NAKHLE Rami, H05553

OBEID-GERMANI Sleiman, H05555

Sovereign Wealth Funds and the Global Financial System

Under the direction of Mr. Tomasz MICHALSKI

Finance Major

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Abstract

This paper examines the impact of Sovereign Wealth Funds (SWFs) on global financial markets and their main constituencies. We document that their role has been ever more significant. During the ongoing financial crisis they have emerged as white knights for the banking system. However, in spite of their benefits to recipient countries, their strategic motives have been questioned. Thus, on many levels it is believed that their impact is asymmetric. On one hand, they represent an unequalled opportunity for their owners to grow their reserves and stabilize their economy. On the other, they constitute a threat to the financial system with their opacity and their affiliation. Stakeholders in addressee companies should welcome any investment by a SWF but stay aware of the shortfalls related to them. Considering all these elements as well the excepted upward trend of commodity prices, we conclude that SWFs are here to stay and prosper. Our findings suggest that there is a need to regulate their actions by defining a set of best practices on the national and multinational level. This debate should be carried out in cooperation with the funds and their sovereign owners and result in the conception of a voluntary code of conduct.

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Introduction

Sovereign wealth funds (SWFs) - government-controlled pools of assets designed to primarily hold and manage foreign assets - have become all the rage. Recently, they have grown into a relevant class of investors in global financial markets. While not a new phenomenon, their past and projected growth and behaviour have stirred debate about their impact on the structure and future of the global financial system.

For the moment, they are getting more media exposure than hedge funds and private equity firms combined. Financial corporations are courting them as never before, they are the hot topic of economic and financial forums, and they have become a major political subject. While being accused of having undisclosed ulterior motives, they have been hailed as a savior of Wall Street's finest.

This paper gives an overview of the ongoing debate about the expanding role of SWFs in international financial markets. It inspects the ways in which their dimension could affect financial markets and their investments could alter the pecking order of the world economy. As a growing portion of foreign asset investments of SWFs shifts from government debt obligations to corporate equities, concerns have arisen about how institutions in the "investing" and "receiving" countries may need to adapt.

Thus, this paper seeks to determine the impact of these new government-owned investment entities on the main constituencies of today's markets. All through, it questions the real motives behind sovereign foreign investments, and highlights how low transparency and alleged hidden agendas has generated fear in industrialized economies and underpinned calls for international regulation for these investments. Built upon occurrences of real SWFs, it examines the current discussion about SWFs' future and the challenges they pose. While there is no quick fix to these challenges, many efforts in this direction have already been made. They all underline the importance of open markets while aiming to protect national independence.

1 SWF Presentation

1.1 What is a Sovereign Wealth Fund?

Given that international attention has only been recently directed at SWFs their precise definition is still blurry. Typically however, they are known to be state-owned entities aimed at delivering financial returns by investing a portion of the national foreign exchange (FX) reserves. The Sovereign Wealth Fund Institute, a research organization, defines a Souvereign Wealth Fund as:

"A state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets. SWFs can be structured as a fund or as a reserve investment corporation. Some funds also invest indirectly in domestic state owned enterprises. In addition, they tend to prefer returns over liquidity, thus they have a higher risk tolerance than traditional foreign exchange reserves."

Even though SWFs are government-owned, they have various levels of dependence to their owners (i.e. the governments) in their investment decisions and different management structures.

Sovereign Wealth Funds (SWFs) are a rather new name for something that has existed since the mid twentieth century: they are pools of assets owned and managed by governments predominantly in another country's currency. Even though they are not a new phenomenon, they have only been under the radar since early 2000s. The global interest in SWFs has been further accentuated with their high-profile investments in Western financial institutions during the ongoing financial crisis.

Their growth can be thought of as an unplanned result of countries running permanent current account surpluses and accumulating net foreign assets. It is true that most countries have official foreign exchange reserves (whether in dollars, euros, or yen) but rare are the countries with large enough FX capital that

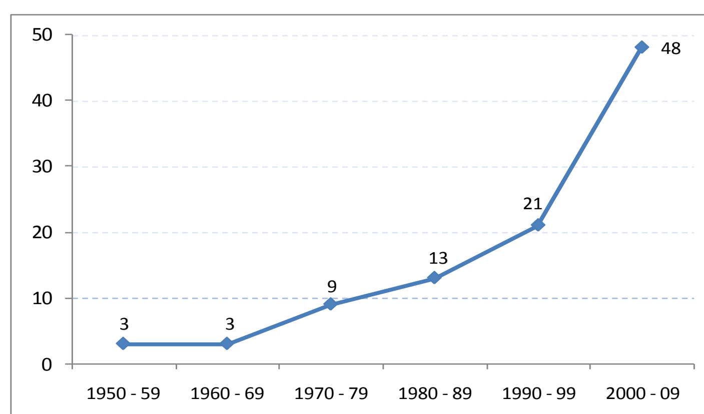
encourages the creation of a specialized investment Fund to manage the "extra" resources. Hence, SWFs are established with funding coming from a sustainable current account surplus, this is usually the result of commodities exports revenues. In some special cases, excess revenues come from tax receipts and/or direct ownership of local companies. The stockpiling of international exchange reserves was accelerated in many developing countries during most of the last decade, reflecting both booming exports (due in part to high commodity prices, particularly mineral ones) and pro-cyclical capital flows.

1.2 Market Size and Growth Trends

Against this current background, it is important to remember that SWFs have been around for many decades, but have largely gone unnoticed so far. However, as the director of the International Monetary Fund's Research Department declared: their *"total size worldwide has increased dramatically over the past 10–15 years"*. In 1990, SWFs held less than $500 billion in combined assets; today their holdings are estimated to approximate $3 trillion - considerably more than the global hedge fund industry that represents $1.4 trillion of Assets Under Management (AUM) . Based on the foreseen evolution of current balances, SWFs AUM could surpass the $10 trillion threshold within 3 to 4 years. This figure is an estimate because SWFs do not usually disclose precise information about their positions, individual figures and the total volume of their AUM.

A growing number of cash rich countries have set up investment funds labeled SWFs in order to manage their foreign exchange surpluses. The folllowing graph illustrates this current trend.

Figure 1: Number of SWFs



Source: Deutsche Bank Research, SWFs institute

The table 1 shows the 25 biggest SWFs, their country of origin, their AUMs and their date of inception.

Table 1: List of the 25 Biggest SWFs

	Country	Fund Name	AUM $Billion	Inception	Origin
1	UAE - Abu Dhabi	Abu Dhabi Investment Authority	$875	1976	Oil
2	Saudi Arabia	SAMA Foreign Holdings	$433	n/a	Oil
3	Singapore	Government of Singapore Investment Corporation	$330	1981	Non-Commodity
4	China	SAFE Investment Company	$312		Non-Commodity
5	Norway	Government Pension Fund – Global	$301	1990	Oil
6	Kuwait	Kuwait Investment Authority	$264	1953	Oil
7	Russia	National Welfare Fund	$225	2008	Oil
8	China	China Investment Corporation	$200	2007	Non-Commodity
9	China - Hong Kong	Hong Kong Monetary Authority Investment Portfolio	$173	1998	Non-Commodity
10	Singapore	Temasek Holdings	$134	1974	Non-Commodity
11	UAE - Dubai	Investment Corporation of Dubai	$82	2006	Oil
12	China	National Social Security Fund	$74	2000	Non-commodity
13	Qatar	Qatar Investment Authority	$60	2003	Oil
14	Libya	Libyan Investment Authority	$50	2006	Oil
15	Algeria	Revenue Regulation Fund	$47	2000	Oil
16	Australia	Australian Future Fund	$44	2004	Non-Commodity
17	Kazakhstan	Kazakhstan National Fund	$38	2000	Oil
18	Brunei	Brunei Investment Agency	$30	1983	Oil
19	South Korea	Korea Investment Corporation	$30	2005	Non-Commodity
20	US - Alaska	Alaska Permanent Fund	$29	1976	Oil
21	France	Strategic Investment Fund	$28	2008	Non-Commodity
22	Malaysia	Khazanah Nasional	$26	1993	Non-Commodity
23	Ireland	National Pensions Reserve Fund	$23	2001	Non-Commodity
24	Chile	Social and Economic Stabilization Fund	$21	1985	Copper
25	US - New Mexico	New Mexico State Investment Office Trust	$16	1958	Non-Commodity

Source: SWFs institute, as of January 2009

1.3 SWFs: Hedge Fund, Mutual Fund or Private Equity?

Depending on their goals and objectives, SWFs can have different levels of risk aversion and can follow different investment strategies. Intergenerational Funds usually have a long term investment horizon, while stabilization funds tend to adopt a more active investment strategy which leads to a shorter investment horizon. As a common ground between those two types of SWFs, we can find the need of investing sovereign funds safely and efficiently in order to generate a relatively high income while maintaining an assuring image that is essential to secure the trust of the general public that is the initial beneficiary of those funds.
The degree of freedom of SWFs managers in the allocation of the funds entrusted to them is sometimes regulated in the laws or statute by which the SWF is set up. Having said that, SWFs enjoy a substantial freedom in their investment decisions and managers are asked to find the most appropriate recipients for the funds entrusted to them. However, SWFs have fewer restrictions in their investment decisions than monetary authorities that are limited to highly liquid and risk-less securities with a short investment time frame. Central Banks reserves are traditionally invested conservatively in safe and marketable instruments that are readily available to monetary authorities to meet balance of payments needs. These securities typically consist of precious metals, in particular gold and government debt typically US T-Bills. On another hand, SWFs normally invest in a broader (and riskier) array of assets that comprises public and corporate bonds, equity, private equity, commodity, derivatives, and alternative investments.
Unless regulated otherwise, SWFs investments are not restricted to certain asset classes and do not have any currency exposure constraints as in the case of mutual funds or private pensions. Thus, SWFs are very similar to hedge funds with respect to their investment options as opposed to the stricIty regulated pension funds universe. However, if we look at the investment horizon of SWFs, we find that their investments are mainly long term, and short-term speculative positions have a marginal role in their investment strategy. This is a big

difference between SWFs and the hedge fund world. In practice, the investment scheme of most SWFs is very comparable to a pension fund.

In most cases, and despite the relatively important stakes taken by SWFs in private companies, they do not search to have an active role in the management of those companies; they rather tend to be passive stake holders. However, some SWFs tend to have a direct involvement in the management of recipient companies, playing a role normally reserved to Private Equity Funds.

SWFs typically make little use of leverage, in contrast to hedge funds and private equity funds which generally engage in highly leveraged transactions. SWFs also differ from large institutional private investors such as mutual and insurance funds, in that although they hold assets, they generally have no specific liabilities to be paid to shareholders or policyholders. SWFs similarly differ from sovereign pension funds (SPFs) in that the latter, while government-owned, have explicit obligations, such as worker pensions.

In general, there is little information concerning the independence of SWFs investment decisions and whether those investments have a pure financial goal and to what extent, if any, does the government, “owner” of the SWF, intervenes in those decisions and if those investments cover a hidden political motivation. Those fears combined with the lack of information about the SWFs’ investment strategies have contributed to an overall sensation in the recipient Western countries, with liquid and efficient capital markets, that SWFs are opaque and unpredictable intermediaries in global financial markets.

1.4 Sources of Funds

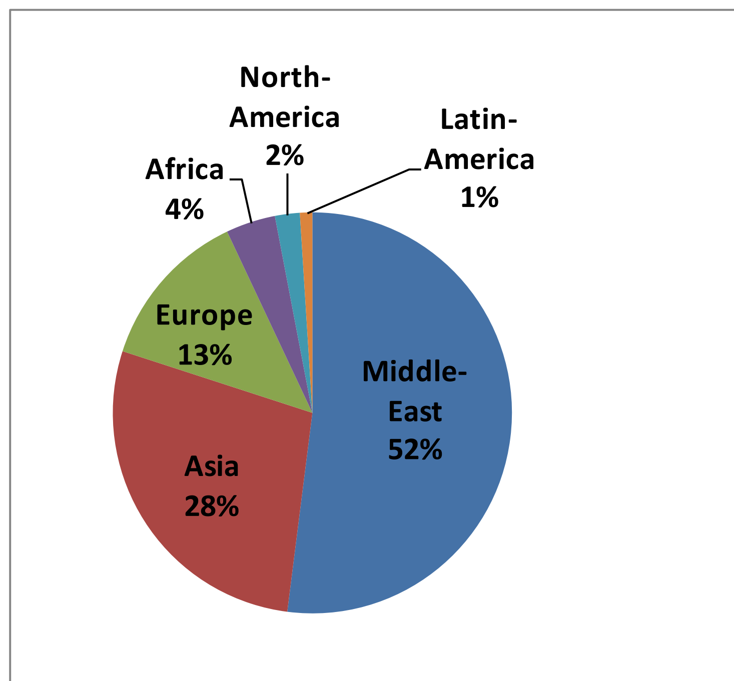
SWFs are usually set up when there is a large enough government surplus to the point where a special management entity is needed to better utilize it. Thus SWFs are created with the double objective of:

- Meeting potential liquidity needs
- Smoothing future cash flows

In the past, foreign exchange earnings resulted from oil or other commodities exports; this is the case of Norway and the Gulf States. Nowadays, rapid growth of foreign exchange can sometimes be the result of an increasing competitiveness and improving balances of payments with respect to mature economies; this is the case of China and South Korea.

As pictured on the graph below SWFs' holdings are concentrated among funds and among countries, each of which has its own source of FX inflow.

Figure 2: Regional Breakdown of SWFs' AUM (in %)



Source: Morgan Stanley

We usually differentiate SWFs according to their funding sources, with three most prominent sources:

- Commodities proceeds: Most of the time, the excess pools of revenues transferred to SWFs come from the sale of oil, gas or other commodities (such as metals and minerals - e.g. Chile). This is shown in the overview of fund "origins" of SWFs presented in Table 1's last column. Most SWFs are located in oil exporting or commodity-rich countries. Commodity

revenues are viewed as "real wealth" as they commonly have no matching liability on the governments' balance sheets. Examples of oil-exporting countries running a SWF include the United Arab Emirates, the Kingdom of Saudi Arabia, Kuwait, Qatar, Venezuela, Russia or even Alaska in the United States. In some other cases, exports of copper, minerals or diamonds are the sources of SWFs' funding. This is the case of countries like Chile, Botswana and Kiribati for example.

- General budget: Fiscal surpluses, proceeds from property sales and privatizations or reallocation of resources from the government's main budget to a special purpose vehicle. The majority of fiscal source are "real wealth", albeit some have obligations. China, for instance, is funding the transfer of foreign reserves from the central bank to CIC by issuing government bonds.
- Foreign exchange (FX) reserves: SWFs funding can stem from external surpluses that governments opt to invest in such funds. These usually correspond to "borrowed wealth" as the reserve accumulation in many countries arises from sterilized foreign exchange interventions, in which case the central bank issues interest bearing liquidity notes to fund the interventions and eliminate the excess liquidity. Nevertheless, a portion of the foreign exchange (FX) reserves can be considered "real wealth", being the result of asset appreciation and the accrual of interest revenues. The proportion of foreign reserves handled by SWFs is usually considered as "excess" reserves because it exceeds the amount believed to being necessary for the running of foreign exchange policy and prudential motives.

