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Sovereign Development Funds

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- For the first time financial actors from developing countries are playing with other OECD financial giants as equals through their Sovereign Wealth Funds (SWFs).
- SWFs could become major actors of development finance: Sovereign *Development* Funds.
- If SWFs chose to allocate 10 per cent of their portfolio to emerging and developing economies over the next decade, this could generate inflows of $1 400 billion, more than all OECD countries' aid to developing economies put together.

SWFs are in the headlines in all OECD countries. Despite concerns about their potential global financial impact and their investment policies, the development dimension is missing from the debates[1].

This is a striking omission. SWFs are major actors precisely from emerging and developing countries. Beyond their spectacular emergence there is promising news for the wealth of (developing) nations: SWFs are (or could be) major actors of development finance. Not only in and from their homelands but also abroad, in other emerging economies and developing countries. In this perspective, we may have to rename them using more appropriate terminology: SWFs are above all Sovereign Development Funds.

SWFs are symbols of a major global economic and financial rebalancing of power. Their emergence is not only controversial because of the fear of politically induced investments, lack of transparency and other arguments relying more or less on sophisticated conspiracy theories, but also because they symbolise a much deeper and bigger phenomenon that is reshaping the world's economy and finance. Emerging markets are taking an unusual lead, becoming, among other things, massive creditors to the world and to industrialised countries in particular. Since the early 2000s, the emerging world, as a whole, is for the first time, running current account surpluses and exporting capital to the rest of the world. Emerging countries are now key engines of the world economy.

When the OECD was created 46 years ago, its members represented nearly 75 per cent of world GDP. Now the figure is closer to 55 per cent. In 2007, the engines of growth were located in emerging countries. For the first time, we are seeing major outward foreign direct investment coming from emerging countries. Takeovers by emerging multinationals from the Middle East, emerging Asia or Latin America have multiplied all around the world. The novelty is not only the size of the takeovers but that the bulk of their targets were OECD multinationals.

The emergence of SWFs should be seen in this broader perspective: financial actors from developing countries are playing with other OECD financial giants as equals. These new global players are no longer headquartered in The City of London, or in the Boston or New York financial districts but in hitherto more exotic places like Beijing, Singapore or Dubai. They already represent sizeable global financial players. The largest SWF, from United Arab Emirates, Kuwait and China, for example have reached the same scale as the largest global asset managers or the biggest hedge funds and private equity firms. The Abu Dhabi Investment Authority (ADIA) has already around $875 billion of assets under management, compared to Barclays Global Investors' $1 815 billion or State Street Global Advisors' $1 750 billion.

On a more aggregate level, the size of the assets managed by SWFs from emerging markets is impressive: by the end of 2007, these new power brokers had amassed more than $3 100 billion, according to Morgan Stanley.

1. For a more conceptual approach see the note written from a development economics perspective by my coleague Helmut Reisen (2008),"How to Spend it: SWFs and the Wealth of Nations", OECD Development Centre *Policy Insights* No. 59.

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However, their holdings represent less than 2 per cent of the world's $167 000 billion of financial assets. Put in other terms, they account for just 1.3 per cent of the world's stock of financial assets (stocks, bonds and bank deposits). Their total, however, is still more than the total invested in the hedge fund world or the private equity industry. If their growth trends maintained their current pace, they could reach $17 000 billion over the next decade, over 5 per cent of global financial wealth.

SWFs are becoming major players in the development financing of other emerging countries. If their recent spectacular stakes in big OECD banks have dominated newspaper headlines and their bailouts of traditional Western financial institutions are impressive ($35 billion by the end of 2007), their bets on emerging economies are where the real interest should lie.

Some SWFs already have large stakes and investments in Asian companies. Temasek, of Singapore, for example, has a $160 billion portfolio that includes substantial chunks of India's ICICI Bank, Tata Sky, Tata Teleservices and Mahindra and Mahindra auto manufacturers. Asia (excluding Japan and including Singapore) now represents 40 per cent of its portfolio, which is more than its total holdings in the home country (38 per cent) and double that in OECD countries. The much more recently created China Investment Corporation is planning to allocate part of its $200 billion fund in Asian and Pacific countries.

Such bets by SWFs are already paying off: Kuwait Investment Authority (KIA), the $215 billion Middle Eastern sovereign wealth fund, has already made juicy profits on its $750 million stake in the Industrial and Commercial Bank of China.

KIA is already cutting the proportion of its portfolio invested in Europe and in the United States to under 70 per cent from about 90 per cent. Emerging markets in Asia and elsewhere are attracting more and more attention: why bother to invest in low OECD growth economies when you can access nearly double digit growth rates in emerging countries?

Dubai International Capital is willing to pursue its moves towards emerging Asia, a region where it intends to raise its portfolio to reach levels of 30 per cent of the total. For the moment its portfolio is concentrated in Europe (70 per cent), with the rest in the Middle East. Istithmar, another Dubai-based institution, has for the moment located the bulk of its investments in the Emirates (50 per cent) and the remainder in the United States (27 per cent) and Britain (10 per cent), but is also willing to look for more opportunities in emerging countries. Mubadala, another Emirates-based institution created in the early 2000s in Abu Dhabi, also has a portfolio concentrated in the MENA region and is willing to diversify away from Western Europe. Dubai Investment Group is betting on North Africa with a recent 17.5 per cent stake acquired in Tunisie Telecom in 2007.

This could be good news for developing countries. SWFs will contribute to boosting equity investments, injecting capital into local companies and emerging countries' projects. They are building long-term portfolios and will therefore contribute to reducing volatility. They also tend to look for secure investments and long-term returns. Though they have invested the bulk of their resources in OECD countries for this very reason, they would probably be better served by extending more into Africa, Asia and Latin America, where the correlation of returns with the OECD area remains low and where infrastructure gaps are huge. In the future, their portfolio diversification strategies will push them to look not only for higher return on investments but also for allocations less correlated with their homelands. There is thus likely to be an increasing interest in Latin America or Africa in preference to Asia and the Middle East. Africa could become an important investment playing field for all of them, with the promise of higher returns and less correlated investments.

This could offer an unexpected helping hand for Africa in reaching the Millennium Development Goals. If Sovereign Development Funds chose to allocate only 10 per cent of their portfolios to other emerging and developing economies over the next decade, they could generate inflows of $1 400 billion. This would be a yearly amount superior to all OECD countries' aid to developing economies. Far from being a threat to OECD financial systems, SWFs could be allies in the struggle to stimulate development and support donors as development finance partners.

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