

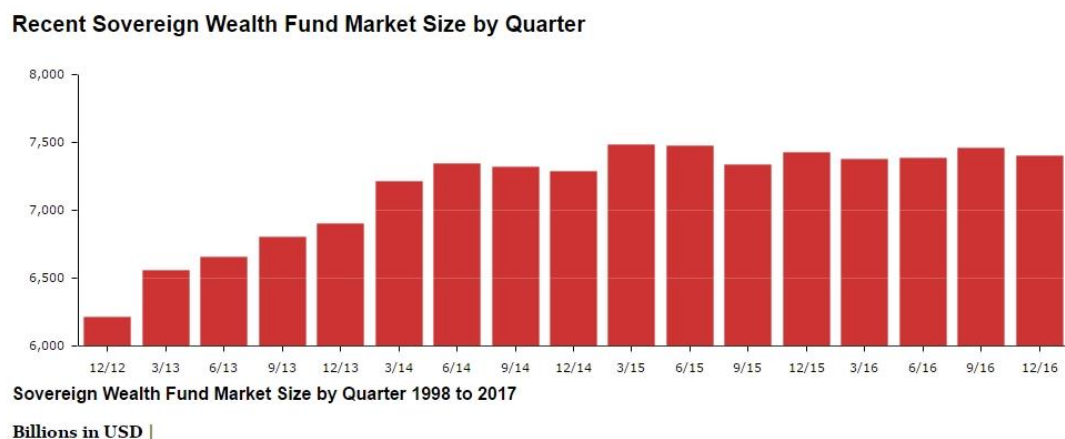
European Parliament Econ Committee Hearing Sovereign Wealth Funds
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I Evolution of Sovereign Wealth Funds' Assets

Since the period when developing and emerging countries, as well as some developed ones, such as Norway, saw their current account surpluses increase, since the early 2000s, there was an extraordinary process of reserve accumulation without parallel in recent history. This process was accompanied by a major accumulation of assets in Sovereign Wealth Funds (SWFs), which tend to be run autonomously from traditional reserve management by central banks and/or finance ministries. By 2007, they reached a level of approximately US \$ 3 trillion, whilst by March 2017, they reached \$ 7.5 trillion. What is interesting is that as commodity prices fell in the mid 2010s, and many of the countries with previously large current account surpluses saw them shrink or reverse, SWF assets have not fallen much, as illustrated below. It is important to emphasize the scale of other similar assets, for example pension funds manage about US \$35.0 trillion of assets across the globe

Recent figures(see Graph and Table below) show US \$ 7445 billion in assets, in March 2017, with very little volatility in these total assets, especially since end 2015

Figure 1



Source: <http://www.swfinstitute.org/fund-rankings/>

Table 1

Period	Total Sovereign Wealth Fund Assets	Total Oil & Gas Related	Total Other	Total Oil & Gas Related (%)	Total Other (%)	Total Gulf SWF Assets
Mar 2017	7,445	4,239	3,206	56.93%	43.07%	2,988
Dec 2016	7,402	4,221	3,182	57.02%	42.98%	3,008
Sep 2016	7,462	4,265	3,197	57.15%	42.85%	3,031
Jun 2016	7,389	4,211	3,178	56.99%	43.01%	3,006
Mar 2016	7,373	4,215	3,158	57.17%	42.83%	3,007
Dec 2015	7,430	4,247	3,183	57.16%	42.84%	3,001

Source: <http://www.swfinstitute.org/fund-rankings/>

A careful analysis by Bocconi entitled The Sky Did Not Fall

<http://www.ifswf.org/sites/default/files/Bocconi%20SIL%202016%20Report.pdf> concludes that

Selling by SWFs and central banks certainly was not the main cause of the equity rollercoaster in 2015 and 2016. However the expiration of the Petrodollar Put paves the way to a new environment in global capital markets where a patient class of investors with a long term investment horizon and the ability to deploy assets when other investors are forced to sell will play a less pervasive role.

To understand the impact of such shift we need to ask “What happens when the Petrodollar Put expires”? The mechanism starts working in reverse with securities prices under pressure and a rebalancing towards less risky asset classes. So did the plunge in oil prices trigger the stock market roller coaster in certain periods and is there a risk of an unravelling of the bull market as the bulls run out of money? So far the outflow has been relatively limited and, more importantly, has involved mostly government bonds. It is true that the current account surpluses of the EMEA oil exporters shrank from a peak of USD 652 billion in 2011 to USD 342 billion in 2014, turning slightly negative in 2015 to an estimated –USD 19 billion. Moreover the current account surpluses of emerging markets has shrunk from USD 681 billion in 2008 to USD 158 billion in 2014 and to an estimated deficit of USD 24 billion in 2015. Nevertheless such U-turn has hit primarily the foreign reserve assets held by central banks, not so much the AUM by SWFs. Central bank reserves are typically