1.5 Rationale for Outsourcing Funds to SWFs

Central banks typically manage the foreign exchange (FX) reserves by investing them in safe and marketable instruments and in currency reserves. However given that:

- These liquid investments are not always optimally profitable
- They typically offer lower returns the more liquid they are
- They couldn't be all spent efficiently on internal investments
- They couldn't be all invested directly in state-owned projects such as infrastructure

Countries establish SWFs and allocate to them the excess funds they possess.
Thus SWFs are created to be separate bodies, often operationally independent, with specialized portfolio management, investing what can be perceived as unsustainable revenues in long-term, less liquid assets such as bonds and equities.
Two main arguments justify the creation of such funds:

- The first one relates to the finitude of exported natural resources, source of wealth for their owners. Likewise, the international competitiveness of any country can be a momentary phenomenon that could considerably change sooner or later.
    - Thus, the clearest rationale behind the establishment of a SWF is the accumulation of foreign currencies in nations that lead the market in the production and export of finite resources such as oil, charcoal and gas
    - With the foreseeable dry up of these resources, it is only in their holders benefit not to waste all the corresponding revenues and save a portion of for future generations
    - Therefore, these nations are faced with the issue of inter-generational equity and with the way of converting existing revenue

flows from the exploitation of natural resources into sustainable income

- The second one relates to the volatility of global commodity markets. The exposure to these markets is very risky, thus, there is a need to diversify. The establishment of a SWF aims at undermining the fluctuations in exports revenues due to the cyclicality of global economy. Empirical studies have shown commodity prices to be the more volatile between traditional asset classes, thus nations need to diversify away from them.

1.6 Conclusion: Footprint of SWFs over the World Economy

As the Financial Times has observed, SWFs are "*rapidly becoming a huge force in global markets and economies*" and as Goldman Sachs has commented "*their growth is due to global imbalances, and their investments in industrialized countries rebalance the world economy"*.

Although their AUM represents less than 2 percent of the total $165 trillion of global traded securities (smaller than insurance companies, pension funds or mutual funds), the International Financial Services London (IFSL) notes that SWFs expansion is much faster, and that they "*are likely to become more important participants in global financial markets over the coming years as inflows from trade surpluses and commodities exports continue."*

SWFs are highly concentrated by countries of origin. The UAE, Singapore, Norway, China and Saudi Arabia account for them alone 75 percent of the total volume of SWFs' assets.

Given the size of their SWFs, these five countries have grown in prominence and thus the power has shifted from traditional Western economies to more emerging, commodity-rich countries. This power shift has encouraged more countries to establish their own SWF; indeed, it is presumed that India and Japan are planning to establish their SWFs. Brazil announced the launch in 2009 of a

SWF with $6 billion of AUMs primarily financed from budget surpluses. This fund will tremendously benefit from the recent oil discoveries announced in the country.

2 Impact of Sovereign Wealth Funds on Global Financial Markets

Sovereign Wealth Funds have grown to be major players in the global financial system, which has already begun adjusting to their emergence. So what are their implications? One can look at this from numerous angles; ours will be to reflect on the phenomenon of SWFs in terms of their impact on global financial markets and on the main actors and constituencies affected by their investments.

- The SWFs themselves
- The SWFs' owners
- The recipient countries of SWFs' investments (the likelihood that they will feed protectionist sentiment)
- The multilateral regulatory and oversight institutions
- Other financial institutions
- The recipient companies of SWFs' investments
- World-financial markets (in terms of their impact on economies and markets around the world)

Based on our research each of these groups has interests and concerns that will have to be weighed and balanced in order to come up with an optimal formula to all.

As of today, frictions are arising among several of these constituencies. They relate to such issues as opaqueness and regulation of SWFs.

2.1 The SWFs

Even if more than 50 funds all around the world are described as SWFs, each and every one of them has its own history, mandate, purpose, size, source of funding, structure, transparency and asset allocation. However, they all share some common points:

- SWFs like to be seen as large private funds or as renowned public pension funds. That is, they seek higher-risk adjusted returns on their investments, leading positions in the most interesting transactions and attracting the market's best talents and ideas. Mainly, they wish to compete without disadvantage against other constituencies of global markets.
- They give a big importance to their privacy and independence.
- Another general characteristic is that most funds seek to be discreet in their investments and do their best to stay away from political tumults. They also usually stand by calls for greater transparency and/or regulation. Jesse Wang, the chief risk officer of China's CIC, for example, claims that his fund is similar to other foreign public pension funds or college pension funds, *"adopting a diversified, long-term and passive investment strategy"*. Nevertheless, the remarkable growth of SWFs and the diversification of their portfolios have shed the spotlight on them. Even if they want to play the role of quiet investors, their newfound visibility prevents them from doing so.
- Age and sophistication of individual SWFs are key factors that have some bearing on their investment policies. Newly established funds from emerging countries, such as Libya or the Central Asian Republics, tend to be occupied in basic matters as finding the optimal scheme to manage themselves while catching up with mature, sophisticated investors. Older SWFs such as KIA, ADIA, or Temasek serve as models to the newer, less reputable funds. Considering their experience and sophistication, the "old

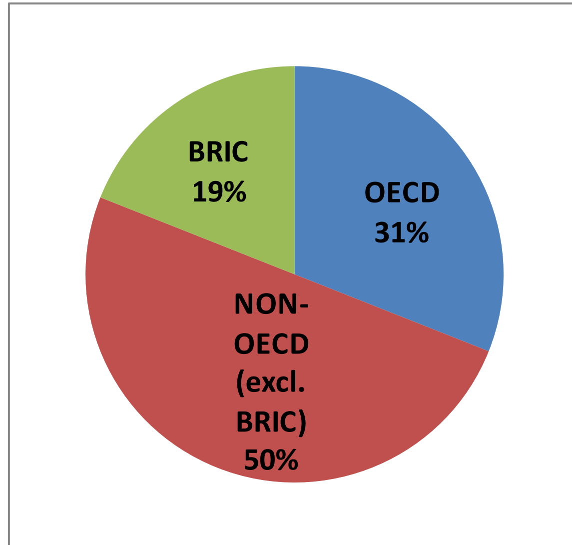
hands" among SWFs are purely focused on returns, market positioning, and supervising outsourced tasks.

- Sovereign owners' identity is another particularity common to all SWFs. Given that they all aim to serve their owners' interest, SWFs choose the investment strategy that best suits these interests. Thus SWFs from developing countries could tend to take lower levels of risks in their investments than SWFs from "wealthy countries". Given that SWFs belong to citizens, in low income countries there may be a greater need for prudence.

Beyond commonalities, an important matter remains unsettled; it concerns SWFs management style (active vs. passive) in the companies in which they invest. This issue has no clear or right answer. During the current financial crisis, SWFs made huge investments in many distressed banks without asking board seats or imposing their conditions on the financial institutions management. This move can perhaps tone down public apprehension about their motivation but it deprives SWFs from the glamorous role of "shareholder activist" and hence, questions the long term impact of those investments on recipient companies. Indeed, in corporate finance theory, the presence of a passive cash-loaded stakeholder may not be good for long-term corporate health according to Andrew L. Friedman, Samantha Miles in "Stakeholders, Theory and Practice". Hitting the right note will be crucial.

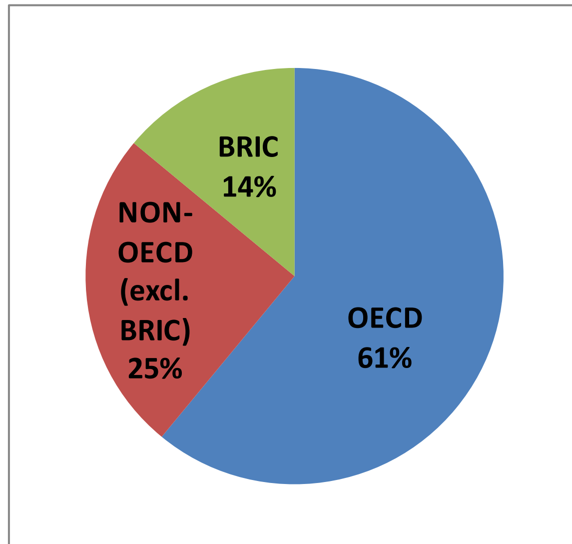
Figures 3 and 4 show the geographical distribution of SWFs investments between OECD countries, BRIC countries and Non-OECD (excluding BRIC) countries by number of deals and by USD value.

Figure 3: Number of Deals by Region (Total of 785 Deals)



Source: Monitor Research

Figure 4: Value of Deals by Region (Total of $ 250 Billion)



Source: Monitor Research

2.2 Firms Considering Investments by SWFs.

2.2.1 Benefits for Recipient Firms and their Stakeholders

Companies subject to SWFs investments have various interests that could be in line with the funds - or at odds with them.

Companies' management usually favors the entry to capital of long-term, passive investors who very rarely try to interfere in corporate strategy or to disinvest their stake. As a matter of fact, institutional investors, especially those with a long-term investment horizon, are generally greeted with open arms on equity markets. Firms seeking to have a stable capital base may find in SWFs a very thought after shareholder.

A possible explanation is that in many instances SWFs have proven to be loyal and un-disturbing investors. This is particularly the case of KIA which continues to be a low-profile and dependable investor in its holdings around the globe. This feature was very well exemplified by its management of its minority stake in Daimler-Benz.

KIA is the single largest shareholder of the German automobile maker with a 7.1 percent stake. Daimler-Benz acquired Chrysler in 1998 as part of its ambition to become an internationally integrated car manufacturer. In 2007, faced with the evidence that Daimler had not been properly integrated with the American automobile producer, Chrysler was spun-out. This sudden divestiture that follows a failed business operation could have driven KIA to adjust its holding but it didn't and refrained from intervening. Such examples are encouraging for recipient companies

As Howard Socol, CEO of Barney's, declares after the acquisition of his company by Dubai's Istithmar in 2007, *"This transaction further enhances our ability to develop our brand and grow our business."*

For the companies being purchased, capital inflows can be a net positive situation. More capital means more money for research and development, more

money for investments and more money to pay salaries. Especially, this means lower urgency to have recourse to financial debt, with equity (or its derivatives) emerging as a substitute for indebtedness especially in times of weak liquidity on credit markets. This also implies an ease of pressures on management for debt amortization.
Finally, having a SWF as stakeholder – in whichever way - could turn out to be beneficial for accessing foreign markets, in terms of facilitating the entry or softening regulatory stringency and abbreviate delays.
To illustrate this last positive effect for recipient companies we recall the case of China who many believe will try to leverage foreign entrance to its own market with its own incursions into foreign territories. Following, the China Development Bank's acquisition of 3.1 percent of Barclays, the target's chief executive John Varley acknowledged that the transaction would open the Chinese retail market to its bank. This access would have been otherwise difficult. And it is no coincidence that its is Blackstone that provided advisory services for this deal given the PE group's relation with China's SWF CIC (who controls a 10 percent stake in it). In autumn of 2007, Blackstone bought a 20 percent stake in China National Bluestar Corp, a large Chinese chemical products manufacturer.

2.2.2 Threats and Letdowns for Recipient Firms and their Stakeholders

Every single advantage of the above mentioned has nevertheless its downsides. To begin with other stakeholders with shorter investment frames could prefer other shareholders to be more aggressive and implicated in fixing high criteria for management performance.
Moreover, as several observers have rightly indicated SWFs do not need to assign two directors to the board to exude influence when they control 10 percent of a firm. This is the case of Saudi's Prince Walid Bin Talal, who though not represented on Citigroup's board has had a significant command over the bank's

key strategic decisions, as evidenced by his not so invisible hand on the dismissal of chief executive officer and chairman Charles Prince III in November of 2007.

Also recalling the Isthismar – Barney's case outlined above, if Mr. Socol praised the deal as it happened, he later resigned because what have been rumored as sharp differences with the company's new owners over strategy especially plans for overseas expansion. Mr. Socol disagreed with the aggressive timetable put in place, according to close source he believed that Barney's new owners had *"plans to grow helter-skelter in a bunch of countries*." In this way, Isthismar lost a veteran of retail business and struggled for six months to name a new CEO at Barneys to the point that some believed that it had developed a case of "buyer's remorse".

Also, a sovereign investment in a firm may complicate the entry to countries that have a tense relation with the SWFs' owners. This narrows the possibilities to attract new investments from some new countries or new investors. It could also hamper plans to engage in certain politically controversial sectors or complicate a company's external growth through mergers and acquisitions. Lastly, firms are usually aware of the public relations damages and implications of a foreign investors connection to their capital, whether a SWF or any other government-owned entity.

Therefore, boards of directors and top executives of firms in which SWFs invest should work on understanding the intentions and strategic drivers of SWFs as well as all the threats they carry. The outer shell of those new liquidity providers with enormous resources is undoubtedly appealing, especially that these suppliers appear to be patient, long-term investors who rarely interfere in governance or management. But any corporation considering a liquidity injection from a SWF should check elements with a more careful and dubious eye in order to assess the genuineness of these appearances and their viability over time if conditions came to alter.

Accepting the entry of a SWF in its capital base should not be problematic if managed well. The most important point is to listen and try to address the

concerns of the other shareholders, of the media, and of the other participants of the international financial system.

2.3 Other Financial Institutions

Other financial institutions consist mainly of financial services firms, asset managers, various types of funds, and private institutional investors. Of course, these players perceive the rise of SWFs through the lens of their own interests. SWFs may be competitors, but also potential partners, co-investors, or clients. As a matter of fact, other financial institutions perceive SWFs equally as a source of opportunities as a source of threats.

2.3.1 Threats and Concerns

The concerns of other financial institutions mirror the various roles that SWFs have come to play. Indeed, SWFs have an edge compared to the private sector and this edge could be summarized in two main points**:**

- The first one would be the access to private information gathered by the security services and intelligence agencies of the owning government. This information is clearly not available to private investors.
- The second one would be the idea that a SWF, being backed by a government or a sovereign entity, can benefit from low financing rates and that again is not the case of private investors.

The growth of the SWFs is another concern. The dynamics of supply and demand advocates that a flood of new money may drive up asset prices and drive down risk premiums. The small size of SWFs relative to other financial players in the global economy mitigates this effect, though it may be pronounced in some geographies and sectors.

Many financiers think that managerial talent is lacking in several of the recently created SWFs and thus could occasion mistakes that resound over the whole financial system. Ultimately, this concern will diminish as more SWFs become more sophisticated and knowledgeable investors — but that prospect also raises its own competitive concerns, as there will be intensifying competition for talents and deal flow.

Another potentially harmful impact concerns specifically the private equity sector. Some believe that the emergence of SWFs could remove one of the pillars of this industry. As a matter of fact, the private equity surge over the last decade has been analyzed by some scholars as an attempt to arbitrage away the overvaluation of fixed income instruments relatively to equity instruments. This situation is said to be the consequence of the prevalent investment of central banks in debt as opposed to equity. By bringing in debt relative to equity, the private equity groups helped deal with that imbalance. Given, the instauration of SWFs and the resulting shift from secure, liquid investments by central banks to more risky, “speculative” ones a major pillar of the private equity industry could thus be eliminated.

