

# Sovereign wealth funds: A developing country perspective

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# Motivations for accumulating foreign exchange assets

	Long-term current account surplus	Short-term current account surplus	Capital account surplus
Commodities	Wealth substitution motive	Counter-cyclical (prices)	
Non-commodities	Resilient surplus motive	Counter-cyclical (volumes)	Self-insurance

# Some implications (1)

- It is difficult to rationalize a SWF if there is no current account surplus
- Possible “Dutch disease” effects associated with dynamic economies of scale (learning and building commercial networks)
- If diversification activities have weak returns, it may be better to leave resources under ground
- Long-term current account surpluses can lead to savings funds. Cyclical surpluses to either stabilization funds or reserves.

## Some implications (2)

- Difficulty in differentiating a “permanent” vs. a “transitory” commodity price boom (shock persistence or random walks).
- A “retention” or a tax on the booming commodity makes sense
- “Self-insurance” should be managed through reserves, not SWFs...
- ... but it may make sense to undertake financial intermediation with excess supply of capital flows.
- Public sector surplus always useful for sterilization purposes. Otherwise, sterilization is costly, particularly if instruments are short-term and domestic interest rates are high.

# Asset allocation criteria for SWFs

- Return more important than liquidity
- Different funds (savings versus stabilization) imply different liquidity needs
- Clear prudential rules, as assets belong to countries' citizens
- Can partly serve long term development objectives, as well as good returns:  
Norwegian precedent but developing countries may have more strategic interests

# Major political economy issues

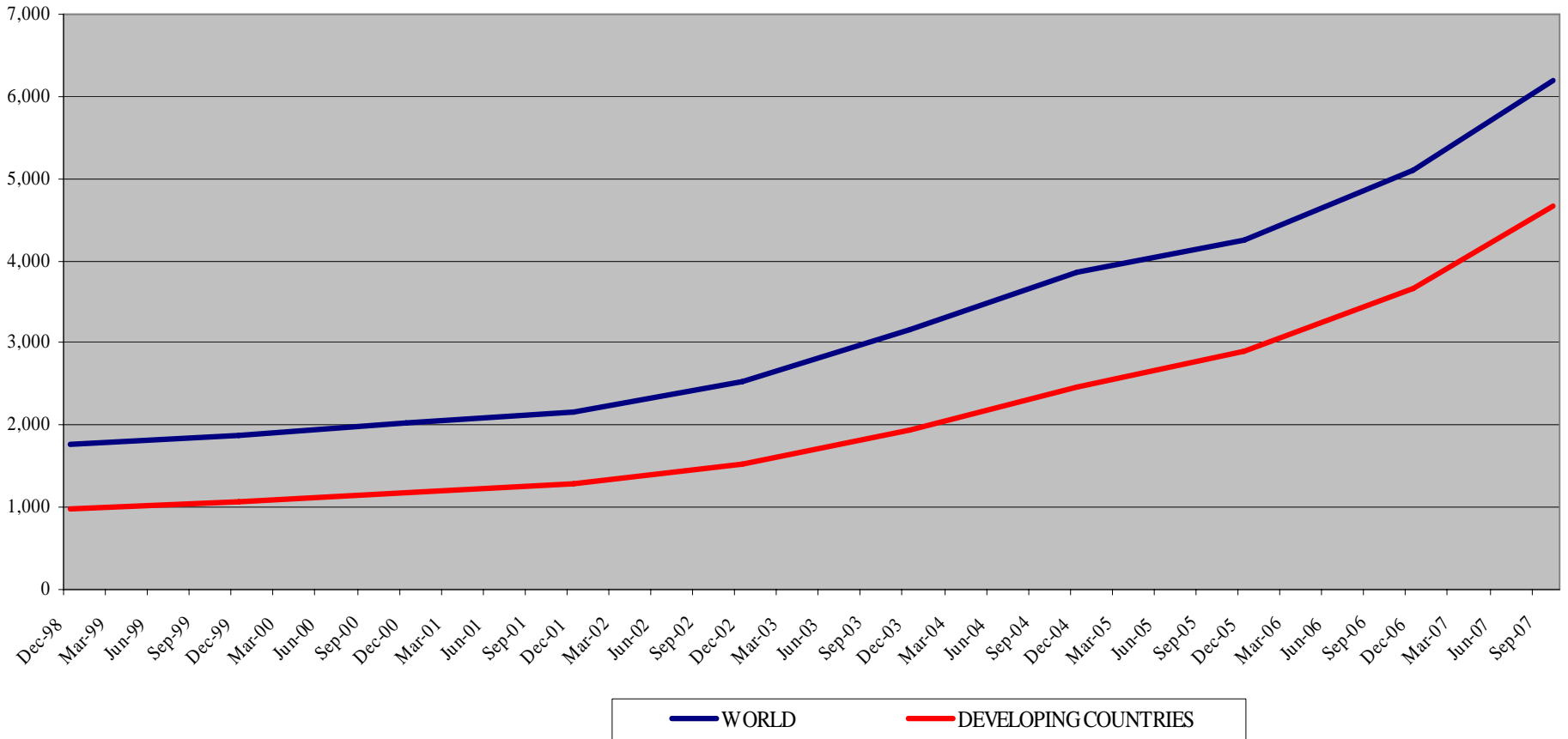
- Strong political economy pressures to spend a transitory boom or accumulated funds.
- It is difficult to justify savings in a SWF to compensate for private sector “exuberance”
- The decision to accumulate resources in a SWF should be consistent with general fiscal rules
- Rules for the management of a SWF should avoid both risk aversion and excessive risk taking
- Professional and independent management is critical (possible role of central banks)

