Deutsche Bank Research

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Sovereign wealth funds – state investments on the rise

State-owned investment funds are on the rise, already managing assets in excess of USD 3 tr, i.e. twice as much as the global hedge-fund industry, but still a fraction of other investor categories. Given the growth dynamics, sovereign wealth fund (SWF) assets could grow to over USD 5 tr within the next five years and more than USD 10 tr within the next ten years.

Given such growth, further diversification and focus on returns, **liquidity inflows into a wide range of asset classes** can be expected. At the same time, **demand for asset management and investment banking services** by these funds is set to increase.

SWF growth carries implications for global financial market stability, corporate governance and national interests. **Public policy should be directed by key principles:**

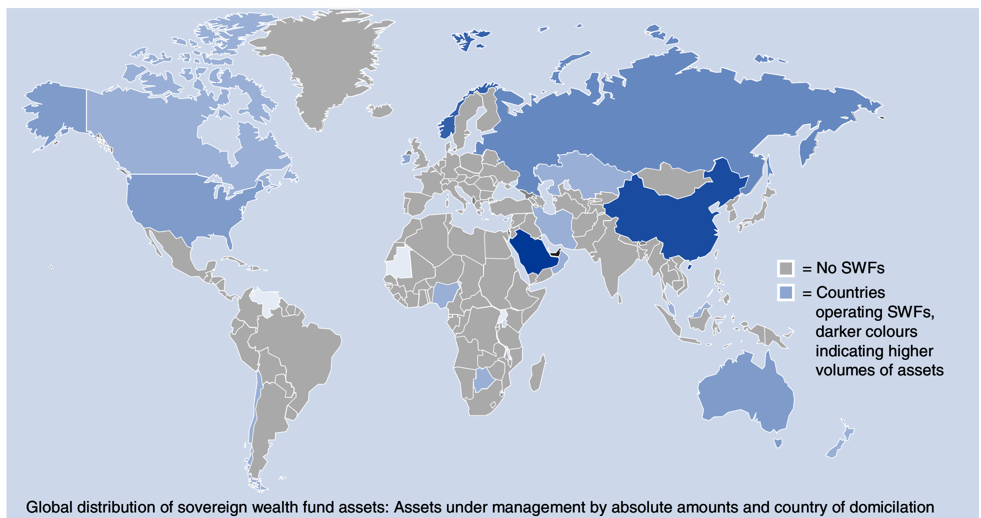
— **Open markets** for foreign investments by SWFs as a general rule.

— **Reciprocity** in openness of market access.

— **Political intervention with politically sensitive investments as a last-resort** option, and only in cases where national security is under threat. Decisions should be based on pre-defined principles. Within the EU, the design of measures and instruments should be coordinated.

— **Greater transparency of SWFs** should be achieved through internationally agreed codes-of-conduct and yardstick best practices devised e.g. in the context of the IMF.

On market access, debate at the national and EU levels is characterised by diffuse concerns and uncoordinated initiatives. There is an **urgent need for greater appreciation of the potential benefits of SWF commitments as well as a sober assessment of the risks involved.**



Global distribution of sovereign wealth fund assets: Assets under management by absolute amounts and country of domicilation

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Sovereign wealth funds – definition and delineation

Sovereign wealth funds – or state investment funds – are financial vehicles owned by states which hold, manage or administer public funds and invest them in a wider range of assets of various kinds. Their funds are mainly derived from excess liquidity in the public sector stemming from government fiscal surpluses or from official reserves at central banks. SWFs can be categorised into two types of funds according to their primary purpose. On the one hand, so-called stabilisation funds aim to even out the budgetary and fiscal policies of a country by separating them from short-term budgetary or reserve developments which may be caused by price changes in the underlying markets, i.e. in oil or minerals, but also in foreign exchange conditions. On the other hand, savings or intergenerational funds create a store of wealth for future generations by using the assets they are allocated to spread the returns on a country's natural resources across generations in an equitable manner.

Even though similar in their purpose and investment behaviour to other forms of funds – such as pension funds, investment funds and trusts, hedge or private-equity funds – SWFs essentially differ from the former as they are not privately owned, raising important questions in terms of financial market policy and corporate governance. Chart 1 provides a list of the major SWFs worldwide, including estimates of the values of assets they manage as purported by public sources, as well as the respective year of inception and the source from which their funds are reported to be drawn.

State-owned funds represent just one way of holding financial and corporate assets from a state's perspective. Alternatively, states can invest directly in financial assets, especially stocks, and act as passive or active minority or majority stakeholders. Similarly, state entities can hold assets on behalf of the state. These entities primarily include central banks, holding official reserves. Further, states can be indirect owners of financial assets via existing state-owned companies which in turn take stakes in private companies. Finally, states can take informal influence on private corporations, e.g. by influencing corporate decisions or management selection of private companies. These are important channels of state influence on the private sector that in many cases today are more significant inroads than SWFs.

Introduction

A global industry of state-owned funds almost twice the size of the hedge-fund segment, with discretionary asset management strategies and virtually no transparency vis-à-vis the outside world? This scenario has attracted increasing attention by policymakers, market participants and commentators in the past months. Policy action has been announced, working groups formed and comments disseminated from various sides in reaction to an industry which is increasingly perceived as a potential source of challenges to the global financial system.

Yet, so-called sovereign wealth funds (SWFs) have been around for many decades, but have largely gone unnoticed so far. What is different these days are the scale of the SWF business and the perception of the potential influence these funds may have as investors at a global scale, in conjunction with the emergence of new players, mainly in emerging markets. Public attention has, in addition, been raised by concerns over a potential sale of strategic assets, a transfer of vital industrial knowledge and expertise, or issues of public security.

All this taken together, this appears to turn the world upside down – a paradigmatic change from a world in which private investors from wealthy industrialised countries used to invest around the globe to one in which emerging market governments become major share-holders in Western companies. An allegedly new twist in the globalisation story – *in extremis* feared by some to herald the sell-out of important strategic assets in the Western industrialised world.

To be sure, these concerns bear little relation with today's reality. This article[1] looks into the largely unknown world of sovereign wealth funds and puts them into perspective with global financial markets, towards an assessment of their current and future importance, and discusses the policy questions at hand.

It will be argued that, in the first place, SWFs are welcome investors bringing important injections of liquidity to a broad range of asset classes. Although not nearly as large as other, traditional institutional investors such as investment and pension funds or insurance companies, SWFs have already trespassed the threshold to systemic significance in financial markets. This, as well as political fears about the potential implications for single companies and economies at large of foreign state investments have provoked serious questions about the need for regulating the SWF industry. We propose that any steps in that direction should be well-considered, well-coordinated, and fundamentally based on the principle of free market access.

Sources of sovereign wealth

SWF funds generally reflect the availability of excess government revenues and reserves in the relevant countries and the perceived need to manage these funds with a view to meeting the specific future liquidity needs according to the fund's objectives and smoothing income streams.

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[1] I would like to thank Philipp König for his valuable research assistance.

