Sovereign Wealth Funds

Thomas N. Carson & William P. Litmann
Editors

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THOMAS N. CARSON AND
WILLIAM P. LITMANN
EDITORS

Nova Science Publishers, Inc.
New York

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LIBRARY OF CONGRESS CATALOGING-IN-PUBLICATION DATA

Available upon request

ISBN: 978-1-60692-319-1

Published by Nova Science Publishers, Inc. ; New York

SOVEREIGN WEALTH FUNDS

PREFACE

Sovereign wealth funds (SWFs) are investment funds owned and managed by national governments. Such funds currently manage between $1.9 and $2.9 trillion and are expected to grow to over $12 trillion by 2015. This is due to the rapid growth of commodity prices and large trade surpluses in several emerging market economies. During the second half of 2007, interest in SWFs increased as Asian and Middle Eastern SWFs, fueled by surging foreign exchange reserves, invested large sums of capital in U.S. and other Western companies. Policy makers in the United States have raised two broad policy concerns about SWFs: (1) their lack of transparency and (2) their possible misuse for political or other non-commercial goals. Hearings have been held by several congressional committees including the House Financial Services Committee and the Senate Foreign Relations and Senate Banking Committees. Additional congressional hearings are expected in 2008. SWFs pose a complex challenge for policy makers.

On one hand, SWFs are long-term investment vehicles looking beyond quarterly results and therefore serve as stable funding sources during financial turbulence. On the other hand, however, there are operational concerns stemming from government control (i.e., lack of transparency and possible non-commercial investment goals). Without transparency, it is difficult to attain a clear picture of SWF investment activity. A lack of SWF transparency can also obscure governance and risk-management problems within SWFs. Many are also concerned that countries will use SWFs to support what one analyst has called "state capitalism," using government-controlled assets to secure stakes around the world in strategic areas such as telecommunications, energy and mineral resources, and financial services, among other sectors. In response to these concerns, many analysts and policy makers are evaluating the operations of existing SWFs and are looking to the international financial institutions such as the International Monetary Fund, World Bank, and the Organization for Economic Cooperation and Development to establish guidelines for SWF operations. All of these institutions are currently developing proposals that will be deliberated during 2008.

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CONTENTS

Preface		**ix**
Chapter 1	Sovereign Wealth Funds: Background and Policy Issues for Congress *Martin A. Weiss*	**1**
Chapter 2	China's Sovereign Wealth Fund *Michael F. Martin*	**21**
Chapter 3	State Capitalism: The Rise of Sovereign Wealth Funds *Gerard Lyons*	**41**
Chapter 4	Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States:Assessing the Economic and National SecurityImplications: Testimony before the Committee on Banking, Housing, and Urban Affairs, United States Senate, November 14, 2007 *Edwin M. Truman*	**83**
Chapter 5	Testimony of Patrick A. Mulloy before the Senate Committee on Banking, Housing & Urban Affairs Hearing on "Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the U.S.: Assessing the Economic and National Security Implications", November 14, 2007	**107**
Chapter 6	Foreign Government Investment in the U.S. Economy and Financial Sector: Joint Hearing before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services *U.S. House of Representatives One Hundred Tenth Congress Second Session, March 5, 2008*	**117**

