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Economic Viewpoint

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State of Confusion over Sovereign Wealth Funds

Sovereign Wealth Funds (SWFs) come in various shapes and sizes. In sum, however, they total over $3 trillion in assets and are rapidly a major force in international recycling and investment. Global concern has focused on their possible use as political weapons, while far less attention has been directed at SWFs as positive instruments. Let's take a quick look at SWFs.

Whether the assets of a SWF derive from natural resource exploitation (e.g., Norway and the Gulf) or from exports turned into reserves (e.g., China) or privatization proceeds (e.g., Temasek of Singapore), their strategic goals are to maximize returns and realize gains for future generations. In the case of Norway's Pension Fund of $400 billion, investment rules are consciously conservative as the political elements are limited to a "negative list" of companies/activities where investment is prohibited. Other funds have no such restrictions, and given their growing size -- due to rising oil prices, large surpluses in East Asian economies, and a growing realization, even among conservative central banks, that holdings in US Treasury assets are yielding negative returns when they are exchange rate adjusted -- the question that arises is how SWFs will be used.

Stepping back, petro dollar recycling after the 1973 oil price surge was dominated by banks and hence, some of the credit defaults in Latin America and much publicized reschedulings. The 1979 and onward intermediation utilized capital markets, and once again led to unsustainable indebtedness and the "Brady Bonds" era. What's different today is the investment by SWFs in emerging markets' equities rather than debt. This is potentially good news for developing countries.

Put in perspective, global foreign direct investment is $470 billion, but 60% of the amount destined for developing countries is directed at ten countries. Poorer countries are dependent on Official Development Assistance ($100 billion) and remittances ($240 billion according to estimates). Javier Santiso of the OECD notes that even 10% of SWF investments, if directed to developing countries, would add billions to their development finance. This source of financing is particularly attractive nowadays since governments' budgets will be strained with the fiscal consequences of the food/fuel crises, and infrastructure needs will be underfinanced. SWF flows may be the key new recycling mechanism to help drive a growth agenda by helping private/public investment in infrastructure. New modalities could help incentivate such investments.

Concerns about the political use of SWFs are so far unsubstantiated; moreover, should SWFs be viewed any differently than large pension funds.? CALPERS, California's public pension fund, has assets of $250 billion and it has excluded investments in countries with poor governance countries. And recall the debates as to whether university endowments should invest in particular countries. It will therefore be impossible to totally rule out political factors from investment decisions, regardless of the principles adopted or promulgated.

Of greater interest might be the possible economic benefits of these long-term investments for development efforts. With limited progress in increasing aid flows and with current bias towards specific sectors like health, the third world's infrastructure and credit needs may require a boost from private sources. Rates of return may be high, although the risks are as well. The World Bank's President has called for a "one percent solution" to see 1% of SWF assets gravitate to Africa. While this would need to be a guide rather than a prescription, it is no different from other portfolio allocation rules. Insofar as economic policy frameworks are a key determinant of SWFs decision, there may well be a role for international validation of the policy environment by objective agents such as the World Bank. Its private investment arm, the International Finance Corporation, already plays a leading role in identifying profitable investment opportunities.

The potential is huge. If SWFs grow to the levels envisioned by observers -- take the OECD's estimate of $14 trillion by 2012 -- even a conservative allocation to emerging market economies (say 5 % in equities) would end up dwarfing total Official Development Assistance. The benefit would be that the funds would be aimed at the private sector and thus would contribute more directly to growth. And if these investments are successful, would it be too much to envision CALPERS and the Harvard Endowment being far behind? At the Doha Meeting on Financing for Development, SWFs should be given greater prominence than empty debates on who is to blame for what. SWFs may be less of a problem and more of a solution.

*The views expressed here are personal and do not represent necessarily the position of either the World Bank Group or its Board of Executive Directors. Comments can be sent to *Dannyleipziger@gmail.com.*