held in highly rated government bonds and other high quality fixed income securities, hence this withdrawal has been absorbed easily by markets awash with central bank liquidity (in fact yields since 2014 have dropped, in many cases below zero). Based on a typical asset allocation structure, the Bocconi report estimated that in 2015 SWFs sold USD 50 billion of equities and central banks sold equities worth USD 150 billion, which accounts for 0.13% and 0.40% of total trading volume (according to the World Federation of Exchanges). Essentially oil exporters are filling the fiscal gap by selling some of the reserve prudently accumulated during the good times in central bank (and in Treasury-controlled bank accounts), but are preserving the assets managed by SWFs that pursue more sophisticated (and lucrative) strategies, although the inflow into these funds have dried out.

II Different sources of SWFs and their implications

When understanding the rationale for and the behaviour of SWFs in investment, it is important to start with the current account, as well as the underlying reasons for a current account surplus. If there is no current account surplus, it is difficult to rationalize the creation of SWFs. Indeed, a SWF merely created on the basis of “borrowed reserves” (or, more broadly, “borrowed liquidity”), we can think of it really as a form of financial intermediation, as it would not involve really the management of net foreign exchange assets.

We can differentiate four major motives for the accumulation of net foreign exchange assets. (see Table 2 below). The first can be called the wealth substitution motive. In this case, there is a current account surplus that results from the exploitation of a non-renewable natural resource. We can think of this case as the transformation of an illiquid natural resource asset into net foreign exchange assets.

There are several factors that must be taken into consideration in this case. The first is that it may make sense to leave the resources under ground, particularly when the revenues it generates are merely consumed. If they are invested, the crucial question is the relation between the marginal profitability of the associated investments vs. the expected increase in the value of the natural resource. Domestic investment of the resource makes sense to the extent that it leads to accumulation of capital assets that result in sustainable long-term growth, particularly by diversifying the productive base of the domestic economy. Of course, if the resource is merely consumed, the crucial question is the inter-temporal time preference, as well as guaranteeing a smooth trajectory of consumption. A major problem in relation with these decisions is the political economy pressures that may result in the excessive consumption of the natural resource today or over investments in infrastructure and “diversification” activities that may have low marginal social benefits.

A second issue is related to the “Dutch disease” literature, and may be seen as the policy decision to use the revenues associated with the exploitation of the natural resource to accumulate foreign exchange assets vs. domestic spending. Both the decision to exploit or leave the resource under ground, and to allocate the associated revenues between the accumulation of financial assets and domestic spending with more immediate development effects should vary by countries’ level of income (Sachs, 2007). Whereas a rich country like Norway rightly may privilege more very long-term savings, a middle or, even more, a low income country may maximize welfare by devoting part of the resources to investment with relatively quick development impact.

A second motive could be called the resilient surplus motive (with the surplus referring to the current account). The issue here is the tendency of some non-natural resource based economies (like China, or indeed one could think of Germany) to run current account surpluses that are fairly resilient to growth and even to exchange rate appreciation.

The third may be called the counter-cyclical motive. We must differentiate between two entirely different situations. The first case relates to cyclical swings in real exports (volumes) associated with foreign business cycles (global or of the relevant trading partners). The second and most relevant for Latin America and Africa today is associated with cyclical swings in external prices, particularly commodity prices. Both issues have certain features in common: the possibility of overheating of the domestic economy during the boom that would lead to variable mixes of domestic inflation and nominal exchange rate appreciation, resulting in both cases in real exchange rate appreciation. When the source is a commodity boom, there is an advantage but also a complication for the design of stabilization vehicles.

The advantage results from easy identification and, therefore, design of the stabilization instrument. The complication arises because cyclical patterns may be difficult to differentiate from long-term trends. It is thus difficult to find a rule that identifies the cyclical component of a price boom vs. its possible long-term character that would make it possible to distinguish ex ante between the “transitory” and the “permanent” component of the shock.

The fourth can be called the strict self-insurance motive, which applies when the source of the abundance of foreign exchange is the capital rather than the current account. Since capital flows are strongly pro-cyclical for developing countries, the relevant criteria are the risks of capital flow reversibility. Thus, self-insurance should be higher the larger the share of more volatile capital flows (a differentiation which is increasingly difficult in practice; see: Dodd and Griffith Jones, 2007, for the role of derivatives in this) and the more open the capital account. Table 2 summarizes in a simple table the basic motivations for the accumulation of foreign exchange assets, differentiating two dimensions: the source of the boom (a long-term or short-term current account surplus, or net capital inflows), and the role played by commodities vs. other factors influencing foreign exchange abundance.