Finally, it would be predictable if calls for increased transparency of SWFs be followed by similar calls for other financial players, like hedge funds and investment banks. In this way, the call would be symmetrical: the entire financial system should be transparent. Financial institutions must prepare themselves for such an alternative and determine which information they’re willing to share and which they’re not.

2.3.2 Opportunities and Mutual Interests

Notwithstanding the risks and anxieties summarized above, the emergence of SWFs affects positively other financial constituencies of world capital markets, in particular investment banks and asset management firms.

The asset management industry had so long been refused access to foreign exchange reserve management, which was handled solely by central banks. The outsourcing of funds by SWFs to external managers would drive up demand for investment banking services, such as trading and purchase of equities and fixed income, consulting and valuation advice. Corporate finance departments of major European and American banks are exerting extra efforts and resources to work with SWFs on their asset management, with Morgan Stanley, JPMorgan and Merrill Lynch having created internal dedicated teams for SWFs advisory.

In order to have an approximate idea of the potential gains for other financial institutions we examine two studies recently carried out. The first one performed by Morgan Stanley guesstimates that close to US$200 billion could be annually outsourced in the coming four years while SWFs carry on with their size expansion. Merrill Lynch estimates (under certain assumptions) that between $4 and $8 billion would be generated in incremental annual revenue for global asset managers.

Thus, SWFs can jointly engender an upwelling in global asset supply, as financial institutions would be incited to structure new products to meet the demand of these institutions with very deep pockets. Asset classes that attract most SWFs are local government debt, emerging market corporate debt and the asset management industry.

Knowing that they might invest in the same companies as the SWFs, the financial institutions are eager to have additional information about those funds, how they think and where they are looking to invest, by sector, geography, and level of economic development. This information is a highly valuable competitive intelligence that could support pre-emptive moves and/or positioning from the financial institutions. *"In the future,"* says David Rubenstein, founder of the Carlyle Group, *"sovereign wealth funds and private equity firms are likely to pursue large investment opportunities through joint ventures."*

2.4 Sovereign Government Owners

SWFs can be one of the most efficient tools for their sovereign owners to boost growth. However, the delicate issue for countries is not to maximize their fund's size but the manner by which they can reinvest fruitfully its proceeds into the local economy. This, however, is no easy game with recipient countries increasingly viewing SWFs as a potential threat to their economy. This causes many SWFs owners to feel unfairly treated. And as one senior official observed, *"For decades, the West has told us that we had to open our borders. We let Western multinationals into our economy, and they have been running the show. But now, when we try and do the same thing, we are told it poses a 'security risk.' It's just hypocritical."*

2.4.1 Common Advantages of SWFs to their Sovereign Owners

Sovereign government owners of SWFs should compare the returns of this form of investment with those of other government-owned investment funds.

- The existence of SWFs allows countries to diversify their wealth clear of conventional financial assets.
- SWFs investments are a way for their sovereign owners to get hold of intellectual property and get an access to research, design and development that would otherwise take years to develop at home.
- On the long-term, buying a stake in a foreign financial institution (throughout a SWF or any other corporate form) is a way of transferring financial knowledge to local markets and is beneficial to national financial markets in emerging countries. This is the case of Singapore's Government Investment Corporation (GIC) and Temasek Holdings which partially are the expression of a desire to bolster Singapore's standing as an international financial centre. The Korea Investment Corporation has been similarly managed.

- By establishing SWFs, the different countries aspire to achieve efficient risk adjusted financial returns over time.
- Greater national wealth implies more resources to apply to national priorities as well as a safeguard against short-term business cycles and a resource to apply to long-term challenges.
- Finally, greater national wealth elevates the standing of a nation in foreign affairs and strengthens its voice in multilateral institutions.

Anything that could potentially lay these benefits on the line should be considered as a source of apprehension. Sovereign government owners want recipient countries to welcome the funds as reliable participants in financial markets.

Hence most governments have established their SWFs to be overseen by authorities independent of customary government agencies and run in respect of professional investment standards, though most have until now resisted calls for increased transparency.

2.4.2 Common Risks and Pitfalls of SWFs to their Sovereign Owners

Citizens of SWFs country owners face the risk of social and economic neglect as income flows from SWFs' lucrative investments reduce the pressure on politicians to undertake complex tasks of structural domestic reforms. In this regards, proceeds from SWFs that are distributed to the population in the form of cash or welfare transfers may result in disruptive and uncompetitive economies in the future. This would have long-standing repercussions on citizens of the SWF owner and on the global economy.

Another risk to sovereign government owners is ignoring the consequences of their policies and behaviors on the way other players of the global economy perceive their investment vehicle. Of course, providing greater transparency of SWFs' objectives and activities is a positive step toward giving other participants

in world markets better information, but it does not eliminate political concerns. Neither transparency of a SWF's intentions or activity nor the democratic credentials of its owner can guarantee that SWF investments will be greeted favorably in the recipient countries. The pivotal element is the track record of observable behavior in international affairs of the SWF's owner.

This last idea should be emphasized. SWFs of nations that are viewed as hostile or reckless will be suspect. Broadly speaking, it is understandable that SWFs from nations that back, host or fail to deal with terrorist clusters, drug smugglers, or money launderers will always get an unwarm reception in foreign markets. Likewise, funds located in nations that get low marks for protectionism, corruption, transparency, and incompetent or politicized legal and regulatory systems also will be suspect.

As seen on corporate levels, "ethical" investments are more and more encouraged by Western countries. Private investors and fund managers are pushed to divest from companies with unethical activities. In the same context, SWFs aspiring to enter the Western market can expect to be stained by the parent's government image in its commitment to social, political, and cultural values defended by the Western countries.

In Weber et al's "World without the West," Political and regulatory scrutiny from western economies might block emerging market nations SWFs from investment opportunities in OECD markets. As a result, these SWFs might be encouraged to opt to invest in less binding regions of the world.

2.4.3 SWFs as a Means to Achieve Macroeconomic Stabilization

For commodity exporting economies, SWFs – especially stabilization funds – contribute in the smoothing of the countries' returns. Indeed, because of the high volatility of commodity prices, and their exposure to global economy's cyclicality, the fund performs as a liquidity pool which is refilled in times of bullish

commodities markets or currency inflows, and which can be drawn upon in times of bearish markets or scarcity of reserves.

2.4.3.1 The case of the Government of Singapore Investment Corporation (GIC)

Established in 1981, the Government of Singapore Investment Corporation (more commonly GIC) has grown over the years to become one of the most influential SWFs in the world. With a wide diversified portfolio in corporate equities, bonds, real estate and money-market instruments, the fund was awarded the mission to contribute to the stabilization of the Singaporean economy. In 2008, Morgan Stanley estimated the fund's assets at US$330 billion, making it the world's third largest sovereign wealth fund; this figure was confirmed by multiple sources. During the seventies, Singapore kept accumulating reserves to the point that the Government thought it was better to invest these reserves in high-yielding assets. Thus, it established GIC and handed to it the mission of stabilizing on the long term the Singaporean economy. Thus, GIC is to facilitate government savings necessary to meet power strikes, budget deficits, tax hikes, rising oil prices, currency volatility, global disinflation and to support the nation's wealth over the long term.

In addition it was given a quantitative objective: GIC has a wealth enhancement objective, which is to achieve a real rate of return (5%) over and above G3 inflation rate over a long-term horizon. On the medium-term it performance is to outperform (by a non-disclosed percentage) an appropriate composite of recognized market indices including the Morgan Stanley's MSCI World Equity Index for equities.

GIC has been successful and even though it does not publicize its holdings or returns, for its 25th anniversary it was announced that over its lifetime it has achieved an average annualized return of 9.5%.

However, the influence of the government on the SWF is very much felt when we look at the key people in this fund: Lee Kuan Yew, the chairman of the fund is Singapore's founding prime minister, and his son, the current prime minister is its deputy chairman.

2.4.3.2 The Case of Chile's Economic and Social Stabilization Fund (FESS)

Created to replace the Copper Stabilization Fund, Chile's Economic and Social Stabilization Fund (FESS) is meant to serve for counter-cyclical social spending during economic recessions to make sure that public spending is disconnected from prices on the copper market and the global economic outlook. In this way it helps stabilizing Chile's economy. As copper, Chile's main export, is highly cyclical, FESS has provided a shield to the country's economy to the point that some pretend that Chile is one of the best positioned countries to overcome the current crisis. Indeed, copper revenues are committed to FESS when prices are high. By January 2009, that fund was valued at $19.5 billion, or 10.5 percent of Gross Domestic Product (GDP). In this way, Chile's recent fiscal stimulus of about 2.5 percent of GDP was affordable.
Chile inoculated itself by basically saving what it considers as windfall profits from its state-owned copper firms and the fiscal revenues from private mines. It is investing these revenues on global markets in fixed corporate debt (around 20% by end of 2008) and variable income products (around 15%) by maintaining a low risk profile because it must preserve its portfolio's liquidity. Thus, when the Chilean economy stumbles, the government can tap this "economic and social stabilization fund" for revenue.

2.4.4 SWFs as a Means to Secure Future Generations and Provide Public Services

Several SWFs have been set up with the long-term mission of passing wealth to future generations, to be used after natural resources have been consumed. Thus, SWFs can be meant to invest revenues or wealth over long time horizons for future needs. The sources of these funds are typically commodity based or fiscal. This concentrated exposure of public assets to volatile commodity prices is therefore transformed into a balanced and diversified global exposure, thereby protecting the income of future generations. In this way, SWFs are earmarked for as covering future public pension liabilities.

2.4.4.1 The Kuwaiti Case

This is particularly the case of Kuwait Investment Board. Indeed, the mission of the Kuwait Investment Authority (KIA) is to achieve long-term returns on Kuwait's surplus oil revenues and to provide an alternative source of government income for when the country's oil resources are exhausted.

Kuwait was one of the first countries in the world to set up an oil fund. In 1953, some 8 years before its independence from the UK, Kuwait founded an Investment Board Fund (IBF) in London to invest its surplus oil revenue.

Shortly after oil discovery, the role of the state as the provider of basic services such as education and healthcare considerably expanded to meet the needs of rapidly growing population. In an effort to organize public finance, the General Reserve Fund (GRF) was established in 1960 as the main treasurer for the government. The GRF received all revenues, including all oil revenues, from which all the state's budgetary expenditures were paid.

In 1976, Crown Prince Jaber al-Ahmed al-Jaber al-Sabah, the deputy emir of Kuwait, issued Law no.106, under which the Future Generation Fund (FGF) was established. Article 2 stated, *"A special account shall be opened for creating a*

reserve which would be a substitute to the oil wealth. An amount of 50 percent of the available state's general fund is to be added to this account". Article 1 stated, *"An Amount of 10 percent shall be allocated from the state's general revenues every year."*

In 1982, the government established the Kuwait Investment Authority (KIA) to manage the growing increase in oil revenues it allocated for investment. KIA assumed responsibility for managing and developing the financial reserves of the state's IBF as well as the FGF. The holdings in the former are mostly invested locally and regionally, while those in the latter are broadly diversified. KIA's purpose is *"to achieve a long-term investment return in order to provide an alternative to oil reserves, which would enable Kuwait's future generations to face the uncertainties ahead with greater confidence."*

The KIA's portfolio allocation is based on the global distribution of world GDP. However, a strategic review in 2004 recommended that the KIA diversify away from bonds and equities into other asset classes, such as private equity, real estate, and into emerging markets.

KIA holds stakes in big corporations such as DaimlerChrysler (7.1 percent stake) and British Petroleum (3.3 percent stake).

Among its most recent investments to be mentioned:

- A $720 million investment in the Industrial and Commercial Bank of China in 2006 that made the KIA its main shareholder
- A $3 billion capital injection in Citigroup
- A $2 billion capital injection in Merrill Lynch during late 2007 and early 2008
- A $1 billion investment to finance Dow Chemical's acquisition of Rohm and Haas, a specialty materials company, in summer 2008.

That same summer, the KIA decided to allot up to $50 billion, or 20 percent of its funds in Japan, seemingly to rebalance its portfolio.

This strategy of investing oil proceeds has proven decisive for Kuwait's financial welfare and political survival. By the late 1980s, Kuwait was earning more from overseas investments than it was from direct sale of oil. Oil revenues were disrupted in 1990-91 as a consequence of the Iraqi offensive and occupation of

Kuwait. The government and population in exile relied exclusively on investment revenues. These revenues were also used to pay for international coalition expenditures, postwar reconstruction and to restore damaged oil wells and other facilities.

2.4.4.2 The Alaska Case

The Alaska Permanent Fund Corporation (APFC) was launched in 1982 after a 1976 public referendum by voters of the State of Alaska. It was given the mission to invest the state's royalties from its oil proceeds. According to the Article IX of Alaskan constitution *"at least 25 percent of all mineral lease rentals, royalties, royalty sales proceeds, federal mineral revenue-sharing payments and bonuses received by the state [must] be placed in a permanent fund" according to the fund's. The fund is "fully invested in the capital markets, diversified among various asset classes."*
The fund's goal is to protect the principal of its investments while optimizing total return. The fund's mission is to guarantee intergenerational money transfer and equity for all Alaskans. Realized fund returns may be spent. They usually derive from stock dividends, bond coupons, real estate rental fees and the over/undervalue made by the sale of any of these securities. Unrealized earnings—those resulting from marked to market accounting—cannot be used. Most spending from the Fund has been for dividends to qualified Alaska residents.

2.4.5 SWFs as a Means to Bypass Political Sanctions and Credit Restrictions

This is mainly the case of Iran's Oil Stabilization Fund (OSF) created in 2000 with the objective of cushioning the state's budget from fluctuations in oil prices

however the fund's primary objective has shifted over the years. Like all oil-exporting countries, Iran witnessed a steep increase of its Foreign Exchange inflows thanks to skyrocketing oil prices since the beginning of the decade. But as opposed to neighboring GCC countries, Iran has faced severe American hostility since the Islamic revolution in 1979; this was further exacerbated by imposition of recent UN sanctions. These sanctions have negatively affected Iran's economic perspectives, especially on the energy side.

Banks have been unable to lend to Tehran over the last few years because of increased pressure by Western countries and supranational institutions not to do so. This comes in the context of a general plan of economic and political sanctions aiming at impelling Iran to abandon its nuclear agenda. Indeed, the US government has launched during the fall of 2006 a vast campaign to discourage its local banks from doing business with Iran claiming that they could be unintentionally financing Iranian military and nuclear projects.

To prove this point, oil minister Vaziri-Hamaneh declared in December 2006 *"Foreign Banks are refusing to grant us capital or to participate financially in oil industry projects under various pretexts."*

One solution Iran's government is sponsoring is to tap the fund to support oil and gas projects. For instance, officials said that $12 billion were withdrawn from the fund for budget purposes in March-August 2007. In December 2007, another $2billion were withdrawn from the OSF to develop water related projects and passenger aircraft acquisition. Thus, accurate data on the size of OSF is hard to find given these recurring withdrawals by the government.