Chapter 7	Statement of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System before the Committee on Banking, Housing, and Urban Affairs United States Senate	**273**
Chapter 8	Investments and Acquisitions in the United States by Government Entities, Testimony by Alan Larson, Senior International Policy Advisor, Covington & Burling LLP, before the Senate Committee on Banking, Housing and Urban Affairs, November 14, 2007	**283**
Chapter 9	Sovereign Wealth Funds and Implications for Policy, Testimony by Jagdish Bhagwati, before The Senate Foreign Relations Committee, Wednesday, 11th June 2008	**291**
Chapter 10	U.S. Regulatory Framework for Assessing Sovereign Investments, Testimony by Jeanne S. Archibald, Director, International Trade Practice, Hogan & Hartson LLP, Before the Senate Committee on Banking, Housing and Urban Affairs, April 24, 2008	**297**
Chapter 11	The Foreign Policy Implications of Sovereign Wealth Funds *Daniel W. Drezner*	**303**
Chapter 12	Testimony of David Marchick, Managing Director and Global Head of Regulatory Affairs, the Carlyle Group, before the United States Senate, Committee on Foreign Relations, June 11, 2008	**309**
Chapter 13	Testimony of David Marchick, Managing Director and Global Head of Regulatory Affairs, the Carlyle Group, before the United States Senate, Committee on Banking, Housing, and Urban Affairs, April 24, 2008	**315**
Chapter 14	The Regulatory Framework for Sovereign Investments, Testimony Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, April 24, 2008, by Ethiopis Tafara, Director, Office of International Affairs, U.S. Securities and Exchange Commission	**319**
Chapter 15	U.S. Senate Committee on Foreign Relations, Senator Richard G. Lugar, Opening Statement for Hearing on Sovereign Wealth Funds, June 11, 2008	**325**
Chapter 16	Statement of Chairman Dodd, "Turmoil in U.S. Credit Markets: Examining the U.S. Regulatory Framework for Assessing Sovereign Investments"	**327**

Chapter 17 The Committee on Foreign Investment in the United States (CFIUS) **331**
James K. Jackson

Index **353**

In: Sovereign Wealth Funds
Editors: T. N. Carson, W. P. Litmann

ISBN: 978-1-60692-319-1
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Chapter 1

SOVEREIGN WEALTH FUNDS: BACKGROUND AND POLICY ISSUES FOR CONGRESS*

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ABSTRACT

Sovereign wealth funds (SWFs) are investment funds owned and managed by national governments. Such funds currently manage between $1.9 and $2.9 trillion and are expected to grow to over $12 trillion by 2015. This is due to the rapid growth of commodity prices and large trade surpluses in several emerging market economies. During the second half of 2007, interest in SWFs increased as Asian and Middle Eastern SWFs, fueled by surging foreign exchange reserves, invested large sums of capital in U.S. and other Western companies.

Policy makers in the United States have raised two broad policy concerns about SWFs: (1) their lack of transparency and (2) their possible misuse for political or other non-commercial goals. Hearings have been held by several congressional committees including the House Financial Services Committee and the Senate Foreign Relations and Senate Banking Committees. Additional congressional hearings are expected in 2008.

SWFs pose a complex challenge for policy makers. On one hand, SWFs are long-term investment vehicles looking beyond quarterly results and therefore serve as stable funding sources during financial turbulence. On the other hand, however, there are operational concerns stemming from government control (i.e., lack of transparency and possible non-commercial investment goals). Without transparency, it is difficult to attain a clear picture of SWF investment activity. A lack of SWF transparency can also obscure governance and risk-management problems within SWFs.

Many are also concerned that countries will use SWFs to support what one analyst has called "state capitalism," using government-controlled assets to secure stakes around the world in strategic areas such as telecommunications, energy and mineral resources, and financial services, among other sectors.

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* Excerpted from CRS Report RL34336, dated March 26, 2008.

In response to these concerns, many analysts and policy makers are evaluating the operations of existing SWFs and are looking to the international financial institutions such as the International Monetary Fund, World Bank, and the Organization for Economic Cooperation and Development to establish guidelines for SWF operations. All of these institutions are currently developing proposals that will be deliberated during 2008. This report will be updated as events warrant.

INTRODUCTION

Sovereign Wealth Funds (SWFs) are investment funds owned and managed by national governments. Originally created in the 1950s by oil and resource-producing countries to help stabilize their economies against fluctuating commodity prices, and to provide a source of wealth for future generations, they have proliferated considerably in recent years. Although their lack of transparency makes estimating SWF investment levels difficult, it is estimated that they currently manage between $1.9 and $2.9 trillion.[1] Estimates of their growth over the next several years vary, with the consensus hovering around Morgan Stanley's projection of $12 trillion by 2015.[2]

SWFs can be funded through a variety of means, including profits from the sale of commodities (such as oil) or a current account surplus. SWFs can be established to serve several different objectives. These may include diversifying national assets, stabilizing the domestic economy against volatile commodity prices, saving for future generations, getting a better return on investment than traditional foreign exchange reserves, and promoting political or strategic interests.

