Data across the globe for the first half of 2010 indicate that the global economic recovery from the 2008–09 financial crisis is under way. However, many analysts anticipate that the recovery will be particularly uneven: strong growth will resume in developing countries, with emerging Asian economies leading the way out of global recession, and developed countries will continue to struggle with a fragile situation and no appetite by the central banks to raise rates in the near future.

Interest rate differentials can be expected only to widen—creating opportunities for arbitrage that produce a resurgence of unsustainable capital flows to developing countries, exacerbate exchange rate pressure and sterilization policies, and intensify global imbalances and reserve accumulations. This macroeconomic and financial landscape is set to create mounting incentives for the central banks of emerging markets to allocate even more foreign reserves into sovereign wealth funds (SWFs) to release the pressure on money supply; reduce the cost of sterilization; and use reserves in excess of prudential levels more productively, away from low-yield, dollar-denominated securities.
Sovereign Wealth Fund Assets and Portfolios

Precrisis estimates of SWF assets ranged from US$13.4 trillion to US$17.5 trillion by 2017.1 If the foreign assets under SWF management were to be invested under the reasonable assumption of a mix between the portfolio allocations of Singapore and Norway before the crisis,2 we could expect SWFs to invest about 20 to 30 percent of their assets in developing countries, of which 45 percent would be allocated into equities, 45 percent into bonds, and 10 percent into private equity, real estate, and commodities. At least US$2.7 trillion to US$5.0 trillion of total assets theoretically could be invested in developing countries by 2017 (equally split between equities and bonds). If one excludes the regions where these funds originate (that is, Asia and the Middle East), these assets could represent 8 to 16 percent of the combined gross domestic product (GDP) in developing countries in Latin America, Africa, and Eastern Europe; 1 to 2 percent of their market capitalization of traded companies; and 10 to 19 percent of the total debt securities in these regions.

However, no one knows with certainty the pace of reserves accumulation and the size of SWF increases at the margin. On the one hand, external imbalances are expected (hoped) to somehow diminish in the medium term, because surplus countries may be under pressure to increase internal demand. On the other hand, the crisis and its associated policy response actions to support the global economy might create mounting incentives for central banks to allocate even more foreign reserves into SWFs, and for the SWFs to seek higher yields and diversification.

Quite naturally, where SWFs invest is also going to be governed by a number of considerations. Although developed countries, and the United States in particular, have been the main recipients of SWF investments to date, a shift in attention toward developing-country securities is likely to increase because of the economic prospects of developed countries in the medium and long terms. Despite differences in investment strategies and appetite for risk and liquidity—reflecting different objectives, liabilities structure, and so forth—the desire to diversify their portfolios in the hope of maximizing returns for acceptable levels of risk is a common feature of all SWFs and will support such a shift (albeit gradually). In September 2009, the move by China Investment Corporation (CIC) to take a US$1 billion minority stake in the Hong Kong,
China–based Noble Group, a commodities trading and supply chain manager, was a step in this direction. J.P. Morgan calculates that other deals worth US$50 billion of investments are likely to materialize between the CIC and companies in developing countries.

In addition to maximizing portfolio performance, portfolio allocations may also have strategic considerations, like future access to commodities. Despite its early, visible stakes in Blackstone, Morgan Stanley, and other financial institutions in the United States, the CIC has also focused on other areas—namely, natural resources (Wei 2007). Before the crisis, for instance, East Asia accounted for more than a quarter of global demand for commodities and a significant portion of demand for agricultural commodities (Lyons 2007). Gaining access to strategic commodities and resources will require not only contracts, but also mergers and acquisitions. In this regard, it has been reported that a number of Chinese companies already have been securing strategic assets in energy and raw material supplies in Africa and Latin America, with the backing of China’s government; the Industrial and Commercial Bank of China’s investment in Standard Chartered was seen by many market analysts as China’s strategic entry point into the African continent, using the bank as the principal investment agent.

