A number of factors have come together to galvanize public interest in those financial institutions.

Sovereign Wealth Funds: An Introduction

Sovereign wealth funds (SWFs) and their investment activities have emerged as one of the most controversial issues in international finance. As their name implies, SWFs are characterized by two defining qualities—ownership and control by the government, and pursuit of high risk-adjusted returns as the central objective. Although the term SWF was coined only 3 years ago by Rozanov (2005), these funds have actually been around for quite some time. The oldest SWF, the Kuwait Investment Authority, goes all the way back to 1953. A number of factors have come together to galvanize public interest in those financial institutions. For one, the proliferation of SWFs is a concrete symptom of the broader problem of global imbalances. For another, a string of highly publicized purchases of assets, such as the new People’s Republic of China (PRC) SWF’s May 2007 $3 billion investment in the Blackstone Group, a United States (US) private equity firm, have raised the profile of the SWFs as a whole.

The SWFs’ growing visibility has raised concerns among host-country policy makers and the public that domestic firms and industries may be taken over by state-owned foreign entities pursuing politically motivated noncommercial objectives. Such concerns tend to be more pronounced in industrialized countries since the new SWFs are predominantly from developing countries and often target acquisitions in industrialized countries. Their general lack of transparency, along with the sheer size of some SWFs, has also fuelled fears that they pose a significant risk to international financial stability. The global debate on SWFs tends to view those institutions primarily from the perspective of industrialized countries. The objective of this brief is to bring some balance to the debate by examining SWFs from the viewpoint of developing Asia.

Why are SWFs Emerging in Developing Asia?

SWFs have traditionally served as instruments for oil exporters such as Norway and the Gulf states to invest their export revenues abroad. In contrast to those older SWFs, developing Asia’s new SWFs are not based on natural resource export revenues but conventional current account surpluses derived from non-resource exports. Capital inflows have also contributed to Asia’s large and persistent balance of payment surpluses in the post-crisis period. As a result of those surpluses, the region’s foreign exchange reserves have risen sharply, in both absolute and relative terms (Figure 1). Developing Asia’s reserve growth is not limited to the PRC even though PRC accounts for 50% of the growth since 1990. The region’s other big reserve holders—India, the newly industrialized economies, and ASEAN-4—have also experienced a rapid buildup of reserves. Asia’s reserves differ from those of
oil exporters in that they are the products of the central bank’s purchases of foreign exchange rather than fiscal income accruing to governments.

Central banks purchase foreign exchange reserves as a form of insurance to protect a country from unexpected shortages of foreign exchange. This precautionary motive for holding reserves has a special resonance in developing Asia, which suffered a devastating currency crisis in 1997–1998. However, there is a growing consensus that the region now has far more reserves than all plausible estimates of what it needs for traditional liquidity purposes. Widely used measures of reserve adequacy invariably confirm that reserves have in fact reached excessive levels. For example, reserves comfortably exceed the total amount of short-term external debt in many regional countries and, in some cases, by many times over (Figure 2). The emergence of large and growing surplus reserves has led to widespread calls for more active reserve management. Since SWFs have a long history of using state-owned foreign exchange to maximize risk-adjusted returns, they provide a natural institutional blueprint for shifting surplus reserves from liquidity management toward profit-seeking investment. In particular, the commercial success of Singapore’s Temasek and Government of Singapore Investment Corporation (GIC) has inspired many Asian countries to set up SWFs of their own.1

![Figure 1](image1.png)

**Figure 1** Developing Asia’s nominal and real foreign exchange reserves, 1990–2007

Note: Real reserves were obtained by deflating nominal reserves with US consumer price index (CPI), US CPI in 2000 = 100.

![Figure 2](image2.png)

**Figure 2** Ratio of foreign exchange reserves to short-term external debt in selected developing Asian countries, 1990–2007


**Benefits and Risks of SWFs for Developing Asia**

Although much of the global discussion on SWFs revolves around the impact of their investments in industrialized countries, SWFs also entail substantial benefits and risks for their home countries as well. Despite its breakneck growth rates and transformation into a major exporter of capital, developing Asia as a whole remains a poor region facing a wide range of huge long-term developmental challenges. The challenges include physical infrastructure, contingent pension liabilities, health care costs, environmental services, and development of lagging regions. Addressing the challenges effectively will require ample fiscal resources. The income from investing surplus reserves represents additional fiscal resources. Therefore, if the returns on their investments substantially exceed the returns on traditional reserve assets, SWFs would allow developing Asian governments greater fiscal flexibility, and enhance their capacity to tackle long-term developmental challenges.