During the second half of 2007, Asian and Middle Eastern SWFs, fueled by surging foreign exchange reserves, invested large sums of capital in the United States and other developed countries. While SWFs are invested broadly throughout Western markets, investments have been particularly concentrated in financial institutions. Following losses stemming from the August 2007 U.S. sub-prime mortgage crisis, many financial institutions sought large investments from foreign SWFs and other large institutional investors.[3] According to Dealogic, a financial data provider, SWFs invested $37.9 billion in U.S. financial institutions in 2007, 63% of their total activity.[4]

The dramatic recent increase in SWF activity has raised concerns about this relatively unexamined class of international investors. This report provides background on SWFs, including what countries operate SWFs and the size of the SWF market, and discusses two broad areas of concern to Members of Congress and the international financial community:

- governance and transparency-related issues, and
- possible non-commercial investment goals, including the potential use of government-controlled investment vehicles to attain global strategic and political goals.

Some U.S. policy makers stress that their concerns about SWFs are not meant to undermine the U.S. commitment to open investment. They maintain that the United States is one of the most open economies in the world and note that foreign investment in the United States provides many benefits, including lower interest rates, increased employment, productivity, and access to capital for American enterprise. Indeed, for countries such as the

United States, which have both a high national budget deficit and historically low levels of public savings, foreign investment has been crucial.[5]

BACKGROUND

The rising profile of SWFs is a direct consequence of the massive accumulation of global foreign reserve assets over the past decade. While reserve accumulation has occurred in many emerging market economies, it has been especially sharp among oil producers and Asian countries that have large trade-surpluses with the United States and other developed countries. In these countries, reserves have swelled to levels far in excess of the amount needed for balance of payments support, thus presenting an opportunity for foreign exchange reserve managers to maximize returns.

Foreign exchange reserves are traditionally invested in low-risk assets such as U.S. Treasury bills, but their recent growth has seen an increasing shift of excess reserves to higher-risk, higher-return investments. In contrast to traditional foreign exchange reserves, SWFs invest in a much broader array of assets, including stocks, bonds, fixed assets, commodities, derivatives, and alternative investments such as real estate and hedge funds. Like private hedge funds and government pension funds, SWFs often rely on outside expertise and professional fund managers.[6]

Two key forces drove interest in SWFs during the second half of 2007: (1) the introduction of new funds and (2) major acquisitions by existing SWFs following large losses by Western financial institutions from the U.S. sub-prime mortgage crisis. Many point to the September 29, 2007, launch of the new China Investment Corporation, Ltd. (CIC), with $200 billion of capital as a catalyst of the initial Western interest in SWFs.[7] In addition to the introduction of the CIC, several Middle Eastern and Asian SWFs have recently announced or completed large deals, with a focus on multinational financial institutions following the market turmoil in the second half of 2007. During the fourth quarter of 2007, Morgan Stanley estimates that SWFs invested $44.5 billion in Western financial institutions (Figure 1). Presumably, as long-term investors, SWFs see these investments as currently undervalued. In addition, many emerging market countries are looking to boost their own domestic financial institutions, which would likely be facilitated by the transfer of knowledge gained from major investments in more experienced Western financial institutions.

Large recent deals include the following:

- On September 20, 2007, the Mubadala Development Company, which is owned by the government of Abu Dhabi, announced a deal to buy a 7.5% stake in the Carlyle Group, a U.S. buyout investment firm, for $1.35 billion.[8]
- On November 26, 2007, the Abu Dhabi Investment Authority (ADIA), the world's largest SWF, announced a deal to buy a 4.9% stake in Citigroup for $7.5 billion.[9]
- On December 10, 2007, UBS AG, a Swiss bank, announced that the Government of Singapore Investment Corporation is investing $9.75 billion for a 9% stake, while a Saudi investor is investing $1.77 billion to UBS AG.[10]
- On December 19, 2007, Morgan Stanley, a U.S.-based investment bank, announced that the China Investment Corporation would invest $5 billion for a 9.9% share.[11]