Table 2
Basic Motivation for the Accumulation
of Foreign Exchange Assets by Developing Countries

	Long-term current account surplus	Short-term current account surplus	Capital flows
Commodities	Wealth substitution	Counter-cyclical (prices)	
Non-commodities	Resilient surplus	Counter-cyclical (volumes)	Self-insurance

Source: Griffith Jones and Ocampo (2009) Sovereign Wealth Funds: A developing Country Perspective. *Revue D'Economie Financiere* Special Issue

The motives clearly determine the nature of the fund that should be used and the composition of its investments. SWFs are the appropriate instrument when there is a current account surplus and, particularly, when it is clearly long-term in character. The polar case is that of the self-insurance motive. It is difficult to justify a SWF in this case. Any fund that is created on the basis of net capital inflows could be seen in fact as an international financial intermediary, to channel capital inflows for lending or investment abroad. It could then make sense to create a development bank or fund if capital flows are deemed to be stable. In that case, the bank or fund could intermediate such capital flows by channelling those resources to neighbouring countries, including in infrastructure projects that could encourage trade with them, or accumulate part of those funds in regional or sub-regional development banks. As not all capital inflows are deemed to be stable, self-insurance calls for accumulating foreign exchange reserves in central banks and investing them in very liquid instruments.

A related issue has to do with asset allocation strategies for SWFs and whether these should vary by type of fund and by the origin of the surpluses (commodity vs. non-commodity). In principle, return may be more important than liquidity for SWFs, and they should therefore invest in longer-term assets with a different risk/return mix than typical assets held in official reserves. The main reason for this lies in the more long-term horizon of these funds, which allows greater tolerance of short-term fluctuations in returns. An example is the Norwegian Fund. Obviously, in all cases asset allocation should be subject to strong prudential rules. Three additional considerations seem relevant here. Firstly, as the assets of SWFs belong to all the citizens of a country and their children (many of whom have low incomes), there may be a greater need for prudence in investment by SWFs owned by developing countries, to lower levels of risk than wealthy individuals. Therefore, the criteria for choosing a portfolio of assets may be somewhat different for SWFs than for private management of assets. As a consequence, central banks or governments may wish to either manage assets themselves or define clearly and monitor carefully the level of risk fund managers are accepting on their SWF investments. Secondly, the investments by SWFs (or a part of them) should serve long-term development objectives of the country as well as ensure good long-term returns. As in the case of investments in development banks or funds (which could be a potential use of the SWF resources), part of these investments could go into financing projects in neighbouring countries or the country may wish to invest in companies abroad in more developed economies for reasons such as gaining access to new and better technologies. However, it is important that such criteria are transparent, and that other objectives are not inappropriately used as an excuse for low financial returns. Emphasis on sustainable development as an aim is desirable for developing country SWFs.

Thirdly, it is important to distinguish between savings funds, which can invest with longer-term criteria, and stabilization funds, which (given their cyclical role) would seem to need higher proportions of relatively more liquid assets. In this sense, stabilization funds' liquidity needs can be seen as intermediate between normal foreign reserves (requiring high levels of liquidity) and savings funds, with far longer term horizons.

III How can SWFs assets be channeled to long-term investment in the European Union, especially in context of Juncker Plan?

The long-term nature of assets of SWFs, as well as of other long-term investors, such as institutional investors,- like pension funds and insurance companies,- are clearly ideal for long term investment, such as infrastructure ,(especially sustainable one), innovation, etc.

Indeed institutional investors and SWFs are already major investors in EIB bonds. To the extent that there is increased demand for funding for EIB investment, or more broadly through EFSI, in the context of the Juncker plan, it would seem likely that SWFs would contribute to such funding, provided the risk/return ratio to assets is attractive.

Three broad potentially interesting issues arise.

A first one is whether specific mechanisms should be developed especially to attract sovereign wealth funds to channel resources to invest in the European Union?

Indeed, should particular mechanisms be developed for certain categories of investors. One example is surely the role that Chinese investment can play in the Juncker Plan, especially perhaps in the context of the New Silk Road; similarly, could the AIIB perhaps be interested in specific investments.

Second, national development banks (both existing and new ones) are set to play an increasing role in the Juncker Plan, and more broadly in European investment, following and building on the experience of the KfW, and other successful development banks in the EU. What role could SWFs play in financing such a greater scope for these national development banks?

Third, clearly European institutions, like the widely praised Norwegian Sovereign Wealth Fund, could be a valuable source of further funding for EU investment. Are there any specific mechanisms/features that need to be developed for this to happen on a more significant scale? Furthermore, several EU countries, such as Germany and Netherlands, have large current account surpluses, as proportion of GDP. What mechanisms could be developed for these countries to be encouraged to channel more of their long term savings to productive investment , either in their own countries and/or in other EU countries, especially via EU mechanisms , such as the Juncker Plan? Could for example, German pension funds be encouraged to invest more in other EU countries? What would be the best mechanisms/incentives for that?