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# The evolution of sovereign wealth funds and their influence in the global economy. The case of China

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**Abstract.** *This paper, through the deductive analysis and the causal explanations, catches the positive and negative character of the Sovereign Wealth Funds development as a relatively new economic tool, but with a strong impact in the global economy, especially in the context of the current financial changes. The benefits brought by them to the global capital market, in terms of increasing liquidity and allotting financial resources, however cannot diminish the fears related to the states holding sovereign funds in the economy of other countries, and in order to give an example we present the case of China.*

**Keywords:** sovereign wealth funds (SWFs); economic tool; capital market; investment; globalisation.

**JEL Codes:** F01, F65.
**REL Codes:** 10A, 10I.

## 1. Introduction

In the current context in which the world economy is under a strong impact of the economic, monetary, technological, military and diplomatic changes, globalisation seems to have generated an unprecedented development of a relatively new economic tool called sovereign wealth funds (SWFs). They recorded a sustained increase of the assets' value in the last ten years and, in the context of the effects of the current economic crisis, they have undergone spectacular dynamics, growing from $ 3.265 billion in September 2007 to $ 5.182 billion in December 2012, a value which exceeds by far the aggregate capital of the hedge funds and of the private equity. During the financial crisis and the recession, public debts, budgetary deficits and investments are followed more attentively at world level (Pociovălişteanu, 2011, p. 1018).

To assess the impact of the SWFs on the capital market, not only the value of their assets is important, but also the way of making investment decisions. The decision to invest requires a careful analysis of the field to which the investment is directed, and the decision to invest is subject to a number of factors (Ioneci, Mîndreci, 2010, p. 199). The general feature of the investment funds is that they operate according to the business principles to the benefit of the holding country.

China is the country that has become increasingly important in the global economy, benefiting greatly from globalisation, through the use of foreign capital to improve economic efficiency, to encourage competition and to gain access to the state-of-the-art technology. China is currently the world's second largest economy in the world, the world's leading exporter and producer, surpassing, in turn, established countries in the world hierarchy, such as the USA, Japan and Germany.

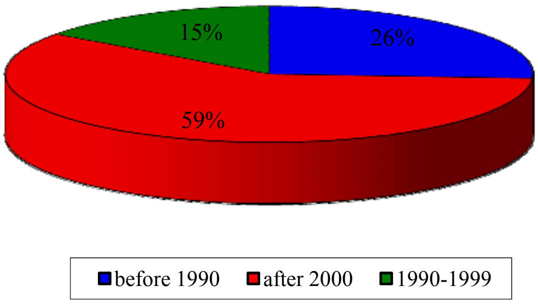
China's sovereign wealth funds amount to approximately 29% of the total assets of all SWFs in the world, positioning itself on the first place in the world in this regard, with a significant lead over the second place, the United Arab Emirates (16%)

## 2. Evolutionary and functional aspects of the sovereign wealth funds

In the second half of the twentieth century, the emerging states group recorded deficits of the current account, which have been kept under control by accessing external capital. Paradoxically, after 1999, the emerging economies have recorded current account surpluses and have exported capital worldwide. This surplus has increased rapidly, reaching an estimated value of $ 685 billion in 2006, that is to say 1.3% of the global GDP (Mezzacapo, 2009, p. 3). Basically, the countries in Asia are models of this trend, but also the oil-exporting countries and the developing countries in Latin America were included in the category of capital creditors. Also as a result of this process, the emerging countries began to accumulate foreign assets. When the level of these assets exceeded the level of the reserves required for stabilisation purposes, it became reasonable to seek more benefits from these reserves by diversifying investments, by creating sovereign wealth funds (SWFs). According to Christopher Balding, ISPs need predictable sources of capital, being dominated primarily by the commodity-dependent countries (Balding, 2012, p. 1). The strong development of these investment vehicles reflects the significant change in the emerging economies from debtors to creditors. Under the impact of the globalisation effects one can notice the rise of sovereign wealth funds as a direct consequence of this irreversible phenomenon (Mostrous et al., 2010, p. 4).