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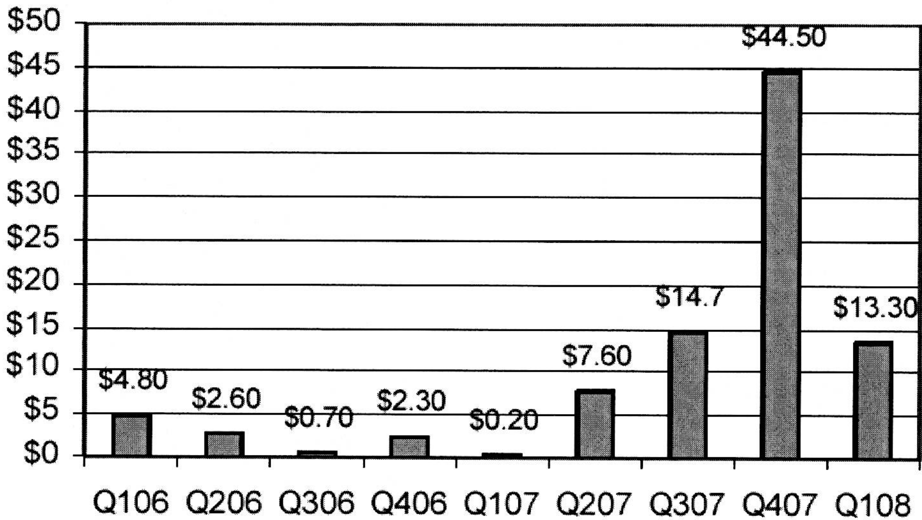
- On December 24, 2007, Merrill Lynch announced a $6.2 billion private placement from Singapore's Temasek and New York-based Davis Selected Advisors. Temasek is expected to invest $4.4 billion in Merrill Lynch common stock, with the option to buy an additional $600 million in stock by March 2008.[12]
- On January 15, 2008, Citibank announced that it is receiving $14.5 billion from investors including the governments of Singapore and Kuwait, former Chairman Sanford Weill, and Saudi Prince Alwaleed bin Talal. On the same day, Merrill Lynch announced that it is to receive $6.6 billion from a group led by Tokyo-based Mizuho Financial Group Inc., the Kuwait Investment Authority, and the Korean Investment Corp.[13]



Source: Morgan Stanley.

Figure 1. SWF Investments in Western Financial Institutions ($ billions).

Several international bodies, including the IMF, the U.S. Treasury, and the European Central Bank have drawn attention to the positive impact that this SWF investment appears to have exerted so far by providing liquidity and stability during the U.S. sub-prime mortgage crisis that began during the summer of 2007.[14] In its December 2007 six-month Financial Stability Review, the European Central Bank wrote:

> As SWFs, in particular those that put the emphasis on savings for future generations, are likely to have a long-term horizon for their investments, they may also contribute to the broadening of the long-term investor base for risky assets, such as equities, corporate bonds, emerging market assets, private equity and real estate. In this regard, such funds could become a more stable investor base for risky assets in certain markets. In addition, provided that the investments of such funds are driven entirely by risk and return considerations, SWFs may contribute to a more efficient allocation and diversification of risk at the global level.[15]

While SWFs represent a small percentage of all investment classes globally, their rapid and projected growth could increase demand for riskier assets, including equities and bonds. Deutsche Bank estimates that future SWF asset allocation could lead to a gross capital inflow of over $1 trillion into global equity markets and $1.5 trillion into global debt markets over the coming five years.[16] Merrill Lynch, using more aggressive assumptions, estimates that $3.1 to $6 trillion is likely to be invested in riskier assets by SWFs in the next five years.[17]

What Are Sovereign Wealth Funds (SWFs)?

While the term "Sovereign Wealth Fund" was coined only recently, SWFs have a more than 50-year history, with the first fund established by Kuwait in 1953.[18] There is no universally agreed upon definition of SWFs. The U.S. Treasury Department narrowly defines SWFs as "a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities (the Central Bank and reserve-related functions of the Finance Ministry)."[19] The U.S. Treasury Department's definition is meant primarily to distinguish SWF investment from official reserves managed by a country's central bank. Because the primary goals of official foreign reserves are liquidity and security, the investment horizon for these for reserves is short.