Overview of important SWFs worldwide

Country	Fund	AuM (USD bn)	Inception year	Source
United Arab Emirates	Abu Dhabi Investment Authority (ADIA)	875	1976	Oil
Singapore	Government of Singapore Investment Corporation (GIC)	330	1981	Non-commodity
Norway	Government Pension Fund - Global (GPFG)	322	1990	Oil
Saudi Arabia	Various funds	300	NA	Oil
Kuwait	Kuwait Investment Authority (KIA)	250	1953	Oil
China	China Investment Company Ltd.	200	2007	Non-commodity
Hong Kong	Hong Kong Monetary Authority Investment Portfolio	140	1998	Non-commodity
Russia	Stabilization Fund of the Russian Federation (SFRF)	127	2003	Oil
China	Central Hujin Investment Corp.	100	2003	Non-commodity
Singapore	Temasek Holdings	108	1974	Non-commodity
Australia	Australian Government Future Fund (AGFF)	50	2004	Non-commodity
Libya	Reserve Fund	50	NA	Oil
Qatar	Qatar Investment Authority (QIA)	40	2000	Oil
United States	Alaska Permanent Reserve Fund Corperation (APRF)	40	1976	Oil
Brunei	Brunei Investment Agency (BIA)	35	1983	Oil
Ireland	National Pensions Reserve Fund (NPRF)	29	2001	Non-commodity
Algeria	Reserve Fund	25	NA	Oil
South Korea	Korea Investment Corporation (KIC)	20	2006	Non-commodity
Malaysia	Khazanah Nasional BHD (KNB)	18	1993	Non-commodity
Kazakhstan	Kazakhstan National Fund (KNF)	18	2000	Oil, gas, metals
Canada	Alberta Heritage Fund (AHF)	17	1976	Oil
Taiwan	Taiwan National Stabilisation Fund (TNSF)	15	2000	Non-commodity
United States	New Mexico State Investment Office Trust Funds	15	1958	Non-commodity
Iran	Foreign Exchange Reserve Fund	15	1999	Oil
Nigeria	Excess Crude Account	11	2004	Oil
New Zealand	New Zealand Superannuation Fund	10	2003	Non-commodity
Oman	State General Stabilisation Fund (SGSF)	8.2	1980	Oil, gas
Chile	Economic and Social Stabilization Fund (ESSF)	6.0	2007	Copper
Botswana	Pula Fund	4.7	1993	Diamonds et al.
United States	Permanent Wyoming Mineral Trust Fund (PWMTF)	3.2	1974	Minerals
Norway	Government Petroleum Insurance Fund (GPIF)	2.6	1986	Oil
Azerbaijan	State Oil Fund	1.5	1999	Oil
East Timor	Timor-Leste Petroleum Fund	1.2	2005	Oil, gas
Venezuela	Investment Fund for Macroeconomic Stabilization (FIEM)	0.8	1998	Oil
Kiribati	Revenue Equalisation Reserve Fund (RERF)	0.6	1956	Phosphates
Chile	Chile Pension Reserves Fund	0.6	2007	Copper
Uganda	Poverty Action Fund	0.4	1998	Aid
Papua New Guinea	Mineral Resources Stabilization Fund (MRSF)	0.2	1974	Minerals
Mauritania	National Fund for Hydrocarbon Reserves	0.0	2006	Oil, gas
United Arab Emirates	Dubai Intern. Financial Centre Investments (DIFC)	NA	2002	Oil
Angola	Reserve Fund for Oil	NA	2007	Oil
Total		***3,190.00***		
Memorandum items: Planned SWF projects				
China	State Foreign Exchange Investment Corporation (SFEIC)	200	2007e	Non-commodity
Russia	Future Generations Fund of the Russian Federation (SFRF)	32	2008e	Oil
Bolivia	(Establishment of SWF planned)	NA	2008e	Oil
Japan	(Establishment of SWF presumed)	NA	NA	Non-commodity
Total incl. Memorandum items		*3,422.00*		

Data on assets under management reflect latest available figures as reported by each individual entity or other authoritative sources. Various reporting dates between 2004 and 2007.

Sources: Various public sources, DB Research **1**

Evolution of the SWF industry

The history of SWFs dates back to the 1950s. In 1953, the Kuwait Investment Board was set up with the aim of investing surplus oil revenues to reduce the country's reliance on its finite oil resources. Replaced in 1965 by the Kuwait Investment Office (KIO), a subsidiary of the Kuwait Investment Authority (KIA), the organisation today manages a substantial part of the Future Generation Fund to which the State of Kuwait allocates 10% of the country's oil revenues annually. The KIO portrays itself as a global investor with investments in all main geographical areas and asset classes, managed actively and with a long-term view to outperformance relative to the benchmark and within specific risk parameters.

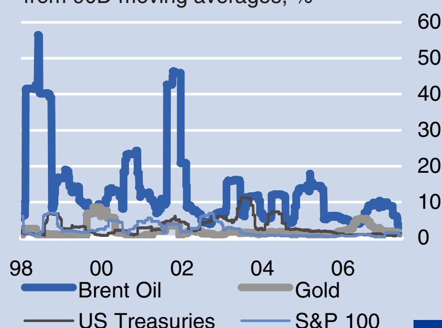
In 1956, the British colonial administration in the Gilbert Islands (since 1979 the Republic of Kiribati) established the Revenue Equalisation Reserve Fund (RERF) to hold royalties from phosphate mining in trust for the Pacific island state. Since its inception, assets under management by RERF have grown to AUD 636 m, corresponding to nine times Kiribati's GDP and returning investment income of around 33% of GDP. The fund is a major source of revenues for the country and well diversified with investments overseas.

Since these first two funds were established, the number of SWFs has grown in two major waves, first in the 1970s – e.g. Singapore's Temasek Holdings in 1974 and the Abu Dhabi Investment Authority, ADIA, in 1976 –, and, second, since the 1990s the Iran Oil Stabilisation Fund (1999; also Foreign Exchange Reserve Fund), the Qatar Investment Authority (2000), and others.

Today, the SWF industry comprises more than 40 institutions. This includes a number of large funds with assets under management in excess of USD 100bn each. The Abu Dhabi Investment Authority (ADIA) and the Government of Singapore Investment Corporation (GIC) are considered the two largest funds with estimated assets of USD 875 bn and USD 330 bn, respectively.

Asset volatility in comparison

Price volatilities, standard deviation from 90D moving averages, %



Source: DB Research

2

In practice, the excess revenues and reserves invested in SWFs in most cases originate from the sale of oil, gas or other natural resources. This is well reflected in the overview of fund sources of SWFs presented in chart 1. The majority of SWFs can be found in oil exporting or otherwise commodity-rich states in which the proceeds from the sale of the natural resources or taxes levied on commodity income of private corporations accrue to the state. Typical examples for oil-exporting countries operating SWFs include Kuwait, Qatar, the United Arab Emirates, Saudi Arabia, Russia, Venezuela or Alaska in the United States. In countries like Chile, Botswana and Kiribati, natural resources in the form of copper, diamonds or minerals form the basis of SWF funding.

Other than commodity proceeds, SWF funding can originate from general budget or external surpluses that governments choose to invest in such funds. In particular, some countries – most notably in the recent case of China – dedicate official central bank reserves to state funds. Conventionally, these reserves have been invested by central banks in liquid sovereign debt as well as precious metals, notably gold.

Rationale of outsourcing funds to SWFs

In contrast to consuming what can be regarded as temporary profits, or to investing them directly in state-run projects such as infrastructure, states operating SWFs allocate their excess funds to these vehicles which are separate, often largely independent operational entities, aiming at a systematic, professional portfolio management.

The case for a systematic external fund management can be made on the basis of two principal challenges to the accumulation of national wealth over time. First, natural resources are exhaustible, and their consumption and export leads to their depletion. Similarly, superior international competitiveness of domestic industries can be a transitory phenomenon that may substantially change in the course of time. Governments are therefore confronted with the challenge of inter-generational equity as well as of transforming the present-day revenue streams from the sale of the resources or other export successes into sustainable income. Second, the international market for commodities is characterised by a high level of price volatility. As chart 2 illustrates, this makes natural resources comparatively risky assets[2] from which societies may wish to diversify.

In the light of these challenges, the potential advantages of delegating national wealth management to an SWF can be summarised as follows:

— **Intertemporal stabilisation**

SWFs – especially stabilisation funds – can help shield an economy against volatility in markets of critical value for an economy, such as oil or other commodities. In this case, the fund serves as a liquidity pool which is replenished at times of favourable commodity price conditions or reserve inflows, and which can be drawn upon in cases of low asset prices or shortage of reserves.

[2] For a detailed comparison of the relative risks see Johnson-Calari (2007).

Effectiveness of SWFs

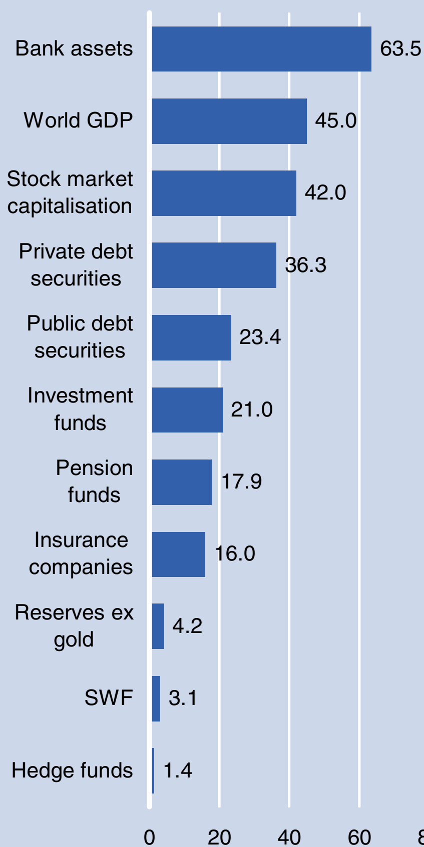
Based on an econometric study of 12 economies, including 5 with a natural resource fund and 7 without, the IMF draws five conclusions on the effectiveness of such funds:

- For countries with resource funds, the establishment of the fund did not have an identifiable moderating impact on government spending.
- In terms of causality, findings suggest that countries with more prudent expenditure policies tended to establish resource funds, rather than the fund itself leading to increased expenditure restraint.
- The establishment of resource funds may have helped in the relevant cases to maintain cautious policies in the context of ongoing revenue variability.
- The coordination of fund operations with overall national fiscal policy – to the extent that this is defined as a policy objective – has proven difficult.
- Evidence suggests that funds have been most difficult to operate when the extent of reliance on resource revenues has been largest.

