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Theme 197
SOVEREIGN WEALTH FUND

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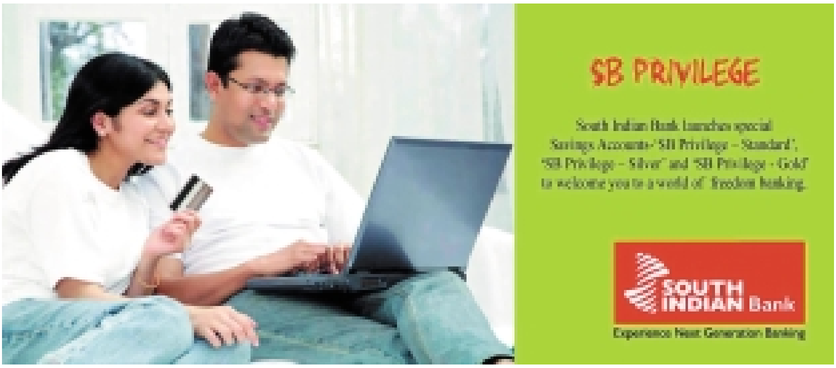

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SIB STUDENTS' ECONOMIC FORUM

APRIL 2008

Theme No. 197 : SOVEREIGN WEALTH FUND

A **Sovereign wealth fund (SWF)** is a state-owned fund composed of financial assets such as stocks, bonds, property or other financial instruments. Sovereign wealth funds have gained world-wide exposure by investing in several Wall Street financial firms including Citigroup, Morgan Stanley, and Merrill Lynch. These firms needed a cash infusion due to losses resulting from the credit crunch.

Some sovereign wealth funds are held solely by central banks, who accumulate the funds in the course of their fiscal management of a nation's banking system. This type of funds are usually of major economic and fiscal importance. Other sovereign wealth funds are simply the state savings which are invested by various entities for the purposes of investment return, and which may not have significant role in fiscal management.

What is the nature and purpose of sovereign wealth funds?

SWF's are typically created when governments have budgetary surpluses and have little or no international debt. This excess liquidity is not always possible or desirable to hold as money or to channel it into consumption immediately. This is especially the case when a nation depends on raw material exports like oil, copper or diamonds. To reduce the volatility of government revenues, counter the boom-bust cycles' adverse effect on government spending and the national economy or build up savings for future generations, SWFs may be created. One example of such a fund is The Government Pension Fund of Norway.

Why Sovereign Wealth funds are attracting close attention now?

Assets under management of SWFs increased 18% in 2007 to reach $3 trillion. Most of this growth stemmed from an increase in official foreign exchange reserves in some Asian countries and rising revenue from oil exports. There was also an additional $6.1 trillion held in other sovereign investment vehicles, such as pension reserve funds, development funds and state-owned corporations and $5.3 trillion in official foreign exchange reserves not held in other sovereign investment vehicles.

As this asset pool continues to expand in size, its potential impact on various asset markets increases. Some critics worry that foreign investment by SWF's raises national security concerns because the purpose of the investment might be to secure control of strategically important industries for political rather than financial gain. The traditional investment vehicles for sovereign wealth in the form of foreign currency reserves have been the debt instruments such as government bonds from the industrialized nations.

The low returns on these investments, however, have prompted nations with excess foreign reserves to invest in equities to achieve a higher return. The expanded activities of the SWFs over the past several years as well as the increased amounts available to the funds have created concern that the SWFs can destabilize financial markets and the global economy if their investments are motivated by political rather than economic considerations.

What is the history of Sovereign Wealth funds?
Sovereign Wealth Funds have been around for decades but since 2000, the number of Sovereign Wealth Funds have increased dramatically. The first SWF was the Kuwait Investment Authority, a commodity SWF created in 1953 from oil revenues before Kuwait even gained independence from Great Britain. Sovereign wealth fund as a term has been around at least since 2005. List of largest sovereign wealth funds are given in the inside cover page.

Currently more than 20 countries have these funds, and half a dozen more have expressed an interest in establishing one. Still, the holdings remain quite concentrated, with the top five funds accounting for about 70 percent of total assets. Over half of these assets are in the hands of countries that export significant amounts of oil and gas. About one-third of total assets are held by Asian and Pacific countries, including Australia, China, and Singapore.

