Sovereign Wealth Funds

and International Financial Stability

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Abstract

Over the recent period, many emerging market economies and commodity-exporting nations are experiencing unprecedented growth and accumulating unprecedented amounts of foreign exchange reserves. The management of these foreign reserves has led to the emergence of an important financial actor, namely the sovereign wealth fund (SWF). While SWFs have existed in one form or another since the 1950s, it is only recently that they have risen in prominence and been exposed to public scrutiny and debate. In this paper, we outline their possible impact on international financial stability. We conclude that SWFs are long-term investors who can play a stabilizing role in financial markets by supplying liquidity and reducing market volatility. SWFs are also contributing to the gradual unwinding of global imbalances as they gradually diversify their portfolios. While the potential for destabilization by one or more SWFs does exist if other investors mimic the same investment strategies, there is little evidence of this occurring during the recent period. Similarly, the rise of financial protectionism as host countries adopt rules to protect sensitive industries might unduly restrict global capital flows, but is not likely to destabilize the international financial system.

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The global economy has experienced unprecedented growth over the recent period, with many emerging market economies (EMEs) and commodity-exporting nations experiencing sustained capital inflows and accumulating unprecedented amounts of foreign exchange reserves. ¹ The management of these foreign reserves has led to the emergence of an important financial actor, namely the sovereign wealth fund (SWF).² While there is no commonly accepted definition of a SWF, it may be defined as a government investment vehicle funded by foreign exchange assets and managed separately from official reserves (Kimmitt 2008). This definition includes the stabilization funds and inter-generational savings funds set up by commodity exporters, and the investment funds arising from the sterilization of current account surpluses. While SWFs have existed in one form or another since the 1950s, it is only recently that they have risen in prominence and been exposed to public scrutiny and debate. Much of this attention is due to the establishment of SWFs by systemically important countries such as China and Russia, which has raised concerns about the role of state actors in global markets. The objective of this note is to outline what issues SWFs pose for international financial stability – both the potential stabilizing effects and the destabilizing effects. Given the focus on financial stability, this note does not discuss other important policy issues that do not relate to this question.³ Table 1 provides an overview of the main effects on international financial stability that are discussed in this Violets.

This note concludes that SWFs are long-term investors who can play a stabilizing role in financial markets by supplying liquidity and reducing market volatility. SWFs use low amounts of leverage and adopt investment strategies that minimize their impact on markets. SWFs are also contributing to the gradual unwinding of global imbalances as they diversify their portfolios gradually into other assets classes and currencies. The recent injection of capital into a number of distressed banks and financial institutions highlights the constructive role they can play as contrarian investors. While the potential for one or more SWFs to disrupt markets does exist if other investors mimic the same investment strategies, there is little evidence of this occurring during the recent period. Similarly, the rise of financial protectionism as host countries adopt rules to protect

¹ Previous research at the Bank of Canada has focused on related topics; see Lavigne (2006), King and Maier (2007), Lavigne (2008).
sensitive industries might unduly restrict global capital flows, but is not likely to destabilize the international financial system. Since SWFs are a relatively new phenomena, there is not an extensive body of research dedicated to their analysis. Therefore, the arguments in this note are necessarily of a speculative nature. The goal is to discuss risks that may exist and to forecast scenarios that may unfold. This is by no means to say that these developments will inevitably unfold, but merely to recognize the potential risks that exist.

Table 1: Potential stabilizing and destabilizing effects on international financial stability

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</table>

Section 1 provides stylized facts on SWFs. Section 2 outlines the stabilizing effects for international financial stability. Section 3 examines potential destabilizing effects. Section 4 evaluates proposed and potential policy responses. Section 5 concludes.

1. **Stylized facts on SWFs**

As a large and rapidly growing institutional investor, SWFs have the potential to significantly impact financial stability. As with other financial actors, there is a continuum of SWFs, representing varying sources of financing and objectives. Accordingly, this section briefly examines the definition, sources and objectives of SWFs as well as their projected growth. Appendix A provides details on several major SWFs, including the Alberta Heritage Savings Trust Fund (AHSTF), with details on their date of establishment, assets under management (AUM), objectives and governance structure.
Definition, sources, and objectives

Given the relative novelty of SWFs, there is not, as yet, a commonly accepted definition; while all definitions contain a fair amount of overlap, efforts are made to incorporate the varying sources, purposes and management structure into one standard definition, often rendering it unwieldy and vague. Kimmitt (2008) defines SWFs as “government investment vehicles funded by foreign exchange assets and managed separately from official reserves.” Other definitions stress that the investment of these funds are in a broad portfolio of risky assets including equity, corporate bonds, real estate, infrastructure and alternative investment strategies. Finally, a key defining characteristic seems to be that these foreign reserves are managed independently from official reserves.

