

# A few sovereigns more: the rise of sovereign wealth funds

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One of the most striking developments in international financial markets over recent years has been the emergence of dedicated government investment vehicles as an important investor class. These so-called 'sovereign wealth funds' (SWFs) have grown rapidly both in size and number, fuelled by a sharp and sustained rise in energy and commodity prices and by large current account surpluses among the export-oriented economies of East Asia.

With particular focus on the recent growth of sovereign wealth funds in East Asia, this paper finds that while these funds may not pose a direct threat to financial stability, concerns over a lack of transparency and non-commercial investment motives may give rise to an increase in 'financial protectionism'. The establishment (and adoption) of international standards of 'best practice' SWF management would help to offset these pressures. Other risks from SWFs, such as the potential for inappropriate fiscal loosening and resource allocation distortions, are likely to be magnified if governance structures are poor.

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## Introduction

Sovereign wealth funds (SWFs) have grown rapidly over recent years, both in size and number. Initially popularised by oil-exporting nations (oil stabilisation funds), a number of East Asian economies have since established their own SWFs, while others have expressed an interest in establishing one over the coming years.

With SWFs becoming increasingly important players in global financial markets this paper examines what this phenomenon means for the stability of the international financial system and also associated concerns over the risks posed by ‘financial protectionism’ and poor governance structures. We do not seek to compare establishment of SWFs with alternative uses of public funds, although such opportunity costs always exist.

While the paper finds that SWFs pose few direct threats to financial system stability, a strong case can be made for developing international guidelines on ‘best practice’ SWF management. The establishment (and adoption) of such guidelines, by institutions such as the IMF, would help to temper concerns over the politicisation of global capital flows and threats to financial stability.

## What is a sovereign wealth fund?

At its broadest level, the term *sovereign wealth fund* (SWF) refers to any government-controlled fund that manages and invests government savings, regardless of the revenue source.<sup>2</sup> A narrower definition focuses on government investment vehicles which are funded by foreign exchange assets, but which manage those assets separately from official reserves.<sup>3</sup> These foreign exchange-based SWFs generally fall into two categories based on the source of the foreign exchange assets:

- *commodity funds* are established from the proceeds from commodity exports, either owned or taxed by the government; and
- *non-commodity funds* are typically established through transfers of assets from official foreign exchange reserves.

Although some SWFs have been around for decades, recent growth in both the size and number of funds in existence has sparked a great deal of interest in the scope and scale of their activities. As the proportion of cross-border capital flows directed via

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<sup>2</sup> According to this definition, Australia’s Future Fund can be considered a SWF.

<sup>3</sup> This definition is consistent with that suggested by the US Department of the Treasury (see Lowery 2007).

these funds continues to grow they are also becoming an important part of the debate over broader global saving and investment imbalances.

## Why are SWFs being created?

Many of the commodity-based SWFs — such as the Abu Dhabi Investment Authority, the Norwegian Government Pension Fund-Global and the Kuwait Investment Authority — have been in existence for many years. They were originally created for the purposes of stabilising fiscal revenues, intergenerational wealth transfers, or for balance of payments sterilisation. However, given the sharp and sustained rise in commodity prices over recent years, many funds initially established for fiscal stabilisation or balance of payments sterilisation purposes have evolved into intergenerational savings funds.

Three important drivers of the recent growth in East Asian SWFs can be identified:

- the accumulation of ‘excess’ foreign exchange reserves in the course of defending hard (or soft) currency pegs;
- the desire to seek higher returns on reserves to cushion actual and anticipated increases in reserve funding costs; and
- the quantity of outstanding mature market bonds is increasingly insufficient to meet demand from official reserve investors, including SWFs.

## The accumulation of ‘excess’ foreign exchange reserves

Driven by large balance of payments surpluses, East Asian economies have been accumulating foreign exchange reserves on an unprecedented scale over recent years (see Chart 1). In order to maintain hard (or soft) exchange rate pegs, central banks have intervened in foreign exchange markets, buying assets denominated in foreign exchange with local currency. In addition, central banks have often issued bonds in their domestic markets in order to absorb resulting increases in domestic liquidity (sterilisation bonds).<sup>4</sup> Foreign exchange-based SWFs thus have matching liabilities for their foreign exchange assets, making these East Asian SWFs fundamentally different from their counterpart commodity-based SWFs (which essentially just convert a finite physical asset into a financial asset and, thus, have no corresponding liabilities).