The Iranian fund does not appear in the country's national accounts. It is supposedly administered as a separate account at the Central Bank by a seven-member Board of Trustees of senior government representatives from several ministries. The board is headed by the Chief of the Management and Planning Organization. In January 2008, newly appointed Central Bank governor Tahmasb Mazaheri, proclaimed that the OSF held $10 billion which is a small figure compared to other commodity funds.

Because of its extreme secrecy, the OSF has been under investigation by the State Inspectorate Organization. The latter is examining how OSF funds have been withdrawn and spent during the fourth 5-year development plan (2005-10).
However, it has been said that the fund has been hit hardly by declining oil prices since the end of 2008 as well as mismanagement by Mahmoud Ahmadinejad's government. It is difficult to assess how bad the fund's performance is. Jahangir Amuzegar former Iranian Finance minister, reckons, *"Handling the OSF has shown the futility, if not indeed the absurdity of setting up a rainy day fund if it can be freely used while the sunshine had never been brighter."*
The Iranian fund seems contested even on the local level. With its extreme secrecy, and governments' constant withdrawals from it, the OSF might well be a mean to avoid international sanction but not necessarily an efficient way to do so.

2.4.6 SWFs as a Means to Achieve Wealth and Risk - Return Optimization

Non-commodity-based economies that presently hold reserves far higher than needed for common usage are more and more aiming at maximizing their returns. This is driven by the opportunity cost associated with funds being invested in low return, close to risk-less assets.
Authorities could aim to optimize their risk-return profile on their state wealth. When examining traditional reserves management as carried out by central banks, central-bank portfolios – normally invested in short-term securities with an investment grade rating and money market investment vehicles – have had a Compounded Annual Growth Rate (CAGR) of close to 1 percent in inflation according to a research conducted by Summers in 2007 in adjusted annual returns from 1946 to 2004. On the contrary, the equivalent inflation-adjusted return on a portfolio composed of 60 percent stocks and 40 percent bonds would have been just short of 6 percent, as shown below.

Table 2: Annualized risk and return of investment portfolios (1946-2004)

Stylised Portfolio	Average real return in % p.a.	Annualised standard deviation of return in %	Probability of negative real return for 10Y holding period in %
Typical central-bank portfolio	0.98	1.24	37.00
Typical pension-funds portfolio	5.75	12.45	12.50
All-US-stocks portfolio	7.11	19.37	13.30

Source: Summers (2007)

Certainly, investments in equities and fixed-income securities are linked with high risk premium, i.e. high annualized volatility of returns.

Nevertheless, when considering longer-term investments (10 years), results change, it becomes less likely to get negative inflation-adjusted return on a pension-fund like portfolio than on a traditional central-bank investment. This gives a good reason for nations to create SWFs instead of leaving all their revenues with their central banks.

2.4.6.1 The Case of Abu Dhabi Investment Authority (ADIA)

With about $875 billion in AUMs, Abu Dhabi Investment Authority (ADIA) is the single largest SWF in the world. ADIA invests the oil surpluses of Abu Dhabi, the richest city-state within the UAE, which also includes Dubai.

Following the oil price spike of the 70s, ADIA was created in 1976. The idea was to invest Abu Dhabi government's surpluses across the world in a variety of asset classes and to shield and sustain Abu Dhabi's growth thanks to sensible management of the Emirate's financial assets. At the time, it was unusual for a government to invest its reserves in anything other than gold or short-term credit securities.

ADIA invests in all international markets – equities, fixed income, real estate, private equity and other alternatives. Its portfolio has always been diversified across regions and asset classes; it traditionally invests in public equity and fixed

income markets. Like its counterparts, ADIA has recently focused on emerging economies particularly China, Russia and India.

This interest in the emerging economies shows that foreign investors are trying to stay away from the US market. It is true that the recent drop in value of the US dollar makes the investment in the US more interesting because cheaper, but it also holds the risk of a further decline of the dollar which would affect the value of any dollar holding.

On November 27, 2007, ADIA invested $7.5 billion in what it believed to be an undervalued bank: Citigroup. This investment has given the Abu Dhabi fund a 4.9 percent stake in the American financial conglomerate, making it its largest shareholder, just under the 5 percent threshold at which the US Federal Reserve has to examine and make a memorandum on the transaction. The ADIA-Citigroup deal is a template for petrodollar recycling in this millennium. Abu Dhabi has emerged as a white knight for the American banking system in contrast to the hostility in Congress and the US media to the Dubai Ports World - P&O's American seaport deal.

Even Senator Charles Schumer of the Senate Banking Committee, who led the protectionist firestorm against DP World, has not opposed the ADIA - Citigroup deal brokered by the bank's acting Chairman Bob Rubin, the US Treasury Secretary who managed the bailout of Mexico after the peso devaluation crisis in 1995.

ADIA's Citigroup investment also has a political explanation: the Emirate has been one of the closest diplomatic allies of the United States in the Middle East ever since the creation of the UAE Federation in December 1971.

The political acceptability of the deal is enhanced by the fact that, despite the scale of its investment, ADIA has not sought or received a seat on Citigroup’s board.

Given the recent plunge in Citigroup’s share price, and the general fear about its possible bankruptcy, one could argue that this investment has not been profitable to ADIA who has proven unsuccessful in its investment decision. Thus, while aiming for a high return is a respectable objective for a SWF, it comes with a

price: risk. And given political interventions, this element could easily be omitted leading to loss-making investments which dilapidate public money and thus negatively affect the SWFs owners. In this case, it might be preferable to have a conservative management of the commodity revenues.

2.4.6.2 The Qatar Case

Created in 2003, Qatar Investment Authority's (QIA) main mission is to contribute in diversifying the Emirate's financial assets into new asset classes and to reinforce its economy. Accordingly, the QIA main investments are made in global financial markets; for its local investments QIA targets industries unrelated to the energy sector. Assets under management approximate $60 billion coming mainly from exports of the Emirate's natural resources.

In its most recent disclosure, QIA stated that its portfolio breakdown is: 40 percent in U.S. dollar; 40 percent in the Euro; and 20 percent in other currencies.

QIA has made investments in a number of high profile companies across Europe and the US. These include:

- A €2.08 billion investment in British Four Seasons Health Care, one of the leading independent healthcare providers in the UK, acquired in September 2007 from Allianz Group.
- A 15.1 percent equity holding in the London Stock Exchange one of the largest stock exchanges in the world.
- A 6.0 percent stake in Lagardère, the French conglomerate, with holdings in publishing, retail, media and aerospace.
- A 10% stake in Credit Suisse, the Suisse Financial Services Company, acquired in February 2008.
- A 27.3 percent in Sainsbury J plc, the third-largest supermarket chain in the UK.
- A 6.4% stake in Barclays, the second largest bank in the UK, acquired in July 2008. QIA is currently the largest shareholder of the bank. An

additional 1.9% was purchased by Challenger an investment vehicle owned by a member of Qatar royal family.

Furthermore, QIA is constantly trying to build alliances within the Middle East and other emerging countries especially Asian countries such as China, Japan and Vietnam. As asserted by Kenneth Shen, head of strategic and private equity at the QIA, *"Historically, we've been heavily invested in the US and Europe, and we've been underweight in Asia. We're going to increase our investments there, though not necessarily at the expense of Europe and the United States".* QIA's interest in Asia is an attempt to counter a weak dollar and secure high returns.

- In March 2008, the QIA and Abu Dhabi's IPIC announced the establishment of a new $2 billion fund for global acquisitions. The tie-up fits with the ambitions of both countries for gas trade.
- In the real estate, QIA established Qatari Diar Real Estate Investment Company, as a platform to handle several significant investments in local as well as international markets including: Morocco, Egypt, Oman and Syria.
- In May 2008, QIA created the Rawabi Project a new $350 million West Bank town (40,000 residents) with local MASAR Company and the support of the Portland fund.

QIA is taking steps inside and outside its territory. Thus, it has set up a number of partnerships in emerging countries, these include:

- A $400 million PME Infrastructure Management Limited Fund to invest in African transportation, communication, and energy sectors.
- A memorandum of understanding for the establishment of an investment fund jointly owned by the QIA and Vietnam's State Capital Investment Corporation created in April 2008 with the objective of investing up to $1 billion in Vietnamese companies.
- Projects currently under consideration in Indonesia.

Given all these examples, it is clear that QIA is an aggressive investor with an investment strategy focused on Europe and emerging economies Asia and Africa with high growth potential. In this way it is optimizing its risk-return allocation. The

fund focuses on three asset classes: private equity, investment funds and real estate.

2.4.7 SWFs as a Means to Fund Shortfalls in the Pension System

This is particularly the case of the Russian fund. Since the late 1990s, Russia has emerged as a major player in world energy markets. Today Russia is the largest exporter of natural gas and the second largest oil exporter after Saudi-Arabia. Energy exports have been a key driver of Russia's economic growth, as Russian oil production has risen sharply and world oil prices have reached an all-time high. This has created an intense debate over the smartest means to make use of the substantial energy proceeds stockpiled over the last decade.

In order to tackle these concerns, the Russian administration set up a Stabilization Fund (SF) in 2004 to be run by the ministry of finance. This decision is a part of large transformation of the Russian economy with three main elements of novelty:

- Under Boris Yeltsin's presidency, the Russian government divested from a number of key oil corporations it owned to the benefit of local oligarchs. This process was reversed once Vladimir Putin became president; in an effort to reinstate state power a wave of acquisition of commodity assets was undertaken, it's the so-called re-nationalization or de-privatization.
- Over the last decade, Russia has benefited from large oil revenues with the rocketing commodity prices.
- Several voices were raised to call for a state intervention favoring the development of sectors unrelated to energy. The increase in revenues from natural resources was seen as a deindustrialization of the Russian economy following the loss of competitiveness of the manufacturing sector and the entanglement of public services with business interests. This phenomenon commonly known as Dutch disease has been as reality in Russia since the start of the millennium. The concept of Dutch disease

tries to explain the apparent relationship between the exploitation of natural resources and a decline in the manufacturing sector combined with moral fallout. The theory is that an increase in revenues from natural resources will de-industrialize a nation's economy by raising the exchange rate, which makes the manufacturing sector less competitive and public services entangled with business interests. The Russian economy has experienced this phenomenon and its potential harmful effects could be substantial.

Thus, a SWF was established with funding flowing from various sources including a portion of oil and gas export duties, another from the severance tax on mineral resources, and another from the federal budget surplus. The law also defined a cut-off price at $27 per barrel for Urals oil, when oil is sold for a price superior to this level proceeds are transferred to the SF. In 2008, the SF's assets were about $157 billion.

Since its foundation, the SF has provoked violent deliberations on the proper mandate it should be given. Corporate and political figures favored the use of its returns for supporting pensions and social benefits. Another proposal was to distribute the SF's profits in the form of development loans.

The government in the person of its finance minister Alexei Kudrin and many local economists were against these proposals stating that such actions could raise inflation level eventually eroding the SF assets. In their opinion, it is preferable to use the funds revenues to redeem Russia's external debt. Logically, IMF backed the latter proposition, because of its stabilizing effects on Rubble and inflation. Both ex and current presidents: Vladimir Putin and Dimitri Medvedev shared IMF's point of view.

Thus in March 2007, Putin endorsed the transformation of the SF into two distinct funds. This split took place in February 2008 between a Reserve Fund, which is invested abroad in low-yield securities and aimed at cushioning the budget when oil and gas incomes fall, and the National Welfare Fund (NWF), which invests in riskier, higher return vehicles, as well as federal budget expenditures. The latter *"intended to buoy the pension system as the Russian population ages and the*

share of those working shrinks". The Reserve Fund was given $125 billion and the National Welfare Fund (NWF) was given $32 billion.

Table 3: Economic Diversification

Purposes/sources	Commodity revenues	Fiscal sources	Foreign reserves
Revenue stabilization	Russia: Reserve Fund Kuwait: Reserve Fund Mexico: Oil Stabilization		
Futures generations / public pensions	Russia: National Prosperity Fund Kuwait: Future Generation Fund Norway: Government Pension Fund	Australia: Future Fund New Zealand: Super Fund	
Management of government holdings	Mubadala Saudi Arabia: Public Investment Fund	Singapore: Malaysia: Khazanah Vietnam: State Capital Investment Corporation	China: Bank holdings managed by CIC
Wealth or risk/return optimization	Abu Dhabi Investment Authority (ADIA) Brunei Invsetment Authority (BIA) Qatar Investment Authority (QIA)	Singapore: Government Investment Corporation (GIC)	Singapore: Foreign reserves managed by Korea: Foreign reserves managed by China: Foreign reserves managed by

Source: JPMorgan

2.4.8 SWFs as a Means to Promote Economic Diversification and Domestic Industries Encouragement

Commodity exporting countries usually face the risk of under diversification due to their unilateral exposure to the exported commodity they provide to the global economy. This risk is mostly significant because of the exhaustibility of their main resource and the risk of revaluation of their local currency due to the high inflow of foreign currencies which consequently negatively affects the competitiveness of their exports on the global markets. International investments made by SWFs largely contribute to the reduction of this risk.

2.4.8.1 The Mubadala Case

In the United Arab Emirates, the emirate of Abu Dhabi has set up three major SWFs:

- ADIA: Abu Dhabi Investment Authority
- Mubadala Development Company
- IPIC: International Petroleum Investment Company

The biggest of these funds, ADIA aims at holding a diversified global portfolio, the second one Mubadala is much smaller and has a more aggressive function in diversifying Abu Dhabi's economy away from heavy reliance on oil and energy. Established in October 2002, Mubadala was mandated to create new companies and acquire stakes in local or foreign existing ones. Since its inception, it has built up a large portfolio of international and local partnerships in various industries such as energy, utilities, aerospace, real estate, private partnerships, basic industries and services.

What can be concluded from Mubadala's investments is that SWFs can be used to build international alliances to develop the economy of their sovereign owners. Indeed, owing to its 7.5 percent stake in private equity group Carlyle, acquired in September 2007 for $1.35 billion, Mubadala is able to indirectly control companies in various industries. Also, thanks to its 25 percent stake in LeasePlan, the world leading fleet and vehicle Management Company, Mubadala launched LeasePlan Emirates in December 2006. The new company currently offers comprehensive fleet management and vehicle leasing solutions to corporate clients throughout the UAE. Finally, owing to its 5.0 percent stake in Italian sports car manufacturer Ferrari, Mubadala played a major role in lobbying for the appearance of UAE Formula One Grand Prix on the FIA calendar, starting October 2009.

There are several instances of Mubadala's efforts to develop large-scale projects in Abu Dhabi. The latest example is its partnership with General Electric (GE)

announced in July 2008. Mubadala aspires to be one of General Electric's top ten shareholders, which, on the day of the investment implied an additional capital injection of more than $3 billion. Furthermore, General Electric and Mubadala have made an agreement to launch – thanks to $8 billion global alliance- joint projects in commercial finance, clean energy, aerospace, industry, and executive education. In this way, SWFs can serve as a means to reshuffle and boost domestic industries.

