Appendix 3

Sovereign Wealth Funds

The exceptionally rapid and sustained increase in global foreign exchange reserves since 2001 has been well-documented.[1] The accumulation of official reserves far beyond established benchmarks of reserve adequacy has led an increasing number of countries to establish, or consider the establishment of, Sovereign Wealth Funds (SWFs). Appendix 4 is intended as a brief overview of SWFs and related issues.

What is a Sovereign Wealth Fund?

There is no single, universally accepted definition of a SWF. This appendix will use the term SWF to mean a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities (the Central Bank and reserve-related functions of the Finance Ministry).[2] SWF managers typically have a higher risk tolerance and higher expected return than traditional official reserve managers. SWFs generally fall into two categories based on the source of the foreign exchange assets:

- *Commodity funds* – Commodity funds are established through commodity exports (either owned or taxed by the government). They serve different purposes, including stabilization of fiscal revenues, inter-generational saving, and balance of payments sterilization. Given the recent extended sharp rise in commodity prices, many funds initially established for fiscal stabilization or balance of payments sterilization purposes have evolved into savings funds. Savings funds may invest in a broader range of assets than stabilization funds, which typically focus on liquid, relatively secure assets.

- *Non-commodity funds* – Non-commodity funds are typically established through transfers of assets from official foreign exchange reserves. Large current account surpluses (in some cases complemented by capital account surpluses) have enabled non-commodity exporters (particularly in Asia) to transfer "excess" foreign exchange reserves to stand-alone funds.

Since commodity SWF assets often derive from foreign currency accruing directly to the government, the foreign currency is not converted to domestic currency, does not enter the domestic economy, and therefore does not need to be sterilized through the issuance of domestic debt to avoid unwanted inflationary pressures. In contrast, non-commodity SWFs assets often derive from at least partially sterilized exchange rate intervention and may therefore be thought of more as "borrowed funds."[3]

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[1] See, for example, "The Adequacy of Foreign Exchange Reserves", Annex 3 of the December 2006 Semi-annual Report on International Economic and Exchange Rate Policies.

[2] This definition is meant to differentiate SWFs, funded from the start by net foreign assets (through commodity exports or exchange rate intervention) from, for example, ordinary domestic pension funds which are initially funded in domestic currency but which may then diversify internationally. However, the two types of funds do share certain common characteristics and not all analysts distinguish between them.

[3] See "International Reserve Diversification and Disclosure", speech by Mr. Malcolm Knight, General Manager of the BIS, to the Swiss National Bank/Institute for International Economics Conference, Zurich, September 8, 2006. http://www.bis.org/speeches/sp060908.htm

SWFs are also not a new phenomenon, even if they have recently gained in prominence. Two of the largest such funds were founded over 25 years ago – the Abu Dhabi Investment Authority (ADIA) in 1976 and Singapore's Government Investment Corporation (GIC) in 1981.

What Distinguishes Sovereign Wealth Funds from Official Reserves?

The IMF's *Balance of Payments Manual* defines reserve assets as "those external assets that are readily available to and controlled by the monetary authorities for direct financing of payment imbalances, for indirectly regulating the magnitude of such imbalances through intervention in exchange markets to affect the currency exchange rate, and for other purposes".[4]

Key issues in determining whether SWF assets can be considered as official reserve assets include their liquidity and marketability as well as whether there is some legal or administrative guidance that would preclude the assets from being readily available to the monetary authorities to meet a balance of payments need.[5]

Whether a given foreign exchange asset can be classified as a reserve asset has to be assessed on a case-by-case basis:

- In some cases, SWF assets may be invested in liquid and marketable instruments and the monetary authorities retain a clear legal right to call upon those assets to meet a balance of payments need. These SWF assets are likely to be classified as official reserves.
- In many other cases, however, SWF assets may be invested in less liquid instruments and/or the monetary authorities may not have a clear legal right to call upon them. These SWF assets would not be classified as official reserves.[6]

As SWF assets fall out of reserves, even if perfectly appropriate from a statistical perspective, they also risk falling out of the mechanisms that the international financial system has for reserves transparency. The two principal such mechanisms (both voluntary) are the IMF's aggregate quarterly Currency Composition of Official Foreign Exchange Reserves (COFER) database and the Data Template on International Reserves and Foreign Currency Liquidity (Reserves Template), part of the IMF's Special Data Dissemination Standard (SDDS). 119 countries currently participate in COFER, and 64 countries subscribe to the SDDS.

How Large are Sovereign Wealth Funds?

Because relatively little is known about most SWFs, market estimates of their size vary widely. Market estimates of aggregate assets of known SWFs range from $1.5 – 2.5 trillion. This compares (and is in addition) to the roughly $5.1 trillion in official foreign exchange reserves as

[4] IMF, *Balance of Payments Manual V*, 1993, paragraph 424.
[5] Draft IMF Balance of Payments Manual VI;http://www.imf.org/external/pubs/ft/bop/2007/bopman6.htm. See also Antonio Galicia-Escotto, IMF Committee on Balance of Payments Statistics Reserve Experts Technical Group Issues Paper #5, "Investment Funds," December 2005. http://www.imf.org/external/np/sta/bop/pdf/resteg5.pdf.
[6] Indeed, the same would apply to foreign exchange assets managed by the Central Bank or Finance Ministry if invested in less liquid, less marketable instruments.

of end-January 2007. SWF assets are also currently fairly concentrated. By some market estimates, four funds[7] account for around two-thirds of total SWF assets. In addition, market estimates currently attribute approximately two-thirds of SWFs assets to commodity funds and the remaining one-third to non-commodity funds.

Market analysts have also projected various upward paths for global official reserves and SWF assets, though these paths are inherently uncertain – and not just because of the individual country decision whether to allocate a given increase in external assets to official reserves or a SWF. For non-commodity SWFs, much will depend on how successful Asian emerging markets in particular are in shifting to increased exchange rate flexibility. Commodity SWF asset accumulation is largely dependent upon the price of oil and the ability of oil exporters to rapidly formulate and implement investment plans. The IMF projects that oil exporters' aggregate current account surplus will roughly halve from 1% of global GDP in 2006 to 0.5% in 2009.[8]

How are SWF Assets Invested?

Public disclosure of investment management strategy varies widely and individually by SWF, but overall is quite limited.[9] Though SWFs are still considerably smaller than official reserves, their growing size means that their investment allocations will be increasingly important to global financial markets. SWF assets may be invested in a broad range of asset classes, including government bonds, agency and asset-backed securities, corporate bonds, equities, real estate, derivatives markets, alternative investments, and foreign direct investment.[10] This raises the question of whether the development of operational best practices, focused on governance, transparency, and accountability, would benefit the international financial system.

[7] The UAE's ADIA, Norway's Government Pension Fund-Global, Singapore's GIC, and Russia's Oil Stabilization Fund.
[8] IMF *World Economic Outlook*, April 2007, p. 16. Oil exporters are defined as Algeria, Angola, Azerbaijan, Bahrain, Republic of Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Russia, Saudi Arabia, Syrian Arab Republic, Turkmenistan, United Arab Emirates, Venezuela, and Yemen.
[9] Norway's Government Pension Fund-Global is broadly recognized as exemplifying best practices in transparency.
[10] As noted earlier, the same applies to reserves invested in less liquid, less marketable instruments.