Sovereign wealth funds – public investment vehicles, foreign policy element. Comparative evolution in the international context

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ABSTRACT

Sovereign funds are an important actor occurring on international financial markets in the last decade, being, in fact, state controlled international investments. Generally, they are financed from foreign currency reserves of the emergent countries they are constituted in, being managed apart of the official reserves and used for external expansion; they are likely to be detrimental to certain strategic interests. As public financial vehicles, they own, endorse or manage public funds of some emergent countries, freely invested by them in a great number of assets, being seen as a foreign policy element.

Key words: *public sector, public liquidities, governmental investments, international financial markets, foreign currencies reserves, emergent countries, strategic interests*

JEL: *F33, F36, F42, F53, F55, F59, G01, G15, G18, G32.*

1. PRESENTATION

Sovereign funds are an important actor occurring on international financial markets in the last decade. These are state controlled funds, involving the governmental savings management and investment, irrespective of their revenue source. More precisely, these are governmental investment vehicles, established based on goods or resources traded at international level, but managed separately from the official reserves. The fundamental characteristic of these investment funds is that they are financed by the state, being, in fact, state controlled international investments. Generally, they are financed from the foreign currency reserves of the emergent countries they are constituted in, being managed apart of the official reserves. These are investment funds where the control participants are not institutions or private persons, but the states themselves. These investment funds belong to state authorities, particularly from China, Russia, Saudi Arabia, Kuwait or United Arabian Emirates, meaning the countries which have accumulated huge amounts from exports, based on which they have established substantial foreign currency reserves used for external expansion. Usually, the SWFs adopt a diversified investment strategy, with a high level of accepted risk, envisaging high level of gains (direct investments, acquisitions of companies and investments in stack exchanges or in the real estate sector).

Classification of sovereign funds

Figure 1

1. Stabilisation funds, whose role is to protect the budget and the economy against price fluctuations for goods;
2. Savings intended for next generations, in view to stimulate the conversion of non-renewable goods into a diversified portfolio of goods;
3. Corporations for reserves investment, where the goods are treated as belonging to reserves and established in view to increase their profitability, despite higher risks;
4. Development funds, set up in view to finance social-economic and infrastructure projects;
5. Pension quotas reserves, set up in view to finance social security and to cover health care expenses.

2. SOVEREIGN FUNDS, FOREIGN POLICY ELEMENT?

The sovereign funds which are based on international exchanges are generally subject to a breakdown depending on the type of exchanged goods: funds based on products or resources, established based on levies on exports, held by the government (the Chinese Investment Corporation, the Governmental Global Pension Funds of Norway, the Investments Authority of Kuwait, the Investments Authority of Qatar, etc); funds which are not based on products or resources, established based on exchanges of goods from official foreign reserves.

Beside the fact that all these funds are under state ownership, they do not represent a well defined class, since they could not be seen neither as financial, nor as political actors, but their definition as welfare reserves that could make use of finances as an instrument for promoting the national interests abroad is exactly the characteristic consecrating them as a foreign policy element. The sovereign funds could be seen as international finances pillars.

There are three major factors which have entailed the recent increase of sovereign funds: the accumulation of an „excess" of reserves during the defensive attempt of fighting against the policy of reporting the national currency to a stronger international currency; the raise of crude oil barrel price during the '70s -'80s, which entailed the foundation of sovereign funds' wave, held by the governments of states which could take advantage of their endowment with this natural resource, signing up large-scale transactions at international level; the willingness of acquiring higher profits from the reserves, seen as a protection against the current increases in the financing reserves costs.