SWFs may be classified along two dimensions – the sources of their funds, and their investment objectives. Generally speaking, all SWFs are financed by current account surpluses arising from two main sources: (i) revenues generated by net commodity exports (typically oil) and (ii) revenues generated by a merchandise trade surplus. The largest SWFs are typically designed with one or more policy objectives in mind. These objectives include: stabilization funds, intergenerational savings funds, and reserve management funds.

- Stabilization funds – as they were originally conceived – were designed to smooth planned government budgets. In principle, excess reserves were accumulated during a commodity boom when prices for a commodity were above a pre-determined level. These reserves could then be drawn down to finance government expenditure when prices fell below this threshold level. In practice, few if any of the stabilization funds operate in this fashion.

- Intergenerational savings funds were designed to accumulate a portion of the windfall revenues in order to benefit future generations and force intertemporal expenditure-smoothing.

- Recent SWFs have been created to earn a higher return on foreign exchange holdings than is normally associated with traditional reserve instruments.

This list is by no means exhaustive. SWFs can also be used for several ancillary objectives such as debt re-payment, funding for development projects and – in the case of Brazil’s proposed SWF – exchange rate intervention.

It is important to differentiate SWFs from state-owned enterprises (SOEs), national or private pension funds, and other institutional investors, such as hedge funds. These actors may be distinguished by their primary function, their sources of financing, and their management structure.
• The primary function of a SOE is to own, operate and invest in real assets that are of strategic importance to the national economy. The SOE is funded by issuing capital (debt and equity), and operates as a private sector company subject to government oversight and/or management.

• The objective of national or private pension funds is to pay out future retirement benefits to specific beneficiaries who have contributed to the fund through payroll taxes and employer contributions. Pension funds are typically managed at arms-length from other government institutions, supervised by a government regulator, and held accountable by law for meeting their fiduciary obligations.

• Hedge funds are financial investors who seek to earn positive risk-adjusted returns for private investors by employing risky investment strategies that typically involve leverage. Hedge funds are only loosely regulated, and managed by principals who are paid based on performance and may have significant personal wealth tied up in the business.

By contrast, SWFs invest in financial assets, rather than owning or operating real assets directly. Unlike hedge funds, SWFs are typically unleveraged investment vehicles with little or no liabilities. The SWF is funded by foreign reserves accumulated through the sterilization of current account surpluses. In most cases, a country’s citizens do not have a direct claim on the SWF assets. Typically SWFs are passive investors who do not play an active role in operating the underlying business. There is no common model that describes their management structure, as each SWF is unique. SWFs are loosely regulated, if at all.

**Relative size and projected growth rates**

Sovereign wealth funds represented 2.5% of global assets in 2007, and are projected to grow rapidly over the next 15 years, reaching almost 9% of global assets by 2022 (Miles and Jen 2007). Currently there are approximately 40 SWFs, 20 of which have been established since 2000, holding estimated assets of $2-3 trillion (McCormick 2008). By comparison, the total value of foreign reserves is currently $5.1 trillion. While large in size, Figure 1 shows that the assets under management by SWFs are still relatively modest compared to pension funds and mutual funds, although they have surpassed the unlevered assets managed by hedge funds. But, more importantly, SWFs have the potential to grow rapidly.

Miles and Jen (2007) estimate that SWFs could grow to as much as $27.7 trillion by 2022, compared to total foreign reserves of $13.0 trillion and total global financial assets of over $300 trillion. This rapid growth scenario above is based on a number of assumptions. Analysts assume that future foreign exchange holdings will be transferred to
the SWFs rather than official reserves. They also assume an annual return on investment of 5.5%, with all profits reinvested. The assumptions underpinning the growth of total global financial assets are that the current stock of $100 trillion grows by 7.5 percent, which is the weighted average return on a portfolio composed of equal shares of bonds and stocks. Using different assumptions, Kern (2007) estimates that over the next decade SWF asset allocations could lead to a gross capital inflow of over $3 trillion into global equity markets and $4.5 trillion into global debt markets.\(^4\)

**Figure 1: Relative Size of SWFs**


Unlike other institutional investors, the AUM of SWFs are concentrated in the hands of a few large players. As can be seen in Appendix A, the top 5 SWFs represent almost 80 percent of total SWF assets. To have such substantial assets controlled by few investors means that any one of them could potentially have significant impacts on the stability of global markets.