# Accumulation of forex reserves

- Massive increase of forex reserves to US\$6.2T, 80% in developing countries
- Steeper increase recently, especially China, India and oil exporters
- Latin American reserves doubled since 2001
- Origins of reserve accumulation vary by region and in time.
- Latin America increasingly capital account led

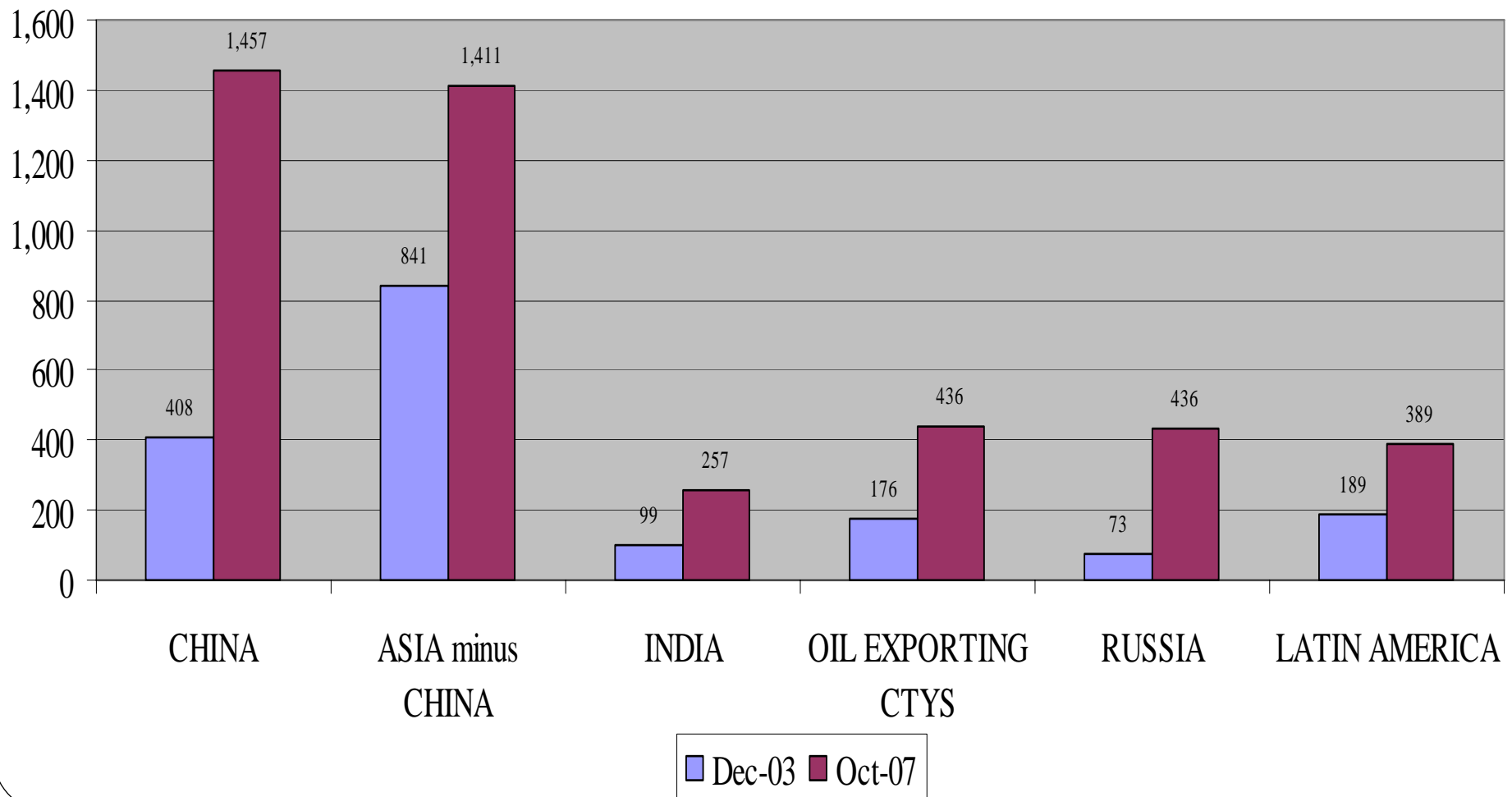
# Massive increase of reserves

Global Reserve Accumulation, US\$billion (1998-2007)



# Reserve accumulation by region

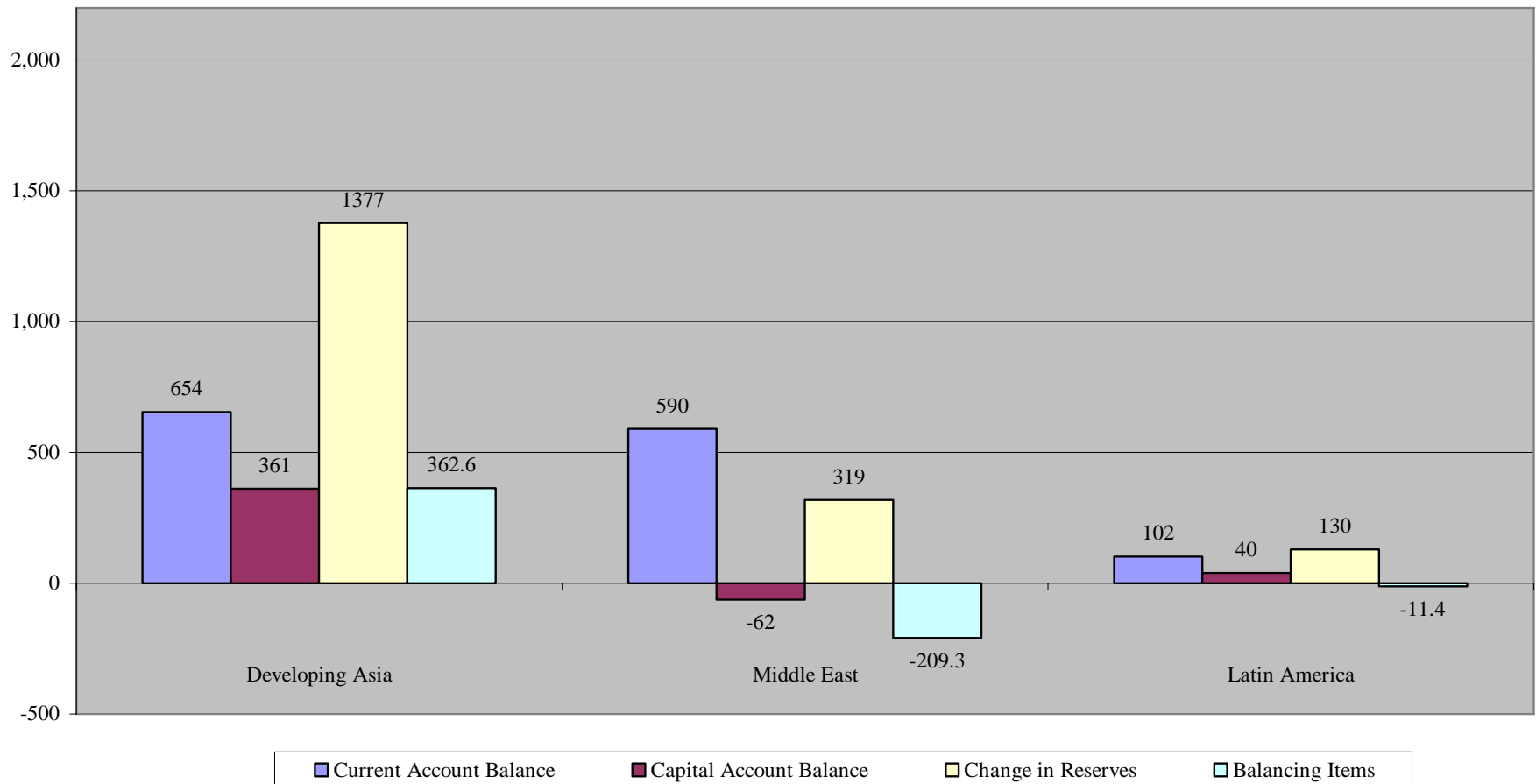
Global Reserve Accumulation--Selected Groupings and Countries (US\$billion)



