Economics of Sovereign Wealth Funds
Issues for Policymakers

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Foreword

This volume is focused on the economics of sovereign wealth funds (SWFs). It is intended to increase the understanding of SWFs and to help guide informed discussions about them. The book features contributions by leading experts and reflects the IMF’s ongoing commitment to these important participants in the international monetary and financial system.

The global financial crisis that erupted in 2007 replaced SWFs as the center of financial policy debates. Previously, much attention had been focused on the objectives of SWFs and the potential implications of their investment decisions. Interest in SWFs likely will increase again in the coming quarters—many of the factors that boosted their importance will persist, especially the large foreign exchange earnings of commodity producers. Moreover, international capital flows are expanding again as the financial crisis recedes and the global economy mends. Proposals now under consideration for avoiding future crises likely will affect SWFs, either directly or indirectly.

The recent crisis created many serious challenges, but it also provided important lessons about the need for stronger risk management, greater transparency, and stronger supervision of all financial institutions. With regard to SWFs specifically, a few issues are particularly relevant. Recent events underscored that SWFs work best when they are integrated into their sponsoring government’s overall policy framework. In this context, it is important that adequate information is provided to stakeholders and that SWF operations are reflected in national accounts. The funding and withdrawal rules for SWFs should be consistent with their objectives, underpinned by well-framed corporate governance arrangements.

In general, sponsoring governments set SWFs’ objectives and governance structures, including well-defined accountability frameworks. These measures are intended to create clear roles and responsibilities for, and interrelationships between, the different entities involved in SWF administration and management. An important element in determining an SWF’s effectiveness is its operational independence in making investment decisions. Thus, SWFs need investment management that is consistent with their policy objectives and that covers their asset choices as well as their risk-management practices.

These key considerations are reflected in the Santiago Principles that were agreed to by the SWFs in 2008, following extensive consultations. The principles have contributed to greater understanding of SWFs and have enhanced their overall credibility. Implementation of the principles continues to advance. For example, more SWFs are publishing annual reports. Moreover, SWFs have established an International Forum to share views on the application of the principles, among other things. Ongoing implementation of the Santiago Principles underscores the positive impact that SWFs can make to global prosperity and stability.
I would like to extend my thanks to all those responsible for the volume’s creation, and to my colleagues, and I hope that this volume provides a valuable resource to everyone interested in the role and operation of SWFs.

John Lipsky
First Deputy Managing Director
International Monetary Fund
This book is the culmination of the efforts of many policy makers, asset managers, financial market analysts, academics, and IMF staff. It also reflects the work and efforts of sovereign wealth funds (SWFs). Their coming together has been instrumental in improving the understanding of SWFs and their activities, and in helping strengthen international cooperation. We would like to thank Joanne Blake and Michael Harrup of the IMF’s External Relations Department for coordinating the production of the book. A special word of thanks goes to Sherrie Brown who as our copyeditor provided many excellent suggestions for improving the style and content of the chapters.

This book would not have been possible without the support and encouragement of Masood Ahmed, director of the Middle East and Central Asia Department, and José Viñals, financial counsellor and director of the Monetary and Capital Markets Department of the IMF. We would like to pay a special tribute to Jaime Caruana, the former director of the Monetary and Capital Markets Department, and now the general manager of the Bank for International Settlements, who contributed in several different ways in bringing together the SWFs and in ensuring the successful completion of the Santiago Principles. Last, but not least, we would like to thank a large number of colleagues at the IMF and at the International Forum of SWFs for their support.

Udaibir S. Das, Adnan Mazarei, and Han van der Hoorn
Introduction

This book is about understanding sovereign wealth funds (SWFs) from an economic policy perspective and how they fit into the changing global financial landscape. It aims to contribute toward allaying concerns about the economic and financial roles SWFs fulfill in their home countries and in the countries in which they invest.