Is assets under management of SWF's very huge in size and potential?
Assets under management of SWF's is estimated at $3 trillion by the end of 2007. Whether it is a huge amount or not depends on a comparison. U.S. GDP is $12 trillion, the total value of traded securities (debt and equity) denominated in U.S. Dollars is estimated to be more than $50 trillion, and the global value of traded securities is about $165 trillion. In that context, $3 trillion is significant but not huge.

It is, however, large relative to the size of some emerging markets. The total value of traded securities in Africa, the Middle East, and emerging Europe combined is about 4 trillion; this is also roughly the size of these markets in all of Latin America. And total assets under management by private hedge funds-a broad category of private investment funds that seek high returns and, as a consequence, often take on considerable risks-are estimated to be around $2 trillion. So, perhaps not surprisingly, a debate about the potential risks and opportunities of sovereign wealth funds, similar to the ongoing debate about hedge funds, is now developing.

What are the investment strategies of SWF's?

There is a lot we don't know about sovereign funds. Very few of them publish information about their assets, liabilities, or investment strategies. It's thought that they've traditionally been "long only": that is, they pursue buy-and-hold strategies, with no short positions and perhaps no borrowing or direct lending of any kind. They probably have long horizons and, like other long-term investors, are willing to step in when asset prices fall. This likely exerts a stabilizing influence on the world's financial system. But there is also anecdotal evidence that some sovereign funds have placed investments with other leveraged funds.

What are the advantages and disadvantages of SWF's?

For those countries who promote SWF, it is a valuable tool for achieving certain public policy and macroeconomic goals. The movement of capital around the world with unregulated ease can contribute to rapid productivity growth and a global boom.

But there are always some national security limitations on what foreigners can own. Recent developments in the world suggest there may be a perception that certain foreign governments should not be allowed to own what are regarded as an economy's "commanding heights". This may encourage capital account protectionism, through which countries pick and choose who can invest in what. Its time to begin a constructive discussion on the salient issues of SWF. It must be determined what information countries are willing to share and what information can be used in global economic and financial analysis.

What is the likely future of sovereign Wealth Funds?

Sovereign funds are not likely to go away. They are based on current account surpluses and will become less important only if the countries with large surpluses begin to run prolonged current account deficits. Major countries have committed to reducing their current account imbalances, and this would limit the growth of sovereign funds. But the world economy evolves continuously in ways that make it hard to be sure whether current account imbalances will shrink. For example, global growth may accelerate or decelerate, and this is likely to affect commodity prices. But if commodity prices remain high, commodity exporters will have large surpluses for the foreseeable future. If commodity prices fall, the surpluses of Asian counties that export manufactured goods may increase. At their current levels of $3 trillion, SWF's are not a pressing issue. But, as the level creeps closer to $10 trillion, the phenomenon will attract greater attention.

Is there a strong reason for India to set up a SWF?

India's foreign exchange reserves stood at $.313 billion on April 25, the third largest holding in Asia. There were reports that the government of India is considering a SWF with an initial corpus of $5 billion. But the Government is yet to take a final decision on the use of India's forex reserves for setting up a SWF. RBI Governor Dr.Y.V. Reddy has observed recently that the Indian economy has a current account deficit as also a fiscal deficit. India does not have any dominant "exportable" natural resources output, which might promise significant revenue gains. India also has a negative international investment position (IIP) with liabilities far exceeding assets. But most countries that had set up SWF's had built reserves through current account surpluses or revenue gains from commodity exports. India's large reserves reflected an inability of the economy to fully absorb capital flows.

Gold Sovereign Wealth Funds

Estimated Assets

March 2007, $bn

Country	Fund	Assets, $bn	Inception year
UAE	ADIA	875	1976
Singapore	GIC	330	1981
Saudi Arabia	Saudi Arabian funds of various types	300	na
Norway	Government Pension Fund - Global	300	1996
China	State Foreign Exchange Investment Corp. + Central Huijin*	300	2007
Singapore	Temasek Holdings	100	1974
Kuwait	Kuwait Investment Authority	70	1953
Australia	Australian Future Fund	40	2004
US (Alaska)	Permanent Fund Corporation	35	1976
Russia	Stabilisation Fund	32	2003
Brunei	Brunei Investment Agency	30	1983
South Korea	Korea Investment Corporation	20	2006

Source: Morgan Stanley

*Not yet finalised

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur, Kerala 680 001 or by E.mail: ho2099@sib.co.in