  - More supportive of long-term growth
  - Limit bond-market distortion (‘negative risk premium’ on long-term interest rates)
  - Spread asset-price increase over a broader class of assets
- Inter-temporal income-smoothing is good
- SWFs contribute to public finance sustainability and to government overall asset-liability management

- Main risk: worsening geographic ‘allocation puzzle” (i.e. capital not flowing to those countries which need it) and perpetuating underdevelopment of regional financial markets

Risks to financial stability?

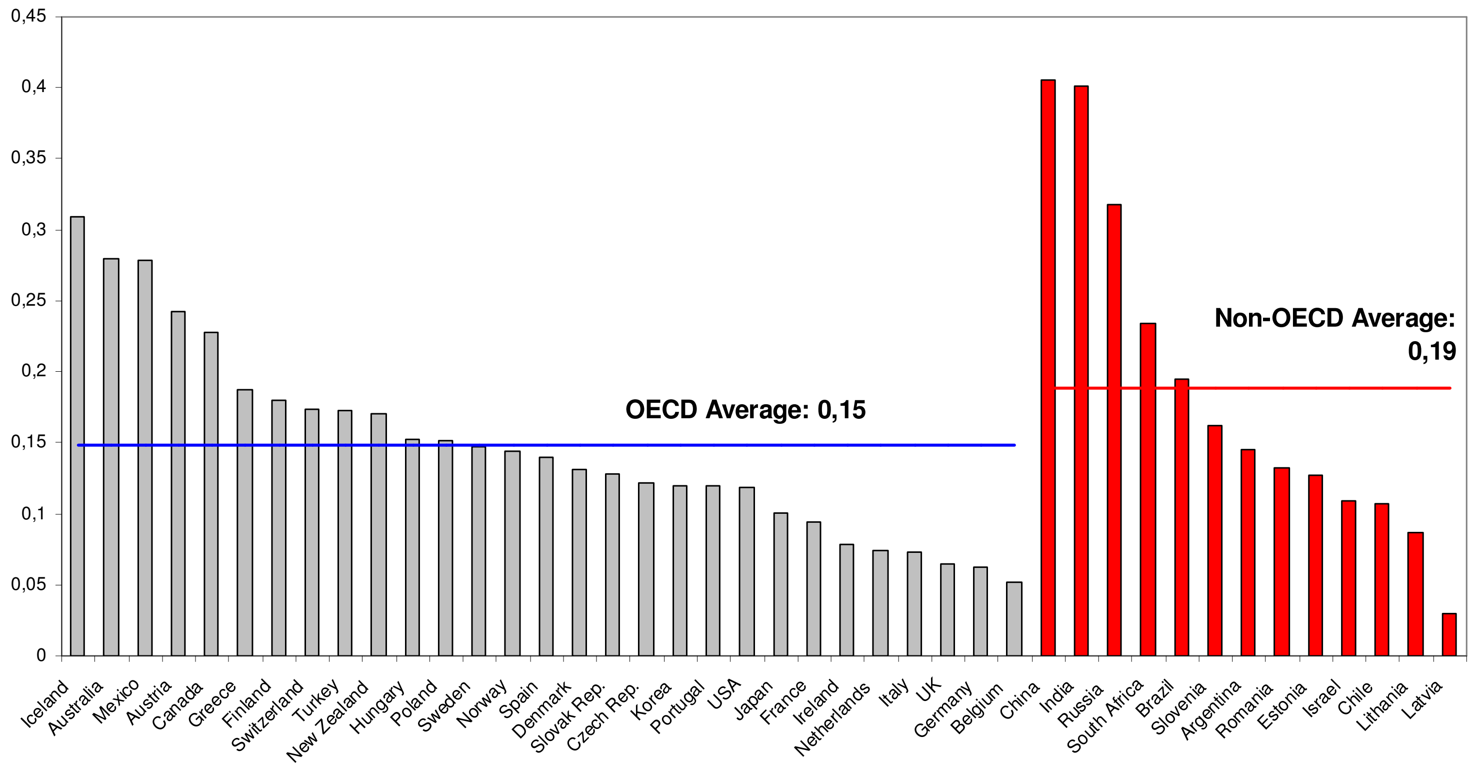
- Hard to single out risks that would be inherent to the nature of SWFs
- No ‘herding behavior’ observed so far, rather a stabilizing role on financial markets
- Incentives are in place to promote asset diversification, investment delegation, risk control:
  - Long term value maximization
  - Abrupt allocation shifts would create asset price volatility
- Transparency is nevertheless useful to avoid misguided market reactions to perceived allocation decisions and to help market participants anticipate relative asset price movements

- Main risk: creating bubbles in narrow markets such as real estate, private equity, emerging stock markets

Risk of investment wars?

- Burgeoning debate in G-7 and emerging countries on government-sponsored cross-border investment
  - Involved cross-border investment flows are not only ‘South-North’ (Dubai/P&0, CNOOC/Unocal) but also ‘North-North’ (e.g. within EU) and ‘South-South’ (Temasek/Shin Corp)
  - A specific Asian dimension: 60% of East-Asian investment is government-sponsored as compared to 2.5% in the US
- Perceived or actual lack of reciprocity of FDI rules (e.g. control of Chinese banks) is key to the political reaction
- Government-sponsored cross-border investment can be easily accepted if and only if it can be proven that its objective is purely financial

Stronger restrictions to inward FDI come from emerging market economies



Source: Gollub, 2007.

The way forward

- Assess optimal level of FX reserves
  - Not an easy task in a world where financial crises originate in the financial account and where countries maintain sub-optimally high reserves due to lack of confidence in international coordination
- A SWF 'Code of conduct' as a way to facilitate fair treatment
  - Strict principal/agent relationship to be put in place between government and SWF
  - Asset class diversification and risk dispersion constraints
  - Transparency on broad asset allocation, objectives, selection and valuation methods, return
  - Pure index investment is an option to avoid potential political and information cost of company-level investment and control
  - Code of conduct has to be decided by investing countries themselves, not by the IMF or OECD alone, and based on existing best practices of SWFs and public pension funds
- Need for reciprocity of investment protection rules