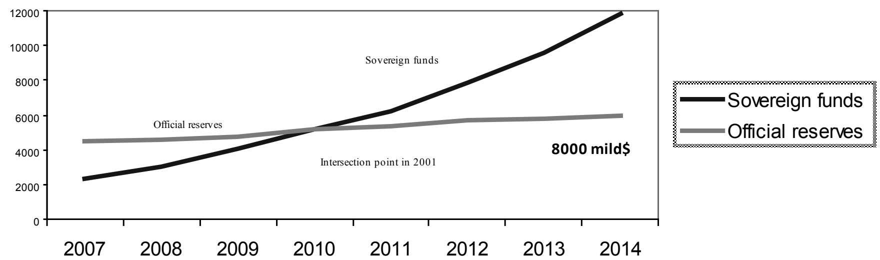
3. THE EVOLUTION IN THE INTERNATIONAL FINANCIAL CONTEXT; ASCENSION, FEARS AND OPPORTUNITIES

The sovereign funds have shown a fast raise during recent years1[1], both in terms of volume and of number, becoming extremely popular among the crude oil exporting nations. Nowadays, these became major actors on the global financial markets. They have entailed a large scale controversy, due to the fact that this kind of financing points out the failure of state ownership.

1. Johnson, S., "La montee en puissance des fonds souverains", Finances et Developpement, septembre 2007

Comparative evolutions of sovereign funds and of official reserves

Figure 2



Source: Morgan Stanley Report, 2010

The factors contributing to the recent raise of sovereign funds2[1] are important for the analysis of the internal mechanisms of this concept and in view to promote a better understanding of their evolution.

In 2008, the European Commission adopted the communications on sovereign wealth funds and on the adaptation of European and world financial systems in view to better promote the financial stability. It is necessary to avoid the situations where certain sovereign wealth funds are managed in a manner lacking transparency[2] or where these are used in view to acquire certain objectives of another nature than the economic one. A common approach at the European Union level is necessary, without different responses of the Member States that could lead to a fragmenting effect upon the domestic market. The Commission Communication on sovereign wealth funds suggests to the European Union leaders a common approach, both balanced and proportionate, for the protection of legitimate political interests, without falling into the trap of protectionism. The general objective is to preserve an open investment environment, enhancing at the same time the transparency, predictability and accountability of SWFs investments. At present, IMF is drawing up a code of conduct in relation with the SWFs, in collaboration with the countries owing such funds.

The EC proposal for an “International code of conduct for sovereign funds” is a reaction to the way they are acting and has implications over the way the Members States are treating such investments

1. Hildebrand, P., “Comment controller les fonds souverains?”, La Tribune, 22 janvier 2008

2. Truman E.M., “Sovereign wealth funds: the need for greater transparency and accountability”, Policy Brief no. PB 07-6, august 2007, Peterson Institute for International Economics

The OECD has, however, appreciated that there is no need for a new legislation on SWFs, stating that such legislation would limit the investments freedom and stressing that SWFs should not be subject to certain restrains insofar certain conditions are met: they are motivated by profit acquiring, they are under the leadership of professional teams and regularly offer details on the own financial results. OECD is nowadays working on the identification of best practices for the beneficiary countries. The United States of America have reach in 2008 to an agreement with Abu Dhabi and Singapore on a set of principles concerning the activity of sovereign funds, the most important being that politics should never interfere with their activity. In 2008, the sovereign funds of China, owning funds amounting to USD 200 billion, has bought a participation of over USD 100 million to the company releasing credit cards, VISA.

The resources of sovereign wealth funds are so substantial that cautions are recommended, to avoid becoming the target of political or market inferences or to become dependent on foreign governments decisions. Most of the western countries have the tools allowing them to prevent foreigners of making undesired investments in all the industry sectors. The western countries fear for the funds could be used as political arms by the governments which have the control upon them. These could make use, at any time, of abatement from the normal behaviour of the respective funds on the market, with a shift from the acquirement of profits to pursuing certain political purposes.

Europe, however, should not become passive in relation with other nations or with big companies owned by the state, but should play an active role in globalisation modelling. The adoption of a permissive attitude, based on voluntary transparency, has the best chances for being successful[1].