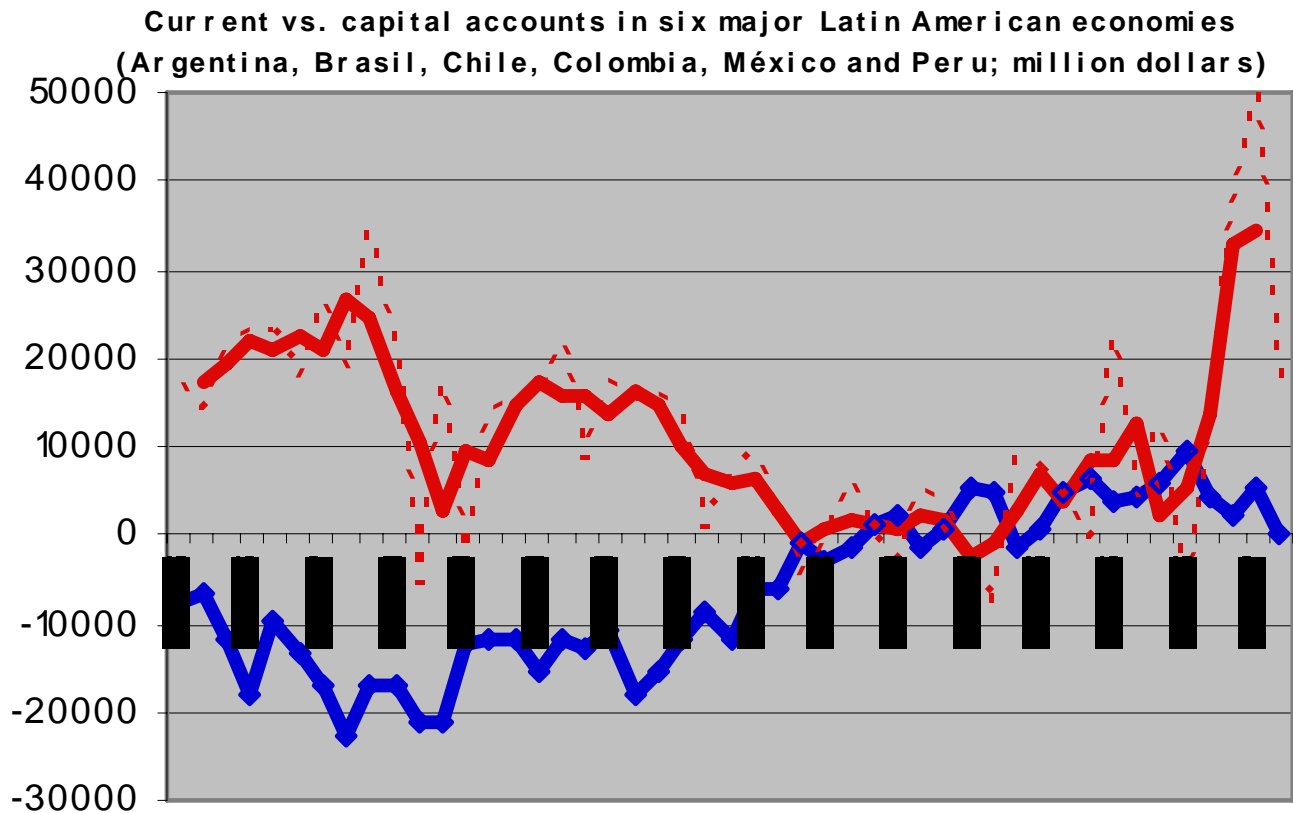
# Sources of reserve accumulation

Drivers of Reserve Accumulation, US\$ billion (2002-06 cumulative)

Source: IMF World Economic Outlook; CEPAL



# The source of reserve accumulation in Latin America has changed



—◆— Current account    - - - - Capital account    — Capital acc. (3 quarters average)