The first sovereign investment fund was Kuwait Investment Authority, created in 1953 to invest the excess income from oil exploitation. In 1956, the Republic of Kiribati created the investment fund called the Revenue Equalization Reserve Fund to hold the revenues from the export of phosphate applied as fertilizer. The creation of Abu Dhabi's Investment Authority (1976), Singapore's Government Investment Corporation (1981), and Norway's Government Pension Fund (1990) show the resumption of the states' concerns for SWFs, starting with the 70s, after the first oil shock.

The increase of the size, but also of the number of sovereign wealth funds is a relatively recent phenomenon, given that more than half of the number of FSI was created after 2000. Upon them acted as if FDI several factors that favored SWFs and touching capitals (Ene, 2012, p. 71).




**Source:** TheCityUK, *Sovereign Wealth Funds*, Financial Market Series, February 2012, p. 3.

**Figure 1.** *The launch year of the 50 largest sovereign wealth funds*

Under the pressure of the changes in the current economic environment, new sovereign wealth funds have been created to exploit the opportunities generated by the global crisis. Nigerian Sovereign Investment Authority (2011), for example, was created to manage the revenues from crude oil. The Italian Strategic Fund (2011) aims to support the growth of the Italian strategic companies. The feverish outbreaks of the worldwide market cause more and more countries, such as Angola, Bolivia, Canada, India, Japan, Taiwan and Thailand, to plan the establishment of investment funds. The growing role of SWFs on the international financial market and their opening towards adapting the operating characteristics to the current economic changes, is more and more visible. Basically, the participants in the international financial-monetary market have focused their attention on SWFs, which have visibly become major players on this market.

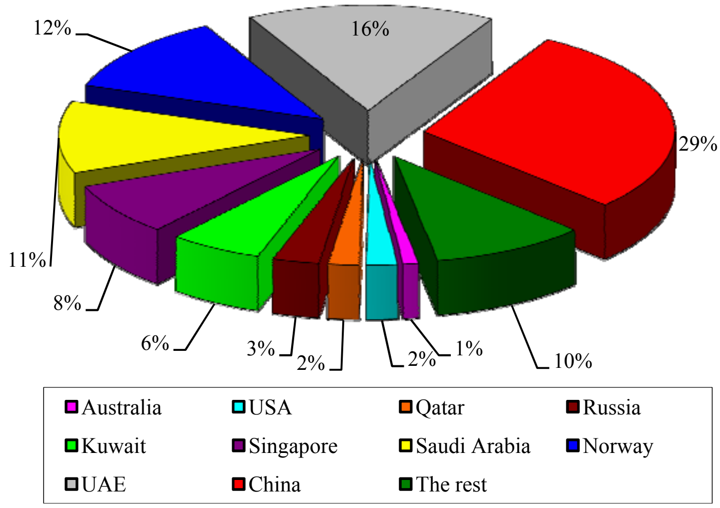
Robert M. Kimmitt, then deputy US treasury secretary, distinguished among four different kinds of sovereign wealth: SWFs, international reserves, public pension funds, and state-owned enterprises. International reserves are the funds countries hold for use by their treasuries or finance ministries and central banks. Public pension funds hold the funds that states promise their citizens. Kimmitt noted that these funds have traditionally kept low exposure to foreign assets. State-owned enterprises are companies fully or partly managed by the state, each of which may have its own assets and investments. SWFs are defined by International Working Group of Sovereign Wealth Funds (IWG, 2008, p. 27), as those special purpose investment funds held by a general government. Created by the government for macroeconomic purposes, SWFs hold, manage or administer assets to achieve the financial objectives, and employ a set of investment strategies which include investment in the foreign financial assets. Regarding the funding sources, they come from: the surplus of the balance of payments, official foreign currency operations, income from privatisations, fiscal surpluses and/or from the receipts resulting from raw materials exports. The definition of the sovereign wealth funds excludes the assets from the foreign currency reserves held by the monetary authorities for the balance of payments or for monetary policy purposes, the operations of the state-owned companies in the traditional sense, the government employees' pension funds, or the assets managed for the benefit of the natural persons.