1. Truman E.M., “Sovereign wealth funds: the need for greater transparency and accountability”, Policy Brief no. PB 07-6, august 2007, Peterson Institute for International Economics

Figure 3

TOP 10 SOVEREIGN FUNDS

COUNTRY	FUNDS	ASSETS (USD BILLION)	YEAR OF SETTING UP	ORIGIN/ SOURCE
United Arabian Emirates – Abu Dhabi	Abu-Dhabi Investment Authority	627	1976	Crude oil
Norway	Government Pension Fund-Global	443	1990	Crude oil
Saudi Arabia	SAMA Foreign Holdings	415	n/a	Crude oil
China	SAFE Investment	347,1	n/a	Non – commodity*
China	China Investment Corporation	288,8	2007	Non – commodity*
Singapore	Government of Singapore Investment Corporation	247,5	1981	Non – commodity*
China	Hong Kong Monetary Authority	227,6	1993	Non – commodity*
Kuwait	Kuwait Investment Authority	202,8	1953	Crude oil
China	National Social Security Fund	146,5	2000	Non – commodity*
Russia	National Welfare Fund	142,5	2008	Crude oil

*Sources from foreign currency reserves, budgetary surplus and privatisation revenues;
Source: sovereign wealth fund institute (evaluations – june 2010)

The transformation of certain reserves from governmental debts to sovereign funds, which invest a wide panel of instruments could enhance resources allotment, provided these investments are based on commercial criteria. The investments in transferable securities could contribute to the manifestation of the common interest of emergent economies and of developed economies towards the good performances of the involved companies and of the markets where they operate. Thus, the emergent economies integration to the global financial system could be sustained, while the investors are encouraged to actively participate in drawing up policies at global level.

4. SOVEREIGN FUNDS AND THE FINANCIAL CRISIS

The European Commission recognised that, at this moment, the sovereign funds represent the core transmission belt within the engine of financial globalisation, acting either as global powers, or as global power brokers.

The approach of sovereign funds, coordinated at European level, is crucial in the context where an incoherent and fragmented response of the European countries would bear certain risks. Thus, an uncoordinated series of national responses of the sovereign funds' owners would affect the functioning of the single market and of the European Union as a whole. On the other side, the setting up of a coherent policy at European level would help the sovereign funds' owners through a clear, predictable and trustable policy for their investments.

Therefore, the sovereign funds represent an important class of investors, with a fast pace development. As the size and influence of sovereign funds increase, the associated investments are inevitably subject to beneficiary governments' scrutiny, since their desire is to counterbalance a so called threat. In the context of stability and global financial effectiveness, the sovereign funds could be part of a solution[1], on the background of the current financial crisis[2], or one more threat. These funds affect both the investors and the beneficiary countries. The developing Asia has a legitimate interest in using the reserves surplus as profitable as possible[3], while the beneficiary countries have the legitimate interest of preventing that such investments would harm or damage their economies. Though the activities of funds owners jeopardize to a low extent the financial system stability, the international community should appropriately manage the raise of this investors' class, in a manner that avoids financial protectionism. The regulation of their activity could be done through the development of "best practices".

The sovereign funds have focused their investments preponderantly towards the banking institutions and real estate. A significant increase in the investment banks financing is to be noticed, these being confronted with a dead end due to the large scale credit turmoil. On the background of opportunistic transactions carried out by the governments with the support of

1. Betbeze, J.P., sous la dir., "Fonds souverains: a nouvelle crise, nouvelle solution?", PUF, Paris, avril 2008

2. Betbeze, J.P., "Crise financiere, fonds souverains et private equity: le nouveau recyclage", Les Echos, 27 novembre 2007

3. Problemes Economiques no. 2946/2008, "Que fait la Chine de ses devises?" Topic-HEC Eurasia Institute, fevrier 2007

sovereign funds, the profile of these investors could be appreciated as similar to the one of certain entities awaiting for the appropriate moment for action, taking advantage of high quality consulting and being extremely attentive when measuring the raise of investment portfolios or their entry to the new markets.