SWFs have existed for many decades. Yet, for a long time, they remained largely unknown to the public and out of the policy limelight. This relative obscurity changed abruptly in 2006 with the controversy surrounding the attempted purchase by Dubai Ports World of port management operations at six major U.S. seaport terminals. The proposed takeover fueled national security concerns in the United States that quickly led to a wider debate about the roles, rights, and responsibilities of sovereign investors. At the same time, several sovereigns had begun accumulating foreign currency and fiscal surpluses and deploying them actively in foreign financial assets. Suddenly, the sovereigns had emerged as a major class of cross-border institutional investors. These developments attracted considerable policy and commercial interest. They also generated controversies that became so widespread and politically intense that in October 2007 the international community asked the IMF and other international organizations to analyze the key issues surrounding SWFs and start a dialogue with the SWFs and countries receiving SWF investments. The key outcome of this effort was the development of the Generally Accepted Principles and Practices (Santiago Principles) by the SWFs, with support from the IMF. The aim of the process that resulted in the Santiago Principles was to identify a set of practices that would lead to greater clarity about the operations of SWFs and at the same time fortify SWFs’ operations. These steps were intended to contribute to a more stable environment for cross-border investment flows and also stave off protectionist sentiments against SWFs, a task that is now being carried forward by the International Forum of Sovereign Wealth Funds (IFSWF), established by the SWFs that developed the Santiago Principles.

The global economic and financial crisis that began in 2007 changed the character of the focus that had been put on SWFs. Thanks to their fairly stable sources of funding—oil and commodity revenues in many cases—SWFs were a welcome source of fresh capital, particularly to the financial industry, during the crisis. SWFs identified attractive long-term investment opportunities as market prices dropped dramatically. Through their actions and communications, many SWFs managed to reassure country authorities and financial markets that their investment decisions were driven by financial risk-return considerations. Additionally, since 2006 the Organisation for Economic Co-operation and Development (OECD) has hosted the Freedom of Investment process, which led to guidance for recipient countries on policies toward SWFs to minimize the risk of the return of protectionism.

With the adoption and publication of the Santiago Principles in October 2008, much more is known and understood about SWFs today than, say, five years ago. Yet, much remains to be better explained, especially from an economic and policy
angle, about how the funds are evolving as a result of both their greater experience and the important lessons learned from the recent crisis.\footnote{At its second meeting, in Sydney (May 6–8, 2010), the IFSWF acknowledged the continuing importance and value of the Santiago Principles in strengthening their operations as reliable and responsible sovereign investors. The forum also felt that a lot more work was needed on improving public understanding of the principles. The SWFs were of the view that they remain important actors in their home and host countries, and that while not escaping the effects of the 2007–09 global financial crisis, the assets under management of the forum members are expected to continue growing as the global economic recovery takes place.} Several countries are meanwhile contemplating establishing new SWFs. It is for these reasons that we decided to publish this book, in which renowned experts explain the SWF phenomenon and discuss the role of SWFs, both domestically and internationally. Some new insights are also provided on the strategic asset allocation choices pursued by the SWFs and their impact on financial markets and macroeconomic stability.

**ROLE AND MACROFINANCIAL RELEVANCE**

The book starts by describing and explaining SWFs. In Chapter 1, Klitzing, Lin, Lund, and Nordin explain why SWFs exist and what they do, and clarify some important distinctions between different types of SWFs. The chapter compares SWFs with other institutional investors, notably central banks, and argues that in many cases the focus on SWFs is too narrow, particularly when most foreign assets are held by a country's central bank and that often the central bank has an investment strategy very similar to that of an SWF.

In Chapter 2, Lu, Mulder, and Papaioannou analyze the policy and structural questions associated with the creation of SWFs. Specifically, they discuss the conditions under which it would be appropriate for countries to set up an SWF. They consider alternatives to an SWF as a mechanism for managing public savings, as well as policy options when liquidity or stabilization support is needed from an SWF in a balance of payments crisis. The chapter explains how countries have benefited from having SWFs during the global economic and financial crisis, yet are also exposed to additional risks.

In Chapter 3, Kern discusses the political responses in recipient countries to foreign state investments. He views SWFs and their investments as just one facet of a new phase of globalization, one that will be defined by the global ownership of assets and the participation of emerging markets in the global economy. A better dialogue between SWFs and recipient countries increases the chances of achieving mutually acceptable policy outcomes.

