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Straight Talk

The Rise of Sovereign Wealth Funds

We don't know much about these major state-owned players

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SOVEREIGN wealth funds are a fairly new name for something that's been around for quite a while: assets held by governments in another country's currency. All countries have foreign exchange reserves (these days, they're typically in dollars, euros, or yen). When a country, by running a current account surplus, accumulates more reserves than it feels it needs for immediate purposes, it can create a sovereign fund to manage those "extra" resources.

Sovereign funds have existed at least since the 1950s, but their total size worldwide has increased dramatically over the past 10–15 years. In 1990, sovereign funds probably held, at most, $500 billion; the current total is an estimated $2–3 trillion and, based on the likely trajectory of current accounts, could reach $10 trillion by 2012.

Currently, more than 20 countries have these funds, and half a dozen more have expressed an interest in establishing one. Still, the holdings remain quite concentrated, with the top five funds accounting for about 70 percent of total assets. Over half of these assets are in the hands of countries that export significant amounts of oil and gas. Norway has a large sovereign fund, as do places as disparate as Alaska, Canada, Russia, and Trinidad and Tobago. About one-third of total assets are held by Asian and Pacific countries, including Australia, China, and Singapore.

Is $3 trillion a lot of money? It depends on the comparison. U.S. GDP is $12 trillion, the total value of traded securities (debt and equity) denominated in U.S. dollars is estimated to be more than $50 trillion, and the global value of traded securities is about $165 trillion. In that context, $3 trillion is significant but not huge.

It is, however, large relative to the size of some emerging markets. The total value of traded securities in Africa, the Middle East, and emerging Europe combined is about $4 trillion; this is also roughly the size of these markets in all of Latin America. And total assets under management by private hedge funds—a broad category of private investment funds that seek high returns and, as a consequence, often take on considerable risks—are estimated to be around $2 trillion. So, perhaps not surprisingly, a debate about the potential risks and opportunities of sovereign wealth funds, similar to the ongoing debate about hedge funds, is now developing.

A dearth of information

As has become apparent in today's fast-paced financial markets, the impact of a particular pool of money on financial stability depends not only on assets under management but also on the potential leverage (that is, debt) used in investment strategies.

For example, many hedge funds and (their cousins) private equity funds are reported to use leverage ratios of 10:1. That means they borrow 10 times their own capital for particular transactions. In some cases, leverage is even higher, probably significantly higher. Hedge funds almost certainly improve the allocation of capital around the world, but recent developments indicate that, in some forms, they also pose a danger to the global financial system. The consensus so far is that while hedge funds deserve considerably greater scrutiny, there are advantages for the allocation of global capital flows if this sector continues to have a relatively light direct regulatory burden.

Unfortunately, there's a lot we don't know about sovereign funds. Very few of them publish information about their assets, liabilities, or investment strategies. It's thought that they've traditionally been "long only": that is, they pursue buy-and-hold strategies, with no short positions and perhaps no borrowing or direct lending of any kind. They probably have long horizons and, like other long-term investors, are willing to step in when asset prices fall. This likely exerts a stabilizing influence on the world's financial system. But there is also anecdotal evidence that some sovereign funds have placed investments with other leveraged funds.

At least one central bank is reported to have had investments with Long-Term Capital Management when that hedge fund went bankrupt in 1998. Another central bank has invested recently with a major private equity fund. The Norwegian sovereign wealth fund reports that it has shifted somewhat from bonds to equities, and we think the same movement may be under way more broadly. It seems clear that some part of the hedge funds' assets and private equity assets under management now comes from sovereign wealth funds (care must be taken not to double count when the assets of these related entities are added), but there are no numbers.

Rogue traders, a serious issue for all types of investment funds, are also a potential problem for sovereign funds. Although the problem isn't likely to be widespread, there are specific instances in which traders employed to invest central bank reserves have taken large speculative positions and lost heavily. At least some of these traders acted without the approval of the appropriate credit risk managers. It wouldn't take many such transactions to awaken calls for regulation of cross-border capital flows when decisions by sovereigns are involved.

The emergent approach to "regulating" hedge funds is not to regulate them, but rather to watch carefully over the regulated intermediaries that lend to them (that is, commercial and investment banks). The idea is that this protects the core of the financial system while allowing innovation and risk taking. But as sovereign funds grow in importance, they effectively become a significant unregulated set of intermediaries that may or may not invest with hedge funds in the future.

The real danger is that sovereign wealth funds (and other forms of government-backed investment vehicles) may encourage capital account protectionism, through which countries pick and choose who can invest in what. Of course, there are always some national security limitations on what foreigners can own. But recent developments in the world suggest there may be a perception that certain foreign governments shouldn't be allowed to own what are regarded as an economy's "commanding heights." This is a slippery slope, which leads quickly and painfully to other forms of protectionism. It's important to preempt such pressures.

New players

Sovereign funds are not likely to go away. They're based on current account surpluses and will become less important only if the countries with large surpluses begin to run prolonged current account deficits. Major countries have committed to reducing their current account imbalances, and this would limit the growth of sovereign funds. But the world economy evolves continuously in ways that make it hard to be sure current account imbalances will shrink. For example, global growth may accelerate or decelerate, and this is likely to affect commodity prices. But if commodity prices remain high, commodity exporters will have large surpluses for the foreseeable future. If commodity prices fall, the surpluses of Asian countries that export manufactures may increase.

What should the IMF do about this situation? There's certainly no need for dramatic action. For one thing, the situation involves sensitive issues of national sovereignty. For another, at their current level of $3 trillion, sovereign funds aren't a pressing issue. But as the level creeps closer to $10 trillion—although even $10 trillion isn't a huge amount of money—the phenomenon will likely attract greater attention.

Still, it's time, before the debate becomes politically charged or part of an election campaign, to begin a constructive discussion on the salient issues. And to do that, it must be determined what information countries are willing to share, what information it makes sense to ask for, and what information can be used in our global economic and financial analysis.

There's no apparent reason to see the continued existence of these funds as destabilizing or worrying. In fact, the IMF has strongly encouraged exporters of nonrenewable resources to build up exactly such funds in preparation for a "rainy day."

In sum, sovereign wealth funds are major state-owned players of the 21st century. Hedge funds, while becoming more prominent in this century, are in some sense a throwback to the end of the 19th century, when large pools of private capital moved around the world with unregulated ease—and generally contributed to a long global boom, rapid productivity growth around the world, and a fair number of crises. What happens when the 21st-century state meets the 19th-century private sector? The outcome remains to be seen.

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