Therefore, we can say that SWFs are defined and characterised by several elements which contribute significantly to the achievement of the objectives aimed at by:

- *The system of property*. SWFs are owned by a general government, a term that includes both the central government and the subnational governments.
- *Investment strategies*. They include investment in foreign financial assets, so that those funds that invest only in domestic assets are excluded.
- *The goals and objectives aimed at*. SWFs, established for macroeconomic purposes, operate to invest the government funds to achieve the financial objectives, and can have responsibilities that are only broadly defined, allowing thus the SWFs to have a wide range of investment strategies on medium or long-term.
- *The economic impact*. SWFs behave, usually, as a fiscal stabiliser, providing their governments additional income and, in some cases, directing money to help pay pensions or for company with financial problems, thus fuelling disputes about transparency and the intentions of SWFs.

## 3. Empirical research on sovereign wealth funds – China's case

In the top made by the Sovereign Wealth Fund Institute (SWF Institute), the largest investment fund was, in December 2012, the Government Pension Fund-Global of Norway (664.3 billion dollars), which surpassed Abu Dhabi Investment Authority (627 billion dollars) (SWF Institute, 2012).




**Source:** (www.swfinstitute.org/fund-rankings). Accessed on 02 Dec. 2011.

**Figure 2.** *Country distribution of the Sovereign Wealth Funds value in April 2012*

At the end of 2012, out of the total assets of SWFs ($ 5,182.1 billion), 58% had as main source of financing oil and natural gases, and the difference came from other funding sources that are not based on raw materials.

Table 1

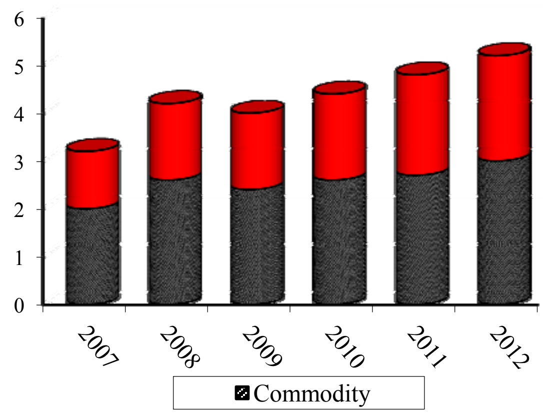
**The evolution of assets administered by SWFs at the beginning of the financial crisis**

(billion $)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | Sept. 2007 | Dec. 2007 |
| | | | | | | 3,265 | 3,259 |
| March 2008 | June 2008 | Sept. 2008 | Dec. 2008 | March 2009 | June 2009 | Sept. 2009 | Dec. 2009 |
| 3,427 | 3,916 | 4,054 | 4,140 | 3,749 | 3,790 | 3,914 | 4,022 |
| March 2010 | June 2010 | Sept. 2010 | Dec. 2010 | March 2011 | June 2011 | Sept. 2011 | Dec. 2011 |
| 4,052 | 4,107 | 4,154 | 4,406 | 4,551 | 4,731 | 4,847 | 4,830 |
| March 2012 | June 2012 | Sept. 2012 | Dec. 2012 | | | | |
| 4,995 | 5,019 | 5,135 | 5,182 | | | | |

**Source:** SWF Institute, (www.swfinstitute.org/fund-rankings). Accessed on 26 Jan. 2013.

The value of the SWFs assets, during the global economic crisis, has seen a positive trend, recording in September 2012 a value higher by 57% than in September 2007, before the onset of the crisis. The funds investing primarily in debt securities (for example, state bonds) have been largely unaffected by the global financial crisis, and the sovereign wealth funds with significant exposure to equities suffered a dramatic erosion in the value of their investments (WIR, 2011, p. 14). However, together with the return of world stock exchanges, most SWFs were able to recuperate their losses during the crisis. Moreover, the sovereign wealth funds have experienced a sustained increase of the assets' value in the last ten years and the strong growth in the share of the funding sources that are not based on raw materials, from 23% in 2002 to 42% in 2012 is obvious.