Moreover, in the aim of becoming a major player in the aluminum business, Mubadala has set up a joint venture with Dubai Aluminium Company (DUBAL) to create Emirates Aluminium (EMAL). On January 30th, 2008, it stated that it was considering developing an aluminum smelter project in Saudi Arabia. In order to ensure the availability of the needed raw materials (bauxite) for the manufacturing of aluminum, Mubadala had to invest in the extraction and refining capacity of Guinea, the country with the world's largest bauxite reserves. Via EMAL, Mubadala is also carrying out a feasibility study to construct a smelter in Algeria to improve provisioning of the American and European markets.

So what explains this sudden interest in aluminum? For the past few years, high energy prices have cut down the bottom line of many companies, especially energy-intensive industrial sectors such as the aluminum production industry. As energy costs account for one-third of aluminum production costs, aluminum producers are moving toward regions where there is a cheap supply of natural gas. The Middle East is fast becoming the destination of choice, which causes the aluminum industry to grow into a multi-billion industry in this region. This is the rationale behind the interest of Mubadala and many other Middle Eastern players in this sector. New capacities to meet increasing future demand, is expected to be largely developed in energy-rich areas. And with the generally upward trend in energy markets (from a long-term point of view), aluminum estimated long-term price has been increased making the construction of these facilities ever more profitable. In this context it should be noted that these objectives can also be pursued through other mechanisms, such as foreign direct investment by state-owned companies.

Given the growth potential of the aluminum industry why hasn't the private sector invested in it? For the moment, it is to be said that it has played only a narrow role in diversifying Abu Dhabi's dependence on oil and gas. This public intervention does not respond to market inefficiencies; however it grabs an opportunity non taken advantage of by the private sector. In this way, SWFs appear to be playing the role of a private corporation whose main objective is profitability and not a public entity whose objective is palliation of market deficiencies. Added to that, the Middle-eastern governments have generally been at the heart of most economic activity in the region, resulting in close links between business and politics and highlighting the potential for resource misallocation. In addition, some projects probably benefit from access to cheap petroleum or electricity inputs controlled by governments; this is particularly the case of aluminum.

In this way, Mubadala is trying to develop the sustainability of a broad-based economy for the fast-growing United Arab Emirates. Its plans to boost Abu Dhabi's existing aerospace industry into a global aerospace hub have been materialized with the signing of a multi-faceted alliance agreement with Boeing and the European Aviation Defense and Space Company (EADS).

Thanks to its aptitude to establish networks within and across diverse industries, Mubadala plays an aggressive role in diversifying the Emirate's economy.

Mubadala, released on April 22nd, 2009, its first annual report which revealed losses for the year 2008 of AED11.8bn (€2.5bn) corresponding to 176% of the 2008 consolidated income.

The report – the first of its kind by a Gulf state investment entity– provides a rare insight into the losses incurred by SWFs after the drop in securities prices and the downfall of international equity markets.

2.4.8.2 The Saudi Arabia's Public Investment Fund Case

Being the biggest oil producer in the world, Saudi Arabia is the foremost contender for running a sizeable SWF. Nevertheless, Saudi Arabia has long been reluctant to utilize sovereign funds as a mean to invest in capital markets for two main reasons:

- The first being its resource constraints before the increase in oil prices observed since 2003.
- The second being its concerns about potential local and international condemnation of this move.

It is only in late April 2008 that Saudi Arabia reconsidered its investment policy of foreign exchange assets and unveiled its project of a SWF establishment. Thus far it had exclusively given its central bank: Saudi Arabian Monetary Agency (SAMA) the mission to handle all the official reserves. SAMA's approach was that of a conventional central bank, which implies a large portion of the assets were in cash and liquid government securities.

The appeal of higher returns being too strong, Saudi Arabia's Public Investment Fund (PIF), announced on April 30th, 2008 the inception of the kingdom's first SWF. The decision was endorsed by the Saudi Cabinet on July 15th, 2008. The new investment entity, Sanabil al-Saudia, was allotted an authorized capital of $5.3 billion (20 million riyals), it is entirely owned by PIF but is run by a dedicated independent management team. It has been conceived to diversify the Saudi's financial asset base and enhance its long-term rates of return. It also is consistent with the Kingdom's recent efforts to develop and modernize its financial services industry and build the asset management business in the country.

Any speculation about the future role of Sanabil al-Saudia in the kingdom's domestic economy and the global capital markets is too premature to be accurate.

2.4.9 SWFs as a Means to Strengthen a Position in the Energy Markets

At the peak of the recent commodity surge, SWFs joined pensions, hedge funds and other institutional investors among those diving into commodities, including oil and gas. These investments are made either directly through stake acquisitions in commodity companies or indirectly through investments in hedge funds, private and public equity that invest themselves in energy. It is somewhat surprising that SWFs, which are usually held by commodity-rich countries, would increase their owners' exposure to such resources thus defying the rule of diversification. But it is to be said that as much as oil and gas-rich countries aim at diversifying their revenues away from these resources on the short run, they want to maximize these inflows on the short run. SWFs are thus created to manage and especially control these revenues. As for less energy rich countries – such as East Asian Countries like China and Singapore – they may scale up investments directly as they seek to hedge energy price risks.

2.4.9.1 The Case of Abu Dhabi's IPIC

Abu Dhabi has yet another SWF that was set up to invest in the hydrocarbons and related sectors outside of Abu Dhabi. The International Petroleum Investment Company (or more commonly IPIC) is wholly owned by the government of Abu Dhabi and is supervised by the Supreme Petroleum Council of Abu Dhabi which oversees the United Arab Emirates' oil and gas operations and related industries. Its $8 billion investment portfolio encompasses of stakes in a number of energy producers in Austria, Denmark (Borealis), Egypt, South Korea, Pakistan (Parco), Spain (Cepsa) and one in Dubai's Gulf Energy Maritime Shipping Company.

As reported, IPIC usually seeks out a significant minority equity stake of around 25-40 percent, complemented by proper minority shareholder protection. In

addition, it takes on occasion controlling stakes of 65 to 70 percent in its largest investments. IPIC is today on the hunt for fresh investments in Asian and North American markets. As Khadem Al Qubaisi, head of IPIC's investment management division said *"We are looking to buy refineries and marketing companies in the Far East, targeting Thailand, Malaysia and Korea,"*. He added *"We are also interested in utilities and gas companies because it is important for us to diversify our portfolio and we need exposure on the utility side, especially in Malaysia."*

As a primarily financial investor, IPIC does not typically participate in the day to day management of addressee companies, except in exceptional circumstances.

IPIC is owned by the government of Abu Dhabi. It has investments covering over two million barrels per day of refining capacity and a market capitalization of around $5 billion. "*We are positive about the refining industry because of demand in general and the synergies between Abu Dhabi and the Far East,"* Qubaisi said.

2.5 Recipient Country Governments

SWFs' investments' recipients are facing a major dilemma regarding the political risks implied by the growing influence of SWFs on their local economy.

Ensuring free entry of capital from emerging countries to domestic markets is a major concern for Western politicians. Without the heavy injections of capital, the credit-crunch crisis would have hit even harder the Western world in late 2007 and 2008.

2.5.1 The Benefits of Foreign Capital Inflows

Countries usually seek to brighten their image on international markets in order to receive the maximum amount of foreign direct capital (FDI), thus SWFs' investments are more often than not greeted in recipient countries. The

advantages of foreign investments are numerous: in addition to creating or preserving jobs, bringing in foreign currencies and providing international exposure to local markets, they usually provide much needed foreign resources to local companies in need of it. On the long run, intertwined cross-border economic interests play a part in global peace and stability.

Sadly, discussion in addressee countries has to date tended to center around potential negative consequences of SWFs interventions on financial markets thus omitting the positive role they could (and are in fact) playing. Their investments are typically conceived, implemented and finalized by knowledgeable investment professionals, often in association with local financial institutions, and rarely do they target sensitive industries. During the still ongoing financial crisis, SWFs were the supplier of crucial capital inflows for a financial system in desperate need of it. By injecting badly needed capital transfusions in American and other OECD companies, SWFs are protecting jobs and fiscal revenues and allowing distressed companies to recover and carry their businesses on.

Thus, provided that SWFs restrict themselves to passive portfolio management they are not the source of major concern.

2.5.2 Fears of SWFs' Political Objectives

Notwithstanding the recognized benefits of SWFs investments, some concerns have been raised by recipient countries especially when these investments are perceived as having a potential influence on key segments of national economy. It is feared that SWFs' investments are incursions i.e. just a cover-up for a foreign espionage and/or geo-strategic influence.

Therefore, national security continues to be a matter of sharp apprehension for recipient countries when pondering over foreign investments in particular if:

- These investments come from foreign government-owned investment entities
- They concern key sectors of the economy chiefly

    - Armament
    - Energy
    - Telecommunications
    - Financial services
    - Media
    - Intellectual property related industries
- The investment's objective is not purely financial as it is a means to facilitate access of foreign firms to domestic technologies and know-how

Some of these fears are founded many are not and some believe, like the Economist put it, that SWFs' funds are being *"set up as the next villains of international finance."* European Union and the United States both apprehend the emergence of states beyond the closed circle that has controlled international finance since the end of World War II. They fear a possible shift of power and influence to emerging players who do not always have the same views and values with regard to the free flow of capital and commerce. In this context, the new French administration has lately expressed concern over the unequal evolution of international cross-border investment.

2.5.2.1 The case of KIA's investment in British Petroleum (BP)

In order to better picture the above phenomenon we recall the case of Kuwait Investment Authority's (KIA) investment in British Petroleum (BP). In 1987, KIA bought 22 percent of the then newly-privatized BP. This equity purchase allowed KIA to become BP's biggest shareholder. This caused apprehension about foreign control of such a key company for the British economy, and an inquisition by the UK Monopolies and Mergers Commission urged the KIA to reduce its shareholding to below 9.9 percent by October 1989. Thus, though it had made clear to the British authorities that it did not aspire to be actively involved in the management of BP, the KIA had to sell more than half its stake (which currently is set at 3.3 percent). A possible explanation of Britain's reaction is the fear of a

foreign political influence to direct BP's investments mainly towards Kuwait in order to develop the energy sector in the Middle Eastern country. Favoring Kuwait to other countries for potential investments regardless of their profitability would negatively affect the efficiency of the British Company. In this way the British government intervention seems justified; however, one could wonder if the same surge in the participation of a private foreign player in the capital of BP would have raised the same protectionist hostilities from the recipient country. This question remains unsettled.

2.5.2.2 The Hypothetical Case of China's Fund

One needs to address the issue of SWFs while keeping in mind the recent and ongoing shift in the global economy with the incredible rise of China. China's rise is not a new phenomenon. Already in 1800 it was the largest economy in the world. However the effects of its growth are different today with the globalization of world economy and the race for power and influence that industrialized economies are engaged in since the end of World War II. This rise is materialized by an increased Chinese demand for commodities combined with a Chinese ever more acute intrusion in African affairs.

As evidence to the first phenomenon, one could notice that between 2004 and 2006, China moved from accounting for 21% to 26% of aggregate global demand for six industrial commodities (by last year accounting for 30% of zinc demand, 32% tin, 19% nickel, 27% lead, 23% copper and 26% of global demand for aluminum). As evidence to the second phenomenon, one can evoke the substantial aids granted by the Chinese government to several African countries with the objective of accessing their commodity resources in return. Some wonder if these aids are motivated by strategic ambitions. Others also wonder if the same ambitions can theoretically motivate future Chinese SWFs' interventions. Why this suspicion from outside observers? Because insiders i.e. Africans have themselves expressed this suspicion. Indeed, following an early

enthusiasm, China's interest in Africa was met with an increased concern. Apparently, some doubt that Chinese investments serve the continent's best interests while others reflect over their real motives. Thus, a very likely future investment by the CIC in African assets would probably be examined with suspicion and care as African politicians seem to think that the objectives behind it could be other than purely commercial. Some argue that even China's courting of African leaders should be looked at with skepticism as they believe that Chinese are only securing their future supplies. Thus, African nations may be tempted to obstruct Chinese investments in their economy if they get to see that these investments are not optimal solutions to their problems or if better alternatives come to arise. This case is only conjecture but it is good to foresee possible future events and latent threats of SWFs.

2.5.3 SWFs' Blurriness is Responsible for Recipient Countries' Anxiety

Many funds are becoming less risk-averse than before. This is triggering a wave of anxiety, mainly because the sovereign investments are made more frequently by prominent nations like China and the Arab Emirates. On many occasions, the funds have been themselves nourishing this fear by opting for an ambiguous language. *"We mainly do farming, but occasionally we go hunting,"* says CIC's Jesse Wang, adding, *"We don't rule out the possibility of making a few other investments if good opportunities come up."* Evoking CIC's $5 billion equity investment in Morgan Stanley, the manager even went further when he added *"If there is a big fat rabbit, we will shoot it."*

On another level, we detect a systematic trend as the least transparent funds are owned by countries with either a weak legal system or low democratic accountability. From a policy standpoint these patterns are worrying since a low degree of accountability vis-à-vis the public, in combination with low corporate governance standards, may facilitate the pursuit of strategic objectives through

SWFs. Huge piles of investment capital are being assembled in Beijing, Caracas, Moscow - and many other capitals around the globe in vehicles for government who have always had a tainted reputation. These governments don't usually explain the motive behind their investments and tap into their funds at their discretion. This is case of the Irani fund (seen above) and some say it is also the case of the Venezuelan National Development Fund.

The latter has been used to serve president's Chavez domestic and regional political agenda. Oil profits are channeled to the fund which is controlled directly by the president with no accounting or legislative oversight whatsoever. The fund, instigated in 2005 was used to repurchase more than US$4.7 billion of external debt (including most of Venezuela's Brady bonds) in 2006. It also 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. Owing to these acquisitions, the fund is being used as President Chavez personal war chest. Indeed, the controversial president tapped into it to fund its electoral campaign through massive distributions to low and middle-income households, in the form of free medication, healthcare, education and subsidized food and oil.

2.5.3.1 The Case of Abu Dhabi Investment Council

When the Emirate of Abu Dhabi announced in 2007 the creation of the Abu Dhabi Investment Council (more commonly ADIC), it was widely believed that it would assume the Emirate's domestic investments by taking over ADIA's local portfolio. Investments in neighboring Arabic countries were also envisaged.

Yet, given its weak public disclosure policy it is practically impossible today to check if ADIC is abiding by its original mission. Therefore, no one can precisely identify ADIC's role among Abu Dhabi's set of investment bodies. This sate of confusion is further intensified by unexpected investment moves carried out by the fund such as its take over of 90 percent of the Chrysler Building in June of

2008. This $800 million foray has shed the light on the council just a few months after its inception. Its rationale seems inconsistent with the fund's alleged local and regional focus, and has thus swollen the utter incomprehension over the mandate of each Abu Dhabi SWFs. Thus, this blurriness is responsible for recipient countries' fears of SWFs and their protectionist inclinations towards them.