### 2. Stabilizing effects of SWFs

SWFs have proven to be a stabilizing force on global financial stability in a number of ways. At the country level, they have allowed states to manage capital inflows, while

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\(^4\) Kern assumes a “pension-fund-typical” portfolio, with 40 percent allocation into equities and 60 percent allocation into interest-bearing securities. Given that this allocation is the inverse for many SWFs, the figures noted above could be significantly higher.
addressing long-run structural issues, thus providing a basis for sustained economic growth in EMEs. At the same time, by virtue of their size and investment strategies, SWFs are liquidity providers and contrarian investors who support global markets in times of stress while facilitating the gradual unwinding of global imbalances. These issues are examined below.

**Managing capital inflows**

SWFs can aid in the macroeconomic management of large current account surpluses. By transferring excess revenues into investments funds, states can alleviate inflationary pressures arising from capital inflows. Many of these states are already growing at a rapid rate, putting upward pressures on asset prices. Capital inflows also place upward pressure on nominal exchange rates, reducing demand for exports and slowing growth. For countries with a pegged exchange rate regime or managed float, maintaining competitive exchange rates increases the attractiveness of their exports, the very sources of growth for many of these countries that have depended on export-led growth. Off shoring capital inflows allows SWF states to ease pressures on domestic prices and resist real exchange rate appreciation.

**Portfolio diversification and a higher risk appetite**

Traditional reserve assets are safe, liquid investments offering low returns. By diversifying their investment portfolio, SWFs hope to earn higher returns on their holdings. Table 2 provides an example of this portfolio diversification based on the estimated investment portfolio of the Abu Dhabi Investment Agency (ADIA). ADIA allocates approximately 60% of their portfolio to listed equities, 20% to fixed income, and the remainder to other assets such as private equity, real estate, and alternative investments.

| Table 2: Asset Allocation of Abu Dhabi Investment Agency |
|-----------------------------------------------|------|
| Asset class                    | Percentage |
| Listed equities               | 60%  |
| Fixed Income                  | 20%  |
| Private equity                | 10%  |
| Real estate                   | 5%   |
| Alternative investments       | 5%   |

*Source: Roy (2006)*
By diversifying out of traditional reserve instruments, SWFs are accepting a higher level of risk than traditional foreign reserve investments. This higher risk tolerance can facilitate international risk sharing, as SWFs move into different classes of assets. Diversification allows SWFs to spread the risk in their portfolios across a variety of assets and currencies, thus reducing their reliance on one asset price (such as oil prices). They will also be able to rebalance in less volatile assets and better hedge their investments, reducing the negative outcome of a sharp drop in (or volatility of) the price of any given asset. In doing so, SWFs are building more balanced portfolios that will not only earn them higher returns, but allow them to protect themselves from volatility in one market, thus stabilizing their revenues.

**Addressing longer-horizon structural issues**

Strategically investing “excess” revenues can provide SWF states with a means to deal with future issues such as demographic pressures and economic development and diversification. Savings funds facilitate intergenerational transfers, allowing future generations to benefit from current favourable economic conditions. At the same time, increased profits on foreign holdings allow a larger cushion in the event of external shocks from falling commodity prices. Additionally, importing knowledge and technical expertise can help develop local industries and provide a basis for sustained growth as natural resources are slowly depleted. As such, strategic investment can allow SWF states to address structural weaknesses in their economies, reducing both macroeconomic and financial vulnerabilities that may lead to instability in the future.

**Providers of liquidity**

Large investors can play a stabilizing role by providing liquidity to financial markets. One of the commonly cited advantages of SWFs is that, due to their large scale, they are able to inject liquidity into global capital markets, thereby supplying capital to those who require (or demand) it. This function was clearly exhibited recently, when SWFs invested heavily in Western financial institutions, allowing them to recapitalize after substantial losses due to the U.S. subprime crisis.