Source: Davis et al. (2001). The evidence is exclusively based on natural-resource funds.

SWF – asset volume in comparison

Indicators for size of markets worldwide
USD tr, 2005



Source: DB Research **4**

— **Diversification**

Oil or other commodity exporting economies often run substantial concentration risk owing to their dependence on the natural resource they sell on international markets. This risk is particularly salient with regard to the exhaustibility of natural resources as well as the danger of misallocation of capital if the sale of natural resources in turn leads to an appreciation of the real exchange rate and thereby diminishes the competitiveness of other sectors in the economy.[3] The diversification of national wealth by investing internationally and in a greater range of assets can help reduce these concentration risks.

Annualised risk and return of investment portfolios

1946-2004

Stylised portfolio	Average real return in % p.a.	Annualised standard deviation of return in %	Probability of negative real return for 10Y holding period in %
Typical central-bank portfolio	0.98	1.24	37.0
Typical pension-funds portfolio	5.75	12.45	12.5
All-US-stocks portfolio	7.11	19.37	13.3

Source: Summers (2007) **3**

— **Risk-return optimisation**

Governments may seek to optimise their risk-return profile on national wealth. Looking at conventional reserves management as undertaken by central banks, central-bank portfolios – typically invested in short-duration, high-grade government securities and money market instruments – have earned around 1% real returns annually over the past 60 years. In contrast, the equivalent real return on a diversified portfolio of 60% stocks and 40% bonds would have been about 6%, as summarised in chart 3.

To be sure, a diversification into stocks and bonds may be associated with significant risk premia, as the annualised standard deviations of returns in the above table illustrates. Assuming a longer investment horizon, however, relative risks change so that, for a 10-year holding period, the probability of a negative real return on a diversified pension-fund type portfolio actually lies noticeably below that of a conventional central bank reserves portfolio. This suggests that governments can realise substantial net benefits in the long run by redirecting excess revenues or reserves to dedicated fund management.

— **Transparency**

Allocating assets to SWFs can help increase transparency and accountability in the government sector by increasing public scrutiny of public finances. Depending on the organisational form and on the reporting requirements which the fund is obliged to fulfil, managing national assets via a separate entity can, in

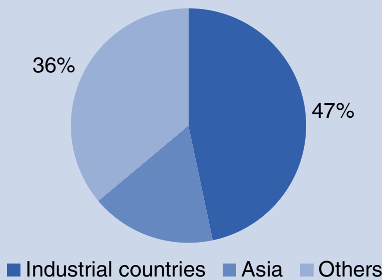
[3] For a detailed discussion of what is often referred to as the Dutch Disease, see Rietveld et al. (2007).

Regional distribution of official reserves

Official reserves in % of worldwide total

1996

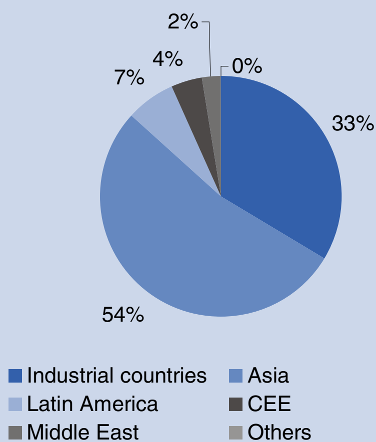
Total official reserves: USD 1.5 tr



Industrial countries ■ Asia ■ Others

2006

Total official reserves: USD 4.2 tr

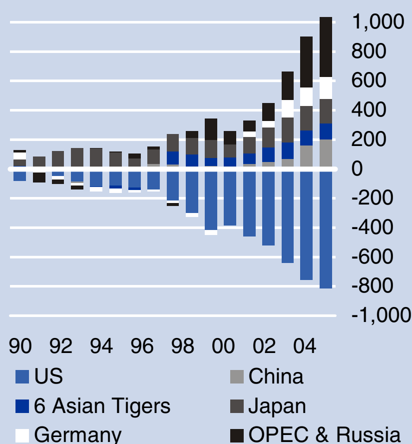


Industrial countries ■ Asia ■ Latin America ■ CEE ■ Middle East ■ Others

Sources: Bank for International Settlements, DB Research **5**

Global current account divergences

Current account balances, USD bn



Sources: IMF, DB Research **6**

theory, contribute to a less opaque management of national wealth.[4]

To date, there is no comprehensive and conclusive evidence on the extent to which SWFs have been able to realise these potential benefits in practice. Focusing on natural resource funds, the IMF has analysed a selected number of cases, evidence on which suggests that, as a general rule, improvements in terms of stabilisation and diversification can be achieved (see box page 5). Thus, both theory and practice suggest that there are good incentives for governments in situations of excess revenues or excess reserves to consider having sovereign wealth managed by separate SWFs.

Management of SWF funds

SWFs can differ substantially in their asset allocation and risk management behaviour. Most importantly, these differences originate from diverging objectives with respect to their intertemporal obligations: Intergenerational funds can be expected to adopt a long-term approach to their investment and spending decisions, while stabilisation funds also need to be able to react to funding and investment developments in the short term, if necessary. Common to both types is that they need to strike a delicate balance between the social objectives of investing sovereign funds safely, retaining sufficient liquidity, generating high returns on their investment, managing the funds efficiently and – in most cases – in a manner that secures the trust of the wider public to whose benefits they are usually erected.

To these ends, SWFs enjoy substantial freedom in selecting the assets that they deem appropriate for investing the funds entrusted to them. The extent to which they can do so is in some cases regulated in the laws or statutes by which each fund is established. In clear contrast to the reserves management by central banks, which have traditionally limited their investments to precious metals, especially gold, as well as sovereign debt securities, typically US Treasury Bills, the asset classes in which SWFs are observed to be investing are substantially broader, including public and private debt securities, equity, private equity, real estate and the use of derivative instruments.

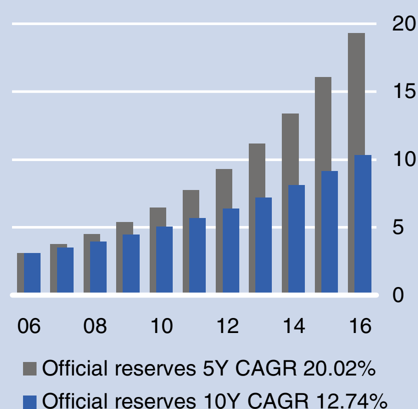
Unless regulated otherwise, SWFs are not subject to investment rules with respect to certain asset classes or currency exposures as they are known for private pension or investment funds. In terms of the range of their investment options, SWFs are therefore more similar to hedge funds than to the regulated fund industry. At the same time, and as emphasised by many SWFs especially of the savings-fund type, their investment horizon can be considered as rather long term, whereas purely speculative elements are understood not to play a dominating role in their investment strategies. This may be interpreted as differentiating the asset management by SWF from that of hedge funds. In practice, the asset allocation e.g. of Norway's Government Pension Fund – Global, one of the largest single state investment funds, very much resembles that of a typical pension fund.[5] Other funds, again, have

[4] For details see Rietveld et al. (2007).

[5] According to the regulations of the GPFG, 50% to 70% of the Fund's overall portfolio is to be invested in fixed income securities and 30% to 50% in equities.

SWF growth scenarios

Total AuM based on past 5Y and 10Y growth of official reserve assets, USD tr



Sources: Bank for International Settlements, DB Research

7

Outlook on SWF growth – calculative uncertainties

The simple calculation presented here sheds some light on the potential weight of state-funded investment entities in the medium to long term provided that the favourable economic conditions observed over the past decade, especially in emerging economies, persist. Such projections, however, are subject to a number of substantial economic and political uncertainties, most importantly, the general level of growth, especially in the emerging markets, the development of individual balances of payment, and commodity prices, especially oil. In addition, the calculation entails some specific imponderabilities – on the downside as well as the upside:

- The actual growth of SWF assets may be substantially weaker than these figures suggest if asset inflows into state funds are reduced by e.g. cyclical downturns in general, a weakening of competitiveness in exporting economies, or a slowing of oil price rises in the case of oil exporting countries.
- Additional transfers from official reserves into SWFs are far from unlikely, given the current level of excess reserves in the emerging markets. Even by conservative measures, excess reserves have been calculated to amount to more than USD 1.5 tr in the emerging markets.
- The above results may be taken as conservative projections, taking into account that they start off from the current estimates of existing state funds and do not discount that countries which have not established SWFs so far may decide to rededicate available funds into SWF-type entities in future.
- More optimistic assumptions on general economic and commodity market conditions yield considerably higher forecasts.

been observed to be pursuing significant stakes in selected companies on a discretionary basis, mostly with a passive approach to management intervention but at times also direct involvement, very much resembling investment strategies typically associated with private equity funds.