Unfortunately, although attractive in principle, earning returns above those on US government securities, for example, is neither automatic nor guaranteed. Above all, the institutional capacity of new Asian SWFs such as the PRC’s China Investment Corporation (CIC) or Korea’s Korea Investment Corporation (KIC) is limited due to their lack of experience and knowledge. For this reason, even if the new SWFs had complete operational independence and were run on a purely commercial basis, it is improbable that they would be able to replicate

1 Park (2007) provides a comprehensive discussion of developing Asia’s surplus foreign exchange reserves and sovereign wealth funds.
the success of Temasek or GIC. In fact, in terms of investment performance, the downside risks outweigh the upside potential, at least during the early years of operation.\(^2\) For example, CIC’s $3 billion stake in Blackstone has lost about one sixth of its value, provoking much criticism from the public. More generally, the current global financial turmoil rooted in the US subprime crisis highlights the formidable risks of investing in global markets, especially for novice investors such as the new Asian SWFs.

### The Risk of Financial Protectionism

A more structural risk confronting SWFs is that of financial protectionism. There is a widespread perception that SWFs are sinister organizations whose investments are based on noncommercial ulterior motives. The fact that SWFs are state-owned institutions from countries with different political systems has aroused a great deal of concern and hostility in the US and the European Union. The underlying fear is that of opaque and well-endowed foreign institutions with unclear investment objectives acquiring firms and industries that are important for national security and welfare. Host governments have a legitimate interest in ensuring that the investment activities of foreign institutions do not adversely affect their countries. On the other hand, host governments may attempt to block SWF investments out of purely protectionist motives aimed at keeping out foreign investors.

The widely expressed concern that SWF investments may be motivated by political or strategic rather than commercial objectives, although not entirely groundless, tends to be overblown. It should be remembered that the driving impulse behind the creation of Asian SWFs is to make as much money as possible subject to manageable risk. In other words, SWFs are intrinsically commercial creations. There is another fundamental reason why SWFs are unlikely to undertake investments that undermine the interests of host countries and thus invite financial protectionism. From the perspective of SWFs, financial protectionism constrains how and where they can invest, and thus imposes a significant additional cost. This explains why many SWFs, including CIC and KIC, have signed up to an ongoing initiative led by the International Monetary Fund (IMF) to set up a voluntary code of conduct for SWFs, which would guide their investment practices and calm fears about their motives.

### Developing Asia’s SWFs and Global Financial Stability

The two most striking characteristics of SWFs are their sheer collective size—they already control as much as $2.5 trillion in assets—and their general lack of transparency—their disclosure and reporting standards are comparable to those of hedge funds and private equity firms. The mixture of weight and opacity is fueling concerns about the potential risks they pose for global financial stability. Their size means that SWFs have the power to move financial markets and their opacity means it will be difficult to track their investments. Also worrying is the fact that new SWFs such as KIC and CIC are fledgling investors with limited experience in navigating the often-turbulent waters of international financial markets. Indeed before the outbreak of the US subprime crisis and the ensuing global financial turmoil, SWFs were viewed as one of the biggest threats to global financial stability.

At least for now, these fears appear somewhat exaggerated. In fact, there are sound reasons to believe that SWFs can promote rather than harm global financial stability and efficiency. SWFs undertake long-term investments in a highly diversified international portfolio and are not swayed by capricious market movements. Furthermore, they are largely unleveraged and have limited liquidity needs. Therefore, in principle, investors such as SWFs should be welcomed by global financial markets. The still-unfolding subprime crisis has dramatically highlighted their potential contributions. Specific examples include CIC’s $5 billion investment in Morgan Stanley and KIC’s $2 billion investment in Merrill Lynch. Those investments substantially bolstered the balance sheets of financially distressed western investment banks. This has prompted John Lipsky, the first deputy managing director of the IMF, to praise the role of SWFs as “shock absorbers” on 3 September 2008.

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Developing Asia’s New Sovereign Wealth Funds and Global Financial Stability

There are sound reasons to believe that SWFs can promote rather than harm global financial stability

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\(^2\) Park (2008) examines in detail the main risks facing the new SWFs from developing Asia.
In the context of global financial stability and efficiency, it is not clear whether SWFs will always be part of the solution, as they have been during the current global financial turmoil, rather than part of the problem. What is clear is that SWF investments necessarily affect both investor and host countries. Developing Asia has a legitimate interest in using its large and growing surplus reserves more profitably. At the same time, host countries have a legitimate interest in preventing the investment activities of SWFs from harming their markets or economies. A dispassionate international dialogue on SWFs in which the voices of both investor and host countries are equally and fully heard would mark a helpful first step in ensuring that SWF investments benefit both sides. The substantial potential for mutual benefit was most emphatically borne out by SWF investments in troubled western financial institutions since September 2007.

References