**Long-term investment horizon**

SWFs have an explicit mandate of long-term investments and can withstand short-term fluctuations. SWFs are focused on long-term returns as well as other positive externalities that will arise from their investments, such as market access and knowledge transfer and expertise in sectors that their domestic economies lack, like infrastructure and financials. Additionally, SWFs have not highly leveraged and have very little capital adequacy requirements, unlike other large institutional investors such as hedge funds. The focus on long-term returns and the lack of specific capital requirements will decrease the risk of a rapid liquidation of investments and the ensuing impact on financial instability. Much like hedge funds, SWFs can act as contrarian investors, investing in times of market distress. As noted above, SWFs investments in Western financial institutions are an example of this behaviour; in seeking out long-term gains, they are able to invest when markets are in difficulties, focusing on the long-run outcome.
Facilitate unwinding of global imbalances

Moving out of official assets towards market-based assets facilitates the gradual resolution of global imbalances. Warnock and Warnock (2006) estimate that foreign official purchases of U.S. government bonds have lowered the yield on U.S. 10-year Treasuries by 90 basis points and that around two-thirds of this impact came from East Asia. Given that SWFs invest significantly more in equities and other assets than in fixed-income instruments, their investments may contribute to a gradual reversal of this effect. To the extent that SWF investments can also contribute to a depreciation of the U.S. dollar, this would contribute to the narrowing of the U.S. current account deficit, allowing a gradual unwinding of global imbalances that have been prevalent over the recent years.

Other positive externalities

As noted above, strategic investments can allow SWF states to develop their domestic economies and provide a basis for sustained growth. Gaining access to international markets and importing technical expertise will allow states to nurture non-commodity sectors and diversify their economies in preparation for the eventual depletion of finite natural resources or to provide for other sources of income when commodity prices are low.

Off shoring excess revenues also eases inflationary pressures in domestic economies and resists real exchange rate appreciation. Profits from SWF investments will aid in the financing of future liabilities such as upcoming pensions outlays.

The experience with the 1980s LDC debt crisis also highlights a positive externality from SWFs. During that period, petrodollars arising from the 1970s oil shocks were deposited with money center banks that lent freely to many countries in Latin America. This excess credit creation and lending was followed by sovereign defaults that crippled the balance sheets of many large financial institutions, and destabilized the international financial system. Many of these countries experienced large inflations and output losses over the next decade. By investing their commodity wealth directly, SWFs have avoided this boom-bust scenario with its damaging side-effects for the international financial system.

Potential risks to international financial stability

While SWFs may provide benefits to both domestic economies as well as global markets, significant outflows of capital from SWF states present potential risks to international financial stability. While most concerns are focused on what may be tail events, it is worthwhile to examine their possible impact on international financial stability.

Triggering “herding” behaviour

SWFs present a risk to global financial markets due to the fact that the control of large sums of capital is concentrated in the hands of a limited number of large actors. In the absence of SWFs, these surpluses would be distributed amongst domestic citizens. Then
the decision to consume, save or invest would be left to the discretion of (small) individual households, who can be assume to be distributed along a continuum of risk preferences. Whereas central banks follow a conservative investment strategy, SWFs, while still conservative in nature, may demonstrate a significantly higher risk preference than traditional reserve managers.

The presence of a large player with a high risk appetite can induce market behaviour that could lead to a negative outcome. Much of the existing literature on “large players” focuses on the role of highly leveraged institutions, such as hedge funds, in the various 1990s exchange rate crises. While it is often found that large players have the potential to play a destabilizing role, Corsetti et al (2004) argue that the size of the impact depends on the information content of the move and the signal being sent to the smaller traders.

While the possibility of SWFs inducing “herding” behaviour does exist, the risk that SWFs would deliberately do so is minimal. First, SWFs are committed to diversifying their portfolios, reducing investment in one specific asset class. Second, if SWFs were to invest large sums of funds into any one asset, there is a possibility that the market would move against them, which is something they would try to avoid. Corsetti et al (2004) stress that if the large actor has significant holdings of assets denominated in the currency under attack, his presence will actually make the attack less likely. They conclude that being aware of the large player’s initial portfolio positions is significant. Additionally, they note that, in order to avoid adverse price movements, large actors would have an incentive to avoid signalling or disclosing their position until the move is executed (and possibly even beyond that).