Especially in the case of discretionary fund management, little is known about the extent to which the management of SWFs is independent in its investment decision with the aim of maximising the return of the portfolio, or whether the government on behalf of which the SWF operates actually intervenes, and whether such interventions are in any way politically motivated. In general, the scant knowledge about SWF investment strategies together with uncertainties about potential political motivations behind discretionary investments have contributed to the widespread perception in countries with liquid and efficient capital markets that SWFs are intransparent if not incalculable participants in global financial markets.

Market size and growth trends

As SWFs commonly do not disclose detailed information about their operations, individual figures and the total volume of assets managed by state-owned funds cannot be quantified with precision. Based on market estimates[6], assets under management by SWFs may currently amount to over USD 3.1 tr. This is more than twice the size of the hedge fund industry's USD 1.4 tr assets under management[7], but only a seventh of the global investment-fund industry (USD 21 tr assets under management[8]), and less than 5% of bank assets worldwide.[9] In terms of size, therefore, SWFs are a more significant industry than hedge funds, but – for the moment – are far smaller than most other types of institutional investors.

Their relative weight in global capital markets, however, may well change in the years to come given the growth dynamics behind state funds, especially in emerging economies, as the volume of funds disposable for SWF investments may increase substantially in future. This is, among other variables, reflected in the growth of official reserves, one of the major sources of SWF funding in many countries, and an important indicator for the net capital inflows into a country, even though the precise correlation between the two variables is not possible to specify owing to the lack of data.

International reserves have been growing steadily over the past years. This has particularly been the case in many emerging economies which benefited from oil revenues, such as oil-exporting countries in the Middle East or Latin America, or rising competitiveness and improving balances of payments vis-à-vis established industrialised economies, especially China, South Korea or Taiwan. As depicted in chart 5, the share of these countries in official

40% to 60% of the equity portfolio is invested in currencies and markets in Europe, 25% to 45% in the Americas or Africa and 5% to 25% in Asia and Oceania. Where fixed income securities are concerned, 50% to 70% has been invested in currencies and markets in Europe, 25% to 45% in the Americas or Africa and up to 15% in Asia and Oceania.

[6] Data on global assets under management and figures presented in table 1 are extracted from various publicly available sources. Calculations by Deutsche Bank Research.

[7] International Monetary Fund.

[8] European Fund and Asset Management Association.

[9] International Monetary Fund.

reserves has increased significantly over the past decade.[10] The substantial absorption of commodities and goods and services by industrialised economies from these regions is at the centre of this success, causing large current account surpluses there as well as the frequently criticised deficit in the US[11] (see chart 6). The distribution of SWFs in regional terms reflects this development and stands in close relationship with that of official reserves, as already discussed, highlighting the dominance of emerging economies, especially in Asia and the Middle East, in asset accumulation.

In quantitative terms, the growth of official reserves worldwide has been strong, with a compound annual rate of growth of 13% over the past decade and even 20% in the past five years. The accumulation of revenues and reserves in the relevant countries is set to continue as long as consumption and production patterns in industrialised and emerging economies and the resulting current account surpluses prevail and major adjustments in exchange rates and exchange-rate policies are excluded. Likely increases in savings ratios, especially in the US, as well as strengthening domestic demand in Asian economies and further revenue diversification in the Middle East may, however, mitigate the global current account imbalances in the years to come.[12] Thus, if official reserves were to grow at the ten-year average pace going forward, and assuming SWF funds were to increase in line, total SWF assets under management may *ceteris paribus* increase to more than USD 5 tr within the next five years and in excess of USD 10 tr within the next decade, as illustrated in chart 7.

SWFs, investment patterns, and governance – the implications

Based on the above stock-taking, we may conjecture that nothing about SWFs is particularly novel or disconcerting. In particular, institutional investors, especially those with a long-term investment horizon, are usually greeted on equity markets as welcome providers of capital. In as far as both pension-fund type SWFs as well as those more similar to private equity funds can be considered to pursue such long-term objectives, companies looking for a stable capital base may consider SWFs as very attractive and reliable investors. Indeed, state funds have been in high demand by investor relations professionals from all over the world for quite a while.

Nevertheless, the SWF industry has been the subject of debate from various sides in politics and the business community. This has been the case most notably in the deliberations on the review of foreign investments in the United States (see box on page 11), and since then in the increasingly lively debate in the EU and its member states as to whether equivalent measures should be sought in Europe.

The debate has been fuelled by the startling growth of SWF assets worldwide, but even more so by a number of major investment decisions by individual SWFs and other state entities, as summarised in the box on the left-hand side. Large-scale transactions of this sort have attracted increasing attention in the US and Europe.

Major state investment projects by SWFs and other state entities

- USD 1.75 bn takeover of IBM's personal computer business by China's Lenovo Group in 2004.
- USD 18.5 bn bid by China National Offshore Oil Corporation (CNOOC) – 70% owned by the Chinese government – to buy US oil major Unocal Oil Company in July 2005, eventually withdrawn.
- So-called Dubai Ports deal – the attempt on the part of DP World, a company owned by the government of Dubai, to acquire the Peninsular and Oriental Steam Navigation Company (P&O), domiciled in London, which was then the fourth largest ports operator in the world, running major US port facilities in New York, New Jersey, Philadelphia, Baltimore, New Orleans, and Miami. The eventually failed transaction was a catalyst for the debate on a reform of the existing CFIUS legislation in the US.
- Acquisition of a 9.9% stake in The Blackstone Group L.P. by the yet to be established state foreign exchange-investment company in China in May 2007. The USD 3 bn investment was made in the form of non-voting common units.
- Increase in the existing 7.6% stake of Delta Two – an investment vehicle owned by the Royal Family of the Kingdom of Qatar – in J Sainsbury plc to a total of 25% in June 2007 by acquiring an additional USD 1.5 bn stake, making Delta Two the largest single shareholder.
- USD 3 bn and USD 2 bn July 2007 investment in Barclays PLC by China Development Bank and Temasek Holdings Ltd. for a 3.1% and 2.1% stake, respectively, with a conditional offer to increase their investment to a combined total of USD 19 bn in case the planned merger with ABN Amro succeeds.
- Rising engagement of China in Africa and Latin America: More than 650 Chinese state companies are invested in Africa, especially in sectors such as oil, other commodities and telecommunications. At USD 1.6 bn at end-05, China is increasingly securing strategic assets in the region, an approach recently underscored by a USD 2.3 bn investment by China National Offshore Oil Corporation (CNOOC) in Nigerian oil and gas exploration (for details see Trinh (2006), Broadman (2007)).

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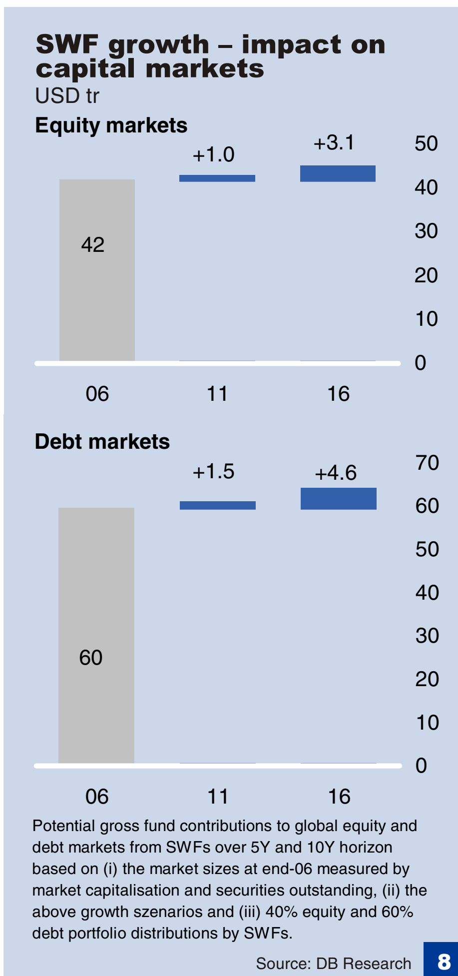
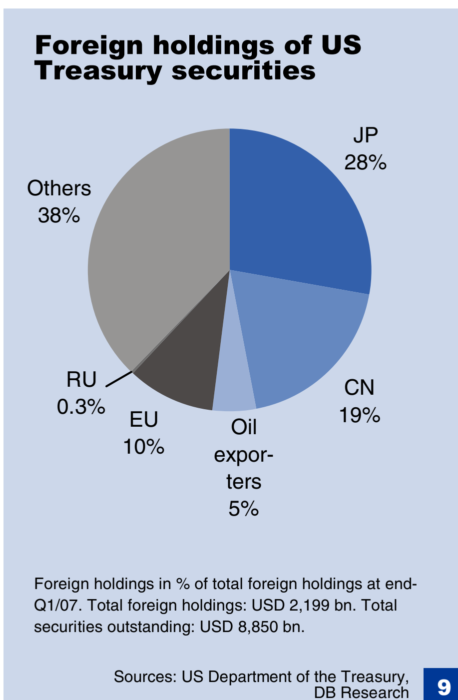
[10] For a comprehensive review of the current distribution of global official reserves as well as their future development see Becker (2007).
[11] For details see Gräf (2007).
[12] Gräf (2007).



