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# GROWTH, FINANCE AND REGULATION

**SOVEREIGN WEALTH FUNDS IN THE  
GLOBALIZATION OF FINANCIAL  
MARKETS**

DJORDJE CUZOVIC

Higher School of Professional Business  
Studies, University of Novi Sad,  
Republic of Serbia

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**Abstract:** This paper studies the investment funds with special emphasis on Sovereign Wealth Funds (SWFs), as new participants in the financial market. Considering that financial markets are one of the main carriers of globalization, our goal is to investigate development and the role of these investment funds with reference to contemporary theory and progressive practice of the market of developed countries. Although SWFs emerged in practice more than fifty years ago, they are not sufficiently explored in the theory.

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## Introduction

The sovereign wealth funds (SWFs), in the terms of globalization, are important participants in the financial market. Although, they are present for over fifty years in the global financial market, they are under-researched in the scientific and professional community. Recognizability of these financial institutions has linked to the accumulation of foreign reserves which are conditioned by the influence of two fundamental factors, namely: the growth of commodity prices and the surplus policies of current account of national economies.

Aim of this study was to analyze position of SWFs in the global market. The total value of capital operated by SWF makes 2% of global market stocks and bonds. Financial experts predict that by 2015 SWFs will reach 6% of global financial assets.

### **Sovereign wealth funds - special financial institution**

SWFs are "... government investment funds, financed by foreign exchange reserves but managed separately from official foreign exchange reserves" (Lee, 2008). The official foreign exchange reserves are low risk assets such as government bonds, whilst the SWFs can hold shares, corporate bonds and other assets, so they are important for financial markets.

In the literature SWFs are defined as "financial institutions (investment companies) of some countries - which invest in some countries: Chile, Mexico,

Brazil, Japan, Spain, etc. Country funds are often considered as an easier way of coming to some foreign financial markets, otherwise, almost inaccessible to small investors. They are generally closed funds whose shares oscillate about net asset value (NAV) per share of the fund, but interestingly, they exhibit the highest volatility in pricing in the US stock market, and not in the stock market of countries where they were invested. This suggests that they act less as foreign portfolio shares and more as the US domestic action” (Šoškić and Živković, 2009, p.481).

Although there is no common definition of SWFs, three elements are recognized, by which they differ from other investment funds:

- a. they are owned by the state
- b. SWFs do not have a clearly defined and limited liabilities
- c. SWFs are separate from the official foreign exchange reserves.

In addition, most SWFs share some features that originate from the specific nature of these financial institutions.

### **Factors influencing the development of SWFs**

SWFs are existed since the fifties of the twentieth century, but their number and size increased dramatically in the last 15 years. The main factor of growth of SWFs is a large surplus, which some countries have achieved through high oil prices, financial globalization, as well as imbalances in the global financial system. List of countries with the largest SWFs consists of one developed (European) country, Norway, and the developing countries: United Arab Emirates, Saudi Arabia, China, Kuwait, Russia and Singapore.

The rapid growth of SWFs means a partial return to state capitalism after decades of application of neo-liberal concept of internationalization of financial markets in the West. Developing countries have used their SWFs to buy shares in companies from the West and to invest in areas that will reduce the effect of volatility of commodity prices, to their income and balance of payments.

For example, in 2007 Chinese SWFs bought shares of US financial firms Morgan Stanley and Blackstone Group, and SWFs from Dubai bought the shares of Sony and several other Asian companies. However, based on research, we come to know that many SWFs lack transparency and it is difficult to make economic objectification (to get reliable data) of this segment of financial markets. Also, in addition to unreliable statistical and empirical objectification of financial resources (assets) at their disposal, it is more difficult to know their strategy and investment objectives.

SWFs in the market of developed countries such as Norway are transparent because they have an obligation to their finite “shareholders” - the public. However, most developing countries are less democratic and have less public pressure for transparency of these funds. As developing countries grow faster than developed countries and invest an increasing share of the surplus in the company from the West, it comes out, on the one hand, interest in SWFs, but also concern about the power and investment strategies of SWFs. For example, Chinese SWFs invested most in the important US financial companies which shows restructuring the performance of the "main" player in the global financial market.