With public attention focused on recipient countries’ responses to a number of high-profile investments, it is easy to forget that the design and operations of SWFs have important domestic macroeconomic consequences. After all, SWFs manage public money that could have been spent domestically rather than invested abroad. A poorly designed SWF can be a source of instability in the home country. In Chapter 4, Shields and Villafuerte explore the ways SWFs could be structured and operated to further their governments’ broader macroeconomic objectives.
INSTITUTIONAL FACTORS

The second part of the book starts with a discussion of the Santiago Principles and the process that led to these principles by Das, Mazarei, and Stuart (Chapter 5). The chapter explains the role and mandate of the IFSWF as the successor to the International Working Group of SWFs, which formulated the Santiago Principles. A topical issue is how the principles affect the behavior of SWFs and the attitude of the recipient countries toward SWFs. The road for implementation of the principles is evolving, and there are signs that SWFs are becoming more open and responsive to public policy concerns about their activities.

In Chapter 6, Bossu, Ezejiofor, Laryea, and Liu address the domestic and international law approaches to capital account liberalization relevant to SWF activities, and consider the mandate of the IMF in these areas under its Articles of Agreement. They view the Santiago Principles as a “soft law” technique that complements (or obviates) “hard law” regulation of capital flows.

Chapter 7, by Heath and Galicia-Escotto, sets out the coherent reporting framework and multilateral surveys set up by the international community to support a stable global financial system and the free flow of capital and investment. Information on data reporting by SWFs is also provided in this chapter.

Some observers have suggested that SWFs could partly allay the concerns about possible political motivations behind their activities by investing through fund managers located in the recipient countries. De Palma, Leruth, and Mazarei, in Chapter 8, examine the usefulness of this proposal by using agency theory. Their results show that, under reasonable assumptions, the use of fund managers may not necessarily address these concerns. This result could, unfortunately, induce recipient countries to address their concerns through more direct and excessive regulation, which could add to the protectionist trends seen in many countries. Therefore, to avoid protectionism, SWFs and recipient countries need to work toward greater organizational and operational transparency.

In Chapter 9, Gordon describes the OECD guidance for recipient countries toward SWFs and the follow-up on this guidance. The guidance reaffirms the relevance of long-standing OECD investment principles, but also indicates ways in which national security concerns should be handled. Of particular relevance is peer monitoring of countries’ adherence to the guidance, which the chapter covers in detail.

INVESTMENT APPROACHES AND FINANCIAL MARKETS

Knowledge of the investment strategies of SWFs is still incomplete. While some disclose full details of the composition of their portfolios—sometimes down to the individual asset level—and explain risks and returns at length, others are more reserved in disclosure. Jen, in Chapter 10, examines some of the traits of SWFs’ long-term investment strategies and how these strategies may be affected by their sources of funding. He also explains how the 2007–09 global financial crisis may lead to changes in the governance and investment strategies of both
SWFs and central banks. One possibility is that the similar investment strategies used by central banks, SWFs, and sovereign pension funds will be replaced by complementary, specialized strategies.

A similar perspective is offered by Kunzel, Lu, Petrova, and Pihlman in Chapter 11, which focuses on the investment objectives of different types of SWFs. They explain why factors such as macro-stabilization and asset-liability management considerations, as well as forthcoming adjustments to the global financial regulatory environment, may need to factor more prominently in SWFs’ investment strategies.

In Chapter 12, Darcet, du Jeu, and Coleman offer a more hands-on perspective on SWF strategic asset allocation issues, describing the steps from determination of objectives to investment decisions, while offering a long-term view of various asset classes.

The next three chapters study, from different perspectives and using different methodologies, the concern that SWFs may destabilize international capital markets. Using an event-study approach, Sun and Hesse (Chapter 13) examine financial stability issues that arise from the increased presence of SWFs in global financial markets by assessing whether and how stock markets react to the announcements of investments and divestments in firms by SWFs. Consistent with anecdotal evidence, the results show no significant destabilizing effects of SWFs on equity markets in a variety of market segments.

In Chapter 14, Kozack, Laxton, and Srinivasan explore the implications of shifts in SWFs’ risk appetites and investment portfolios for global capital flows and asset prices, using illustrative scenario analysis and model-based simulations. The results suggest that the pattern of global capital flows could change significantly if SWFs shift away from U.S.-dollar assets, leading to higher U.S. interest rates and a more depreciated dollar. These findings are consistent with views prevailing before the crisis and may yet come to pass as the global economy gradually recovers and risk appetite returns.