Potential gross fund contributions to global equity and debt markets from SWFs over 5Y and 10Y horizon based on (i) the market sizes at end-06 measured by market capitalisation and securities outstanding, (ii) the above growth szenarios and (iii) 40% equity and 60% debt portfolio distributions by SWFs.

Source: DB Research 8



Foreign holdings in % of total foreign holdings at end-Q1/07. Total foreign holdings: USD 2,199 bn. Total securities outstanding: USD 8,850 bn.

Sources: US Department of the Treasury, DB Research 9

Even though most of these transactions did, in fact, not involve SWF activities at all, they have repeatedly been cited in public debate, highlighting the size of the foreign investment business, the increasing interest on the part of emerging markets for American and European companies, the ample funds available for large-scale transactions, as well as the potential strategic implications such acquisitions may have for macroeconomic, security and industrial policy. These concerns together with the repeated lack of delineation between SWFs and other state entities underline the importance of a thorough investigation of the policy-related arguments.

Changing capital flows and market opportunities

In the first place, the rise of SWFs bears the potential of perceivably changing global asset allocation, capital flows, and asset prices.

— **Increase in demand for capital market products**

Given that their funds are ample and projected to grow substantially, the investment activities of SWFs can be expected to continue to rise in line. As most SWFs enjoy considerable freedom in their investment decisions and are expected to maximise performance, not least by diversifying their assets and seeking international investments, a substantial inflow of funds from SWFs in emerging economies to assets in industrialised countries can be expected.

In their asset management, SWFs are likely to behave similarly to investment, pension, hedge or private equity funds, seeking to diversify across a wide range of asset classes in different countries. This suggests that SWF growth will likely lead to an increase in demand for stocks, private and public bonds, as well as real estate, but also private equity, possibly also funds or hedge funds, as well as the use of derivative instruments.

In quantitative terms, future SWF asset allocation could lead to a gross capital inflow of over USD 1 tr into global equity markets and USD 1.5 tr into global debt markets over the coming five years, if SWFs were to grow in line with the above projections and invested their funds along a stylised, pension-fund-typical, portfolio with a 40% allocation into equities and 60% into interest-bearing securities. Ten years from today, the total additional liquidity could amount to more than USD 3 tr for equities and USD 4.5 tr for debt markets (see chart 8).[13]

For the assets concerned, pressure on prices is likely to rise at the margins while debt yields will tend to fall, with the extent of price and rate changes depending on the overall volume and individual sizes of investments undertaken by the funds. Also, the overall effect of additional funds from SWFs into global capital markets will depend on the likely outflows owing to potential substitution effects. Overall, however, the size of demand and price effects can be expected to be small, considering the volume of inflows into or outflows from capital markets induced by other, more sizeable institutional investors, or private investments.

[13] The calculation abstracts from financial assets other than equity and interest-bearing securities, especially real estate, and does not include substitution effects or other potential outflows.

CNOOC, DP World, CFIUS, FINSA – the US debate

The 2005 bid by CNOOC for Unocal and the attempted acquisition of P&O by DP World sparked off an intense debate in the US about the review of foreign investments in the light of security concerns in the post-9/11 world, reflecting fears of a sell-out of companies in strategically important sectors, such as the oil industry, and of foreign control over sensitive infrastructure like marine cargo facilities.

The review process regarding foreign investments has since 1988 been based on the Exon-Florio Amendment (EFA) of the 1950 Defence Production Act, authorising the US President to prohibit or suspend foreign acquisitions of US business if they were considered credible threats to US security and no other legal authority offered appropriate counter-measures. Reviews of acquisitions covered by the EFA are carried out by the Committee on Foreign Investments in the US (CFIUS), an interagency body chaired by the Treasury, which presents its recommendations to the President who has the authority of taking appropriate decisions. Since 1988 CFIUS has reviewed around 2,000 cases, with only a small fraction withdrawn or modified in light of CFIUS concerns, and only one case in which the President ordered the divestiture of a Chinese company's acquisition of a US aircraft parts company in 1988.

At the time the CNOOC and DP World issues emerged, criticism of CFIUS and the review process mounted, pointing at frequent disagreement over the assessment of security threats between CFIUS and the security agencies (Departments of Defence, Justice and recently Homeland Security). Also, the divergence of views on the optimal extent of CFIUS reviews, risk mitigation measures, their enforcement and what was perceived as an evident lack of expertise among the decision makers involved, was criticised.

The debate of these weaknesses ultimately led to the adoption of the recently signed 2007 Foreign Investment and National Security Act (FINSA), which amends the EFA and provides for a rigorous CFIUS process, including:

— Statutory mandate for CFIUS
— Reform of CFIUS composition
— Appointment of a lead agency for each dossier, while retaining Treasury chairmanship of CFIUS
— Clarification of scope – national security, homeland security, critical infrastructure and further criteria for CFIUS review
— Streamlining of the review process
— Clarification of mitigation process
— Notification of selected Congressional leaders

— **Substitution effects on asset classes**

For those SWFs originally funded out of existing liquidity pools or official reserves, new investments in capital market products may be accompanied by substitution effects, as existing investments in capital market instruments – especially the investment of official central bank reserves in liquid assets such as money market instruments or short-term government paper – will be replaced by investments in assets with higher expected returns, i.e. stocks or private bonds. The impact of such substitution effects may be significant, considering that e.g. China is currently holding USD 420 bn worth of US Treasury securities, i.e. a 19% share in total foreign holdings of US Treasury securities as depicted in chart 9, and is understood to be absorbing more than half of all net new outstandings. Should this absorption capacity diminish as SWFs diversify former reserve funds into other assets, this may have a perceivable impact on market demand and yields. A similar logic would apply to other forms of highly liquid assets. Again, the effects on demand and prices can be conjectured to be comparatively small given the dynamics of inflows and outflows from capital markets originating from other, quantitatively more potent institutional or private investors.

— **Demand for asset management and investment services**

The rise of the SWF industry will not only impact securities markets but also the investment services around the trading and acquisition of equity and debt instruments. For one thing, SWFs have the choice of outsourcing all or a part of their funds to outside fund managers, as has been done by Korea Investment Corporation which is estimated to have around three-quarters of their USD 20 bn portfolio managed by outside fund managers.

Similarly, SWFs can purchase parts of the asset-management value chain from independent suppliers. Thus, market analysis and investment evaluation, portfolio construction and monitoring, securities trading, clearing and settlement, hedging and risk mitigation are services which a state fund can delegate to a third-party provider without establishing and maintaining own expertise and infrastructure in these areas.

Finally, SWFs also acquire and dispose of significant equity stakes or debt tranches in individual companies, which can involve complex investment banking services. These include advisory, valuation and due diligence, legal and accounting advice, placement and distribution, and settlement services.

Given the diversity and scale of SWF investment activities, they can benefit from outsourcing asset management and investment services to third-party providers in possession of the required expertise and infrastructure. Based on the above growth projections for the industry, a significant increase in demand by SWFs for investment banking and broker-dealer services can be expected.

Transparency and financial market stability

A second important aspect of the growth of SWF activities is related to their potential impact on financial market stability. As already pointed out, the SWF industry has grown to more than twice the size of the hedge-fund industry. Judged by the size of the industry, and to the extent that the various players can – despite substantial differences in their market behaviour – be considered a homogeneous group of investors, the SWF industry represents a systemically

Herding and contagion potential risks

relevant part of the global financial industry. Given the volume of individual funds as well as of single investments held by these entities, this may also apply to individual funds in the industry. It cannot be excluded that an individual transaction undertaken by one SWF may lead to herding behaviour by other market participants, resulting in excessive capital movement and price and rate changes for the security concerned as well as – if contagion effects occur – for correlated assets. *In extremis*, such herding behaviour can destabilise regional or segmental parts of the financial industry or even financial markets at a global scale.