In the era of globalization of trade and financial flows, most countries have no objections to the inflow of foreign direct investment (FDI) as a result of trans-nationalization of multinational companies. However, they are quite sensitive to the foreign state investments. The mobility of factors of production, internationalization of financial flows and globalization of world economy, outside the West (especially in developing countries), can cause an increase in trade tensions and protectionism.

The global economic and financial crisis that occurred in 2008 has not left aside either SWFs. Some countries, such as Russia and Qatar, used their SWFs to deal with domestic economic problems, while in other countries SWFs have suffered great losses. This is a warning to countries with SWFs in the future to consider more cautiously (conservatively) where and how to invest free financial resources.

Since the SWFs act as CAMP (Capital Asset Pricing Model), some theorists, question their effectiveness as a factor in the diversification of the portfolio. This is especially true of some of the newly formed SWFs of developing countries. If it turns out that SWFs are less important than some analysts' forecasts, reserves of Asia and the Middle East are likely to cause major changes in the role of the US dollar and the structure of decision making inside the IMF.

Forecasts are slowly coming true. In practice, in addition to this forecast, in 2007 president Putin, as leader of the new rich Russia, invited to establish "a new architecture of international economic relations," and supported the rival to Dominique Strauss Kahn, IMF General Manager candidate, supported by EU (Washington Post, 2007). Although Strauss Kahn was elected for a term of five years, in 2007 the IMF adopted procedure of selection indicating "that every executive manager may submit a proposal, regardless of nationality, for the position of general manager" (IMF, 2007, p.61). Under the pressure of developing countries, in April 2009 the G-20 summit discussed about global financial crisis. It was agreed to make a new distribution of the balance of power in the IMF by 2011, in which the leaders of international organizations selected by merit, and not by nationality. Without going deeper into this discussion, we find the fact that the re-election of the executive manager of the IMF, Mr. Dominique Strauss Kahn, unsuccessfully ended in 2011.

### **Theories that support the establishment of sovereign wealth funds**

Previous studies suggest that the debate on the real intentions-objectives of the establishment of SWFs is still present in the theory and practice. Furthermore, this empirical research shows that one cannot ignore the impact of SWFs on the performance of national economies and companies.

Andrew Razanov (2005) first used the name of the SWFs and established a definition of these funds. He defined these funds as "neither traditional public pension funds nor alternate support to the national currency, but SWFs invest their assets with the following objectives: to isolate the budget and economy from the volatility of revenues, to help monetary authorities to sterilize the negative liquidity, to create savings for future generations or the to use money

for economic and social development". At that time, he estimated the value of assets of SWFs is about 895 billion dollars.

Economist Edwin Truman (2007), according to the assessment of scientific experts, has done some of the most relevant analysis dealing with SWFs in general terms. Truman deals with the history of SWFs and disputes of the US Treasury about SWFs definition, distinguishing between the stabilization funds, which are characterized by low risk investments, and SWFs. By using its stricter definition, Truman estimated that the total assets that are controlled by SWFs are around 2 trillion dollars. He also discusses the problems of transparency and assigns a composite score for a property management, transparency and accountability for each SWF, which fits into his definition.

According to Truman (2007), the recognition of equity management of SWFs is based on the response to the following four questions:

1. Is the role of government in implementing the investment strategy clearly defined?
2. Is the role of managers in implementing the investment strategy clearly defined?
3. Does the fund have arranged and publicly available guidelines for corporate responsibility?
4. Does the fund have ethical guidelines to follow his investment strategy?

He uses similar questions when establishing their rankings for transparency and accountability. The main instrument through which the SWFs can affect the performance of companies is the pressure for change in improving corporate governance.

Shleifer and Vishny (1986) show that small shareholders are not entitled to seek incentives from management, because their assets are so low that the cost of monitoring managers and improving the management is not worth the increasing in yield. They suggest that large institutional investors represent a partial solution of free rider problem because their large stakes in companies give them an incentive to monitor and improve managerial performance.

On the other hand, Demstetz and Lehn (1985), conclude that large shareholders are not well diversified, and therefore they require unnecessary risk reduction of company, forcing the company to be too conservative and thus it misses a potential new investment projects. They also developed the hypothesis that large investors can create an agency problem, which forced the company to act solely in their interest, and to ignore the interests of other shareholders, employees, and even society as a whole. This theory has been discredited by Bergstrom and Rydqvist (1990), using empirical evidence from Sweden.

