



# Economic Premise

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## Sovereign Wealth Funds in the Next Decade

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*A prolonged and multispeed recovery period, its associated policy response, and the new global financial landscape might have important bearing on the size and allocation of sovereign wealth funds (SWFs) assets. SWFs could become a driving force in South-South flows, boosting global wealth by helping recycle large savings in surplus countries toward more productive investments. Whereas they indeed represent a new opportunity for developing countries, they also carry challenges for both home and host countries.*

In recent months, data across the globe indicate that the global recovery is under way. However, many analysts anticipate that the recovery will be particularly uneven: strong growth will resume in developing countries, with emerging Asian economies leading the way out of global recession; and developed countries will continue to struggle with a fragile situation and no appetite by the central banks to raise rates in the near future.

Interest rate differentials can only be expected to widen—creating carry trade opportunities that produce a resurgence of unsustainable capital flows to developing countries, exacerbate exchange rate pressure and sterilization policies, and intensify global imbalances and reserve accumulations. This macroeconomic and financial landscape is set to create mounting incentives for emerging markets' central banks to allocate even more foreign reserves into SWFs to release the pressure on money supply; reduce the cost of sterilization; and use reserves in excess of prudential levels more productively, away from low-yield, dollar-denominated securities.

### SWFs Assets and Portfolio

Pre-crisis estimates of SWFs assets were in the range of \$13.4–17.5 trillion by 2017.<sup>1</sup> If the foreign assets under SWF management were to be invested under the reasonable assumption of a mix between the portfolio allocations of Singapore and Norway,<sup>2</sup> at least \$2.7–5.0 trillion of total assets theoretically could be invested in developing countries by 2017 (equally split between equities and bonds). Excluding the regions where these funds originate (that is, Asia and the Middle East), these assets could represent 8–16 percent of the combined GDP in developing countries in Latin America, Africa, and Eastern Europe; 1–2 percent of their market capitalization of traded companies; and 10–19 percent of the total debt securities in these regions.

However, no one knows with certainty the pace of reserves accumulation and the size of SWF increases at the margin. On one hand, external imbalances are expected (hoped) to somehow diminish in the medium term because

surplus countries may be under pressure to increase internal demand. On the other hand, the crisis and its associated policy response actions to support the global economy might create mounting incentives for central banks to allocate even more foreign reserves into SWFs, and for the SWFs to seek higher alpha and lower beta.

Quite naturally, where SWFs invest is also going to be governed by a number of considerations. Although developed countries, and the United States in particular, have been the main recipients of SWFs' investments to date, a shift in attention toward developing countries' securities is likely to increase because of the economic prospects of developed countries in the medium and long terms. Despite differences in investment strategies and appetite for risk and liquidity—reflecting different objectives, liabilities structure, and so forth—the desire to diversify their portfolios in the hope of maximizing returns for acceptable levels of risk is a common feature of all SWFs and will support such a shift (albeit gradually).<sup>3</sup>

In addition to maximizing portfolio performance, portfolio allocations may also have strategic considerations, like future access to commodities.<sup>4</sup> Before the crisis, for instance, East Asia accounted for more than a quarter of global demand for commodities and a significant portion of demand for agricultural commodities (Lyons 2007). Gaining access to strategic commodities and resources will require not only contracts, but also mergers and acquisitions. In this regard, it has been reported that a number of Chinese companies already have been securing strategic assets in energy and raw material supplies in Africa and Latin America, with the backing of China's government<sup>5</sup>—the Industrial and Commercial Bank of China's investment in Standard Chartered was seen by many market analysts as China's strategic entry point into the African continent, using the bank as the principal investment agent. In February 2010, the oil industry in India called for the government to use parts of the \$278 billion in foreign exchange reserves to create an SWF to compete with China in the race to secure global energy assets.

The current levels of the stock markets in developed countries may slow down the process of portfolio rebalancing as many investment opportunities might materialize in the European Union, Japan, and the United States.<sup>6</sup> Moreover, at a recent Official Monetary and Financial Institutions Forum, attendees also emphasized the role that SWFs could play in purchasing government bonds being issued by countries of the G-7 (projected by the International Monetary Fund to rise from precrisis levels by an average 40 percent of GDP by 2014).

