Sovereign Wealth Fund *Tease*

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Now Latin America is considering getting into the game.

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China's announcement in August 2007 that it too would be entering the ranks of those countries with sovereign wealth funds by setting up the China Investment Corporation has set hearts racing in Latin America. Market participants are now eagerly pondering what the prospective explosive trend in sovereign wealth funds might mean for Latin American financial markets. And they are also hoping that those trends will make the continent less vulnerable to swings in the global economic cycle. Might not Asia's more aggressive approach to managing its vast international reserves permanently improve Latin America's terms of trade as these countries' funds stockpile commodities? And might not those wealth funds provide a new impetus to Latin American equity markets and to foreign direct investment as they search for new investment outlets?

For their part, Latin American policymakers are wondering whether China's example is not pointing in the right direction for how they too might manage their own excess international reserves. Might this not be the right time to think about getting those reserves to earn higher returns than have been obtained to date on staid short-term government debt instruments?

Given the many vicissitudes in Latin America's fortunes over the post-war period, one can well empathize with those who are hoping that sovereign wealth funds will allow the continent's good times to roll on. However, before jumping to overly sanguine

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conclusions, it might be well to consider how big a difference sovereign wealth funds are really likely to make to global financial markets over the next few years. It might also be well to consider how those funds are likely to invest their countries' excess reserves and how far they are likely to stray from highly developed and Asian markets before venturing further afield in any major way.

THE RISE OF THE SOVEREIGN WEALTH FUNDS

Sovereign wealth funds are hardly new to the international financial system. Indeed, these funds have been around at least since the 1950s and over the past decade they have provided increased support to world financial markets. Before China's recent announcement, twenty-five countries had already set up such funds to better manage their excess international reserve holdings, while an additional six countries had announced plans to set up their own funds.

Although sovereign wealth funds have been around for some time, what is new is how rapidly these funds are now growing. Whereas in 1990, sovereign funds held at most US$500 billion under management, that figure has swelled as of today to an estimated US$2–3 trillion. Of that total, the top funds—the United Arab Emirates, Singapore, Norway, Kuwait, and Russia—account for around 70 percent of all such assets. Based on the likely trajectory of the current account surpluses of these countries, the International Monetary Fund estimates that these funds could easily reach US$10 trillion by 2010.

CHINA'S ENTRY INTO THE WORLD OF SOVEREIGN WEALTH FUNDS

China's launching its own sovereign wealth fund this October was bound to attract increased investor attention. After all, with US$1.3 trillion in international reserves, China is by far the world's largest holder of such reserves. And with those international reserves now growing each year by a staggering US$400 billion, it is reasonable to expect that China will account for an ever-growing share of such reserves.

Although China's initial foray into the world of sovereign wealth funds is initially to be limited to US$200 billion, one has to expect that the size of those funds will progressively increase. This is particularly the case given the fact that China's wealth fund has been mandated to manage an unspecified portion of the country's future reserve accumulation.

A further reason for thinking that the Chinese wealth fund will grow exponentially are the many public pronouncements now being made by senior Chinese officials voicing their dissatisfaction with the poor rate of return to date on their dollar reserve holdings. It seems reasonable to expect that the 15 to 20 percent annual increase in the overall size of sovereign wealth funds over the past decade will be easily matched over the coming decade.

HOW MUCH OF A MARKET FORCE ARE THE SOVEREIGN WEALTH FUNDS?

It is all too easy for market participants to get carried away by the prospect that an additional US$400 billion a year of sovereign wealth fund money might find its way to financial markets over the next few years. After all, US$400 billion would not seem to be a trifling sum of money. This line of thinking, however, would seem to beg the real questions that need to be asked. How big are the sovereign wealth funds in relation to the total sum of investment money under management? And how important are sovereign wealth funds in relation to total amount of securities that are traded?

At their current level of between US$2 trillion and US$3 trillion, sovereign wealth funds are approximately double the size of the world's hedge fund industry. However, they are presently only around one-seventh the size of the US$21 trillion of the global investment industry and less that 5 percent of total bank assets worldwide.

The relative importance of sovereign wealth funds would seem all the less significant when one compares

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their size to that of the global securities market. IMF estimates suggest that the total value of traded U.S. dollar-denominated bonds and equities is around US$50 trillion, while the total value of all global securities traded is US$165 trillion. This has to leave one with the impression that while an additional US$400 billion a year in sovereign wealth funds will be supportive of global financial markets, one does not want to exaggerate their overall importance.

SOVEREIGN WEALTH FUNDS AND LATIN AMERICAN MARKETS

From a Latin American perspective it matters not so much how large sovereign wealth funds might be in relation to global markets. Rather, the crucial question for the continent is how much of the increased flow of such funds might find its way into Latin American investments and how much might be channeled into the international commodity markets. After all, with a Latin American security market no bigger than US$4 trillion, it would not take much by way of new flows to move those markets. And with Latin America's still-high dependence on commodity exports, any structural improvement in global commodity markets would be highly beneficial to the continent.

Sovereign wealth funds are approximately double the size of the world's hedge fund industry.

Because of the secrecy and opaqueness that generally surrounds sovereign wealth funds, it is not easy to get an accurate handle on the flows that Latin America might expect from these funds. The best that can be done is to take a look at how the Singapore Government Investment Corporation has been managing its investments to date. This is not only because of the relatively large size and transparency of the Singapore fund. Rather it is also because that fund is likely to be indicative of how the other major Asian and Middle Eastern funds manage their assets and because it is supposedly the fund on which the Chinese Investment Corporation will be modeling itself.

It turns out that the Singapore Government Investment Corporation operates along similar lines as most private management companies, investing government reserves across a range of asset classes and regions. Around 50 percent of its investment mix is currently reported to be in equities, 30 percent in bonds, and the remaining 20 percent in private equity, real estate, and commodity investments. By region, the Singapore Government Investment Corporation has between 45 and 50 percent in the United States, 30 percent in Europe, 10 percent in Japan, and the remaining 10 percent mostly in non-Japan Asia.

If the Singapore investment fund does not appear to have very much of its portfolio invested in Latin America or in the international commodity market, those investments might have an even lesser weight in the Chinese Investment Corporation's portfolio. For the China Investment Corporation's initial forays abroad have been mainly confined to U.S. financial sector purchases, first with an acquisition of a 10 percent stake in the Blackstone hedge fund, and then of a 10 percent stake in the subprime-troubled Morgan Stanley investment bank. Moreover, after its much publicized and unfortunate initial US$3 billion investment in the Blackstone investment group, the Chinese Investment Corporation is now reportedly deciding on whether it should not invest a major part of its initial US$200 billion domestically to shore up China's troubled banking system.

SOVEREIGN WEALTH FUNDS FOR LATIN AMERICA?

Flush with international reserves, some countries in Latin America, most notably Brazil, are contemplating whether or not they too should set up their own sovereign wealth funds. Assessing whether or not that might be a good idea depends very much on a judgment about the relative importance of the existing sovereign wealth funds in the global economy. In particular, one has to ask whether it is reasonable to expect that those funds will somehow manage to smooth the global economic cycle from the downturn that would otherwise result from the ongoing bursting of the U.S. housing bubble and from the associated global credit crunch.

If one buys the argument that sovereign wealth funds behave very much as do private investment funds and that they are far too small to stabilize global financial markets, one has to wonder whether now is the time for Latin America to set up such funds. For not only might Latin America need to draw on its international reserves in the increasingly likely event of a global economic slump. It might also not get better returns on riskier investment than on its present investment in short-dated government bonds as the Chinese Investment Corporation is now learning from its ill-timed Blackstone purchase. ◆