**Source:** TheCityUK, *Sovereign Wealth Funds*, Financial Market Series, February 2012, p. 1.

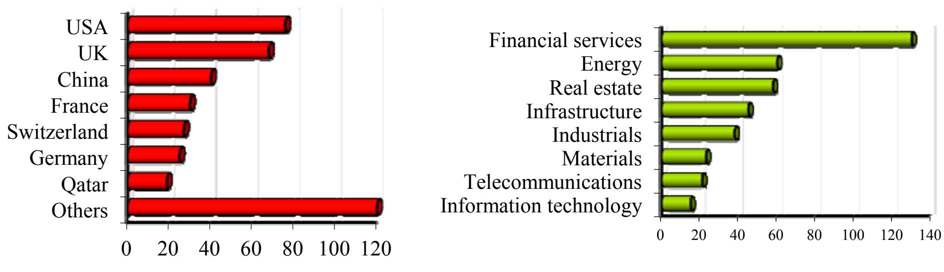
**Figure 3.** *The evolution of the assets managed by SWFs before the onset of crisis (billion $)*

The sovereign wealth funds differ significantly from one another in the allocation strategies of assets and in the risk management, reflecting the differences between objectives and constraints. Typically, SWFs adopt a long-term approach to investment. However, the stabilisation SWFs have shorter investment horizons as they take into account possible terms for the national needs of liquidity and funding. The public disclosure of the investment administration strategy varies among SWFs, although it is generally limited. The SWFs have considerable freedom in asset-allocation decisions and they are not usually constrained to specific asset classes or to currency exposure, unlike other investment administration entities, such as pension funds.

The SWFs of raw materials have a long-term approach to investment decisions and a preference for capital investments. Approximately four-fifths of the petroleum exporting countries' funds are invested in the foreign assets. Out of these, the capital investments represent about 50%, followed by those with fixed income (25%) and by the bank deposits (15%). As the risk aversion of the sovereign funds has increased, the share of investments in bonds is increasing.

The SWFs that are not based on raw materials represent an important source of liquidity for the global capital market. They tend to invest in American assets, particularly in the US government bonds. In October 2011, the central banks in Asia had the largest stock of US. Treasury securities, among which China and Japan each held more than a fifth of the total of foreign holdings. These were followed by Great Britain, with 9%, and the oil-exporting countries by 5% (TheCityUK, p. 6).

The substantial dimension and the high liquidity of the SWFs assets have turned the government sector into a significant group of international investors. Since SWFs have their long-term investment horizons, they are a constant source of capital for investments that can help stabilise markets. The funds' assets largely consist of: holdings of shares on the developed or emerging markets, hedge funds, sovereign or corporate debt, real estate, private equity, raw materials, direct and special investment.




**Source:** TheCityUK, *Sovereign Wealth Funds*, Financial Market Series, February 2012, pp. 6 (SWF Institute – Sovereign Wealth Fund Transaction Database). (www.thecityuk.com/assets/Uploads/SWF-2012.pdf). Accessed on 29 Jan. 2013.

**Figure 4.** *Direct investment between 2005-2011, by country and sectors (billion $)*

The main destination of the direct investments in the period 2005-2011 was the USA, with $ 76 billion or 19% of the total, followed by Great Britain, with 68 billion dollars or 17% of the total. Other important destinations are

China, France, Switzerland, Germany and Qatar. In the period 2006-2009 the activity concentrated mainly in the developed economies. The emerging countries, notably the BRICS countries (Brazil, Russia, India, China and South Africa), however, have accumulated most of the investments after 2009, being very likely for these countries to benefit from a rising share of investments in the future years. Direct foreign institutions have been admitted as an essential factor of assuring economic growth, both in the host-countries as in these of origin (Voiculeț, 2004, p. 136).