**Lack of transparency and short-term volatility**

SWFs have the potential to destabilize small markets by inducing other traders to mimic their strategies, leading to greater buying or selling on one side of the market. The impact of this behaviour may be exacerbated by the lack of transparency surrounding the investments and strategies of SWFs. Since SWFs became more widely known, many analysts have tried to anticipate their strategies, based on the investment strategies of similar institutional investors (see, for example, Van Steenis et al 2007). The lack of transparency about the holdings of SWFs introduces an element of uncertainty into markets. If there is a belief that SWFs will follow a specified strategy, it may induce other market participants to anticipate the move, leading to destabilizing behaviour. If the SWFs’ investment preferences are revealed by their actions, other agents may interpret their investments as signals and act accordingly.

**Non-economic objectives and financial protectionism**

While not necessarily a risk to international financial stability, some observers are concerned about a protectionist backlash against SWFs that would restrict cross-border investment and slow economic growth. The reaction of Western states to SWF investment may lead to the adoption of barriers preventing the free movement of capital as states adopt overly stringent regulations on foreign investment. This policy response may affect not only SWFs but also other institutional investors, such as national pension funds. Much of the concern about SWF investments stems from the lack of clarity
regarding SWF’s motivations and investment strategies. Increasing transparency will alleviate these fears and provide for an atmosphere that is more attractive to foreign investment.

While the leading SWFs have stated that they are long-term, passive investors, they offer little disclosure concerning their investment strategies and corporate governance structures. This lack of transparency leads to concerns regarding political motivations for investing. As seen in Table 3, taken from Truman (2007), SWFs run the gamut from full, open disclosure and high standards of governance (in the case of Norway) to providing little to no information (in the case of Gulf SWFs).

Virtually all countries have legislation in place that protects national industries and interests. However, the prospect of other states controlling domestic companies in sensitive industries has triggered a review of existing rules and may lead to the adoption of new and more onerous regulations. Although policymakers state that these regulations are not specifically aimed at SWFs, there are special clauses that deal explicitly with state-owned enterprises (SOEs).5 While states feel that these regulations are critical to protecting national and economic security, they may create a hostile environment, downgrading their investment climates and may even cause redirection of investments to another state. Furthermore, these regulations may impede the efficient allocation and free flow of capital, undermining the advances thus far made in liberalizing capital flows.

**Monitoring of managers and investor activism**

In the finance literature on principal-agent problems, large stakes by outsiders are seen as a mechanism that improves the monitoring of managers (Jensen and Meckling 1976). In their investments, many SWFs have done their utmost to prove that they will be passive investors, including foregoing any voting rights. While this may ward off protectionist sentiment, it may also impede the monitoring of managers. When a company experiences large capital losses, more active investors (whether they are large institutional investors or individual shareholders) will usually push for some sort of reform to avoid losses in the future. By giving up voting rights, SWFs are less able to protect themselves (and other shareholders) from mismanagement and prevent the same practices from occurring in the future. This weaker oversight may result in the continuance of poor investment strategies or lax risk management that can lead to further instability.

**Triggering a disorderly unwinding of global imbalances**

As noted in Section 2.6, gradual portfolio rebalancing through SWFs can reduce current account imbalances in the global economy. However, large-scale and rapid portfolio diversification can trigger a disorderly unwinding that would provoke volatility in international markets. Since SWF states have been large investors in the traditional

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5 For example, amendments to Investment Canada regulations on December 7, 007 establish a review process for proposed investments to ensure that the governance and commercial orientation of SOEs are of net benefit to Canada.
reserve instruments of U.S. Treasuries and U.S. dollars, there is a concern that asset will put pressure on Treasury bond yields. Furthermore, rapid currency diversification could cause a further depreciation of the U.S. dollar and also put upward pressure on other major currencies.

As noted above, diversification will probably impact both Treasuries and the U.S. dollar, but only at the margin. It is in the interest of SWF states to diversify gradually, so as not to impact the value of their own assets and risk incurring capital losses. Asset diversification implies that SWF states will move out of the traditional reserve instruments; this does not, however, necessarily entail moving entirely out of the U.S. dollar denominated assets. Rebalancing between government bonds and equity investments will still involve a substantial amount of monies flowing into U.S. companies and stock exchanges.

While diversification may also be associated with a weaker U.S. dollar at the margin, a wholesale divestment of U.S. dollars is unlikely, thus reducing the risk of a sharp depreciation of the U.S. dollar. In fact, SWF states themselves would be negatively affected by a large U.S. dollar depreciation, reducing the likelihood that they would intentionally act to bring about this outcome. A weakening of the U.S. dollar translates into a decrease in the value of a state’s net foreign assets, resulting in significant valuation losses.