Asia and Europe are still the favourite directions of the investment funds, 31% of available amounts going to Asia, 30% to the European Union and 20% to the United States of America. Within the European Union, the United Kingdom is the main target of sovereign funds investments.

In the situation where the liquidities crisis from the financial markets becomes a large scale challenge, the sovereign funds await for investment opportunities. The experts state that their assets could overrun quite soon the total amounts of foreign currency reserves from the world central banks. Running so far over USD 2800 billion, with assets that could exceed USD 12000 billion till 2015[1], these funds would become the main investment vehicle at global level. The growth rate of these funds is quite impressive, almost USD 1000 billion per year and is mainly generated by the raising price of crude oil and of other commodities[2].

Among the recent developments, it is worth mentioning that in May 2010 Germany decided upon the temporary interdiction of certain speculative financial transactions of "short selling" type, particularly in relation with sovereign bonds. The measure announced by Germany, meant to prevent financial market instability, was a surprise for the financial markets and gave raise to uncertainties. Under the conditions where this measure would undermine the efforts meant to improve the political coordination and integration in the European Union, the implications for the euro zone could be quite deep. The decision of Germany was more surprising since it was not spelled out on Tuesday, May 18, 2010 during the meeting of the Community Ministers of Finances, which focused on the efforts to improve the regulations on speculative funds functioning and on the coordination of policies aiming at the prevention of financial crises. The EC spokesman in the field of financial regulations, Chantal Hughes, declared that this action would have been more effective if being coordinated at European level. The German decision gave raise to dissatisfaction among the partners from the euro zone, particularly France, thus feeding the uncertainties and the lack of communication which have affected the region since the beginning of debts crisis from Greece.

1. Jen S., „How important will be the sovereign funds by 2015?", Research of Morgan Stanley Bank of investments, May 2007

2. Smith K., Haddock M., "Sovereign funds expected to invest USD 725 billion in real estate by 2015", CB Report Richard Ellis, September 23, 2008

As such, the divergent opinions related to the solutions for tempering the financial markets instability and to the reformation of regulations regarding the financial sector surveillance would be projected at political level. The EU President, Herman Van Rompuy has stated that the close cooperation on all the problems with major impact upon the market is quite important and should be improved. The heads of finances from the EU Member States discussed, during the meeting held on May 21, 2010 the strengthening of budgetary and economic rules, so that to avoid a new debts crisis, similar to the one occurred in Greece.

The Sovereign Wealth Funds Institute estimated the assets of the biggest sovereign wealth fund in the world, Abu Dhabi Investment Authority (ADIA) as being, by the end of March 2010 almost the double of Rockefeller wealth. The richest man of all times succeeded in building up a petroleum empire of over USD 318 billion. ADIA was built up based on petroleum, as well.

Further to the investments made by sovereign funds from the Middle East and Asia, during March 2007 – April 2008, on foreign financial markets, acquiring in their portfolios, for USD 44.9 billion, share stocks on Citigroup, Merrill Lynch, Morgan Stanley, Barclays, Credit Suisse and UBS, the prices recorded, during one year, minimal levels. The appetite for western banks, outlined at that time more clearly than ever, was due either to the desire of controlling the financial world poles and for image reasons (the case of China), or to the willingness of accessing the technical means for financial assets management. The shock of the financial turmoil has stopped any investment in the financial sector, while certain funds, among which ADIA and Qatar Investment Authority, have publicly announced the suspension of foreign investments. During the second half of 2008, the sovereign funds backed off to their own financial markets, aiming at their stabilisation. In 2009, the funds began to regain their interest on foreign markets taking, however, more reserved actions, thus foreshadowing, despite the opacity of decisions, a possible diversification and a higher fragmenting of investments.

The value of investments made by sovereign funds recovered their upward trend. Thus, during the second half of 2009, some funds from the Middle East and from other countries have pumped almost USD 68 billion in direct investments on international markets, as compared to USD 25 billion in the first semester of the same year, preponderantly in industry, infrastructure, energy sector, precious metals and agriculture.