Intransparency of SWF industry aggravates systemic risks

The probability of herding behaviour and contagion is aggravated by the fact that SWFs are comparatively opaque entities. To be sure, state investment bodies have never been famous for their transparency, as the notorious secretiveness of central banks over their reserves management suggests. In contrast to central banks, however, SWFs invest in a far broader range of potentially less liquid securities. Also, central banks directly or indirectly carry responsibility for the stability of financial markets, providing an important incentive for cautious market behaviour. SWFs, in contrast, are primarily maximisers of portfolio value, and not of market stability, making them more similar to regulated and supervised institutional investors.

SWF not covered by conventional regulatory requirements

But even if compared to hedge funds, which as off-shore entities are generally not subject to financial regulation or comparable reporting requirements and have therefore been criticised in the past from various sides for lacking transparency, very little information is available on the SWF industry as a whole as well as on single SWF vehicles. As immediate or indirect state entities, SWFs are usually not covered by existing legal and regulatory requirements imposed upon similar entities, especially investment and pension funds. Public reporting by these funds is therefore sparse and non-systematic in the majority of cases. Similarly, informal market knowledge about strategies and day-to-day transactions by SWFs is understood to be very low. This especially pertains to their overall asset allocation, transaction pipelines, and the use of derivative instruments and leveraged financing. Taken together, this makes SWFs comparatively intransparent market participants which may potentially cause severe uncertainties in financial markets.[14]

SWF industry needs greater transparency…

As a consequence, policy makers and market participants have voiced concern over the potentially destabilising effects that activities of large SWFs may have on global financial markets. From a market perspective, the most efficient solution to this problem is an increase in the transparency of state investment vehicles. In the case of SWFs, such transparency is difficult to enforce at an international level, given that they are owned by sovereign states, some of which may be reluctant to disclose detailed information on their investment activities.

… paying tribute to the industry's systemic relevance

Paying tribute to the special responsibility they carry by operating systemically relevant fund vehicles, the governments concerned may therefore consider raising the transparency of SWFs voluntarily. Such an initiative could consist of a voluntary code of conduct as well as reporting commitments regarding portfolio size and structure, indications as to the investment strategy pursued by the fund as well as to its risk profile and leveraging.

[14] This observation applies to the global SWF industry as a whole. Notable exceptions – SWFs with relatively transparent governance and reporting rules – exist, e.g. Norway's GPFG and GPIF and Singapore's Temasek and GIC.

Formal control mechanisms for foreign direct investments in selected industrialised economies

	US	JP	FR	DE	UK
Legal framework	- Exon-Florio legislation, International Emergency Economic Powers Act	- Foreign Exchange and Foreign Trade Control Law (FECL)	- 1996 Foreign Investment Law	- 1961 Foreign Trade and Payments Act	- Industry Act of 1975 - Foreign Trade Act of 1973
Reasons for review	- National security	- National security - Public order - Public safety - Adverse effects on economy	- Public order - Health - Security - Public functions - Research, production or trade in any substances destined for military use or wartime equipment	- Government has authority to regulate or restrict foreign investments on the basis of national security, public order, foreign policy, balance of trade - No administrative controls, bodies, practices that monitor, screen, track, or otherwise restrict foreign investments	- Government has authority to intervene in takeovers on grounds of national interest, incl. defence, aerospace
Notification	- Voluntary	- Mandatory	- Mandatory ex post - Mandatory ex ante for all transactions related to national security, public order, public safety and all sectors reserved through OECD Code of Liberalisation of Capital Movements	- Not applicable	- Not applicable
Review body	- Committee on Foreign Investments in the United States (CFIUS)	- Ministry of Finance - Ministry in charge of the industry	- Ministry of Economics and Finance, consulting with Ministries of Industry and Defence	- Not applicable	- Not applicable
Review process	- 30D review - 45D investigation - 15D Presidential review	- 30D review - Max. extension up to 5M	- 1M plus postponement rights	- Not applicable	- Not applicable
Judicial appeal	- No	- Yes	- Yes	- Not applicable	- Not applicable
Case-by-case evaluation	- Yes	- Yes - No formal criteria for evaluation	- Yes - No formal criteria for evaluation	- Not applicable	- Not applicable
Evidence	- 1 case blocked	- None since 1992 law revisions	- 9 rejected in 1992, 1993, 1994 for public order reasons	- Powers under Foreign Trade Law never invoked	- Powers under 1975 Industry Act never invoked

Sources: US General Accounting Office, OECD, DB Research **10**

Indirect barriers to FDI

US

— Foreign controlled enterprises may not be granted contract or subcontract involving classified information

Japan

— Investment plans of foreign controlled enterprises can be altered or suspended if national security, public order, public safety are deemed threatened, esp. in aircraft, arms, explosives, nuclear energy, space

EU

— EU competition policy applicable to all relevant foreign investment projects

France

— Government ownership of companies, esp. in defence, infrastructure, energy

— France reserves right to restrict foreign investments in industries covered by OECD Code of Liberalisation of Capital Movements, esp. air transport, maritime transport, insurance

— Exceptions to OECD National Treatment Instrument in numerous sectors

— Restrictions on creation, expansion, operation and national treatment in procurement on foreign-owned companies

— Preference accorded to locally owned firms in procurement for armed forces

Germany

— Federal Cartel Office reviews mergers and acquisitions, including foreign direct investments, for violations of German antitrust law

— Right to restrict investment in air transport, maritime transport, and broadcasting under the OECD Code of Liberalization of Capital Movements

— Exceptions to the OECD National Treatment Instrument for foreign investment in air and maritime transport

United Kingdom

— Government golden share and 29.5% cap on foreign shareholding in British Aerospace PLC and Rolls Royce PLC

— Foreign-controlled company may not be granted defence procurement contracts

— Citizenship requirements for certain companies engaged in classified work

— Veto over disposal of assets for certain companies

— Restrictions on foreign investment activity in certain sectors. Under OECD Code of Liberalization of Capital Movements, UK reserves right to restrict foreign investment in air transport, broadcasting, maritime transport

— Limitations to OECD National Treatment Instrument in aerospace, maritime trans-port, government defence procurement contracts

Sources: US General Accounting Office, OECD, DB Research

In general terms, most governments running SWFs have already committed to contributing to the stability of the international financial system in the context of their membership in the International Monetary Fund.[15] Building on this commitment and drawing on the expertise of the IMF or the World Bank in questions of international financial market stability, the relevant governments could commit themselves to obliging their SWFs to comply with a certain minimum of reporting requirements. A code of conduct agreed at international level would ideally define specific minimum requirements regarding the formal mandates and statutes of SWFs, financial reporting at least on an annual basis as well as an independent auditing of the account and financial reports of SWFs. Similarly, a code of conduct should include a commitment to the adherence by the funds to national and international regulations of financial markets and corporate governance, as well as to the pursuit of financial objectives as apposed to political concerns. An important yardstick with respect to transparency has been established in Norway with the legal framework for the country's two major savings funds, the Government Pension Fund-Global and the Government Petroleum Insurance Fund.

Subsidisation of capital and state financing

Drawing on budgetary revenues or official reserves, SWFs are state-funded investment vehicles, open to the charge that their activities stand in contrast to the concept of a free market economy with minimum state intervention and distort market activities as their funds are not refinanced at market conditions or do not originate from market activity. Indeed, it may appear contradictory from the perspective of an industrialised economy having gone through lengthy privatisations of formerly state-owned companies to the benefit of more efficient management and operations to see the state-funded investment vehicle of a third country take stakes in privatised companies.

Concerns in this regard are, however, not necessarily warranted. The establishment of SWFs can be justified in economic terms on the grounds that otherwise the services offered by that fund would not be produced by market participants alone due to market failure. This case can plausibly be made for both stabilisation and savings funds. Stabilisation of government revenues can be considered a public good around existing state activities. Savings funds can be seen as fulfilling an intergenerational objective. Both would most likely not be provided to a sufficient extent if left entirely to markets. Both, however, assume that the SWF has profit maximisation as its only objective and pursues this in an efficient manner.

On that basis, the investments by SWFs represent a source of capital in the recipient companies – and economies as a whole – which otherwise may not be available at all or only at higher costs.

Sale of strategic assets and know-how

Critical issues can arise, however, if profit maximisation is not the sole motivation – for the investing SWF as much as for the recipient economy. Debate in many industrialised countries has centred on concerns that state investments from third countries which are non-financial in motivation could carry implications in terms of national security, especially with a view to the control over and know-how in the defence industry, public and private infrastructure, high

[15]´ See Articles of Agreement of the International Monetary Fund, Article 4.1.

technology, and financial markets, but also with respect to access to natural resources worldwide. These concerns are most prominently reflected in the debate around major transactions in recent years as listed on page 8.