### 3.1. Analysis of the sovereign wealth funds in CHINA

In the top twelve sovereign wealth funds, accounting for value of the assets in the administration, China is the leading investor in the world, for this type of investment vehicle, being present with four funds, representing almost 29% of the overall total of 5,182.1 billion $: SAFE Investment Company, China Investment Corporation, Hong Kong Monetary Authority Investment Portfolio and National Social Security Fund.

Table 2

**Sovereign wealth funds from China**

| No. | Name of the fund | Total assets (billion $) | Transparency index | Source of capitals |
|---|---|---|---|---|
| 1 | SAFE Investment Company | 567.9 | 4 | Non-raw materials |
| 2 | China Investment Corporation | 482 | 7 | Non- raw materials |
| 3 | Hong Kong Monetary Authority Investment Portfolio | 298.7 | 8 | Non- raw materials |
| 4 | National Social Security Fund | 134.5 | 5 | Non- raw materials |
| 5 | China-Africa Development Fund | 5.0 | 4 | Non- raw materials |

**Source:** SWF Institute (www.swfinstitute.org/fund-rankings). Accessed on 08 Febr. 2013.

To estimate the transparency degree of the SWFs, the Linaburg-Maduell Transparency Index is used (SWF Institute, 2012), which takes values from 1 to 10 and which was developed at the Sovereign Wealth Fund Institute. For an adequate transparency, it is recommended to have an assessment of at least eight of the SWFs. By analyzing the case of China, is appears that only one fund meets this requirement, and the largest fund in China and third in the world is half of the transparency index required.

By analyzing the SWFs from China, it is found that the total value of the assets held by them amount to 1,483.1 billion dollars, an amount equal to 44% of China's official currency reserve, accounting for more than the currency reserves held by the central banks of any other country in the world. The first two funds are the most important:

- The SAFE Investment Company Fund (1997) is a Hong Kong subsidiary of the State Administration of Foreign Exchange (SAFE) - an entity responsible for managing China's currency reserve. The Fund is managed by the SAFE officials and through it there are made capital investments abroad. In terms of strategies and objectives of the fund, it is known that it has made significant investments on the capital market in the UK. The important stakes are: Royal Dutch Shell, Rio Tinto, BG Group, Tesco, BHP Billiton and Barclays. Its investment style is considered to be the Index – Passive type, that is to say small holdings in publicly traded companies.
- The China Investment Corporation (CIC) Fund is responsible for managing part of China's foreign currency reserve, the largest in the world (3,200 billion dollars), totaling half of the reserves currently held by the group of emerging and developing countries. Its investment style is considered to be of Portfolio, that is to say large holdings of publicly traded companies. The CIC fund is, according to the value of assets, the fifth largest in the world and it is considered China's main sovereign wealth fund. The need to seek higher returns, to diversify the growth and desire to hold less US currency helped create the fund. Established in September 2007, CIC has made substantial investments in a variety of asset classes. The capital of the fund is financed by issuing special treasury bonds worth $ 200 billion. The fund wholly owns several state companies, through which it invests in a range of international activities, the most important being the Central Huijin Investment Ltd. The official purpose of the China Investment Corporation Fund is to maximise benefits to acceptable risk tolerances and to improve the corporate governance of certain major state-owned financial institutions. Furthermore, CIC aims to use an external money management and to participate with indirect holdings of shares through various investment funds. Some of the money in the fund is used to help certain state-owned enterprises. The fund is active in pursuing the global resources, such as those in Africa, Asia, North America and Australia.

Some economic analyses identify other reason that led to the creation of the CIC sovereign wealth fund. According to Thomas Lum, its creation was part of a plan to mitigate the inflationary pressures that occurred in China's economy (Lum et al., 2010, p. 58). According to this theory, the rapid growth of the foreign currency reserves, which almost doubled between September 2005 and September 2007, created excess liquidity in China's money supply. In order to remove the excess money from circulation, the People's Bank of China has sold bonds to the public, a process often called sterilization, thereby constituting the social capital of the CIC investment fund.