The older sovereign funds of countries from the Gulf area, such as Saudi Arabia, Qatar, Kuwait, United Arabian Emirates and Bahrain, but also the funds of Norway, have preserved the policy of passive investors, approaching, the same with the commercial banks, the long term investments. China and Russia, however, did not limit their actions to the increase in portfolios value, showing also their interest on venturesome assets in the undertakings meant to widen their sphere of influence.

It is also the situation of the United Kingdom. Though London became the logistic centre for many sovereign funds, such as Kuwait Investment Authority, Brunei Investment Agency, ADIA and Temasek (Singapore), the United Kingdom cannot accept the inference of such giants on its financial market. When China and Singapore showed their interest on Barclays Bank or when Qatar intended to take over the Sainsbury supermarkets chain, the United Kingdom took a position on this matter.

The sovereign funds are, however, hard to stop; a force demonstration took place in October 2007, when during a single day almost half of the London Stock Exchange was taken over by two emirates from the Gulf area.

The last report of London Stock Exchange (LSE) of May 2010 reflects the presence of Qatar Investment Authority among the stakeholders (15.1%).

It is hard to accept high volumes of foreign governmental investments, this fact being reflected in the legislation. Thus, the American legislation stipulated, even since 1988 the interdiction of foreign direct investments by the USA President, if they are perceived as a threat to national security. A replication of the American model is to be also found in Europe, namely in Germany, where the legislation enforce the government to block the purchase of at least 25% of the shares of a German company, provided a decision is adopted that the transaction attempts to national security or to the public order. The Russian investments in airspace companies, in telecommunications and in the energy sector are perceived by Germany as a threat, despite Russian official statements denying it. The fears that economics would further act as a foreign policy instrument still persist, particularly due to the reason that this model was propagated so far through state owned companies (see the gas deliveries ceases of Ukraine towards the giant Gazprom).

The most turbulent policy generated by a sovereign fund was manifest, however, at the moment when Temasek Holdings bought participations to a company owned by the ex-Prime Minister of Thailand, Thaksin Shinawatra, this action being followed by anti-governmental manifestations which entailed the removal of Shinawatra by means of a military coup d'etat in 2006.

5. CONCLUSIONS

In the international context, the sovereign funds are not perceived a direct threat for the countries with budgetary deficit, affected by the current crisis, but in view to prevent any risk of this nature, there is an increasing adhesion at international level to the idea that sovereign funds should be regulated through a series of “best practice” directives. Their drawing up and adoption by institutions with global actions, such as the International Monetary Fund, represent an adjuvant for tempering the concerns related to global capital flows politicizing and to financial stability.

The failures experienced since the beginning of the crisis will lead to improved strategies of these financial giants, starting with the increase of internal managerial capabilities, during the last two years, by the recruitment of financial markets professionals, who became available as effect of the crisis. At present, about 45% of the funds assets are managed by foreign managers.

Despite their uninspired investments at the beginning of the crisis, the sovereign funds made proof that the balance of powers at global level has changed in favour of emergent economies, this aspect being proved by the performances of Brazil, Russia, India and China. The economic systems of emergent countries present, however, certain vulnerabilities. Thus, from the position of saviours of world financial system, the sovereign funds are facing now the situation where they are compelled to be primarily concerned by their own economies. For example, the financial problems of Dubai, will need supporting efforts, on the medium and on the long run, from its neighbour Abu Dhabi, therefore involving the power of the biggest sovereign fund in the world. The Russian fund, the biggest country exporting energy products at world level, will not stand impassive neither to energy and crude oil prices diminution, nor to the implicit depreciation of the rouble in relation with the USD. The Chinese funds, on their turn, will not disregard the exports decrease or the problems faced by the banks from the system and will keep on absorbing the liquidity surplus.

Therefore, the strongest investment capacities are now aside the western world, thus contributing to the change in the current world economic order.

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