

Follow the money to shed some light

<http://archive.gulfnews.com/articles/07/12/29/10178027.html>

12/29/2007 12:34 AM | By **Syed A. Basher,** Special to Gulf News

The rising trend of cross-border investments by governments, the so-called Sovereign Wealth Funds (SWFs), has attracted a lot of attention this year. While the idea behind SWFs (previously known as stabilisation funds) is not new, their growth has flourished primarily in recent years.

Various factors underlie this phenomenon. In most of them, and notably in the GCC countries, the surge coincides mostly with the windfall gain in oil export revenues. In some cases, such as China, the huge build-up of foreign exchange reserves has been responsible. In a nutshell, SWFs are a consequence of countries running persistent current account surpluses.

Currently there are 32 SWFs in 28 countries with an estimated value of \$2.1 trillion. Due to their foreign ownerships and dearth of information, their recent prominence has stirred debate about the extent to which their size may destabilise the functioning of financial markets in host countries. Collectively, the GCC nations own an estimated \$1.1 trillion worth of SWFs, which have helped these economies to be at the centre of the international financial system.

To begin with, governments own and manage SWFs to achieve an array of economic objectives. These include stabilisation of the macroeconomic effects of a sudden increase in export earnings, management of pension assets, or the transfer of national wealth across generations.

For instance, the UAE has placed a significant portion of its excess oil revenues in stabilisation funds to limit domestic liquidity growth and deal partly with domestic inflationary pressure.

At present, by one estimate, the UAE leads the GCC with an estimated sovereign wealth fund of about \$500 to \$875 billion, followed by Kuwait (\$213 billion), Qatar (\$50 billion), and Oman (\$5 billion). That's according to a US study this year by Edwin M. Truman. The recent announcement by Saudi Arabia to increase its SWF to \$900 billion will further strengthen the GCC's position internationally.

Given the current pace of global economic growth, the SWFs are projected to grow sevenfold to \$15 trillion in the next 10 years (according to another recent report by investment firm Morgan Stanley), surpassing the current global holdings of foreign exchange reserves of about \$6 trillion.

Naturally, SWF-type assets are under greater scrutiny, not only for the national and political sensitivities related to ownership, but also because their development could give rise to a number of risks to the international financial system.

One of the risks which some observers fear is that governments might mismanage their funds, and

bring disruption to global conditions. Critics argue that governments are not necessarily skilled investors, and often are not good at picking winners. For instance, a common view is that state-owned enterprises tend not to be the most profitable. Given the huge size of their investments, if there were any mismanagement of their assets, foreign governments might easily contribute to market turmoil and uncertainty in the host countries.

Another concern is that a sovereign's incentive to manage its funds could be motivated by nationalistic considerations (promoting state-owned enterprises or buying controlling positions in foreign firms with proprietary knowledge). With that awareness, capital account protectionism may arise in the host countries, so they decide who may invest and where these funds can be invested. Recall the well-known adverse political reaction to the acquisition of several major US ports by DP World.

One more risk is the so-called 'agency cost', or the risk of conflicts of interest between the owner and the manager of the funds. In a recent interview, Christopher Cox, chairman of the US Securities and Exchange Commission, expressing his concerns about government ownership of investment, said, "Rules that might be rigorously applied to private sector competitors will not necessarily be applied in the same way to the sovereign who makes the rules."

Given the perceived risks and the associated uncertainties, several host countries have come forward (in association with World Bank and International Monetary Fund) to make their markets safer in the presence of sovereign wealth funds. A number of effective measures are currently under consideration to increase the accountability and transparency of their activities. These include structure, governance, transparency and accountability and behaviour.

Through the adoption of such measures, and provided that the foreign governments embrace them, light may be shed on a number of important issues, including (i) how a particular sovereign wealth fund receives its funding, and how its principal and earnings are used by its owner, (ii) what is the exact size of the fund and the actual return it earns, (iii) whether those funds are invested in private equity firms or hedge funds, and (iv) whether the roles between government and manager in setting/executing the investment strategy are clearly defined. That's the intention, in any case.

Transparency

In an effort to rank SWFs in terms of their transparency and accountability, Edwin Truman developed a scoreboard for the 32 SWFs of 28 countries. It was constructed by putting different weights to the four effective measures mentioned above. Under that process, New Zealand's Superannuation Fund received 24 points (out of 25), while, with the exception of Kuwait (which scores above the average), the Gulf countries were well down the list.

Yet, while some of the risks outlined above have not yet been quantified, there is no apparent reason to see the existence of these funds as destabilising or worrying. In fact, one may view SWFs as a stepping stone towards deeper global diversification, as it may encourage the proliferation of country indexes (e.g. S&P 500, Wilshire 5000) in countries that are interested in gaining from financial globalisation. That would support the indexes of the host countries.

Still, following the recent financial turmoil caused by subprime lending in US, with knock-on effect in Europe and elsewhere, it is certain that the GCC nations will be under pressure from the international community to make their investments strategies more transparent, providing broad details of their accounts. Whether the governments of countries with sovereign wealth funds embrace those requirements remains to be seen.

- *The author is an economist specialising in GCC economies.*