Some observers provide a more detailed definition of SWFs. Stephen Jen, a currency analyst at Morgan Stanley, expands on the Treasury definition to provide a broader understanding of SWFs and how they differ from official foreign reserves and other government-sponsored funds. According to Jen, there are five key traits of SWFs. They are (1) sovereign government entities with (2) high foreign currency exposures, (3) no explicit liabilities (such as a national state pension fund), (4) high- risk tolerances, and (5) long investment horizons.[20]

The IMF divides SWFs into several categories based on their stated goals. In practice, however, many SWFs combine elements of the following three categories. The three primary types of SWFs, according to the IMF, are as follows:

1 **Stabilization funds** — Volatile international market prices are a primary concern for resource- and commodity-intensive economies. Some commodities face price fluctuations of an average of 20%-25% per year. To mitigate this volatility, several countries have established funds to sterilize capital inflows[21] and stabilize fiscal revenues. Because stabilization funds serve a more immediate function than long-term savings funds, they tend to be more conservative in their investment decisions, focusing on fixed income rather than equity investments.[22] Examples include Russia's Stabilization Fund of the Russian Federation and Kazakhstan's National Oil Fund.

2 **Savings funds** — Savings funds are intended to share wealth across generations. For countries rich in natural resources, savings funds convert nonrenewable natural resources into a diversified portfolio of international financial assets to provide for future generations or other long-term objectives. According to the IMF, while newer oil funds predominantly focus on stabilization objectives, the recent increase in oil prices has allowed SWFs to emphasize savings objectives. Becuase savings funds have longer investment horizons than pure stabilization funds, they invest in a broader

range of assets, including bonds and equities, as well as other forms of alternative investments, such as real estate, private equity, hedge funds, and commodities. Examples include the Abu Dhabi Investment Authority, Kuwait Investment Authority, Singapore's Government Investment Corporation, and the China Investment Corporation.

3 **Reserve investment corporations** — Reserve investment corporations are funds established to reduce the opportunity cost of holding excess foreign reserves or to pursue investment policies with higher returns. Reserve investment corporations adapt more aggressive investment strategies, including taking direct equity stakes. These funds typically seek higher returns than other SWFs and use leverage (i.e., debt) in their investments. Historically, theses vehicles tend to be more secretive than other SWFs that are primarily portfolio investors.[23] Examples of such funds are Singapore's Temasek, Qatar's Investment Authority, and Abu Dhabi's Mudabala.[24]

Among funds, there are substantial differences in risk-return profiles, investment horizons, asset allocation, eligible instruments, risk tolerances, and constraints.[25] Because each fund is different and has varying goals and objectives, it is difficult to generalize about the investment strategies of SWFs as a class. For example, an oil-exporting economy may initially establish a SWF for stabilization purposes. However, if the assets under management by the SWF grow to exceed the levels needed for stabilization, the country may either change the priorities and investment strategy of the fund or establish a separate fund with a more aggressive investment approach. Thus, several countries have multiple sovereign wealth funds. For example, the United Arab Emirates's primary fund, the Abu Dhabi Investment Authority (ADIA), was established in 1974 to invest surplus cash in assets that provide steady gains and returns over a long time-horizon using a portfolio investment strategy. In 2002, the United Arab Emirates established Mubadala Development to pursue direct investment projects targeted at higher returns.

What Countries Operate SWFs?

The first SWF was established by Kuwait in 1953 as a means to help stabilize the economy from fluctuating oil prices.[26] In 1956 the Gilbert Islands (now Kiribati) established the Revenue Equalization Reserve Fund to manage profits from phosphate mining. Following Kuwait and Kiribati, the next major SWFs were created in the 1 970s in the wake of the oil shock. The most recent wave began in the 1 990s with the Norway Government Pension Fund-Global in 1990 and continues to this day. In the last five years, funds have been established by China, Iran, Russia, Qatar, and the United Arab Emirates.