2.5.3.2 The Case of Temasek's Investment in Thailand

Singapore's SWFs: Temasek and GIC have long been information black holes for outsiders. This has frustrated industrialized Western counties and has even gotten to the point where emerging countries are expressing reluctance about receiving these investments. One instance of emerging country expressing sensitivity to an equity acquisition by a SWF is that of Temasek's acquisition of a controlling stake in mobile-phone and satellite concessions operator Shin Corp. Here Temasek's long-standing blurriness concerning its intents and strategy can be held responsible for the transaction unfortunate consequences. Until then, poorly developed governance regimes in emerging countries meant little investigation of Temasek's investments but that changed in 2006. Further to acquiring Shin Corp from the family of the then-Prime Minister Thaksin Shinawatra in January 2006, Temasek was faced with a political crisis in Thailand. Acquisition of such a sensitive industry with access to confidential private information worried Thai people, it was also said that the seller (the Thai prime minister) was exempted from capital gains tax. Another element of controversy was the fact that the Thai law regarding foreign investments in the telecom sector had been amended just prior to the sale. Consequently, this transaction was perceived with a very suspicious eye in Thailand, which soured relations between the two countries. It prompted the post-Thaksin junta to announce that it would seek to regain control from Temasek of ShinSat's satellites, which it regards as having national security implications. The

transaction made the Prime Minister the target of accusations that he was selling an asset of national importance to a foreign entity, and hence selling out his nation. The Democrat party spokesman called Thaksin worse than Saddam for not protecting the Thai economy from foreigners.

What is most problematic in the Temasek-Shin Corp transaction is a foreign government-owned company buying up assets, seen as tainted by the Thai public, that are owned by the family of Thailand's most powerful person who is actively in the highest political office. As such, it is not a routine business transaction. The buyer is not an ordinary individual but ultimately a foreign government. The seller is not an ordinary corporate entity but ultimately a business domain of its prime minister. This is a deal where the buyer should have been mindful of the integrity of the product being offered. Few with respectable moral and ethical standards would want to come into ownership of a tarnished product, no matter how good a bargain it may seem.

2.5.4 Two Elements of Risk Assessment: Financial Risk and Sovereign Risk

An important element of consideration is that SWFs' attitude towards financial risk varies from a conservative investment posture, similar to central banks and pension funds investments, to an aggressive posture, similar to some private equity firms and hedge funds. Another element is the degree of sovereign ownership risk, that is, the risk posed by the sovereign government owner to other countries in which its SWF may invest. As major geopolitical powers such as China and Russia establish SWFs, sovereign ownership risk may become an increasing concern to traditional Western powers.

The emergence of SWFs raises possibilities of several migration paths away from this conservative reserves management.

One case is that of funds owned by countries which have low sovereign ownership risk but are willing to bear a high financial risk. This is particularly the

case of the most recent SWFs, which are heavily investing in foreign equities and are owned by mature industrialized countries. The SWFs themselves, their sovereign owners, the other financial institutions, and recipient companies usually welcome this movement, though it has its risks and shortfalls, as the government of Iceland discovered in 2006 when a state-owned Norwegian fund shorted its bonds to realize a short-term financial gain.

Another case is that of a fund with high financial risk by a SWF owned by a nation with high sovereign ownership risk. Much of the current deliberations and concerns indirectly reflect this concern. If SWFs migrate towards this case, either directly or in stages they will risk creating general apprehension and causing the closing of markets to their investments and the setting up of a very constraining international regulatory framework.

2.5.5 Protectionist Temptations

With their expanding reserves, SWFs owners could prompt their investment vehicle to go on a "buying extravaganza" of private corporations in foreign lands. This move may well provoke intense nationalistic responses if these buyouts concern companies positioned in industries perceived locally as strategic ones (like defense and energy.)

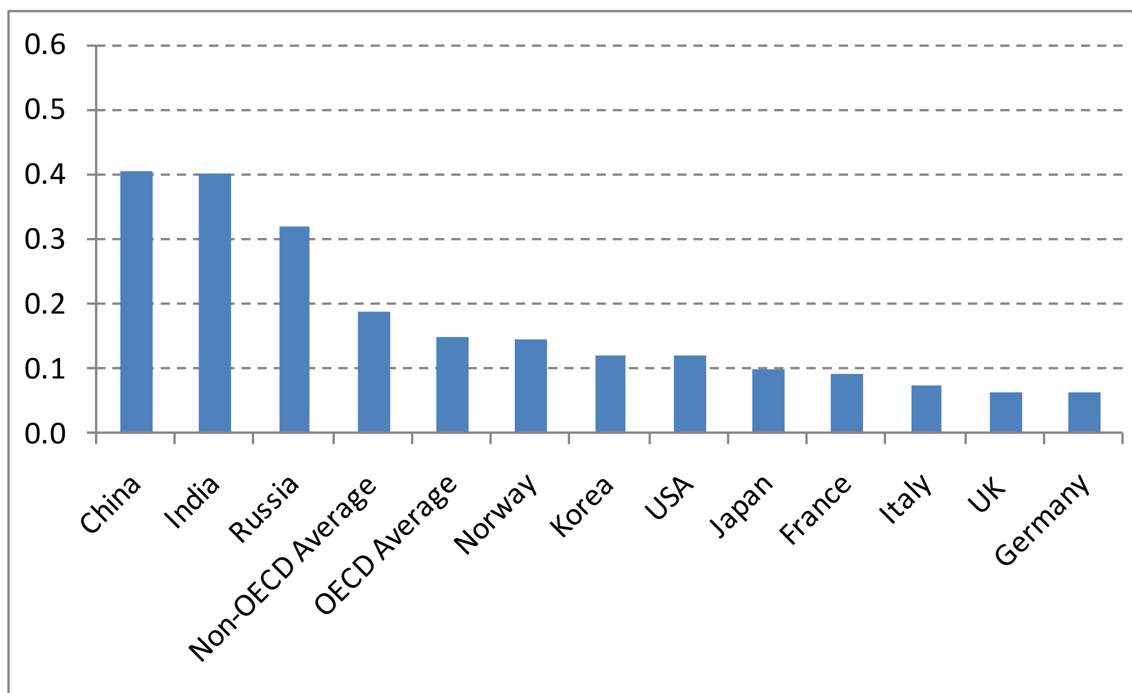
Thus, it is clear that mature economies face a dilemma, on one hand they want to guarantee a constant inflow of crucial capital, on the other they are bound to deal with the popular apprehension regarding sovereign investments. This supports protectionist measures, obstructs the free flow of inward investments from SWFs and constitutes a major problem for the complete globalization of capital markets. This phenomenon, at times unsupported and irrational, has intensified since the events of September 11, 2001.

Certainly, state-controlled foreign investments may be sensitive both from a political and from an economic standpoint, as the opaqueness of SWFs clears

the way for concerns about their motives and in turn intensifies protectionist temptations.

In certain aspects it grasps the current mood in some Western European countries that seems to be inclining towards what some have called a “fear of foreigners”. As the Centre for European Reform (CER) has put it *"Several EU Governments have become alarmed about SWFs. Germany, for example, is thinking of preventing such funds from buying local companies in sensitive sectors.”* Another instance is that of France whose president Mr. Nicolas Sarkozy has asserted that he would use French quasi-publicly owned bank Caisse des Depots et des Consignations to defy any threat posed by SWFs to French national champions. This phenomenon is further enhanced by an asymmetry of market access between owners and recipient countries of SWFs investments. As illustrated by the chart below, emerging economies tend to be more protective of their local market than industrialized Western economies. This forces recipient countries to reconsider their market openness to FDI.

Figure 5: Foreign Direct Investment (FDI) Restriction Index, 1 = closed, 0 = open



Source: OECD, as of April 2006

2.5.5.1 Instances of Recipient Countries Protectionist Measures

As evidence to this phenomenon, we recall the case of Dubai Ports World's failed attempt to takeover management of Peninsular and Oriental Steam Navigation Company (P&O) which operates, among others, the port of New York. The former -not strictly speaking a SWF but rather a state-owned-company- was forced to halt its tender offer because of public and political opposition. An adverse political reaction was occasioned by this takeover bid by foreign investors as congress seemed to consider the portal business as a strategic one for American security. Following this failed attempt, congress was pushed towards passing a law reinforcing official scrutiny of FDI. Abu Dhabi's other SWFs, which have always followed a low-profile investment policy, have learned from DP World's experience and have avoided since then putting themselves in similar situations.

Another example, involves China's state owned oil company CNOOC. Its bid for Unocal – a U.S. oil firm- was also obstructed in 2005 by the American establishment. In September of 2007, Chinese telecom firm Huawei Technologies and US private-equity firm Bain Capital Partners made an attempt to buy US telecom firm 3Com for $2.2 billion. After failing to structure the deal to fulfill the conditions defined by Committee on Foreign Investment in the United States, they had to abandon their joint offer. These cases illustrate the mounting suspicion of the US administration with regards to investments made by foreigners on its territory. Future political responses could be even more radical. Not only governments should be alarmed, markets should also pay close attention to this protectionism effect.

2.5.6 Addressing Fears: National Solutions

To address this challenge, finance ministers from major industrial countries are beginning to consider setting up legislations and establishing local regulators.

SWFs' investments' recipients do have a homogenous position as to the degree of free-float of capital / protectionism that they would like to impose. But the legal deliberations on this matter are still in their early phase.

2.5.6.1 The US position

In the United States, fear of SWFs is a reminder of the xenophobia-fraught days of the 1980s when Japanese interests feverishly bought American real estate after it had plummeted in value. Back then, Americans stepped in to protect their industries and so are they doing now.

They have set up the Committee on Foreign Investment in the United States (CFIUS) which is an inter-agency committee of the United States Government that reviews the national security implications of foreign investments of U.S. companies or operations. CFIUS is able to review investments from sovereign state funds just as it would any other foreign investment. While emphasizing the crucial role that foreign direct investment plays in the U.S. economy, it seeks to insulate national security. In more than a way its mandate is to attract foreign investors to invest in the US by promising them no retaliatory discrimination.

The President's Working Group on Financial Markets, chaired by the Secretary of Treasury, and including regulators, has also initiated a review of SWFs.

Enacted in July 2007, the "Foreign Investment and National Security Act" was conceived to strengthen pre-existing laws including the Exon-Florio Amendment and the Committee on Foreign Investment in the United States. It mandates additional scrutiny and higher-level clearances for transactions involving foreign government-owned investments. Senior officials confirm than never have SWFs bee caught exerting direct control over companies, steeling knowledge from them or undertaking damaging actions for the national security. As U.S. Deputy Secretary of Treasury Robert M. Kimmitt has put it in Policy Principles for Sovereign Wealth Funds and Recipient Countries *"Sovereign wealth funds are*

patient long-term investors and we have no evidence that any of their decisions have been made for political and not commercial reasons."

As if to confirm this point, the Abu Dhabi and Singaporean SWFs signed, on March 30th 2008, an 'Agreement on Principles" with the U.S. Department of Treasury on policy principles for SWFs' investments. In this set of principles, the funds vowed that their projects of investments in the United States will be driven by risk-return optimization and not, directly or indirectly, by geopolitical ambitions. The agreement also summons for larger information disclosure, with SWFs revealing not only their purpose and investment objectives but also their institutional structure, asset allocation, benchmarks, and historical rates of return. The agreement also suggests setting up a predictable investment context with free market access and no discrimination among investors.

In June 2008, the US and China signed a bilateral investment treaty. The Financial Times reported that the US *"would seek a "high standard"* treaty, which *"would strengthen investor rights in China",* to ensure that foreign and domestic investors are treated equally, with the widest possible sectoral coverage. It noted that "*analysts believe that China will favor a more limited investment treaty of the kind it already has with some other nations"*, but that it was *"anxious to ensure that its investors"*, its SWFs included*, "are allowed to buy US assets without discrimination."*

With ongoing financial and economic difficulties it is highly likely that calls for protectionism in the United States, especially with regards to China, will increase. It is a way to favor local interest and to face the increased suspicion regarding Chinese and Arab implication in the American and World economy.

2.5.6.2 The European Position

The European Union is facing the same dilemma: how to abide by its policy of open markets beneficial to its local firms and preserve at the same time sensitive sectors of its economy especially those related to national security.

A European Commission Communication issued in February 2008 restated what it believed to be the advantages of SWFs' investments. It reaffirmed the commission's support of increased transparency of SWFs in particular with regards to their investment tactics and mandates.

In summary this proposed that:

"[…] EU leaders endorse a common EU approach to increasing the transparency, predictability and accountability of SWFs. This common approach will strengthen Europe's voice in international discussions aiming to establish a code of conduct including standards in areas of transparency and governance."

European nations are mostly apprehensive that Russia uses its stabilization fund and state-controlled gas companies to expand its domination of the European energy market through pipeline and other infrastructure acquisitions. The European Union does not have a clear government medium like the CFIUS in the United States to obstruct the takeover of a local company. The European Commission considers that among the EU 27 member states, comprehensive rules governing the activities of foreign investors already exist.

The European Commission favors a voluntary line of attack to the statutory tactics and overall its position appears to be less protective than that of the United States.

In 2008, the commission suggested that any fund willing to invest in Europe be asked to reveal the quantity and origin of its funds with their currency repartition as well as overseeing institutions for its management and laws governing its operations in its home land. It can also be asked to clearly disclose any connections it has with its local government.

Though the European Union constantly restates its allegiance to global free float of capital, it recognizes the likely necessity to adopt a protective approach for strategic sectors, particularly when investing states protect these sectors internally. Hence, this sheds a light on the inevitability of reciprocal market openness.

The European Union has not excluded ratifying a law to implement these rules. European Commission President, Jose Manuel Barroso said *"We will not*

propose European legislation, though we reserve the right to do so if we cannot achieve transparency through voluntary means.”