Furthermore, for those countries not pegged to the dollar, a large U.S. dollar depreciation would effectively cause their currencies to appreciate, weakening their competitive position as goods exporters. Several SWF countries fix their exchange rates to the U.S. dollar, including China and many of the oil exporters. Defending a strict dollar peg or a basket peg would still involve purchases and holdings of dollars, further reducing the risk of a strategic divestment of dollars. In short, a serious off-loading of U.S. dollar assets would do SWF states more harm than good.

Leaving aside the issue of rebalancing official reserves, transfers of national wealth to SWFs that invest in global markets will necessarily involve investments in a variety of currencies. Although the majority of investments will be in U.S. dollar assets, capital will also flow to assets denominated other currencies, such as the Euro and the U.K. pound, exacerbating the upward pressure on their exchange rates.

4. Proposed and potential policy responses

While they have the potential to play both a stabilizing and destabilizing role, it is difficult to evaluate the possible impact of SWFs due to a lack of information. At the same time, negative public opinion against SWFs may encourage policymakers to adopt regulations that unduly restrict capital flows and foreign investment. In formulating policies regarding SWFs, the G-7 and G-20 have called on multilateral institutions such as the IMF and the OECD to identify best practices and codes of conduct, while to review legislation concerning state-financed cross-border investment. There is also a role for bilateral dialogue between governments as they seek to refine a host country’s regulations governing foreign investment.
**Best practices and codes of conduct**

Recent G-7 and G-20 communiqués have stressed the importance of opening dialogue with SWFs and urged them to adopt best practices in management and transparency. They point to the role of multilateral organizations in analysing the issues involved and identifying best practices; the OECD has done previous work on this topic and the IMF is currently working on a set of voluntary codes of conduct. Deputy Secretary of the U.S. Treasury Robert Kimmitt (2008) outlines several principles for SWF investments, which could provide a useful basis for developing codes of conduct. These principles are outlined in Table 3. As noted in Section 3.2, a lack of transparency may result in short-term market volatility; voluntarily adhering to codes of conduct that stress transparency would limit this risk.

**Table 3: Kimmitt’s Principles for SWF Investments**

For SWFs:

a) invest commercially, not politically

b) convey world-class integrity

c) compete fairly with the private sector

d) promote financial stability

e) respect host-country rules.

For countries receiving SWF investment:

a) avoid protectionism

b) uphold fair and transparent investment frameworks

c) respect investor decisions

d) treat all investors equally

Source: Kimmitt (2008)
Financial protectionism and foreign investment regulations

Government officials from the U.S., Canada, and elsewhere are meeting with representatives of various SWFs to learn more about their operations and objectives and, at the same time, are examining their national policies on foreign investment. Many countries, including Canada, have revised their regulations on foreign investment to specifically address proposals from entities owned or controlled by a foreign government.6 As shown in Table 3 above, Kimmitt (2008) also provides some guidelines regarding the treatment of SWF investments in foreign investment legislation.

Unduly stringent regulations on inward foreign investment may discourage investment from both SWFs and other actors. Regulations targeted at one actor can easily affect other institutional investors and create an uneven playing field among investors. Introducing more stringent restrictions against foreign investment may create an investment climate that is unattractive to all types of investors, even those not specifically targeted by the legislation, and may inhibit the efficient allocation of capital. For Canada specifically, there may be a negative reaction to proposed investments by our own sovereign funds (AHST) and large pension funds. The Conference Board of Canada (2008) warns Canada’s large public sector pension funds, such as CPPIB, Caisse de dépôt et placement de Québec, and PSP Investment, may be interpreted as a SWF and subsequently affected. Furthermore, regulations that unduly restrict the free flow of capital would reverse the gains made in the liberalization of capital flows and impede the efficient allocation of funds. As noted in Section 3.3, the possible redirection of capital flows away from deep markets, such as those in Western countries, towards shallower, less liquid markets may destabilize these smaller markets. Additionally, certain proposals may serve to effectively re-nationalize companies and close sectors to free market competition, the very same criticisms that are levelled at many SWF states. Efficient and well-crafted codes of conduct could avoid all of these problems and still allow states to safeguard national and economic security.