As noted previously, the recent growth of SWFs is a consequence of rapid growth in emerging market reserves driven by (1) the impact of rising oil prices for Middle Eastern economies and (2) large trade surpluses, net foreign direct investment flows, and high savings rates among Asian economies. Reserve accumulation has been especially sharp in the case of China, where there has been extensive intervention in the foreign exchange markets to limit the yuan's appreciation against the dollar.[27]

Analysts estimate that foreign assets held by sovereign nations currently exceed $5 trillion and are, as the growing U.S. current account imbalance would indicate, increasing at a

significantly more rapid rate in emerging market countries with high savings rates than in the industrialized countries. Table 1 provides information on the 10 largest holders of foreign reserves (as of the end of 2006) and five additional countries that have large SWFs.

Table 1. Foreign Exchange Reserves and Current Account Balances

	Foreign Exchange Reserves			Reserves/GDP (Percent)	Current Account/GDP 2002-2006 (Percent)
	2006 (USD Billions)	Change '01-'06 (Percent)	Share of GDP 2006 (Percent)		
China[S]	1,066	403	41	8.6	5.5
Japan	875	126	20	2.2	3.5
Russia[SR]	295	807	30	8.4	9.7
Taiwan	266	118	75	8.9	7.1
Korea[SR]	238	133	27	3.9	1.9
India	170	276	19	3.7	-0.3
Singapore[SR]	136	81	103	11.3	22.5
Hong Kong	133	20	70	2.6	9.9
Brazil	86	139	8	1.4	1.0
Malaysia[S]	82	185	54	8.9	13.3
Algeria[S]	78	333	68	14.0	17.2
Norway[S]	56	153	17	2.6	14.3
United Arab Emirates[S]	28	98	16	2.4	12.3
Kuwait[S]	12	32	13	0.9	32.9
Qatar[S]	5	346	10	2.4	20.0

Source: Peterson Institute for International Economics.

Notes: S = has one or more sovereign wealth funds; R = reserves include sovereign wealth fund in whole or in part.

Middle East

The Middle East region is currently experiencing a substantial economic boom due to record high oil prices. The value of oil and gas exports from the Middle East was approximately $650 billion in 2007 and is expected to rise to almost $750 billion in 2008. Because these countries either largely control or heavily tax oil production, government revenue from oil and gas is now estimated at $510 billion for 2007, and will likely rise above $580 billion in 2008.[28] According to RGE Monitor, between 2002 and 2007, the Gulf Cooperation Council (GCC) countries (excluding Saudi Arabia) transferred over $300 billion to their SWFs.[29]

Like other GCC countries, Saudi Arabia, as the world's largest producer and exporter of oil, has benefitted from increasing oil revenues in recent years. Although Saudi Arabia has not formally established a SWF, its central bank holds a significant amount of international investments outside of traditional foreign reserves, and thus is not reflected on the previous chart. Separately, the Saudi central bank controls an estimated $320 billion in foreign assets, with "additional reserves that are not made public for national security reasons."[30] In December 2007, Saudi Arabia announced plans to establish a sovereign wealth fund likely to be the world's

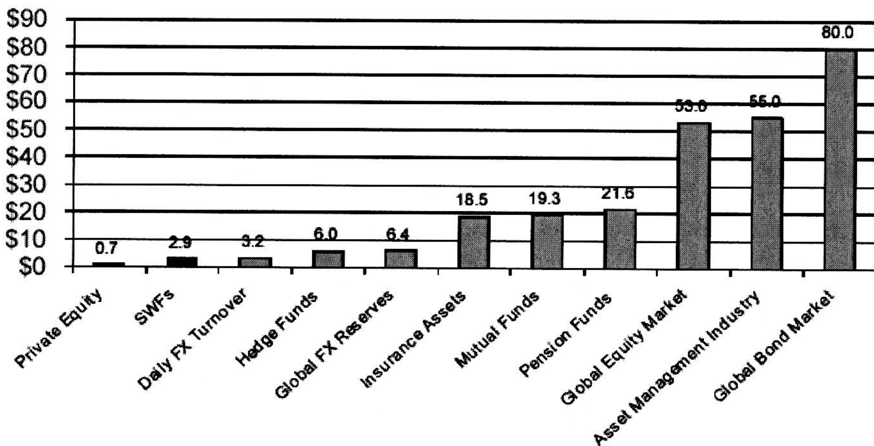
largest. According to the *Financial Times*, the proposed Saudi fund would dwarf the world's largest SWF, the United Arab Emirates' Abu Dhabi Investment Authority (ADIA).[31] The effort is likely to be spearheaded by the government's Public Investment Fund, which has a mandate to invest only within Saudi Arabia.