# Rise of SWFs

- Assets around US\$3T; additional to forex reserves
- Projections reach US\$10-\$12T in 5 -7 years
- Commodity and non-commodity exporters
- 75% of SWF assets belong to oil producers
- Main types: savings and stabilization

# Estimated Size of Largest Sovereign Wealth Funds

Country	Fund Name	Assets (US\$bn)	Inception Year	Source of Funds
UAE	Abu Dhabi Investment Authority	875	1976	Oil
Norway	Government Pension Fund	380	1996	Oil
Singapore	Governemnt Investment Corp.	330	1981	Non-commodity
Saudi Arabia	Saudi Arabian funds (Various)	300	n.a.	Oil
Kuwait	Kuwait Investment Authority	250	1953	Oil
China	China Investment Corp.	200	2007	Non-commodity
Singapore	Temasek Holdings	159.2	1974	Non-commodity
Russia	Stabilization Fund	127	2004	Oil
Australia	Future Fund	54	2006	Non-commodity
Qatar	Qatar Investment Authority	50	2005	Oil
Libya	Oil Reserve Fund	50	2005	Oil
Algeria	Revenue Regulation Fund	42.6	2000	Oil
US (Alaska)	Permanent Fund Corp.	38	1976	Oil
Brunei	Brunei General Reserve Fund	30	1983	Oil
South Korea	Korea Investment Corp.	20	2005	Non-commodity
Malaysia	Khazanah Nasional	18	1993	Non-commodity
Kazakhstan	Kazakhstan National Fund	18	2000	Oil
Canada	Alberta Heritage Fund	16	1976	Oil
Taiwan	National Stabilisation Fund	15.2	n.a.	Non-commodity
Venezuela	National Development Fund	15	2005	Oil
Iran	Oil Stabilization Fund	13	1999	Oil
New Zealand	Superannuation Fund	11	2001	Non-commodity
Chile	Economic and Social Stabilization Fund	9.8	2006	Copper
UAE	Istithmar	8	2003	Oil
Oman	State General RF	6	n.a.	Oil
UAE	Dubai International Capital	6	2004	Oil
Bahrain	Unknown	6	1980	Oil
Chile	Pension Reserve Fund	1.4	2006	Copper
<b>Total</b>		<b>3049.2</b>		

# Reasons for reserve accumulation

- Maintain stable and competitive currencies
- "Self-insurance"; response to crises; wish to avoid IMF conditionality
  - Beyond Greenspan-Guidotti: total external liabilities
  - Against both sudden stops and domestic capital flight
  - Why increase reserves? And not restrict inflows, hedge or issue GDP bonds?
  - Accumulation of reserves mitigates T of T shocks on exchange rates, increasing growth
  - Smooths adjustment to shocks

# "Optimal" level of reserves

(e.g. Olivier and Ranciere)

- Linked to probability of sudden stops, output costs of crises, cost of holding reserves and risk aversion by country
- Actual reserves similar to estimated optimal for Latin America, but higher for Asia since 1997
- Low interest rates reduce costs of holding reserves, but may lower bank profitability, eg China

# Systemic and regional implications (1)

- Counter-cyclical policies and “self-insurance” are rational for each country but may generate “fallacy of composition” effects
- Accumulation of reserves by developing countries makes possible strengthening regional institutions
  - For macro support
  - Development finance
- With small proportion of existing reserves, very large expansion of RDBs and SRDBs, like CAF, can be easily achieved

# Systemic and regional implications (2)

- SWFs have contributed to global financial stability by helping recapitalize large international banks
- Allowing SWFs to invest in developed countries encourages exporters of commodities, like oil, to extract them
- Calls for transparency of SWFs should be symmetrical with that for other financial institutions, like hedge funds

# Significant Acquisitions by Sovereign Wealth Funds

<u>Date</u>	<u>Target</u>	<u>Acquirer</u>	<u>US\$bn</u>
23/07/2007	Barclays	Temasek Holdings	2
19/12/2007	Morgan Stanley	China Investment Corporation	5
24/12/2007	Merrill Lynch	Temasek Holdings	4.4
15/01/2008		Kuwait Investment Authority	2
15/01/2008		Korea Investment Authority	2
27/11/2007	Citigroup	Abu Dhabi Investment Authority	7.5
15/01/2008		Singapore Government Investment Corporation	6.9
15/01/2008		Kuwait Investment Authority	3
10/12/2007	UBS	Singapore Government Investment Corporation	11.5
<i>Total</i>			<b>44.3</b>

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