Table 4: Formal Control Mechanisms for Foreign Direct Investments in Selected Industrialized Economies

	US	JP	FR	DE	UK
Legal framework	- Exon-Florio legislation International Emergency Economic Powers Act	- Foreign Exchange and Foreign Trade Control Law (FECL)	- 1996 Foregin Investment Law	- 1961 Foreign Trade and Payments Act	- Industry Act of 1975 Foreign Trade Act of 1973
Reasons for review	- National Security	- National security - Public order - Public safety - Adverse effects on economy	- Public order - Health - Security - Public functions - Research, production or trade in any substances destined for military use or wartime equipment	- Government has authority to regulate or restrict foregin investments on the basis of antional security, public order, foregin policy, balance of trade - No administrative controls, bodies, practices that monitor, screen, track, or	- Government has authority to intervene in takeovers on grounds of national interest, incl. defence, aerospace
Notification	- Voluntary	- Mandatory	- Mandatory ex post - Mandatory ex ante for all transactions related to national security, public order, public safety and all sectors reserved through OECD Code of Liberalisation of Capital Movements	- Not applicable	- Not applicable
Review body	- Committee on Foreign Investments in the United States (CFIUS)	- Ministry of Finance - Ministry in charge of the industry	- Ministry of Economics and Finance, consulting with ministries of Industry and Defence	- Not applicable	- Not applicable
Review process	- 30D review - 45D investigation - 15D Presidential	- 30D review - Max. extension up to 5M	- 1M plus postponement rights	- Not applicable	- Not applicable
Judicial appeal	- No	- Yes	- Yes	- Not applicable	- Not applicable
case-by-case evaluation	- Yes	- Yes - No formal criteria for evaluation	- Yes - No formal criteria for evaluation	- Not applicable	- Not applicable
Evidence	- 1 case blocked	- None since 1992 law revisions	- 9 rejected in 1992, 1993, 1994 for public order reasons	- Powers under Foreign Trade Law never invoked	- Powers under 1975 Industry Act never invoked

Source: US General Accounting Office, OECD, Deutsche Bank Research

What all these responses underline is the shortage of accuracy in their intent and in their analytical backing. One could wonder how appropriate mechanisms for dealing with sovereign investments could be set up in this intellectual desert. More so, one questions the real motivation to write these legislative texts when considering the element of the “money goes elsewhere”. If US congress were to block foreign investments, these will be directed to other areas of the world illustrating the substitutability effect of “money going elsewhere” Thus, in the

current race for attracting foreign investments, countries would gain from having an easy-going policy which nonetheless puts in danger entire pans of the economy. This conflict of interest could therefore only be solved if nations came to cooperate on an international level under the umbrella of multilateral regulatory institutions.

2.5.7 Rules for an Optimal Policy Response

How do deal with these new power brokers of the world economy? First and foremost, industrialized economies have to acknowledge that the global economic power equation has changed and that the industrialized world is contested in its dominance of capital markets. The Western world needs to acknowledge that rise of SWFs is rather a lasting than a transient phenomenon; and these new players are getting the more and more sophisticated.

Accordingly, in their discussions industrialized economies should keep in mind the geopolitical consequences of closer financial relations. This creates a state of interconnectivity that encourages host countries of sovereign investments to clearly outline a regulation for these controversial investments. SWFs' investments, while directly benefiting their sovereign owners in their economic diversification also indirectly contribute to social and economic development in nations (especially middle-eastern countries) perceived by the industrialized world as unstable.

Given all these elements, an optimal policy proposal should give clear guidance on the four following factors:

- Concerning market openness:

  National and regional markets should welcome investments by SWFs as a general rule. Indeed, as already proved FDI are valuable both for national economies and for international relations. It is therefore in no country's interest to erect impervious barriers to SWFs capital inflow.
- Concerning reciprocity of market access

Markets are to be reciprocally open to their participants as opposed to the state of protectionism.

- Concerning Political intervention:

  In general, investments by SWFs should be handled by authorities the same way any investment is handled. In addition to obeying to the same laws and being overseen by the same institutions they should be granted the same benefit of the doubt. Further inspection should only be undertaken for investments likely to have a harmful effect on well-defined national security affairs. Thus, government should only intervene to stop or complicate SWFs investments in its national corporations when this seems to be the only remaining choice.

  Political interventions should only occur when a number pre-defined set of criteria seem to have been or could potentially be violated. These criteria should be set ex-ante by the authorities and would be used for the examination of any case of foreign investment. This examination would be a clear and quantitatively based process that takes into consideration the time sensitivity of major capital market investments.

  Ideally, these last-resort instruments for political interference would be coordinated across all countries or at least within the European Union for what should theoretically be a unique market to have uniform investment rules and protection. This is the only way to preserve the integrity of the single European market and guarantee an even playing field.

  All foreign investments should comply with the local anti-trust and civil laws. This ensures the protection of free and perfect competition. Reasonable methods for dealing with potentially dangerous foreign investments comprise:

  - A formal examination procedure that abides by the principles discussed above
  - A reporting obligation for investments larger than a given threshold.

Governments should, by no means, make use of certain policy instruments if these appear to distort market efficiency and equilibrium. These instruments include:

- First and foremost golden stakes held by governments
- "Defensive funds" created with the intent to acquire holdings in local companies in case of a raid by international sovereign investors This was the proposal of French President Nicolas Sarkozy for the European commission in order to push local SWFs to purchase stakes in key companies and to foil overseas "predators" seeking control at knockdown prices.

The risks associated with these instruments are dual:

- First an uneconomical utilization of resources
- Second a local government intrusion into corporate affairs.

Analogically, governments should abstain from promising certain industries to protect them no matter the circumstances, as those may change over time. In fact, no company should be granted such a promise as this creates an adverse incentive to the "ins" and the "outs".

- Concerning Transparency

  Greater transparency of SWFs should be based on an internationally defined code of conduct written after analysis by the IMF of their best practices. SWFs would be bound to regularly disclose the size of their AUMs, their investment strategy and their funds' origins. Anyways, a minimum disclosure threshold should be defined and a third party audit of accounts be imposed. SWFs should also commit to abide by national and/or international capital markets and corporate governance laws, and to solely pursue risk/return optimization.

2.6 Multilateral Regulatory and Oversight Institutions

The rise of foreign direct investments reflects a tectonic change in the world economy. For that reason, academics and politicians are seeking to evaluate the repercussions of this shift and the suitable answer to it. For the moment, the debate concerning SWFs investments in the recipient countries has been sharp but it has overall failed to come-up with a consistent methodology for productive collaboration.

International regulatory and oversight organizations such as the IMF and the World Bank are keen on protecting free market access to all participants, including banks, mutual funds, hedge funds, insurance companies, private equity groups, and SWFs.

SWFs are a concern to other financial institutions because they have the ability to uneven the playing field. Their cost of capital may be lower than that of their private counterparts, or they could have access to privileged information - conceivably through other state-owned agencies- which leads to information and intelligence asymmetry. These apprehensions have shown that any legislation targeting SWFs should set standards for their transparency; outline tender offers they have the right to undertake, and define sanctions against potential violators.

However, it is useful to remember that to date SWFs have proven to be dependable passive investors and contributors to the wellbeing of the international financial system. And although, their issue has been discussed in various international forums, there is no clear evidence of their harmful intentions.

Yet, various proposals concerning SWFs activity are currently under examination. Pressured by the Americans and the French, the G7 is compelling the IMF, the World Bank, and the OECD to provide a code of conduct for SWFs by defining best practices upon the recipient and investor sides. In its Heiligendamm declaration of September 2007, it stated that any restriction on SWFs' investments should be minimized and only *"apply to very limited cases which primarily concern national security".*

Separately and in collaboration with the SWFs, the World Bank and IMF are joining forces to write a voluntary code of conduct that would make SWFs more

accountable to the citizens and governments of their own and of recipient countries.

2.6.1 IMF's Work

The IMF's work is centered around SWFs' management and accountability in a voluntary SWFs' management code of conduct currently on the go. Its work agenda was approved by the IMF's Executive Board in March 2008. To this day, this work has included a survey of SWFs, a roundtable meeting of officials and SWFs representatives, as well as coordinating work with the World Bank, OECD and the European Commission.

An International Working Group of Sovereign Wealth Funds (IWG) was created on May 1st, 2008. This voluntary group comprises representatives from 25 IMF member countries running a SWF, including the United States, Norway, China and a number of Arab countries with the IMF providing the group's secretariat position. Saudi Arabia, the OECD and the World Bank participate as permanent observers. The IWG presented in October 2008 a set of principles for SWFs' activities. An initial draft of a best practice text is to be discussed by the IMF's Executive Board in June 2009.

How to put into practice all these regulation proposals? In order to engage in a fruitful debate, the IMF proposes *"to determine what information countries are willing to share, what information it makes sense to ask for, and what information can be used in our global economic and financial analysis".*

However at a time when the legitimacy and impartiality of the IMF are highly contested and when emerging countries are increasingly demanding for more voting rights on its board one could wonder if the IMF is the ideal organization to monitor the global debate on SWFs' regulation.

2.6.2 OECD's Work

On the opposite side of the spectrum, the OECD has dedicated much of its efforts towards analyzing optimal policy responses from countries in receipt of SWFs' investments. OECD goal is to preclude any unwarranted protectionism. The approach it supports is for addressee countries to apply the same principles to investments from SWFs as to any foreign direct investment.

The OECD's Secretary General, Angel Gurría, outlined a *"common OECD position"* on SWFs' policy in a letter to G7 finance ministers in April 2008. The OECD asserts that its member nations "*are committed to keeping their investment frontiers open to sovereign wealth funds (SWFs) as long as these funds invest for commercial, not political ends.*" This letter was complemented by a report: SWFs and Recipient Country Policies, the work of the 30 OECD member countries, 14 non-members, and the European Commission. It conceded that national security concerns were justified but that these *"should not be a cover for protectionist policies".*

The OECD's position is based on the principles in pre-existing "investment instruments" on capital movements, and international investments and multinational enterprises. These "*call for fair treatment of investors*", and include: commitment to non-discrimination; transparency; progressive liberalization; undertakings not to introduce new restrictions; and not to insist on reciprocity as a condition for liberalization.

The OECD Ministerial meeting on 4-5 June 2008 adopted an "OECD Declaration on Sovereign State Funds and Recipient Country Policies", affirming that:

- *"Recipient countries should not erect protectionist barriers to foreign investment.*
- *Recipient countries should not discriminate among investors in like circumstances. Any additional investment restrictions in recipient countries should only be considered when policies of general application to both foreign and domestic investors are inadequate to address legitimate national security concerns.*

- *Where such national security concerns do arise, investment safeguards by recipient countries should be:*
    - *Transparent and predictable,*
    - *Proportional to clearly-identified national security risks, and*
    - *Subject to accountability in their application."*

Finalized and adopted by governments on March 26th, 2009, the final report of the OECD's Freedom of Investment project, that includes recommendations about SWFs' investments, will be discussed by the OECD Council at Ministerial Level on 24-25 June 2009.

2.6.3 Resistance to Oversight

Calls to regulate SWFs will strengthen, but a voluntary "code of conduct" instead of rigid and comprehensive rules could encourage foreign investment and smooth the progress of financial cooperation in the global economy

Many funds however resist the pressure to even adhere to a voluntary code of best practices on a number of grounds:

- First, they say, such a code seems needless given that they haven't till now triggered any major capital market disruption and that very rarely do they seek to take control (whether full or partial) of companies they invest in.
- Second, the industrialized world's calls for regulation are deemed hypocritical given the fiasco to regulate European and American financial institutions.
- Third, industrialized countries have already regulated in their legislations capital inflows to avoid situations of investors' abuse.

Concerns are founded more on skepticism than on evidence. Unlike Norway and a few other oil exporters, very few SWFs publicly disclose their investment policies and financial performance. In spite of this secrecy, no evidence of ulterior political motives has been identified.

Excessive regulation and a broad politicized hostility to SWFs would come at a high price: it would deepen mistrust among countries of origins of SWFs' and Western markets. Instead, confidence-building measures and a free flow of capital, trade and technology would benefit both sides and the overall international financial system.

Any changes to existing multilateral or transnational regulatory frameworks should aim at preserving the benefits that SWFs offer and avoid penalizing them for irresponsible behavior that has yet to occur.

It is in the interest of all participants to capital markets that SWFs not only be treated like other classes of investors but also be observed closely for signs of undesirable influence on their investment behavior by political leaders in their home land. SWFs should enjoy no financial advantages over private investors based on sovereign government ownership.

Questions raised by SWFs in terms of transparency and corporate governance are not much different from those related to the growing role of hedge funds and private equity funds in the international financial system. Increased transparency of SWFs would make the tasks of regulation and oversight easier but would not remove all SWFs' investments from suspicion or regulation.

2.7 Global Financial Markets

2.7.1 Positive Effects on Financial Markets

It is widely believed that SWF's active management of foreign reserves has played a major role in raising market efficiency by supporting global liquidity.

2.7.1.1 Active management of foreign reserves

There are two distinct forms of SWFs: commodity funds set up through commodity exports owned, exploited or taxed by the government, and non-commodity funds funded by transfers of assets from official foreign exchange reserves.

The holding and the management of foreign assets by sovereigns can also take the form of Sovereign Pension Funds (SPFs) also denominated pension reserve funds. In some countries, the stand-alone funds managing government-sponsored investment have both SPF and SWFs' features. This is the case for instance for French FRR (Fonds de Réserves des Retraites), Norway's Government Pension Fund-Global (GPF) and the Government of Singapore Investment Corporation (GIC). Also, like SWFs, SPFs seek return optimization for two reasons: they aim to address better the fiscal burden arising from the ageing process; besides, financial globalization facilitates a reduction in the home bias.

Such diversity implies a variety of objectives: stabilization of fiscal revenues, balance of payment sterilization, intergenerational saving. SWFs - as well as sovereign pension funds – want to protect a minimum level of capital, in real terms, so that the funds' purchasing power is ensured. Still, SWFs who usually do not have any obligation - unlike SPFs - are more able to focus on a return objective and an acceptable level of risk. Among SWFs, stabilization funds are usually conservative in their investment strategy; they direct their efforts towards liquid and low risk securities, while saving funds, with their long-term investment horizon use a wider variety of securities.

Over the last decade, Asian and the Middle-Eastern nations have and are still transferring a large proportion of their currency reserves to SWFs. Concurrently SWFs are constantly increasing their exposure to risky securities as they have been given the mission to realize returns higher than those obtained from conventional management of foreign reserves.

Even mature SWFs have announced a shift in their portfolios from safe to riskier investments. It is uncertain whether the current financial crisis would reverse this trend.

Norway's Government Pension Fund - Global recently approved a revision of its benchmark portfolio allocation to global equities from 40% to 60%. Chinese CIC's portfolio is also presumed to be highly exposed to corporate equities owing to its 10% stake in Blackstone a private equity group acquired in May 2007. Some recent reports have signaled a shift in SWFs asset allocation in favor of riskier assets. Notable steps have been made in this direction since mid-2007, with equity and convertible purchases by SWFs in several major financial institutions such as Citigroup, Barclays, Morgan Stanley, and Credit Suisse. Following record bank losses, investments in financial institutions are extremely risky ones especially in the midst of the financial turmoil. So how do we understand the evolution in the funds' asset repartition? First, returns on conservative investment strategies followed traditionally by central banks have been crushed by those generated by more aggressive strategies. Second, given the high demand for risk-free securities and concurrently the relatively low demand for riskier ones the latter have lost in value and appear to be relatively cheap as of today.

2.7.1.2 Stronger market efficiency

With their dimension and their long-term strategic outlook, SWFs can be major contributors to financial markets' stability. Thus, any change affecting their investment behavior and/or portfolio allocation can have a deep market impact on financial asset pricing. The sheer anticipation of SWFs modifying their portfolio distribution can disturb prices on financial markets. Lately, reports of currency allocation shifts by Asian monetary authorities have caused an agitation on foreign exchange (FX) markets.
Observers usually believe that these portfolio swings would have a favorable effect on equity markets, emerging economies and all high-risk securities markets. The simple comparison of historical returns of several types of securities shows that nations that have been accumulating foreign exchange reserves would benefit from diversifying their investments, though in reality the

appraisal of investment decision also requires to consider individual assets' associated risks.