Asia

Among Asian economies, the expansion of reserves has been even more dramatic. By 2006, Asia held 54% of the then $4.2 trillion of worldwide reserves, more than the global total 10 years earlier.[32] Asian reserve accumulation is largely the result of persistent and sustained current account surpluses with the United States and other Western countries.[33] Following the 1998 Asian financial crisis, many Asian economies began accumulating large amounts of reserves to provide adequate insurance against any future currency fluctuations or macroeconomic insecurity.[34] Two additional factors motivate Asian reserve accumulation. First, several countries have pursued an export-led growth strategy targeted at the United States involving significant market intervention (especially by China) to maintain a stable undervalued exchange rate.[35] Second, many Asian emerging market economies have financial markets that are not developed enough to absorb the traditionally high levels of private savings seen in Asia.[36]

The Size of SWFs

It is difficult to accurately measure the amount of assets under management by SWFs because many funds do not disclose much information about their operations and assets. The funds believed to be the largest do not disclose their size, investment strategies, or current holdings. Estimates for the size of the largest fund, the United Arab Emirates' ADIA, for example, range widely between $500 and $900 billion. Reportedly, ADIA has achieved a 20% rate of return for many years and rarely considers deals less than $100 million.[37]



Source: Norges Bank.

Figure 2. Segments of the Global Capital Market, USD trillion, 2007.

Official and private sector analysts estimate that there is between $1.9 and $2.9 trillion under management by SWFs. This is significantly smaller than other investment classes (Figure 2).

Table 2. Large Sovereign Wealth Funds

Country	Name	Date Est.	Current Size ($ billions)	Source of Funds
United Arab Emirates	Abu Dhabi Investment Authority and Corporation	1976	500-875	Oil
	Mubadala Development Company	2002	10	Oil
	Isithmar	2003	4	Oil
Norway	Government Pension Fund — Global	1990	329	Oil
Singapore	Government of Singapore Investment Corporation	1981	100-330	Other
	Temasek Holding	1974	108	Other
Kuwait	Kuwait Investment Authority	1960	213	Oil
Russia	Stabilization Fund of the Russian Federation	2004	141	Oil
China	China Investment Corporation	2007	200	Other
Qatar	Qatar Investment Authority	2005	50	Oil
Australia	Future Fund	2006	49	Other
Algeria	Revenue Regulation Fund	2000	43	Oil
United States	Alaska Permanent Fund	1976	40	Oil
Brunei	Brunei Investment Agency	1983	30	Oil
Korea	Korea Investment Corporation	2005	20	Other
Kazakhstan	National Oil Fund	2000	19	Oil, Gas
Malaysia	Khazanah Nasional	1993	18	Other
Venezuela	National Development Fund	2005	15	Oil
	Macroeconomic Stabilization Fund	1998	1	Oil
Canada	Alberta Heritage Savings Trust Fund	1976	15	Oil
Chile	Economic and Social Stabilization Fund	2006	10	Other
New Zealand	Superannuation Fund	2001	10	Other
Iran	Oil Stabilization Fund	2000	9	Oil

Source: Peterson Institute for International Economics.

However, analysts expect that if oil prices remain, and there no immediate correction of current global imbalances, SWFs will grow rapidly over the next few years. Morgan Stanley estimates that if foreign reserves continue to increase at a current pace, they could grow to $12 trillion by 2015.[38] Several factors could weaken these growth projections, including a cyclical economic downturn, a reduction in oil prices, or a weakening of competitiveness in Asian exporting economies. On the contrary, given the rapid increase in emerging market foreign exchange reserves, if countries decide to increase transfers from official reserves to SWFs,

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