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# How to Spend It: Sovereign Wealth Funds and the Wealth of Nations

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- Development economics can explain both saving sources and motives that have led to the recent SWF boom, thus helping avoid investment restrictions in OECD countries.
- As the economics underlying funds from oil exporting countries are different from the economics of East Asian funds, so are the appropriate policy answers.

Sovereign wealth funds (SWF) are government controlled investment vehicles that are stimulating protectionist sentiments in some OECD countries. Their asset size (more than $3 billion) and their owners (governments) create fertile ground for conspiracy theories, such as fear of industrial espionnage or geopolitical threats. The funds with assets higher than $100 billion are either from oil exporting countries or from East Asia (Table 1).

In fact, development economics point to *four major motives* for countries to run such funds:

1) Foreign exchange reserves – mostly held in US treasury bonds – have grown excessively large: interest rate and currency risk militate in favour of portfolio diversification and central banks cannot control monetary aggregates anymore.
2) Reducing resource dependence through vertical and horizontal sector diversification.
3) Responding to expected demographic pressures, while smoothing consumption levels of future generations when resources are exhausted.
4) Raising production efficiency as a future driver of growth.

The largest funds are either financed from export receipts earned from a non-renewable resource; or they result from very high corporate or household saving rates and saving surpluses.

An oil exporting country should be indifferent to whether it keeps the oil under the ground (in which case the return is the expected rise in future oil prices) and getting a market rate of return on its sale (*Hotelling Rule* for efficient depletion). Extracting and selling oil amounts to running down capital, unless the receipts are fully reinvested in

Table 1. **SWFs and Savings**

| Country | Fund | Assets ($ billion), 9/2007 | Source | Gross National Savings, 2000 % of GNI | "Genuine" Savings, 2000 % of GNI |
|---|---|---|---|---|---|
| United Arab Emirates | Abu DhabiInvestment Authority (ADIA) | 875 | Oil | n.a. | n.a. |
| China | 1.China Investment Corp. Ltd. 2. Central Hujin Investment Corp. 3. State Foreign Exchange Investment Corp. (SFEIC) | 500 | Non-commodity | 38.8 | 25.5 |
| Singapore | 1. Gov't of Singapore Investment Corp. (GIC) 2. Temasek | 438 | Non-commodity | 47.7 | 35.2 |
| Norway | Gov't Pension Fund - Global(GPFG) | 322 | Oil | 36.9 | 18.5 |
| Saudi Arabia | Various Funds | 300 | Oil | 29.4 | -26.5 |
| Kuwait | Kuwait Investment Authority | 250 | Oil | 40.0 | -12.9 |
| Hong Kong, China | HK Monetary Authority Investment Portfolio | 140 | Non-commodity | 31.8 | 21.4 |
| Russia | Stabilisation Fund of the Russian Federation (SFRF) | 127 | Oil | 37.1 | -13.4 |

*Source:* Deutsche Bank Research (2007); World Bank (2006).

financial, physical or human capital (*Hartwick Rule* for intergenerational equity). Funds can also be helpful for stabilising notoriously volatile raw material prices. The law of diminishing returns forces oil exporters to invest a large share of the savings abroad[1].

Oil exporters would be forced to disregard both the Hotelling and the Hartwick rules, if SWFs could not invest in OECD countries. The Hotelling rule warns that lowering the returns on investment from oil receipts, by preventing investments by SWFs from oil-rich countries, would lead to less oil supply and higher oil prices.

In oil-rich countries, this would lead to more intense waste and corruption today and lower consumption tomorrow, possibly with harsh geostrategic implications. In *Where Is the Wealth of Nations?* the World Bank has calculated that many resource-abundant economies do not follow the Hartwick rule; they have negative "genuine" savings rates and become poorer each year. This highlights the important policy question of what resource rich economies can do to avoid the resource curse. A fund can help, in that oil receipts are eventually transformed into other forms of wealth.

In contrast to oil-rich countries, SWFs from East Asia are financed through transfers from foreign exchange reserves. For a decade, China has been providing "cheap savings" to the United States as it extended supplier credits to pay for the "cheap goods" the country used to export, holding the accumulating reserves mostly in low-coupon US treasury bonds. Now, with reserves at almost $1.5 trillion, currency and interest risk was deemed excessive and monetary control is lost due to exhausted sterilisation capacity. Observing the *Guidotti Rule*[2] of covering all foreign short-term debt *plus* three months of imports would require China to hold $500 billion in reserves, roughly a third of what it actually holds. These excess reserves plus future saving surpluses represent the funding potential for China's sovereign wealth funds.

To be sure, rapidly ageing populations and limited immigration suggest the need for high savings to sustain consumption levels in the future. When savings become excessive and capital returns drop below the growth rate, however, tax-financed pensions achieve that goal better than fully-funded pensions. Mandatory savings and excessive capital accumulation have resulted in "dynamic inefficiency" in both China and Singapore, as shown by recent empirical research. While in most OECD countries growth is driven by productivity gains, it is rather factor accumulation that explains growth in East Asia. In countries with "dynamic inefficiency", so much capital has been accumulated that investment spending tends to exceed capital income; investment is draining resources from the economy rather than augmenting future consumption possibilities.

Next to shifting out of excessive reserves and saving for future generations and old age, economic diversification and efficiency gains are major economic motives for establishing SWFs. The United Arab Emirates are using their fund for rapid diversification of their economies away from oil towards tourism, aerospace and finance. Such a diversification motive is as legitimate as the desire to raise the efficiency of their economy through acquiring stakes in leading global companies. The perspective of raising efficiency in funds allocation may well explain the recent rush by SWFs to take stakes in US financial intermediaries battered by the subprime lending crisis.

From the perspective of development economics, then, there is little need for conspiracy theories to explain what drives the funding and motivation of sovereign wealth funds. Development economics thus can help the OECD in its mandate to identify best practices for member countries that receive foreign government-controlled investment.

1. For an overview of the concepts underlying resource economics see Avendano, R., H. Reisen and J. Santiso (2008), "The Macro Management of Asian Driver Related Commodity Induced Booms", OECD Development Centre *Working Paper* (forthcoming).

2. Reserves allow countries to smooth domestic absorption in response to sudden stops in capital inflows. Popular rules of thumb for policymakers have been linked to the current account, such as maintaining reserves equivalent to three months of imports, or to the capital account, notably the Guidotti rule of full coverage of total short-term external debt.



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