Two analyzes of SWFs were done by economists in the last few years. Christopher Balding (2008), from University of California, conducted an analysis of global portfolio investment of SWFs, concluding that there is no evidence to suggest that the SWFs behave differently than others of rational investors, diversifying his portfolio between fixed income, equity and commercial real estate.

Bortolotti, Fotak and Megginson (2009) from University of Oklahoma have conducted an empirical analysis for the global investment SWFs till heretofore. They came to the conclusion that the SWFs have a negative investment return of up to 240 days, which means that their capital deteriorates the performance of the company.

### **Sovereign wealth funds: New “players” in global financial market**

SWFs are existed since 1953 when the Kuwait Investment Authorities, formed The Kuwait Investment Committee with the aim of investing surplus oil revenues to reduce reliance on the Kuwaiti finite oil sources.

The increase of these financial institutions, in the last decade of the twentieth century and at the beginning of the twenty-first century is linked to the accumulation of substantial foreign exchange reserves of developing countries (new global financial “players”).

Considering globalization of world economy and financial markets, many developing countries (emerging economies) have established new SWFs to increase diversification of foreign assets, improve “the return” to the traditional foreign exchange reserves.

While other forms of national investment markets are known for several decades to many countries, SWFs have recently become important players in global financial markets. Besides the reasons mentioned earlier, one of the reasons is that SWFs help national economies with seeking long-term investment strategies and avoiding explicit debt.

In this way, SWFs differ from state pension funds involved in the explicit debt and continuous flow of fixed payment, and therefore they resemble more to private mutual funds. Second, the absence of explicit liabilities also has an impact on efficiency of taking risk. The standard theories of portfolio also confirm this claim, which provides high-action fixed income securities for funds that are subject to recurrent payment. Finally, most SWFs have an important impact on foreign investment, or even their assets are fully invested in foreign assets.

A group of countries that have established SWFs are economically rich countries and they earn from high oil prices and other commodities at the moment. In these countries, SWFs also serve to stabilize state revenues and revenues from exports, which would otherwise face with fluctuations of oil prices and commodity.

Another purpose of these funds in countries with funds is accumulation of savings for future generations, since funds acquired with “sales” of natural resources cannot renew, and they can disappear after a certain time.

Typical examples of such SWFs are: Norway State Pension Funds; Investment agency established by the member of Gulf Cooperation Council (GCC); Investment company, founded by Abu Dhabi Investment Authority (ADIA) in order to manage foreign assets in the Emirate of Abu Dhabi in United Arab Emirates; and Russia's oil stabilization fund, which are almost turned into a fund for future generations.

The second group of countries, mainly from Asia, established SWFs because the reserves have increased more than it is necessary for the purpose of the balance of payments regulation. The source of reserve accumulation for these countries is generally not associated with primary goods, but relates to an inflexible exchange rate regime.

As the authorities accepted the level of reserves, foreign assets are transferred to special agencies that often have explicit feedback goals and may invest in riskier assets than the central bank.

Familiar examples of these financial institutions are SWFs, such as the Singapore Government Investment Company (GIC), and then recently established funds such as the Korean Investment Corporation (KIC), and the Foreign Exchange Fund's investment portfolio which is managed by Monetary Authority of Hong Kong. China has recently established a new investment agency, China Investment Corporation, which is responsible for managing the portfolio of Chinese foreign exchange reserves.

TABLE 1. LARGEST SOVEREIGN WEALTH FUNDS BY ASSETS UNDER MANAGEMENT

Country	Fund name	Asset, billion USD
UAE -Abu Dhabi	Abu Dhabi Investment Authority	627
Norway	Government Pension Fund -Global	571.5
China	SAFE Investment Company	567.9**
Saudi Arabia	SAMA Foreign Holdings	472.5
China	China Investment Corporation	409.6
Kuwait	Kuwait Investment Authority	296
China -Hong Kong	Hong Kong Monetary Authority Investment Portfolio	292.3
Singapore	Government of Singapore Investment Corporation	247.5
Singapore	Temasek Holdings	157.2
China	National Social Security Fund	146.5
Russia	National Welfare Fund	142.5*
Qatar	Qatar Investment Authority	85
Australia	Australian Future Fund	72.9
Libya	Libyan Investment Authority	70
UAE -Abu Dhabi	International Petroleum Investment Company	58
Algeria	Revenue Regulation Fund	56.7
US -Alaska	Alaska Permanent Fund	40.3
Kazakhstan	Kazakhstan National Fund	38.6
South Korea	Korea Investment Corporation	37
Malaysia	Khazanah Nasional	36.8

