Appendix 2: Sovereign Wealth Funds

Global cross-border assets of the official sector continue to rise at a rapid pace. The IMF projects that sovereigns will continue to accumulate foreign assets at a rate of $800-900 billion per year.[1] Cross-border assets of the official sector include about $6 trillion in foreign exchange reserve holdings and approximately $1.9-2.9 trillion in sovereign wealth fund (SWF) holdings.

Of course, absolute size alone is an insufficient metric to assess the relative importance of official reserves and SWFs in the international financial system. Below are four different relative metrics: private pools of capital; net new issuance of traditional reserve assets; existing stocks of traditional reserve assets; and existing stocks of other financial assets.

Selected Sovereign Wealth Funds

Country	Name of Fund	Estimated Assets[1] ($bn)	Source of Funds
UAE	Abu Dhabi Investment Authority	250-875[2]	oil and gas
Norway	Government Pension Fund - Global	397	oil and gas
Saudi Arabia	Saudi Arabia Monetary Agency	250[3]	oil and gas
Kuwait	Kuwait Investment Authority	213	oil and gas
China	China Investment Corporation	200	non-commodity
Singapore	Government Investment Corporation	>100	non-commodity
Russia	Stabilization Fund	144	oil and gas
South Korea	Korea Investment Corporation	20	non-commodity

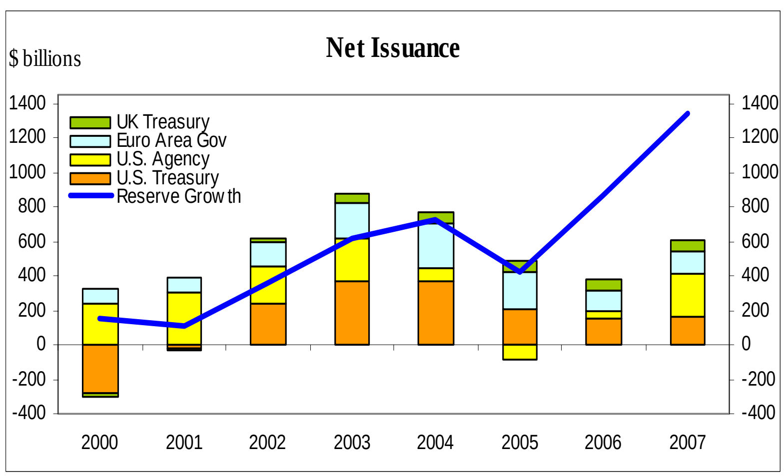
[1] National data unless otherwise noted. [2] Range of market estimates [3] Non-reserve foreign assets.

Private Pools of Capital

To get a better perspective of the relative importance of SWFs, it is useful to consider how they measure up against private pools of global capital. Total SWF assets of $1.9-2.9 trillion may be small relative to the roughly $62 trillion managed by private institutional investors. But SWF assets are currently larger than the total assets under management by either hedge funds or private equity funds (estimated at $1.5 trillion and $700 billion, respectively), and are set to grow at a much faster pace. Some private analysts project that aggregate SWF assets could grow to $7-8 trillion by 2012 and to $12-15 trillion by 2015.

"Forced Diversification" of Official Flows

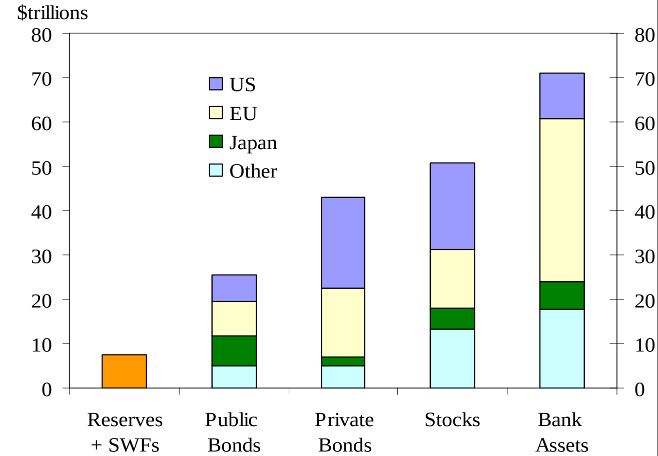
Global official reserve accumulation is running far ahead of new net issuance of traditional reserve assets. In 2007, assuming an annualized rate of global reserves growth of 27 percent (based on actual reserve growth in Q2), new reserves accumulation would be $1.3 trillion and net new issuance $603 billion. So even if emerging market central banks purchased all new net issuance of traditional reserve assets in 2007, they would still need to find somewhere to invest roughly $742 billion.



[1] Annex 1.2. Sovereign Wealth Funds, IMF Global Financial Stability Report, September 2007.

Reserves Size Relative to Stocks of Traditional Reserve Assets
This $742 billion could also be invested not just in new issuance but also in existing stocks of traditional reserve assets through secondary debt markets. Official reserves amounted to nearly 40 percent of the outstanding stock of U.S. Treasuries, Agencies, and Euro-area and UK government securities in 2006. For U.S. Treasuries and Agencies specifically, Treasury International Capital reporting system data show that on June 30, 2006, foreign official holdings constituted 37 percent of marketable long-term Treasury and 8 percent of long-term Agency securities.