Legitimate – albeit diffuse – concerns on national security

These are legitimate – albeit diffuse – concerns that deserve specific attention, both in general as well as in each individual case. Even if no critical cases have been reported to date, it is theoretically conceivable that a state uses its SWF as a vehicle to buy into a strategically important company – e.g. in the arms, high-tech or infrastructure industries – and thereby acquires the ability to influence corporate strategies and operations, or control over that company's assets and know-how. As this may impact the national interest, and especially national security, of the host country, it is understandable that policy makers in many countries have taken an increasing interest in the activities of SWFs. Similarly, it is conceivable that the take-over of a domestic company by an SWF has a negative impact on the level of competition in an industry, leading to static and dynamic welfare losses in the recipient economy.

Liberal approach to foreign investments needed

In assessing these concerns, it is vital, first of all, that industrialised and emerging economies maintain and reinforce their efforts towards liberalising their economies, especially with respect to foreign investments. The benefits of liberalisation and free market access are tremendous and well-documented.

Effective instruments to protect competition already in place…

Looking at potential policy instruments, most economies already have in place effective rules to promote market efficiency and competition. Most importantly, in all countries foreign investment transactions and the operation of foreign-owned enterprises are subject to existing national antitrust, reporting, and corporate governance requirements as well as the entirety of the legal framework that applies to any corporation operating in the respective jurisdiction. This enables governments to bring foreign companies and investors in line with domestic economic and competition policy objectives.

… supported by essential control mechanisms for foreign investment activity

In addition, most economies have instruments available to identify critical transactions and take the measures necessary for averting threats to their security interests. Chart 10 and the textbox on page 13 summarise the most important mechanisms as applied in the United States, Japan, France, the United Kingdom and Germany. Most importantly, the US, France and Japan have regulated foreign investments in separate laws, setting up reporting and review mechanisms to ensure that the authorities are aware of individual foreign investment activities, can gather the information necessary for an assessment, and review the transactions within well-defined time frames. The UK and Germany have less formal mechanisms in place, but enjoy discretion in evaluating and prohibiting foreign investments that are considered against the national interest.

Restrictions only in cases of risks to national security

From the perspective of the recipient economies, there exists a risk that the activities of foreign state funds and the associated concerns are used as a lever for promoting protectionist interests going beyond legitimate national security needs. Protectionism, however, is not acceptable. Restrictions on cross-border capital movement should be strictly limited to cases where there is a danger that vital national and security interests could be violated. The decision whether this is the case should be based on pre-defined principles and thorough analyses by the authorities of each individual case of foreign investment in the course of a well-structured, calculable review process that takes into account the time sensitivities of major

capital market transactions. In particular, governments should be obliged to take their decisions within an overseeable period of time and explain the reasons for their decision.

No place for naivety – security interests should be defended

In practice, other than France, most countries have made only sporadic or no use of these existing instruments so far. Instances in which certain policy objectives had not been possible to reach because the room for manoeuvre provided by the existing legal frameworks was insufficient, have not been reported. Should cases arise in which existing laws are considered insufficient, however, governments should evaluate thoroughly whether national security required additional measures and what forms these measures should optimally take, and be prepared to strengthen their stance.

SWFs can build confidence by means of…

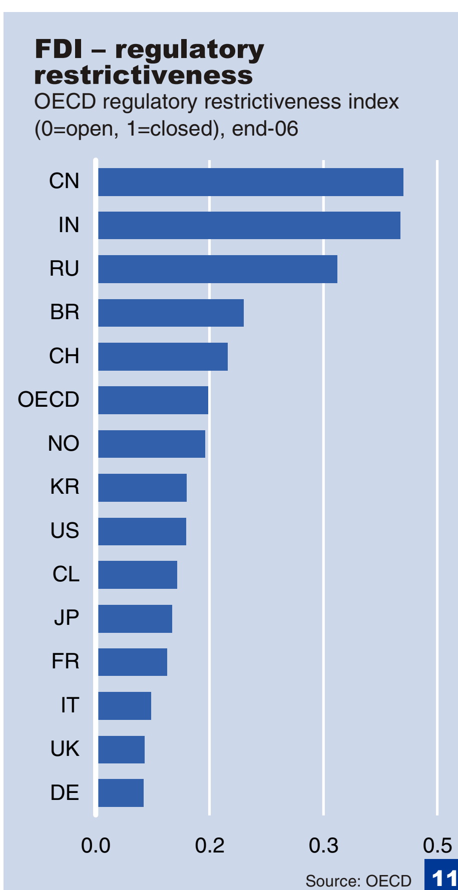
… minority stakes,…

… limiting management intervention

In addition, SWFs themselves can do a lot to build confidence in target industries and countries. In the case of Norway, for example, state investment managers have succeeded in soothing potential concerns over state investments restraining themselves to small minority stakes in single companies and spreading their portfolio across a vast range of individual financial investments – reportedly almost 4,000 different commitments worldwide. Similarly, limiting intervention in management decisions of target companies to strategic issues pertaining to a fund's long-term objective of maximising investment returns can be an important signal underlining a fund's un-political ambitions.

No new dependencies from SWF investments

As a final note, it must be recalled that – from the perspective of recipient countries – it is in many cases not warranted to think of SWF corporate commitments as newly emerging dependencies on foreign states and their investment vehicles. As pointed out above, a substantial part of the funds allocated by SWFs today had previously been held by their sponsoring governments – or more precisely their central banks – as official reserves. As these reserves have been invested predominantly in sovereign paper of countries such as the US or EU member states, equivalent dependencies on foreign investors have existed all along, albeit at state level. The change that is taking place now is that it is no longer established industrialised states such as the US or Germany that rely on the appetite for their debt instruments by foreign investors, such as central banks in Asia. Rather, it is private corporations domiciled in these industrialised countries which now capitalise on foreign state funds and their equity commitments.



Reciprocity in market access

It is important to note that security and other political concerns are not specific to the typical recipient countries but can also be observed in the home countries of SWFs. In fact, many economies in which SWFs are domiciled are significantly less open than e.g. traditional industrialised economies, especially the US and the EU. Thus, Russia has managed to limit foreign participation especially in its hydrocarbons industry and is working on a legal framework to restrict foreign investments in further strategic sectors. Similarly, China maintains a number of restrictions on foreign direct investments, protecting key industries such as telecommunications and finance, and – for all foreign direct investments – prohibiting foreign shares in domestic companies higher than 25%. The member states of the Gulf Cooperation Council, in turn, shield their oil, banking, and real estate markets against foreign stakes.

In fact, compared with the EU, the US and other OECD economies, non-OECD countries are clearly more restrictive in their foreign

China and Russia among the most restrictive economies

investment policies with substantially higher restrictiveness indices, as illustrated in chart 11. China and Russia – two of the largest players in terms of sovereign wealth investments in the world – are at the same time the most restrictive economies, together with India, when it comes to foreign investments in their territories.

Asymmetry in market access not acceptable

This asymmetry has given rise to the question whether market access for foreign investments – including those by SWFs – should be conditional upon rules of reciprocity, i.e. whether market access for specific foreign investors should depend on whether equivalent market access is granted in the investors' home country. Consequently, opening emerging markets for foreign investments has been an important objective of a number of policy initiatives at multilateral level, including discussions in the context of the WTO, Doha, the G8, the OECD as well as a multitude of bilateral negotiations.

Reciprocity in open market access important objective

In order to establish a level playing field and avoid inefficient allocations of capital between countries, efforts towards free and open markets for foreign direct investments are vital. Investors as well as investment targets can benefit greatly from a seamless flow of capital across countries. Achieving symmetrical market access can play an important part in reaching this objective.

Corporate governance standards

Concerns over ability of SWFs to meet corporate governance standards…

Finally, critics of foreign state fund investments have argued that SWFs – especially if domiciled in emerging economies – may not be able to live up to corporate governance requirements to the extent established in many industrialised economies. In particular, it has been questioned whether SWFs would be able to meet standards of capital market law and the responsibilities associated with seats on governing or supervisory boards.

… not warranted

Such challenges seem neither warranted in theory nor in practice. Most importantly, all shareholders are subject to the capital market law and other corporate governance rules applicable to shareholders in the target country and thus to the rights and obligations accruing from this law like any other market participant. There is no evidence that foreign or state-owned institutional shareholders are less apt to meeting these obligations than other investors, domestic, private or else.

SWFs are highly professional investment institutions

Quite to the contrary, SWFs are generally understood to be highly professional investment institutions with well-qualified staff and a profound knowledge and expertise in global capital markets. Similar to other institutional investors, they pursue investment strategies systematically and with a clear focus on returns, either mostly as passive but occasionally also as activist shareholders. An *ex ante* presumption that SWFs could be in danger of not satisfying the corporate governance standards of a target country is therefore – just like for other domestic or foreign stakeholders – not justified.