In addition to US$1.6 billion of acquired assets at the end of 2005, an additional US$2.3 billion has been invested by China National Offshore Oil Corporation in Nigerian oil and gas exploration (Trinh 2006; Broadman 2007). China Development Bank also has launched a US$5.0 billion China-Africa Development Fund to finance the investment of Chinese companies in Africa, following up what was agreed to at the Beijing Summit of the Forum on China-Africa Cooperation. According to China’s Xinhua News Agency, Chinese and African companies and governments at that summit signed 14 agreements worth US$1.9 billion for projects in infrastructure, telecommunications, and other fields. A deal to build a US$8.3 billion railway in oil-rich Nigeria was announced, as were joint China-Africa plans to explore energy development (China’s Xinhua News Agency). In February 2010, the oil industry in India called for the government to use parts of the US$278 billion in foreign exchange reserves to create an SWF to compete with China in the race to secure global energy assets.
SWFs could, of course, play a role in purchasing government bonds issued by the G-7 countries (projected by the International Monetary Fund to rise from precrisis levels by an average of 40 percent of GDP by 2014). But a gradual shift toward the investments of developing countries may be the most likely outcome. As reserves accumulate, SWF strategy will focus initially on a rebalancing from low-yield assets into high-yield equities. Diversification away from the G-7 is definitely going to be more gradual and incremental. SWFs will avoid a further depreciation of U.S. dollars, and that, in turn, could generate large revaluation losses for the central banks’ dollar-denominated assets and a slowdown in the accumulation of future reserves. As long as countries in which SWFs are fed by the accumulation of reserves resist the appreciation of their currencies, a full diversification away from the dollar will be difficult. At the consolidated level (including central bank purchases), there is already some evidence of portfolio rebalancing. The sale of Chinese holdings of U.S. Treasury debt in December 2009—ceding its place as the world’s biggest foreign holder of U.S. debt to Japan—provides clues about China’s appetite for loaning money to the United States. China pared its Treasury holdings by US$34.0 billion, to US$755.4 billion. Japan’s holdings total US$768.8 billion, according to U.S. Treasury estimates.

**Opportunities and Challenges for Host Countries**

Over the 2010–20 decade, SWFs have the potential to boost global wealth by helping recycle large savings in surplus countries toward more productive investments, particularly in the developing world. Over the medium term, many developing countries will continue to depend on external savings to finance critical investment, since excluding China and major oil exporters, developing countries are (on average) net importers of capital. On the supply side, major fiscal stimulus packages in advanced economies are likely to result in a general re-pricing of sovereign debt risk and the associated cost of borrowing and in more limited access to and a crowding-out of credit for developing-country borrowers, forcing some of them into fiscal austerity if they do not find alternative resources.

In this context, SWFs could bridge the gap between the growing investment needs and the reduced supply of external resources, thereby
sustaining growth, accelerating progress toward the Millennium Development Goals, increasing economic integration, and helping build the foundations for a multipolar world. Africa, in particular, may benefit most from SWF resources, given its relatively weak starting point in trade, regional integration, infrastructure, and private sector development. The World Bank’s (2010) Global Economic Prospects 2010 estimates that most of the 53 developing countries that faced an external financing gap in 2009 had current account deficits of 5 percent or more, with private-sourced net-debt inflows financing equivalent to about 2.2 percent of GDP (0.8 percent if Central Asia and Europe are excluded).

Although SWFs could help recycle large savings generated in surplus countries toward the developing world where capital might be socially and economically more productive, several concerns remain, and the memory of the 1980s debt crisis fueled by the recycling of the savings of oil countries is still vivid.

Debt Run-up
The current global savings glut may have similarities with the recycling of the savings of oil countries that fueled the debt crisis in the 1980s. In the 1970s and early 1980s, these windfalls were deposited in banks in the West and were eventually on-lent to developing countries in Latin America and elsewhere. Today, these windfalls may take the form of SWFs directed, for example, to African countries that are becoming increasingly attractive investment destinations, are growing at the fastest rates in the past four decades, are reforming institutions and improving governance, and, most important, have had their government balance sheets virtually wiped free of external debt as a result of the Heavily Indebted Poor Countries and Multilateral Debt Relief initiatives.

Three important factors should be considered.

- First, even though their external debt may have been slashed, many countries are burdened by domestic debt and contingent liabilities related to loss-making state-owned companies or possible banking system problems.
- Second, the institutional capacity of countries to select high-rate-of-return projects is often limited. Besides, the projects have to be
implemented, monitored, and maintained. In other words, the paucity of investment funds may not be the binding constraint to growth and development.