Conclusion

SWFs are significant institutional investors with large funds at their disposal. Based on current projections, they will continue to grow in size and importance, and thus have the potential to impact international financial stability. In this note, we argue that SWFs can play a stabilizing role in international markets. By providing countries with an instrument of better macroeconomic management, SWFs reduce the risk of asset bubbles and encourage domestic savings and wealth. As long-term investors that employ low degrees of leverage and take contrarian positions, SWFs provide liquidity. While SWFs are large actors that have the potential to disrupt small markets, their contrarian investments have so far reduced market volatility. Still the concern remains that extreme policy responses to SWFs could result in states restricting capital flows and limiting investment opportunities, leading to the inefficient allocation of capital and potentially creating

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6 The U.S. ’ Financial Investment and National Security Act (2007) became operational on October 24, 2007. Germany is considering instituting a review process and body similar to that of the U.S. The EU discussed a policy regarding SWF investments at a summit on March 13, 2008. For Canada, see section 3.3
conditions for financial instability. However, our judgment is that these are tail risks; the costs to SWFs in terms of both capital and reputational losses would be large and should prevent them from adopting disruptive investment strategies. SWFs have existed since the 1950s, and there has been no evidence to date that would imply that SWFs will explicitly act in a way that will disrupt global markets. In fact, their own interests would be jeopardized by any such actions. However, the fact that SWFs have more to lose than gain from such behaviour does not mean policymakers should not be concerned. The analysis in this note assumes a rational, profit-maximizing approach to reserve management. The risk of politically motivated actions does exist and non-economic behaviour is always possible. Global investment is a repeated game and SWF states are vulnerable to retaliatory ‘tit-for-tat’ tactics, even if such behaviour leads to sub-optimal outcomes.

A clear articulation of investment goals, greater transparency, improved financial reporting, and higher governance standards would go a long way in alleviating concerns regarding the non-commercial motivations of SWFs. The adoption of best practices and greater transparency regarding investment strategies and risk management practices would clear facilitate the efficient allocation of excess savings and encourage the flow of capital to where it is most needed. Prudent management of SWFs is ultimately in the best interest of these states. This is an opportunity for developing nations to acquire the financial and human capital required for institutional development and productivity gains, thus promoting domestic and global growth while contributing to the stability of financial markets.
Appendix A: Overview of Major Sovereign Wealth Funds

Although it may seem that SWFs are a relatively new actor in the global economy, Table 3 shows that they have existed, in one form or another, since the 1950s. But, since the beginning of this decade, high oil prices and large trade surpluses have led many systemically important EMEs establish their own SWFs. While detailed information is unavailable for many SWFs, the table below attempts to provide a broad overview of the major SWFs currently in existence.

Table 2: Overview of Major Sovereign Wealth Funds

<table>
<thead>
<tr>
<th>Country</th>
<th>Official name</th>
<th>Size $ bln</th>
<th>Reserves $bln</th>
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<td>(established)</td>
<td>(% GDP)</td>
<td>(% GDP)</td>
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<tr>
<td>United Arab</td>
<td>Abu Dhabi Investment Authority (ADIA)</td>
<td>875</td>
<td>28</td>
<td>Commodity</td>
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<td>Emirates</td>
<td>(1976)</td>
<td>(536%)</td>
<td>(16%)</td>
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<td>Govt of Singapore Investment</td>
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<td></td>
<td>Corporation (1981)</td>
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<td>(103%)</td>
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<td>Norway</td>
<td>Government Pension Fund – Global</td>
<td>329</td>
<td>56</td>
<td>Commodity</td>
<td>23.00</td>
</tr>
<tr>
<td></td>
<td>(GPF-G) (1990)</td>
<td>(98%)</td>
<td>(17%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kuwait</td>
<td>Kuwait Investment Authority</td>
<td>213</td>
<td>12</td>
<td>Commodity</td>
<td>12.00</td>
</tr>
<tr>
<td></td>
<td>(1953)</td>
<td>(222%)</td>
<td>(13%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>China Investment</td>
<td>200</td>
<td>1066</td>
<td>Non-commodity</td>
<td>-</td>
</tr>
<tr>
<td>Country</td>
<td>Official name</td>
<td>Size $ bln</td>
<td>Reserves $bln</td>
<td>Source</td>
<td>Truman Score</td>
</tr>
<tr>
<td>-------------</td>
<td>---------------</td>
<td>------------</td>
<td>---------------</td>
<td>--------</td>
<td>--------------</td>
</tr>
<tr>
<td>(established)</td>
<td></td>
<td>(% GDP)</td>
<td>(% GDP)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2007)</td>
<td>Corporation (CIC)</td>
<td>(8%)</td>
<td>(41%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Russia</td>
<td>Stabilization Fund of the Russian Federation</td>
<td>157</td>
<td>295</td>
<td>Commodity</td>
<td>9.50</td>
</tr>
<tr>
<td>(2004)</td>
<td></td>
<td>(16%)</td>
<td>(30%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>Temasek Holdings</td>
<td>108</td>
<td>136</td>
<td>Non-commodity</td>
<td>13.50</td>
</tr>
<tr>
<td>(1974)</td>
<td></td>
<td>(82%)</td>
<td>(103%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Qatar</td>
<td>Qatar Investment Authority (QIA)</td>
<td>50</td>
<td>5</td>
<td>Commodity</td>
<td>2.00</td>
</tr>
<tr>
<td>(2005)</td>
<td></td>
<td>(95%)</td>
<td>(10%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>Korea Investment Corporation</td>
<td>20</td>
<td>238</td>
<td>Non-commodity</td>
<td>9.00</td>
</tr>
<tr>
<td>(2005)</td>
<td></td>
<td>(2%)</td>
<td>(27%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>Alberta Heritage Savings Trust</td>
<td>15</td>
<td>-</td>
<td>Commodity</td>
<td>19.50</td>
</tr>
<tr>
<td>(1976)</td>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