Pressure to maximise profits important management incentive

In fact, investments by profit-seeking SWFs – like other institutional investors – should be welcome as they not only provide important capital for companies, but also as they exert pressure on management to maximise the profitability of their investment. This is an important incentive. Suggestions leading to a lessening of this incentive – most importantly the proposal to restrict SWFs to non-voting shares – are likely to bear substantial negative effects on management and diminish the attractiveness of investments.

Rules for an optimal policy response

Principles for optimal policy rules

Based on the above considerations, it is clear that in economic terms an optimal policy regime should be characterised by the following broad characteristics:

Open markets

— Openness of national and regional markets to foreign investments by SWFs as a general rule.

Reciprocity of market access

— Reciprocity of open market access – as opposed to reciprocity in protectionism.

Political intervention

— Political intervention in SWF transactions – as in any other foreign investment deal – must be a last-resort option, and should only be applied in cases where national security is under threat.

— Political decisions leading to such interventions should be based on a set of pre-defined principles for protective measures and thorough analyses by the authorities of each individual case of foreign investment in the course of a well-structured, calculable review process that takes into account the time sensitivities of major capital market transactions.

— Optimally, the design of measures and instruments for last-resort political intervention should be harmonised at the EU level in order to avoid further fragmentation of investment rules and corporate governance provisions across the member states, thus protecting the integrity of the Internal Market and ensuring a level playing field.

— All foreign investments are subject to domestic market and competition rules. This applies in particular to the maintenance of free and fair competition.

— Economically sensible instruments for addressing potentially sensitive foreign investments include the establishment of a formal review process along the principles defined above, as well as reporting requirements regarding investment transactions beyond a certain size.

— Some policy instruments should not be used, owing to their distortionary effects on the economy. These primarily include the holding of golden shares by the state as well as the establishment of “defensive funds” to acquire stakes in domestic companies to protect them against foreign investments. Both of these instruments bear the danger of an inefficient use of funds, and the risk of domestic state intervention. Similarly, states should refrain from defining critical or strategic sectors and the promise of granting them specific protection. This provides adverse incentives to the “ins” as well as the “outs”.

Transparency

— Global financial market stability should be reinforced through higher transparency of SWFs on the basis of an internationally agreed code of conduct, underscored by a set of best-practice yardsticks, to be defined in the context of the IMF.

— For the prevention of contagion effects, SWF transparency should entail a minimum of timely information on the size of funds, broad strategy of management and investment objectives.

Provisions of the German Foreign Trade and Payments Act

Section 7

Protection of Security and External Interests

(1) Legal transactions and acts in foreign trade and payments may be restricted in order to

1. guarantee the vital security interests of the Federal Republic of Germany,
2. prevent a disturbance of the peaceful coexistence between nations, or
3. prevent a major disruption of the foreign relations of the Federal Republic of Germany.

(2) According to paragraph 1 above, the following may be restricted in particular

[…]

5. legal transactions on the purchase of resident companies which
   — produce or develop war weapons and other military equipment, or
   — produce cryptographic systems admitted for the transmission of governmental classified information by the Federal Office for Information Security Technology with the company's approval, or legal transactions on the acquisition of shares in such companies, in order to guarantee the vital security interests of the Federal Republic of Germany; this applies in particular if the political and security interests of the Federal Republic of Germany or the military security precautions are jeopardized as a result of the purchase.

[…]

Source: Foreign Trade and Payments Act of 28 April 1961 as amended by Article 1 of the Law of 28 March 2006

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A code of conduct should establish minimum requirements regarding the formal mandates and statutes of SWFs, financial reporting at least on an annual basis, an independent auditing of the accounts and financial reports of the funds. In addition, such a code should include a commitment to the adherence by funds to the relevant national and international financial market and corporate governance rules, as well as to the pursuit of financial objectives.

Policy initiatives – SWF growth and national and international responses

Factually, the policy debate on these issues has only just started in the majority of countries concerned. At this relatively early stage, widely diverging views and approaches can be observed – both at the national level as well as in an international comparison. This may not least reflect that there is widespread disagreement not only over the means by which a regulation of the activities of SWFs could be regulated, but on the potential policy implications of their growth and activities in the first place.

— **United States**

In the US, Treasury officials have underlined the country's commitment to an open investment climate, welcoming SWFs in principle. In addition, it has been suggested that the IMF and the World Bank should provide a set of best practice rules for SWFs with a view to providing guidance and incentives to ensure appropriate institutional arrangements, governance, operational and risk management, accountability, as well as transparency of rules, operations, asset management guidelines and per-formance.

— **United Kingdom**

The government maintains the UK's traditional liberal position and has rejected notions of discouraging foreign state invest-ment funds from pursuing investments in the country, and also the negotiations of common rules at international level similar to WTO-type deliberations. However, the Chancellor has emphasised that reciprocity in market access is considered a vital precondition in the long run.

— **France**

France already has a stringent legal framework that allows the protection of key industries against foreign ownership. Although no concrete policy measures have been announced, the current government has indicated that it is pursing an industrial policy that takes a broadly defined national interest into consideration.

— **Italy**

The Italian government has taken a liberal stance on the SWF issue and announced its support for liberal market access and indifference regarding the nationality of potential investors. The concept of golden shares has been met with reservations.

— **Germany**

The government has announced that it will suggest – in the context of its presidency – that the G8 develop a set of trans-parency rules for the operation and asset management of SWFs. It also intends to make equivalent proposals in the context of the IMF. The US and French governments are understood to support these initiatives.

With respect to the protection of vital industries, a working group among the Chancellery, and the Economics and Finance Ministries has been formed to review policy options. The government is planning to amend the 1961 Foreign Trade and Payments Act (see box, page 17).

Potential measures under consideration include enhancing the scope of the relevant provisions of the FTPA to explicitly include a broader range of industries, such as telecommunications, logistics, postal services and energy. Whether the financial sector is intended to be included remains unclear. Other legal instruments that are currently discussed include reporting requirements for foreign transactions, the establishment of a CFIUS-type review committee and a more active use of golden shares. Also, the German government, for its part, is considering establishing an investment fund of its own, which could serve as strategic investor for selected German companies and protect them against undesired foreign investment. In terms of industrial policy, the government is seeking coordination at EU level in order to avoid a patchwork of national rules and a potential negative impact on the Internal Market.

— **European Union**

EU committed to open markets…

The EU has reiterated its commitment to open markets, emphasising that it would be disconcerting if the EU were not open and attractive to SWF investments and the latter were to invest anywhere but in the Internal Market.

… observing potential need to protect sensitive industries

However, the Commission acknowledges the potential need to protect sensitive industries, especially where buying countries protect these domestically. It has emphasised the importance of reciprocal market openness. As a potential mitigant, the Commission is considering the introduction of a regime of European golden shares. Reviewing the implications of SWF growth and possible policy responses, the Commission has announced that it will present a report in mid-September 2007.

— **Russia**

Russia takes protectionist stance

Operating a large SWF itself, the Russian government takes a protectionist stance on foreign investments. Following recent legislation, the Russian national intelligence agency Federal Security Service, FSB, is actively involved in decisions regarding foreign ownership of 39 key industries, such as nuclear energy, aerospace, natural resources and the arms industry.

Conclusion

SWF industry with great potential to grow

The state-investment fund industry has great potential to grow in the years ahead. This reflects rising national wealth, especially in the emerging markets, as well as an increasingly prudent management of public assets with a view to future needs.

New funds into wide range of asset classes

If SWFs grow as expected, and their international diversification continues, liquidity inflows into a wide range of asset classes can be expected. Similarly, a substitution away from central-bank reserves invested in liquid sovereign paper to SWF funds invested in higher-yielding and dividend-bearing private securities is likely to occur. At the same time, demand for asset management and investment banking services is set to increase.

Political action needed on greater SWF transparency

Keeping in mind the many advantages that the rise of SWFs may bring, there is also good reason to expect implications for global financial market stability, corporate governance and national interests. A rationale for action exists with respect to the transparency of SWFs which – if increased – could help promote financial stability and mitigate the potential danger of herd behaviour and contagion effects. Also, national security concerns can be a cause for government intervention, but should be limited to exceptional cases where such concerns exist. As a general rule, however, SWFs – like other investment vehicles, too – should be able to benefit from free markets on a reciprocal basis.

Internationally coordinated approaches needed

In practice, a coordinated approach at EU or international level towards greater transparency is set to be a difficult undertaking and deserves significantly greater support. At the national level, the debate reflects a broad variety of views in the political spectrums and is often characterised by diffuse concerns over the potential impact of SWFs. A more appreciative approach to the potential benefits of SWF investment in companies in search of capital, as well as a sober assessment of the potential risks involved is needed.

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