In Chapter 15, Nystedt compares SWFs with other institutional and commercial investors. He notes that market concerns could arise as a result of sectoral, geographic, or asset concentration by SWFs. Although growing, SWFs as a group, as well as individually, are by no means unusual in size; hence, in his view, concerns about their investment activities are likely to remain more politically motivated than market based, reinforcing the importance of transparency.

**POSTCRISIS OUTLOOK**

The global financial crisis did not bypass SWFs. Not only did they suffer paper losses on their investments, but some SWFs had to realize those losses because their assets were needed to finance domestic support measures during the crisis. Commodity-based funds saw their revenue streams decline substantially as the prices of oil and other commodities fell. Therefore, the crisis has forced SWFs to review their strategies, models, parameter assumptions, and risk tolerance. Three chapters focus in more detail on the long-term implications of the crisis.

El-Erian (Chapter 16) discusses the opportunities and risks that SWFs face in a world changed by the global financial crisis. He argues that the postcrisis world will
be characterized by lower growth and different markets and risks—collectively coined the “new normal.” The chapter outlines the potential components of this new normal that are directly relevant to SWFs and argues that SWFs are well positioned for the new reality as a result of their long investment horizons. There is a need, however, for continuous improvements in the institutional responsiveness of SWFs with regard to their governance, investment processes, and communication.

The on-balance positive outlook is reaffirmed in Chapters 17 and 18, which concentrate more on the risks faced by SWFs. In Chapter 17, Truman argues that SWFs need to build on the successes of the Santiago Principles, both through the IFSWF and individually, and establish a basis for greater accountability of SWFs in home and host countries. Recipient countries need to resist financial protectionism. Clearly, these difficult processes require trade-offs between national interests, accountability, and transparency.

Rozanov (Chapter 18) discusses the importance of analyzing and managing SWF assets in the context of broader national assets and liabilities, and the need to recognize and mitigate the risks that come with an increased role for the state in the local economy. This involves, among other things, reassessing reserves needs, quantifying contingent liabilities, understanding the investment horizon, realigning the risk tolerance of all stakeholders, and educating politicians and the public.

The book concludes in Chapter 19 with a variety of perspectives from the SWFs. Contributors from Canada, Chile, China, New Zealand, Norway, and the Russian Federation provide insiders’ views on SWFs’ roles, objectives, responses to the crisis, and challenges for the future. Although reflecting unique national objectives and facing different issues, many aspects of their SWFs’ operations are similar, including strong support from the owners, the importance of dealing with risk from an asset-liability management perspective, taking into account the contingent liabilities of the government, and the importance of transparency.

***

We hope that this book helps improve policymakers’ and regulators’ understanding of SWFs. It aims at adding to the tremendous body of recent work from academia and analysts, and contributing to the debate about how to better integrate SWFs into the global financial system and into their own countries’ policy frameworks. We also hope that the benefit will accrue equally to the functionaries in the international capital markets who deal with the SWFs, and to those actively researching SWF behavior.


Abbreviations and Acronyms

AUM  assets under management
BIT  bilateral investment treaty
*BPM6*  *Balance of Payments and International Investment Position Manual, 6th edition*
CBC  Central Bank of Chile
CDIS  Coordinated Direct Investment Survey
CFIUS  Committee on Foreign Investments in the United States
CIC  China Investment Corporation
CIS  Commonwealth of Independent States
CPIS  Coordinated Portfolio Investment Survey
ESSF  Economic and Social Stabilization Fund (Chile)
EU  European Union
FDI  foreign direct investment
FOI  Freedom of Investment
GAPP  Generally Accepted Principles and Practices
ICAPM  intertemporal capital asset pricing model
IFSWF  International Forum of Sovereign Wealth Funds
IWG  International Working Group of Sovereign Wealth Funds
MOF  Ministry of Finance
NBIM  Norges Bank Investment Management
NWF  National Welfare Fund (the Russian Federation)
OECD  Organisation for Economic Co-operation and Development
P-A  principal-agent
P/E  price-earnings ratio
P&L  profit and loss account
PRF  Pension Reserve Fund (Chile)
RF  Reserve Fund (the Russian Federation)
SAA  strategic asset allocation
SAFE  State Administration of Foreign Exchange (China)
SAMA  Saudi Arabian Monetary Agency
SWF  sovereign wealth fund
VaR  value-at-risk