- Third, portfolio shifts by SWFs may put some upward pressure on the prices of riskier asset classes, such as equities, and downward pressure on bonds, thus increasing yield.

Again, the impact on developing countries will not be negligible in terms of the cost of borrowing, for instance, and of inflated equity prices. Warnock and Warnock (2005) underscore that total foreign buying (private and official) of U.S. bonds in the years leading up to 2005 kept the 10-year Treasury yield 150 basis points lower than it would have been without foreign inflows. The same study estimates that without foreign official buying, long-term rates would have been 60 basis points higher. Miles and Jen (2007) estimate that, all other things being equal, the emergence of SWFs could push up “safe” bond yields over the next 10 years by 30 to 40 basis points and could reduce the equity risk premium by 80 to 110 basis points.

**Financial Stability**

There are also concerns about the impact of SWF investments on the financial stability recipients, particularly those that have more shallow financial markets. Limited information about SWF objectives, strategies, institutional structure, and investment management may reinforce the unfavorable opinions about how SWFs behave.

**Procyclicality and Herding.** SWFs are believed to be countercyclical in supporting prices and markets, since they have traditionally had buy-and-hold strategies. However, procyclical behavior cannot be excluded. Individual transactions undertaken by an SWF may disrupt more shallow financial markets either because the funds might mirror hedge fund strategies of portfolio rebalancing against possible losses or because perceived shifts or rumors and second-guessing about SWF investment decisions may cause volatility and herding. For example, the sale by Singaporean SWF Temasek Holdings of its shares in two big Chinese banks (Bank of China and China Construction Bank) and in Asia’s largest container-shipping group, Cosco, created rumors about the health of the
banking sector and the belief that several areas of the Chinese economy had reached their cyclical peak. That occurred despite Temasek’s statements that the sale was just “part of our ongoing rebalancing of the portfolio against new opportunities” (Burton 2007).

**Short Positions.** We also cannot assume that taking short positions in quick win-win situations will not occur in the future, rather than waiting to step in when asset prices fall. For instance, *The Economist* (2008) mentioned that, four years ago, Norway’s SWFs began to sell short the bonds of Iceland’s banks when a slowdown of the economy was foreseen. Anecdotal evidence suggests that SWFs farm out part of their assets to highly leveraged funds. For instance, a quarter of Singapore’s SWF is believed to be channeled and invested through hedge funds that use this strategy. Jen (2008) estimates that SWFs may outplace 20 percent or more of assets with external investors.

**Opportunities and Challenges for Home Countries**

The idea behind SWFs is quite simple: divert reserves in excess of those needed for short-term current and capital account requirements (Guidotti-Greenspan rule) or for stabilizing exchange rate movements toward long-term diversified portfolios of equities and bonds. In line with long-standing tradition, reserves are invested in safe but low-yield U.S. Treasury bills; when converted into local currency terms, the return could be close to zero or negative because of the depreciation of the dollar. This might be aggravated by sterilization policies intended to maintain price and exchange rate stability.

The Bank for International Settlements has estimated costs of sterilization to be roughly 0.5 to 2.0 percent of GDP for 14 emerging markets. Similarly, Summers (2006) suggests that central bank portfolios have earned around 1 percent real returns annually over the past 60 years compared with about 6 percent for a portfolio diversified in stocks and bonds. With foreign exchange reserves at 50 percent of GDP, in a country like China, a difference of 500 basis points on the returns to reserves amounts to 2.5 percent of GDP a year. This is more risky than investing in U.S. Treasury bills in the short term, but is also likely to yield higher returns over the long haul. However, although the idea is appealing
and some benefits are undeniable, the following challenges are worth mentioning.

**Net Wealth, Repatriation of Assets, and Dutch Disease**

When a substantial amount of the reserve buildup has been the counter-part of the sterilization of central banks, SWF assets can be considered as a purchase with government debt. An analysis conducted by the Bank for International Settlements suggests that, during January 2000 to May 2006, sterilization might have offset as much as 85 to 95 percent of changes in net foreign assets in India; the Republic of Korea; Malaysia; Singapore; and Taiwan, China; and over 70 percent and 60 percent, respectively, in the case of China and the Russian Federation. Therefore, a careful analysis of government whole-balance-sheet effects is necessary to assess real net wealth, which may not be as large as it first appears. The joint balance sheet of government and the central bank actually would worsen with domestic currency appreciation and high domestic interest rates.