A gradual shift toward developing countries' investments may be the most likely outcome. As reserves accumulate, SWFs' strategy will focus initially on a rebalancing from low-yield assets into high-yield equities. Diversification away from

the G-7 is definitely going to be more gradual and incremental. SWFs will avoid a further depreciation of U.S. dollars; and that, in turn, could generate large revaluation losses for the central banks' dollar-denominated assets as well as a slowdown in future reserves accumulation. As long as countries in which SWFs are fed by reserves' accumulation resist the appreciation of their currencies, a full diversification away from the dollar will be difficult.<sup>7</sup>

## Opportunities and Challenges for Host Countries

Over the next decade, SWFs have the potential to boost global wealth by helping recycle large savings in surplus countries toward more productive investments, particularly in the developing world. Over the medium term, many developing countries will continue to depend on external savings to finance critical investment.<sup>8</sup> On the supply side, major fiscal stimulus packages in advanced economies are likely to result in a general repricing of sovereign debt risk and the associated cost of borrowing; and in more limited access to and a crowding-out of credit for developing-country borrowers, forcing some of them into fiscal austerity if they don't find alternative resources.

In this context, SWFs could bridge the gap between the growing investment needs and the reduced supply of external resources,<sup>9</sup> thereby sustaining growth, accelerating progress toward the Millennium Development Goals, increasing economic integration, and helping build the foundations for a multipolar world. Africa, in particular, may benefit most from SWFs' resources, given its relatively weak starting point in trade, regional integration, infrastructure, and private sector development.

Although SWFs could help recycle large savings generated in surplus countries toward the developing world where capital might be socially and economically more productive, several concerns remain and the memory of the 1980s debt crisis fueled by the recycling of oil countries' savings is still vivid.

### *Debt Run-Up*

The current global savings glut may have similarities with the recycling of oil countries' savings that fueled the debt crisis in the 1980s. In the 1970s and early 1980s, these windfalls were deposited in the West's banks and eventually onlent to developing countries in Latin America and elsewhere. Today, these windfalls may take the form of SWFs directed, for example, to African countries that are becoming increasingly attractive investment destinations; are growing at the fastest rates in the past four decades; are reforming institutions and improving governance; and, most important, have had their government balance sheets virtually wiped free of

external debt as a result of the Heavily Indebted Poor Countries and Multilateral Debt Relief initiatives.

Three important considerations should be well considered. First, even though their external debt may have been slashed, many countries are burdened by domestic debt and contingent liabilities related to loss-making state-owned companies or possible banking system problems. Second, the institutional capacity of countries to select high-rate-of-return projects is often limited. Besides, the projects have to be implemented, monitored, and maintained. In other words, the paucity of investment funds may not be the binding constraint to growth and development. Third, portfolio shifts by SWFs may put some upward pressure on the prices of riskier asset classes, such as equities, and downward pressure on bonds, thus increasing yield. Again the impact on developing countries will not be negligible in terms of cost of borrowing, for instance, and of inflated equity prices.<sup>10</sup>

### **Financial Stability**

There are also concerns about the impact of SWFs' investment on the financial stability recipients, particularly those that have more shallow financial markets. Limited information about SWFs' objectives, strategies, institutional structure, and investment management may reinforce the clouds around how SWFs' behave:

- *Pro-cyclicality and herding*—SWFs are believed to be countercyclical in supporting prices and markets, as they have traditionally been on buy-and-hold strategies. However, a pro-cyclical behavior cannot be excluded. Single individual transactions undertaken by an SWF may disrupt more shallow financial markets either because the funds may mirror hedge fund strategies of portfolio rebalancing against possible losses or because perceived shifts or rumors and second-guessing about SWF investment decisions may cause volatility and herding. For instance, the Singaporean SWF Temasek Holdings' sale of shares in two big Chinese banks (Bank of China and China Construction Bank) and in Asia's largest container-shipping group Cosco created rumors about the health of the banking sector or the belief that several areas of the Chinese economy had reached their cyclical peak. That occurred despite Temasek's statements that the sale was just "part of our ongoing rebalancing of the portfolio against new opportunities" (Burton 2007).
- *Short positions*—We also cannot assume that undertaking short positions in quick win-win situations will not occur in the future, rather than waiting to step in when asset prices fall. For instance, *The Economist* (2008) mentioned that, four years ago, Norway's SWFs began to sell short the bonds of Iceland's banks when a slowdown of the economy was foreseen. There is also an-

ecdotal evidence that SWFs farm out part of their assets to highly leveraged funds. For instance, a quarter of Singapore's SWF is believed to be channeled and invested through hedge funds that use this strategy.<sup>11</sup>