Reserves and SWF Size Relative to Stocks of Other Financial Assets
Other mainstream financial asset classes are absorbing most of the remaining reserve and SWF assets that diversify away from traditional assets. Reserves and SWFs are still small relative to global financial assets, estimated by the IMF to be $190 trillion in 2006. Of that, $120 trillion is stocks and bonds. $96 trillion is in U.S., EU or Japanese markets. Private analysts believe that currently only a relatively small share of assets is allocated to alternative asset classes such as private equity, real estate, or commodities.



Source: Treasury estimates and IMF

Policy Issues
SWFs represent a large and rapidly growing stock of government-controlled assets, invested more aggressively than traditional reserves, with implications for the international financial system.

SWFs have the potential to promote financial stability. They are, in principle, long term, stable investors that provide significant capital to the system. They are typically not highly leveraged and cannot be forced by capital requirements or investor withdrawals to liquidate positions rapidly. SWFs, as public sector entities, should have an interest in and a responsibility for financial market stability. Foreign direct investment by SWFs can contribute to economic growth in recipient countries.

SWFs also raise two sets of potential concerns:

On the investment side, SWFs could provoke investment protectionism, which could have negative consequences for the global economy. Transactions involving SWF investment may raise legitimate national security concerns. SWFs may also raise a number of non-national security issues related to a larger role of foreign governments in markets. For example, through inefficient allocation of capital, perceived unfair competition with private firms, or the pursuit of broader strategic rather than strictly economic return-oriented investments, SWFs could potentially distort markets.

On the financial markets side, SWFs may also raise concerns related to financial stability. They can represent large, concentrated, and often non-transparent positions in certain markets and asset classes. Actual shifts in their asset allocations could cause market volatility. In fact, even perceived shifts or rumors can cause volatility as the market reacts to what it perceives SWFs to be doing.

Policy Response
The Department of the Treasury, in coordination with other U.S. government agencies, is working to shape an appropriate international policy response to financial market and investment issues raised by SWFs.

First, as the chair of the Committee on Foreign Investment in the United States (CFIUS), Treasury is implementing the new Foreign Investment and National Security Act of 2007 (FINSA), which has introduced several reforms to the CFIUS process. CFIUS reviews certain foreign direct investments, including from SWFs. CFIUS reviewed its first SWF investment soon after beginning reviews under the 1988 Exon-Florio amendment to the Defense Production Act. CFIUS's focus has always been limited to transactions that raise genuine national security issues, and FINSA maintains that focus. The U.S. investment security framework, as improved by FINSA, helps protect national security while maintaining the longstanding U.S. commitment to open investment policies. Treasury is actively engaging countries where protectionist sentiment is on the rise to help them avoid reactionary policies.

Second, Treasury has proposed that the international community collaborate on a multilateral framework for best practices. The International Monetary Fund, with support from the World Bank, should develop best practices for SWFs, building on existing best practices for foreign exchange reserve management. These would provide guidance to new funds on how to structure themselves, reduce any potential systemic risk, and help demonstrate to critics that SWFs can be responsible, constructive participants in the international financial system.

Third, the Organization for Economic Cooperation and Development (OECD) should identify best practices for countries that receive foreign government-controlled investment, based on its extensive work on promoting open investment regimes. These should have a focus on proportionality, predictability and accountability, and should be guided by the well-established principles embraced by OECD and its members for the treatment of foreign investment. It is important to address the growing importance of SWFs, on both sides of the investment equation.

The Treasury has already achieved meaningful progress along these lines. On October 19, Secretary Paulson hosted a G-7 outreach dinner with Finance Ministers and heads of SWFs from eight countries (China, Korea, Kuwait, Norway, Russia, Saudi Arabia, Singapore, and the United Arab Emirates) to build support for a set of best practices for SWFs. On October 20, the International Monetary and Financial Committee (IMFC) – a ministerial level advisory committee to the IMF – issued a statement calling on the IMF to begin a dialogue to identify best practices for SWFs. On November 15-16, the IMF hosted a roundtable meeting for sovereign asset and reserve managers. In response to the IMFC statement, the IMF added a special session on policy and operational issues relating to SWFs for official sector delegates. This marks the beginning of an important process in the IMF. IMF Managing Director Dominique Strauss-Kahn opened the roundtable meeting and underlined that some form of agreement on best practices for the operations of SWFs could help maintain an open global financial system.[2] A separate

[2] IMF Convenes First Annual Roundtable of Sovereign Asset and Reserve Managers, IMF Press Release, November 16, 2007. http://www.imf.org/external/np/sec/pr/2007/pr07267.htm

dialogue is well underway in the OECD on investment policy issues with regard to SWFs, building on the discussions on Freedom of Investment, National Security, and “Strategic” Industries.

Fourth, Treasury has taken a number of steps internally and within the U.S. Government to enhance our understanding of SWFs. Treasury has created a working group on SWFs that draws on the expertise of Treasury's offices of International Affairs and Domestic Finance. Treasury's new market room is ensuring vigilant, ongoing monitoring of SWF trends and transactions. Through the President's Working Group on Financial Markets, chaired by Secretary Paulson, we continue to discuss and review SWFs. We also have initiated bilateral outreach to ensure an ongoing and candid dialogue with countries with significant SWFs and their management.

The Treasury Department will continue its work on SWFs through bilateral and multilateral efforts to ensure the United States shapes an appropriate international response to this issue, addresses legitimate areas of concern, and ensures that the United States remains welcoming of foreign investment. Treasury will also continue to keep Congress closely informed, both through formal testimony such as that of Under Secretary McCormick[3] on November 14 to the Senate Committee on Banking, Housing, and Urban Affairs and staff briefings.

[3] http://www.treas.gov/press/releases/hp681.htm