It should be noted that there have always been concerns that the Chinese government, by establishing the CIC fund, could gain control over the key industries and/or access to important natural resources (oil, natural gas, iron ore, etc.) or access to sensitive technologies by getting a place in the boards. The change of the CIC direct investment, which began in the summer of 2009 from financial entities to energy and natural resources companies, draw the attention of investors and analysts. Michael F. Martin said that the change indicated a modification in the CIC investment strategy and that it could be part of a larger effort of the Chinese government to ensure access to natural resources for China's economy which is rapidly expanding (Martin, 2010, p. 10). Ever since the establishment of the CIC fund, the Chinese officials have denied any intention to use the fund to gain control over the Western economies and they have underlined its beneficial importance for solving global economic imbalances and for developing the global economy. Basically, the ability of the Chinese funds as an instrument of global influence is nevertheless a fact, as a result of the SWFs investments in distressed financial firms, such as investment made by CIC in Morgan Stanley, to ensure its stability on the market in the context of the global financial crisis, or in Bleckstone Group, at the end of 2007.

Although China's investment activity in the US is closely monitored, for Americans, there are many economic risks arising from the Chinese sovereign wealth funds, such as the emergence of certain imbalances on the financial-monetary market or undue foreign influence on key industries, as well as access to sensitive technology. The increase of the regulatory constraints of the Chinese investment in the US could generate retaliatory measures on the American companies' access on the financial-monetary market in China.

## 4. Conclusions

No doubt that the sovereign wealth funds bring significant benefits on the global capital market in terms of increasing liquidity and allotting financial resources. However, some governments are reserved concerning the SWFs because of the limited transparency of some of them, which harms the competitive process and limits the positive effects resulting from a stronger market discipline. Moreover, it is feared that they could invest in order to ensure the control of certain important businesses or sectors strategically, from political reasons rather than commercial ones, using these investments to promote their own national interests. Therefore, as the international assets held by SWFs are becoming increasingly important, the politicians and economists' anxiety linked to the impact of the activity of these funds on the receiving countries also intensifies. Basically, SWFs can influence their portfolio companies in a way that involves national security issues for the countries of origin in order to achieve competitive advantages or to gain access to natural resources, to technology and know-how or even to get strictly confidential information.

Following the analysis of the SWF's impact on world economy, a number of concerns was identified with regard to their role and influence, but also a number of proposals to improve the practical performance:

- increased transparency of SWFs by increasing the number of published annual reports and disclosing the assets under management;
- avoiding internal social reactions by informing the taxpayers from the SWFs owner state on how their public resources are invested;
- compliance and continuous improvement of the Santiago Principles by all SWFs as a result of the changes occurring on the global financial-monetary and market;
- increasing the regulatory constraints of the SWFs without proliferating the financial protectionism;
- elimination of unfair practices and retaliatory actions by strengthening the legislative framework and creating a balance between the development of the national economies and the growth of the SWFs;
- elimination of unfair competitive advantages;
- tighter control over the SWFs, as compared to the other foreign investors, to remove the suspicion about the intention of certain governments to achieve strategic economic interests through these funds.

In the current context, the SWFs may have a negative impact on the effectiveness of corporate governance, imposing additional costs by constraining certain companies to act in their own interests to the detriment of the other shareholders' interests. The acquisition of major shares packages from foreign companies operating in strategic sectors gives the foreign government the possibility to intervene to protect the national security and interests. As a result of the confusing boundaries between the private and public investors, the financial system's development based on a free market is countered and the financial power is concentrated on the strategic importance of investments, thus creating pressure for the protectionist measures. Consequently, their dimension and goals of the SWFs create concerns about the impact of the investment-related decisions on the global financial market, on the assets' prices and on the course of the monetary and exchange policies.

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