### **Opportunities and Challenges for Home Countries**

The idea behind SWFs is quite simple: divert reserves in excess of those needed for short-term current and capital account requirements<sup>12</sup> or for stabilizing exchange rate movements toward long-term diversified portfolios of equities and bonds.<sup>13</sup> This is more risky than investing in U.S. Treasury bills in the short run, but is also likely to yield higher returns over the long haul. However, although the idea is appealing and some benefits are undeniable, the following challenges are worth mentioning.

#### ***Net Wealth, Repatriation of Assets, and Dutch Disease***

When a substantial amount of the reserve buildup has been the counterpart of central banks' sterilization,<sup>14</sup> SWFs' assets can be considered as a purchase with government debt. Therefore, a careful analysis of government whole balance sheet effects is necessary to assess real net wealth, which may not be as large as it first appears. The joint balance sheet of government and the central bank actually would worsen with domestic currency appreciation and high domestic interest rates.

A potential currency mismatch is of particular concern for developing countries in light of repatriation of returns on investments because a country's future needs (SWFs' liabilities) are denominated in domestic currency while SWFs' assets are denominated in foreign currencies. Real convergence and catching up in emerging markets inevitably would force domestic currencies to appreciate in real terms relative to those of developed currencies (Balassa-Samuelson effect), reducing the real (and/or nominal) value of repatriated funds. In addition, as SWFs' returns are repatriated, the influx of dollars cannot avoid the need for an adjustment when dollars are spent putting additional upward pressure on their currencies and undermining the competitiveness of the traded goods sectors.<sup>15</sup>

In the long run, it seems that some form of Dutch disease is unavoidable for oil-exporting countries whose intention in setting up SWFs is to avoid real exchange rate appreciation.

#### ***Opportunity Costs***

The issue of investable surplus and real net wealth hints that there are opportunity costs attached to the alternative uses of SWFs' assets. The opportunity costs arise from the fact that in countries with underdeveloped social and economic infrastructure, social and economic return on investment at

home may exceed the return on investing foreign reserves abroad, regardless of the nature of that investment and intergenerational preference of the government.<sup>16</sup>

Since 2003, China has used foreign exchange reserves to support domestic policies with Central Huijin Investment Company to absorb Central Huijin Investment Company and to recapitalize the Agricultural Bank of China and the China Development Bank, including dealing with bad loans. Russia has taken advantage of the recent run-up in oil prices to pay down its external debt, and some other governments (such as Brazil) have considered the possibility of using a share of their international reserves in a fund geared toward the promotion of industrial policy.

For commodity SWFs, the issue of investing foreign reserves domestically is also a fiscal policy issue because foreign currency accrues directly to the government and is not converted into domestic currency unless it is spent by the government.

## Notes

1. Projections by Morgan Stanley, Standard Chartered, Merrill Lynch, and the International Monetary Fund estimated that foreign assets under the management of SWFs could reach US\$12 trillion by 2012.

2. We assume that SWFs could invest 20–30 percent of their assets in developing countries, with 45 percent allocated into equities; 45 percent into bonds; and 10 percent into private equity, real estate, and commodities.

3. In September 2009, the move by China Investment Corporation (CIC) to take a \$1 billion minority stake in the Hong Kong, China-based Noble Group, a commodities trading/supply chain manager, was a step in this direction. J.P. Morgan calculates that other deals worth \$50 billion of investments are likely to materialize between the CIC and companies in developing countries.

4. Despite its early, visible stakes in Blackstone, Morgan Stanley, and other financial institutions in the United States, the CIC has also focused in other areas—namely, natural resources (Wei 2007).