1. Sizes are approximate when not disclosed.

Table 3: Truman (2007) Sovereign Wealth Fund Scoreboard

Truman (2007) compiles a “scoreboard” of major SWFs; the table below lists the scores for the SWFs listed in Table 2 above. The score is based on 25 yes/no questions, gathering information from public sources. A score for the China Investment Corporation is not available at this time.

<table>
<thead>
<tr>
<th>Country</th>
<th>Fund</th>
<th>Structure</th>
<th>Governance</th>
<th>Transparency &amp; Accountability</th>
<th>Behaviour</th>
<th>Total Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Arab Emirates</td>
<td>Abu Dhabi Investment Authority</td>
<td>0.50</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.50</td>
</tr>
<tr>
<td>Singapore</td>
<td>Government of Singapore Investment Corporation</td>
<td>1.50</td>
<td>0.00</td>
<td>0.75</td>
<td>0.00</td>
<td>2.25</td>
</tr>
<tr>
<td></td>
<td>Temasek Holdings</td>
<td>4.00</td>
<td>1.50</td>
<td>8.00</td>
<td>0.00</td>
<td>13.50</td>
</tr>
<tr>
<td>Norway</td>
<td>Government Pension Fund – Global</td>
<td>7.50</td>
<td>4.00</td>
<td>10.50</td>
<td>1.00</td>
<td>23.00</td>
</tr>
<tr>
<td>Country</td>
<td>Fund</td>
<td>Structure</td>
<td>Governance</td>
<td>Transparency &amp; Accountability</td>
<td>Behaviour</td>
<td>Total Score</td>
</tr>
<tr>
<td>---------</td>
<td>-----------------------------------------------------------</td>
<td>-----------</td>
<td>------------</td>
<td>-------------------------------</td>
<td>-----------</td>
<td>-------------</td>
</tr>
<tr>
<td></td>
<td>Maximum score</td>
<td>8.00</td>
<td>4.00</td>
<td>12.00</td>
<td>1.00</td>
<td>25.00</td>
</tr>
<tr>
<td>Kuwait</td>
<td>Kuwait Investment Authority</td>
<td>6.00</td>
<td>3.00</td>
<td>3.00</td>
<td>0.00</td>
<td>12.00</td>
</tr>
<tr>
<td>Russia</td>
<td>Stabilization Fund of the Russian Federation</td>
<td>4.00</td>
<td>2.00</td>
<td>3.50</td>
<td>0.00</td>
<td>9.50</td>
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<td>Qatar Investment Authority</td>
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<td>0.00</td>
<td>0.00</td>
<td>2.00</td>
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<tr>
<td>Korea</td>
<td>Korea Investment Corporation</td>
<td>6.00</td>
<td>2.00</td>
<td>1.00</td>
<td>0.00</td>
<td>9.00</td>
</tr>
<tr>
<td>Canada</td>
<td>Alberta Heritage Savings Trust</td>
<td>7.50</td>
<td>3.00</td>
<td>9.00</td>
<td>0.00</td>
<td>19.50</td>
</tr>
</tbody>
</table>

Source: Truman (2007)
Bibliography