A potential currency mismatch is of particular concern for developing countries in light of repatriation of returns on investments, because a country’s future needs (SWF liabilities) are denominated in domestic currency while SWF assets are denominated in foreign currencies. Real convergence and catching up in emerging markets inevitably would force domestic currencies to appreciate in real terms relative to those of developed currencies (the Balassa-Samuelson effect), reducing the real (or nominal, or both) value of repatriated funds. In addition, as SWF returns are repatriated, the influx of dollars cannot avoid the need for an adjustment when dollars are spent, putting additional upward pressure on their currencies and undermining the competitiveness of the traded goods sectors. Bourdet and Falck (2006) studied the effect of Cape Verde remittances on the traded goods sector. As local incomes rose with a doubling of remittances from abroad, the Cape Verde real exchange rate appreciated 14 percent during the 1990s. The export sector of the Cape Verde economy suffered a similar fall in productivity during the same period—a fall caused entirely by capital flows. In the long run, it seems that some form of Dutch Disease is unavoidable for oil-exporting countries whose intention in setting up SWFs is to avoid real exchange rate appreciation.
Opportunity Costs
The issue of investable surplus and real net wealth hints to the opportunity costs attached to the alternative uses of SWF assets. Those opportunity costs arise from the fact that in countries with underdeveloped social and economic infrastructure, social and economic return on investment at home may exceed the return on investing foreign reserves abroad, regardless of the nature of that investment and of the intergenerational preference of the government. In 2006, several authors attempted to measure the opportunity cost of reserves accumulations. For instance, Rodrik (2006) shows that there is a “social cost” to reserves accumulation to the extent that the private sector borrows at a higher rate than what the central bank earns on its foreign currency assets. Similarly, Summers (2006) suggests higher costs based on the foregone return on infrastructure projects.

Since 2003, China has used foreign exchange reserves to support domestic policies, including through the recapitalization of the Agricultural Bank of China and the China Development Bank with capital from the CIC. Russia has taken advantage of run-ups in oil prices to pay down its external debt, and some other governments (such as Brazil) have considered the possibility of using a share of their international reserves in a fund geared toward the promotion of industrial policy. The use of foreign exchange reserves for domestic purposes has its merits but can also be problematic for monetary policy. For commodity SWFs, investing foreign reserves domestically is also a fiscal policy issue because foreign currency accrues directly to the government and is not converted into domestic currency unless it is spent by the treasury.

Concluding Remarks
A prolonged and multispeed recovery period, its associated policy response, and the new global financial landscape might have important bearing on the size and allocation of SWF assets. SWFs could become a driving force in South-South flows, boosting global wealth by helping recycle large savings in surplus countries toward more productive investments. While they indeed represent a new opportunity for developing countries, they also carry challenges for both home and host countries.
Notes

1. Projections are by Morgan Stanley, Standard Chartered, and Merrill Lynch. The International Monetary Fund estimated that foreign assets under the management of SWFs could reach US$12 trillion by 2012.

2. Before the crisis, Singapore’s Government Investment Corporation operated along lines similar to most private investment management companies, allocating resources across a range of asset classes and regions. The corporation was reported to have around 50 percent in equities; 20 to 30 percent in bonds; and 20 percent in private equity, real estate, and commodities. By region, 45 to 50 percent of assets are reported to be in the United States; 30 percent in Europe; 10 percent in Japan; and 10 percent in Asia, excluding Japan. Similarly, Norway’s Government Pension Fund was operating similarly to a pension fund with assets reported to be 50 to 70 percent in fixed-income securities and 30 to 50 percent in equities. Forty to 60 percent of the equity portfolio is invested in currencies and markets in Europe, 25 to 45 percent in the Americas or Africa, and 5 to 25 percent in Asia and Oceania. Where fixed-income securities are concerned, 50 to 70 percent has been invested in currencies and markets in Europe, 25 to 45 percent in the Americas or Africa, and up to 15 percent in Asia and Oceania.

3. Members of the G-7 are the Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

References