In order to precisely estimate the impact on these assets' prices one would need to consider among other things interest rates' changes. It has been shown on many occasions that a high demand for US treasuries increases their prices and lowers their yields. For example, the Federal Reserve asserts that if foreign demand for US long-term treasuries were to increase by one percent, long-tem interest rates would decrease by 43 basis points. Consequently, with SWFs investing less in government treasuries and more in risky securities government-bond yields would be driven up.

A general shift from fixed income to equity products could, ceteris paribus, back the Japanese Yen, assuming that SWFs invest in equities in line with Japan's stake in the world stock market capitalization (close to 10 percent), whereas less than 3.2 percent of the world's foreign exchange reserves are held in Yen. On the other hand, if we apply the same logic to the US dollar and the Euro we would conclude on a depreciation of these two currencies.

On the whole, the increasing demand by SWFs for financial products should have a positive effect on the global economy. SWFs usually have the following characteristics: high foreign currency exposure, low leverage, no direct obligations, and no funding liquidity pressures. Consequently, they can more than other sizeable participant in the financial markets take long-term positions i.e. adopt buy-and-hold strategies. Similar to other long-term investors, SWFs are keen to intervene as contrarians whenever there is a decline in asset value and can hence accommodate temporary volatility in asset returns and lower liquidity risk premium. Also, being very lightly leveraged on average, SWFs cannot be forced to promptly liquidate their positions if things go wrong, thus they could not be from this point of view an additional source of volatility to financial markets. For all these reasons, SWFs can have a soothing impact on global capital markets and contribute to the growth of emerging ones.

2.7.1.3 Greater global capital mobility

As some argue that protectionist measures would hold back international capital flow, we are among the believers that these measures will be overtaken by an increased emergency for opening up even more so markets (especially in developing countries) to capital entry, and appreciating (under increased pressure) any currency seen as undervalued. By doing so, countries will be encouraging the development of increasingly complex financial products as those operating SWFs will be attempting to purchase these securities in the objective of shielding their national economies from currency appreciation and a vanishing influence of central banks in determining exchange rates.

2.7.1.4 SWFs as Saviors of US Banks -and by extension of the financial system- in the Subprime Crisis

The current financial crisis has underlined the potential benefits of SWFs as a stabilizing force. Indeed, while the heavy accumulation of international reserves by emerging nations has stirred global imbalances, SWFs have played a major role in shaking / steadying financial markets. Problems in credit markets since mid-2007 have squeezed liquidity in several key financial markets and increased pressure on the capital base of financial institutions. SWFs helped afloat many (even most) of the world's largest financial institutions as these incurred enormous losses following the sub-prime crisis. Banks' enormous losses could have possibly caused their individual bankruptcies as well as the failure of the entire system. With no exception, acquisition of stakes by SWFs – usually made known on the same day as massive write-downs – helped tone down anxieties about banks' solvency and curb the unstoppable decline in their share prices. In this way and without any precedent SWFs became the first and last resort capital supplier. This is why their interventions have been described using the term "bail out", however accurate that might be.

Between mid and end of 2007, close to $46 billion were injected by SWFs in Western financial institutions. In June 2008, this number reached $55 billion. These investments were highly welcomed by the recipient companies and countries as they represented minority stakes and occurred in a context of a strong need for capital injections.

Table 5: Recent investments in major financial institutions by SWFs

Investor	Target	Date	Deal type	Size
ADIA	Citigroup	27-Nov-07	Convertible	7.5
CIC	Morgan Stanley	19-Dec-07	Convertible	5.0
	UBS	10-Dec-07	Convertible	9.7
GIC	Citigroup	15-Jan-08	Convertible	6.8
	Citigroup	15-Jan-08	Convertible	3.0
KIA	Merrill Lynch	15-Jan-08	Convertible	2.0
KIC	Merrill Lynch	15-Jan-08	Convertible	2.0
QIA	Credit Suisse	22-Feb-08	Common	0.5
Temasek	Merrill Lynch	24-Dec-07	Common	4.4
	Merrill Lynch	24-Dec-07	Option	0.6
Unknown ME SWF	UBS	10-Dec-07	Convertible	1.8
Total				**43.3**

Source: J.P. Morgan, as of May 2008.

2.7.2 Distortions and Pitfalls on Global Financial Markets

There have been growing concerns that the size of SWFs' portfolios may ultimately destabilize the global financial system.

2.7.2.1 A Pro-cyclical market impact

Large SWFs can have a pro-cyclical impact on markets, i.e. their investments can come to buttress certain movements and trends that are coming into place. In fact, experts have analyzed the projected impact of two phenomenons:

- The foreign exchanges (FX) reserves' shift away from the US dollar

- And SWFs increased interest in minor but rapidly growing emerging economies.

They have concluded that the impact of such movements is considerable because they add-up to the US dollar frailty and to the emerging market equity growth.

Moreover, as the funds grow into larger ones they seem to move more aggressively across the risk spectrum. Being more risk inclined, they devote more of their funds to alternative assets such as hedge funds and private equity and increase their interests in emerging countries. Of course, with riskier investment policy comes a higher tendency to moral hazard, particularly if SWFs seek political on top of their financial goals. Also, this enhanced interest in emerging countries coincides with an apparent shift in international foreign exchange reserves away from the US treasuries. Even though the majority of international foreign exchange reserves are in USD, its share is slowly declining. Indeed, The US dollar’s share of known official currency reserves fell to 63.9 percent at the end of 2007, down from 72.7 percent in 2001 (Jen, 2008). It is certainly not in Asian nations' interest to aggressively trade their dollars for other currencies as of today. Still, that slow diversification is already on its way, as Asian monetary authorities place a lower portion of their reserves in US dollars. Certainly, should they aggressively sell their dollars then the effect on markets would be considerable. For example, should Asian central banks decide to switch reserves to be compatible with their trading activities, they would have to divest $1.39 trillion, i.e. the quarter of global aggregate reserves. Also, as Morgan Stanley’s Global Head of Currency Research, Stephen Jen has argued: SWFs’ shift out of US dollar accounts for a non negligible portion of the structural drop in the US dollar in the past three to four years.

2.7.2.2 The Case of the Chinese Reserves

One can recall here the case of China who created its SWF "CIC" partly to compensate for the decline in book value of its official reserves due to the US dollar's devaluation against the Chinese Yuan. Between the mid-2005 de-pegging and May 2008, the US dollar had dropped 18 percent to the Yuan. China has around 70 percent of its currency reserves in US treasuries. In March 2008, Chinese holdings represented 19.5 percent of total US Treasury assets, right behind Japan, which had a 23.8 percent.
If China, via CIC, starts to reduce its exposure to US treasuries in favor of more profitable instruments, the reversal would provide liquidity to equity markets. The substitution effect induced would play against prices of US T-bills.
In this way, CIC' intervention on the capital markets may be of pro-cyclical nature, i.e. it would reinforce happening trends on the market like the ongoing -slow but sure- diversification of monetary authorities away from the US dollar. Some believe, like certain Chinese officials have said, that China has the power, by liquidating its positions in US dollar, to cause an enormous depreciation of the currency causing a collapse in financial markets. This threat has intensified the fear of pro-cyclical effects of SWFs' on markets and currencies.

2.7.2.3 Risks on Immature markets

Another source of apprehension is the possible unfavorable effects that SWFs investments could have on the smaller, less mature and less liquid markets. These disturbances could affect such areas as parts of Asia, Africa and Latin America. Here, the impact of foreign state funds could be enormous. Leveraging on their sheer size, SWFs could move these undeveloped markets in the direction that serves their interests. The already mentioned case of Asian central banks' USD holdings and the potential impact of a massive sell-off is one example. Not only will US economy be shaken by the sudden decline in Treasury yields, many emerging economies holding large amounts of USD denominated government bonds or "dollarized economies" would incur huge losses.

On the medium to long run, emerging countries may however see an inflow of capital both on the equity and the debt level as SWFs show increased interest in these markets. Emerging government bonds and corporate equities could benefit as they are both seen by international investors as “risky” assets with high yields.

2.7.2.4 Greater equity purchases in mature markets

But consequences would not be confined to emerging markets; they could very well diffuse to long-established ones. The aspiration to drive up yields could translate into larger investments by SWFs in equity assets, which brings up the question of how they will react as shareholders when unfriendly tender offers take place. Would any Western country want to have a fund controlled by say, the Russian administration, deciding on the outcome of a hostile banking takeover? Also, all equity investments undertaken by SWFs can be seen as a reversal of recent trends of privatization as governments enter to the capital of private corporations. Several reservations regarding corporate governance, possible bureaucracy and conflicts of interest can therefore be made. Of course, the only safety measures to prevent this evolution are regulation (applicable to all investors) and other stakeholders intervention, still the risk exists and with it a mounting anxiety.

Also, the asymmetry between the low transparency of some SWFs and the total openness of the corporations they usually invest in could engender further instability -and thus volatility- whenever markets react to headlines of sovereign investments.

Ultimately, this shift out of less and into more risk-associated assets substitutes corporate equities to governmental debt (especially USD denominated one) thus disadvantaging the latter by reducing the demand for it (and for the US dollar).

2.7.2.5 Risks for financial stability

SWFs have become a significant player in financial market. However, the source of anxiety is their unregulated form and their relative secrecy; as it is usually difficult to grasp the difference between SWFs' assets and central bank exchange reserves. For example, there is usually little or no evidence on the existence of a national guidance that would preclude the SWF portfolio to be promptly accessible to the central bank. Thus, for a commodity fund, it not always straightforward to find out which institution's books (the SWF or the central bank) contains the fund's investment portfolio.

A fund could very well benefit from this opaqueness to quickly adjust its governance organization (in case of losses) and investment schemes thus instigating a period of high volatility for certain types of securities.

With the ever increasing size of SWFs any, even partial, readjustment to their portfolio can be welded with volatility spikes on small and illiquid markets, like emerging ones or certain underdeveloped parts of the more mature ones (P.E., real estate.)

Also, in the current framework of decreasing interest rates, SWFs could search for new sources of revenue generation. They could for instance increase their exposure to alternative investments (like hedge funds, real estate, commodities, derivatives etc.). This portfolio reallocation would affect various (if not all) asset classes. Indeed, if SWFs were to overweight hedge funds in their portfolios, all securities targeted by hedge funds would be affected (EM bonds, commodities, junk bonds etc.) Existing studies while incomplete and mostly qualitative support that many SWFs have already begun their asset reallocation in favor of alternatives.

3 Implications, Conclusions, and Questions

Sovereign funds are not likely to vanish from one day to the other. They're based on current account surpluses and will become less salient only if the nations with large surpluses begin to run long-term current trade deficits.

Major countries have committed to decreasing their trade imbalances, and this would curb the growth of SWFs. But the world economy evolves constantly in ways that makes it difficult to ensure that current account imbalances will shrink. For example, global growth may speed up or slow down, and this will definitely impact commodity prices. But should commodity prices remain high, commodity exporters will have large surpluses for at least the near future. Should commodity prices drop, the surpluses of Asian countries that export manufactured products may increase.

From an economic perspective, the funds built up by nonrenewable resources exporters in preparation of bad days may look more legitimate than those recently built up out of excess foreign reserves accruing through global financial imbalances. Indeed, the former reveal genuine wealth stemming from an enduring shock on commodity prices while the latter mainly take advantage of foreign exchange undervaluation.

How to estimate the future of SWFs? It is difficult to say, these estimates vary quite a lot. The IMF claims that SWFs could reach the $10 trillion level by 2012 *"based on the likely trajectory of current accounts".* Morgan Stanley predicts that they could be worth $12 trillion by 2015, and SWFs will exceed global official foreign exchange reserves by the end of 2011. The IFSL predicts SWFs will be valued at $5 trillion in 2010 then exceed $10 trillion in 2015.

All these estimates depend on a number of variables. In order to be the most comprehensive, a bottom-up forward projection of SWFs size should be built on scenarios around the following factors:

- Oil price
- FX policy of surplus countries

- Current account dynamics in the US and its main trade partners in Asia
- Allocation of new reserves or other surpluses to SWFs
- Establishment of new SWFs
- Rate of return

The current global financial turmoil reflects the usefulness of the self insurance services made available by having international reserves. It also underlines the convenience of policies that direct a portion of any extra profit arising from an improvement of terms of trade to SWFs (e.g., see the experience of Chile in recent years). Truth be told that the latest and ongoing decline in world commodity prices and equity markets have worn off the former appeal of SWFs. However, should economic growth pick up, their attractiveness could be revived. Yet this remains conditioned by the volatility path. Should it linger at its high levels of today, monetary authorities could find themselves placing more importance on investing their reserves in short-term, liquid assets in order to minimize the expected losses of a financial downturn, thus moving away from sovereign investments abroad.

In sum, Sovereign Wealth funds are major state-owned players of the 21st century. Much has been written about the seismic shift in the balance of wealth and power from the US and Europe into the hands of emerging countries such as China, India and Russia. But as the US slides into recession, and European economies continue to stumble from subprime chaos, another emerging bloc is on the verge of achieving great-power status.

SWFs are more powerful today than ever before, and if some of their investments carried out during the last two years may seem loss-making on the short term the result could be much different on the long run. From this perspective, one sees the necessity of developing an international code of conduct for SWFs. Indeed, while they are getting larger and more influential they also are getting more opaque and controversial.

It is true that to a large extent, SWFs are their own worst enemy. Their air of secrecy has, in recent years, led to some concern. Even if SWFs can make a

case that there are other participants in global markets who are equally secretive, it is the suspicion about their intentions that makes this a more problematic area. This need not be the case, some SWFs are very open - Norway is a prime example of a fully transparent fund. Another concern relates to empirical evidence that has shown inefficiencies linked with government ownership such as bureaucracy, corruption, fraud, favoritism and slow decision-making. Thus, a concern is that SWFs may reduce economic efficiency in recipient nations by reducing the efficiency of target firms.

At the same time, one needs to remember that over the ongoing financial crisis had SWFs not invested in other financial institutions, the credit crisis from which we may be emerging might have been much more pronounced. So perhaps the SWFs are enhancing national security by taking their "currency reserves" received on the international markets and reinvesting them back into the global economy.

Thus, with their benefits and potential harms on the financial system, SWFs have to be regulated. A code of conduct should be developed; it would be in the mutual interests of both capital exporting and capital importing countries. It could set, define and control SWFs' activities and prevent any undesirable intrusion in sensitive sectors. However, protecting national security from SWFs' predatory actions must be done in a way that preserves open markets and avoids protectionist retorts. SWFs, should become familiar with this sharp scrutiny of their activities and understand that an increased transparency should calm down most of the concerns currently being raised.

How to approach this sensitive subject? In practice, a coordinated approach at the OECD or the international level towards greater transparency and accountability will be a difficult undertaking and deserves considerably greater support. At the national level, the debate reveals a wide array of views in the political spectrum and is often distinguished by diffuse concerns over the latent impact of SWFs. A more appreciative approach to the potential benefits of SWFs investments in companies in need of capital, as well as a clear-headed appraisal of the potential risks involved is needed.

APPENDICES:

I. List of the Main SWFs across the World

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