Source: SWF institute, December, 2011. <http://www.swfinstitute.org/fund-rankings>

Note: \* This includes the oil stabilization fund of Russia. \*\* This number is a best guess estimate.

Political problems, which arise due to emergence of SWFs as major global financial players, vary from problems related to the lack of transparency and the shift in privatization, to the problems of risk in global financial stability.

Those familiar with the global financial markets believe that SWFs, by the reflexive investment strategy, may contribute to the stabilization of global financial imbalances. Therefore, they suggest diversification of the portfolio outside of government bonds marked in US dollars which is invested a large amount of traditional reserves. Another problem relates to the question of whether such funds can warp the value of assets by non-commercial purchase and sale of securities.

### **The most important sovereign wealth funds in the world**

In the preceding section we pointed out that due to lack of transparency in reporting SWFs, statistical and empirical material is unreliable, so that it could be argued which are the world's largest SWFs. However, based on the conditionally acceptable statistical reports, it is considered that the largest investment funds are those whose review is shown in the Table 1.

The amount of assets of the individual SWFs are not always known, so the IMF data as of February 2011 range between 2.093 billion dollars and 2.968 billion dollars. It is estimated that the disposal of assets of the SWFs will reach between 6.000 and 10.000 billion dollars until 2013, although the world's great investment banks (Morgan Stanley and Standard Chartered) estimate that these funds will reach 13.400 billion dollars at the beginning of the next decade.

Although the assets of the SWFs is still relatively small compared to the global financial assets, which it was estimated about 190.000 billion dollars in 2009, it is clear that they will continue to play an important role in the financial markets in the world, since projections indicate that some SWFs will continue to accumulate foreign financial assets as a result of constant and growing surplus in the current account of countries that established them.

### **Portfolio of sovereign wealth funds**

SWFs represent significant segment of the financial market and an important student in the global financial market. These financial institutions have a past, present and future. Over time, they have been creating their own physiognomy, changing themselves and financial environment.

Portfolio of SWFs has been changed chronologically. Initially, the structure of portfolio was foreign assets of government. However, with globalization of financial markets and internationalization of operations of SWFs, particularly in the last decade of the twentieth century and first decade of the twenty-first century, the funds are "transformed" in "excess reserves managers" and other foreign assets.

The transfer of a significant amount of traditional foreign exchange reserves into SWFs, or as they are called in the literature "investment vehicles", can have an impact on global financial flows, because the allocation of these funds



most often follow the investment strategy that significantly differs from the strategy of central bank.

### **Conclusion**

To which extent SWFs will affect the changes in the global financial structure and financial stability, it does not depend on the motives that the investment decision-makers of these investment companies manage.

SWFs can contribute to the expansion of long-term investment base for risky assets such as shares, corporate bonds, emerging market assets, private equity and real estate. In this sense, these funds can exercise a stabilizing effect on financial markets, especially when the SWFs are typically not used. In addition, SWFs may contribute to more efficient allocation and diversification of risk in global financial markets.

On the other hand, other investment motives (e.g. when the acquisition of SWFs is motivated with political intentions) might lead to excessive risk and strain of assets. For example, in theory and practice there is state and concern that certain SWFs can be prone to rapid sales of assets, and thus contributes to the instability of financial markets.

Warnings can also be heard on the other hand, with an emphasis, that some SWFs may acquire stake in the companies of sensitive industries. Also, the SWFs may, based on motives only known to them, financially support local insolvent company and so alter the structure of national economy. The reasons for such investment moves are most often non-economic motives, which change the architecture of economic and political milieu. However, there is no hard evidence of patterns of investment that would negatively affect the integrity of the market.

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