Box 1

SOVEREIGN WEALTH FUNDS - A NEW CLASS OF INVESTORS

Several sovereign wealth funds (SWFs), which are special agencies that manage part of the (mostly foreign) assets of sovereign governments, have emerged as major global market participants over the last few years. Based on individual market and official sources, such funds may have accumulated more than USD 2.2 trillion – slightly more than the total assets under the management of the global hedge fund industry which is currently estimated at around USD 2 trillion. SWFs have complemented, or even replaced, the "traditional" accumulation and management of foreign reserves, as these institutions aim at better diversifying risk and generating higher returns than traditional reserves, which are typically invested in low-yielding government securities. With some market observers estimating that the overall size of SWF assets could exceed that of global foreign reserves within a few years,[1] it is important to better understand the possible impact the activities of such funds could have on asset prices, risk-taking and, ultimately, financial stability which is presently hindered by a lack of data. This box discusses some of the ways in which the activities of SWFs could exert influence on asset prices.

The first countries to establish SWFs include most resource-rich countries, which have benefitted from high and rising oil and commodity prices (see Table). In such countries, SWFs mainly serve the purpose of stabilising government and export revenues which would otherwise mirror the volatility of oil and commodity prices (stabilisation funds). Resource-rich countries also have "heritage funds", which save the proceeds of non-renewable natural resources for future generations. Prominent examples of SWFs in resource-rich countries include Norway's Government Pension Fund, investment agencies set up by the Gulf Cooperation Countries, such as the United Arab Emirates' Abu Dhabi Investment Authority (ADIA), and Russia's Oil Stabilisation Fund which will be partly transformed into a heritage fund from 2008 onwards.

A second group of countries, most notably in Asia, have established SWFs in the face of balance-of-payment surpluses and managed exchange rate regimes. In these cases, once the reserve levels are judged to be adequate, foreign assets are then moved to specialised agencies which often have explicit return objectives and greater freedom to invest in riskier assets than central banks. Prominent examples include the Government of Singapore Investment Corporation (GIC) that has operated for decades, but also more recently established funds, such as the Korea Investment Corporation

1 See, for example, Morgan Stanley (2007), "How Big Could Sovereign Wealth Funds Be by 2015", May.

Table The largest sovereign wealth funds

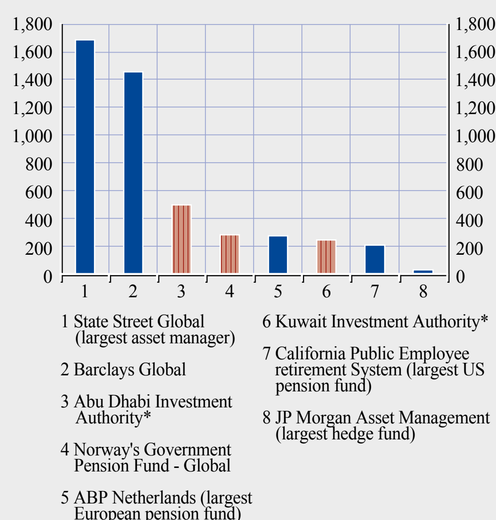
Country	Sovereign wealth fund	Assets under management (USD billions)	Source
United Arab Emirates	Abu Dhabi Investment Authority	250–500	Oil
Norway	Government Pension Fund	263	Oil
Singapore	Government of Singapore Investment Corporation	>100	Non-commodity
Kuwait	Kuwait Investment Authority	160–250	Oil
Russia	Oil Stabilisation Fund	89	Oil
Sovereign external assets			
Saudi Arabian Monetary Agency and government institutions		276	Oil

Source: IMF.

(KIC) and the Hong Kong Monetary Authority Exchange Fund. Recently, the Chinese authorities announced the establishment of a new investment agency that will be responsible for the management of a portion of Chinese foreign reserves, with the principal aim of seeking higher returns on a still-to-be-determined part of China's foreign reserves. In Japan, the second largest holder of foreign reserves, the appropriateness of traditional reserve management is still under debate. Furthermore, South Korea has announced plans to double the proportion of its foreign reserves managed by SWFs by 2010, and similar steps are being considered in a number of other economies in the region, such as Taiwan, Vietnam and India.

Chart Assets under management: the largest sovereign wealth funds in comparison with selected institutional investors

(USD billions)



Sources: Company websites, Norges Bank, IMF (2007) quoting official and market estimates.
Note: Data refer to end-2006. An asterix indicates a market estimate. In the chart, the upper bound from market estimates is depicted.

With a few exceptions, SWFs do not disclose any details on their asset and currency composition. However, anecdotal evidence suggests that such investments are usually more diversified than traditional reserves invested by central banks, as they include equities, corporate bonds and real estate. In this context, it is worth noting that the disclosure requirements for traditional reserves set out by the IMF are very broad so that a proper comparison of central bank reserve portfolios to those of SWFs is hampered by data availability. Whether SWFs assume more risk than traditional funds depends on the main purpose of each fund. A stabilisation fund set up primarily for macroeconomic stabilisation purposes, for example, is likely to have a different asset allocation from a heritage fund with a longer investment horizon.

As regards the potential impact of SWFs on asset prices, it is not clear whether they are large enough to influence asset prices in the most liquid markets. Market estimates suggest that, while the largest SWFs could have more assets under management than the world's largest pension funds or hedge funds, they continue to command significantly fewer assets than large global asset managers (see Chart). Furthermore, a diversification of official foreign assets across instruments may not necessarily imply a diversification across currencies, since the most liquid financial market segments for risky assets are usually denominated in the major reserve currencies. Given that some SWFs may be seen by their governments as managing part of the national balance sheet, asset liability management considerations may still be relevant for the currency composition of SWFs.[2]

As SWFs, in particular those that put the emphasis on savings for future generations, are likely to have a long-term horizon for their investments, they may also contribute to the broadening of the long-term investor base for risky assets, such as equities, corporate bonds, emerging market assets, private equity and real estate. In this regard, such funds could become a more stable

2 See M.P. Dooley, S. Lizondo and D. Mathieson (1989), "The Currency Composition of Foreign Exchange Reserves", *IMF Staff Papers*, June, Vol 36 No. 2, pp.385-434 for an analysis of the interplay between gross and net reserves in the context of currency composition.

investor base for risky assets in certain markets.[3] In addition, provided that the investments of such funds are driven entirely by risk and return considerations, SWFs may contribute to a more efficient allocation and diversification of risk at the global level.

At the same time, however, other investment motives (e.g. political considerations) could potentially lead to inadequate risk management or distort price discovery mechanisms in global asset markets. For instance, some observers have expressed concern that certain SWFs may be prone to abrupt selling of assets, thereby contributing to market volatility. Other observers have warned that certain SWFs may acquire stakes in companies of sensitive industries and bail out or support local firms for non-economic reasons. However, there is so far no evidence of such investment patterns.

On balance, there are several potential channels through which the emergence of SWFs as large global market players may affect the global financial system. Reliable information on the size and asset allocation of SWFs would reduce the uncertainty about their actions on financial markets and thereby contribute to greater transparency in global financial markets.

3 See IMF (2007), *Global Financial Stability Report*, Chapter 2, April.