5. In addition to \$1.6 billion of acquired assets at the end of 2005, an additional \$2.3 billion has been invested by China National Offshore Oil Corporation in Nigerian oil and gas exploration (Trinh 2006; Broadman 2007). China Development Bank also has launched a \$5.0 billion China-Africa Development Fund to finance Chinese companies' investment in Africa, following up what was agreed at the Beijing Summit of the Forum on China-Africa Cooperation. According to China's Xinhua News Agency, Chinese and African companies and governments at that summit signed 14 agreements worth \$1.9 billion for projects in infrastructure, telecommunications, and other fields. A deal to build an \$8.3

billion railway in oil-rich Nigeria was announced, as were joint China-Africa plans to explore energy development.

6. An example is Abu Dhabi's decision to buy 9.1 percent of Daimler through Aabar Investments in March 2009.

7. At the consolidated level (including central banks' purchases), there is already some evidence of portfolio rebalancing. The recent announcement about the sale of Chinese holdings of U.S. Treasury debt in December 2009—ceding its place as the world's biggest foreign holder of U.S. debt to Japan—provides clues about China's appetite for loaning money to the United States. China pared its Treasury holdings by \$34.0 billion, to \$755.4 billion. Japan's holdings total \$768.8 billion, according to U.S. Treasury estimates.

8. Excluding China and major oil exporters, developing countries are (on average) net importers of capital; this makes them dependent on external financing for critical investment.

9. Global Economic Prospects estimates that most of the 53 developing countries that faced an external financing gap in 2009 had current account deficits of 5 percent or more, with private-sourced net-debt inflows financing equivalent to about 2.2 percent of GDP (0.8 percent if Central Asia and Europe are excluded).

10. Warnock and Warnock (2005) underscore that total foreign buying (private and official) of U.S. bonds in the years leading up to 2005 kept the 10-year Treasury yield 150 basis points lower than it would have been without foreign inflows. The same study estimates that without foreign official buying, long-term rates would have been 60 basis points higher. Miles and Jen (2007) estimate that, all other things being equal, the emergence of SWFs could push up "safe" bond yields over the next 10 years by 30–40 basis points and could reduce the equity risk premium by 80–110 basis points.

11. Jen (2008) estimates that SWFs may outpace 20 percent or more of assets with external investors.

12. This means six months of imports or equal the amount of short-term external debt (Guidotti-Greenspan rule).

13. In line with long-standing tradition, reserves are invested in safe but low-yield U.S. Treasury bills; when converted into local currency terms, the return could be close to zero or negative because of the depreciation of the dollar. This might be aggravated by sterilization policies intended to maintain price and exchange rate stability. The Bank for International Settlements has estimated costs of sterilization to be roughly 0.5–2.0 percent of GDP for 14 emerging markets. Similarly, Summers (2006) suggests that central banks' portfolios have earned around 1 percent real returns annually over the past 60 years, in comparison with about 6 percent for a portfolio diversified in stocks and bonds. With foreign exchange reserves at 50 percent of GDP, in a country

like China, a difference of 500 basis points on the returns to reserves amounts to 2.5 percent of GDP a year.

14. An analysis conducted by the Bank for International Settlements suggests that, during the period from January 2000 to May 2006, sterilization might have offset as much as 85-95 percent of changes in net foreign assets in India, Korea, Malaysia, Singapore and Taiwan (China), and over 70 percent and 60 percent, respectively, in the case of China and Russia.

15. Real appreciation in the case of an exchange rate peg; nominal appreciation in the case of floating or renouncing of a peg. Bourdet and Falck (2006) studied the effect of Cape Verde remittances on the traded goods sector. As local incomes have risen with a doubling of remittances from abroad, the Cape Verde real exchange rate appreciated 14 percent during the 1990s. The export sector of the Cape Verde economy suffered a similar fall in productivity during the same period—a fall caused entirely by capital flows.

16. Recently, several authors have attempted to measure the opportunity cost of reserves accumulations. For instance, Rodrik (2006) shows that there is a “social cost” to reserves accumulation to the extent that the private sector borrows at a higher rate than what the central bank earns on its foreign currency assets. Similarly, Summers (2006) suggests higher costs based on the forgone return on infrastructure projects.

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