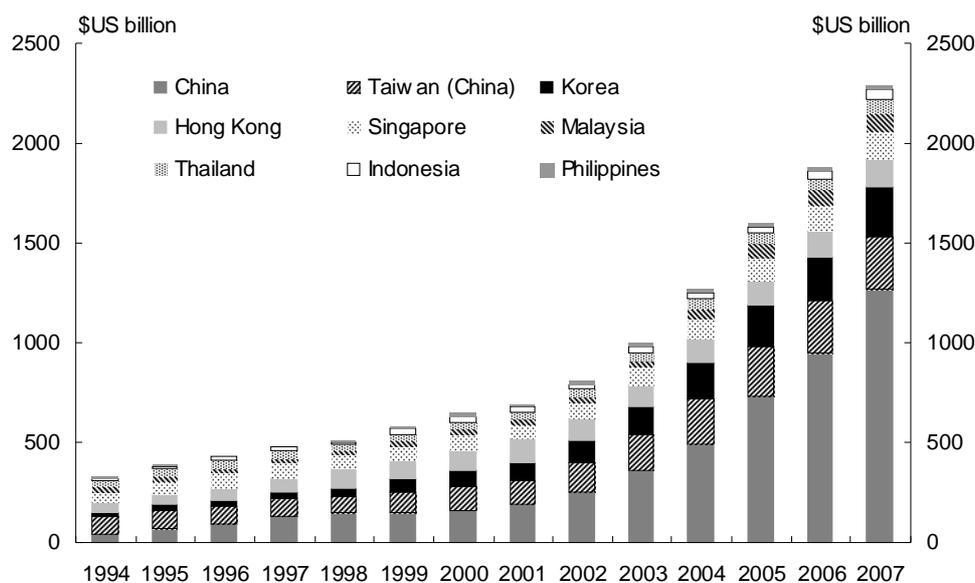
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4 In this case, the domestic bond issuance simply replaces local currency on issue on the liability side of the central banks’ balance sheet.

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While this build-up of reserves has provided an insurance policy against future capital market crises and large unexpected outflows of capital, it appears to have gone well beyond what would seem sufficient for self-insurance purposes — by most measures reserves have grown to levels that surpass, by several multiples, benchmarks of precautionary reserve adequacy (such as months of import cover).

**Chart 1: Foreign reserves — selected East Asian economies<sup>(a)</sup>**



(a) Data for 2007 are calculated as an average over the eight months to August.  
Source: IMF International Financial Statistics

While the vast majority of official East Asian reserves have been used to purchase highly liquid foreign government securities, particularly US Treasury bonds, reserve managers of the region are increasingly channelling these ‘excess’ reserves into dedicated investment vehicles (SWFs) with explicit mandates to earn higher returns on their invested funds.<sup>5</sup>

### Increases in reserve funding costs

While the push to earn higher returns on reserve assets may simply reflect an increase in sovereign investor risk appetite, actual and anticipated increases in reserve funding costs may also be important. The most usual channel through which an increase in reserve funding costs can occur is via an increase in the rate of interest demanded on domestically issued sterilisation bonds. Expectations of eventual exchange rate

<sup>5</sup> To be considered reserves, foreign currency generally must be invested in liquid and marketable instruments that are readily available to the monetary authorities to meet a balance of payments need (Lowery 2007).

appreciation, which would erode returns earned on the funds' international investments (in domestic currency terms), may provide an additional incentive to seek investment opportunities with higher expected returns.

### Constraint on supply of mature market bonds

With the pace of official reserve accumulation outpacing the net issuance of the most traditional reserve assets — US Treasuries, US agency debt, euro area government securities and UK Treasuries — increased diversification may be, to some extent, inescapable.

The US Treasury Department has estimated that even if official reserve and SWF managers had purchased the total net issuance of these traditional reserve assets in 2006, they would still have had some US\$720 billion in funds left over to invest (Lowery 2007). While the remainder could be invested in the existing stock of these securities (on the secondary market), it is perhaps not surprising that a portion is finding its way into other markets and asset classes.

### Other motivations

In some cases, motivations other than those identified above may also be important. In addition to explicit mandates to earn higher returns on government savings or official foreign exchange reserves, for example, the Singaporean and Korean SWFs aim to use their asset allocation decisions to nurture the development of their domestic financial sectors (for a description of the Singapore SWF models, see Box 1 on the following page).<sup>6</sup>

The Australian Future Fund, meanwhile, has been established by the Australian Government to specifically address a known legal liability (that is, its unfunded public sector superannuation liability).

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6 The Korean Investment Corporation aims to attract foreign financial institutions to South Korea to accelerate the transfer of global financial knowledge to South Korea's domestic asset management industry (KIC 2007).

### **Box 1: The Singapore SWF models**

The Singaporean Government has two SWFs, Temasek Holdings and the Government of Singapore Investment Corporation (GIC), both with a mandate to manage Singapore's government savings. The two funds, through their asset allocation approaches, also attempt to nurture domestic industries identified as being of strategic importance.

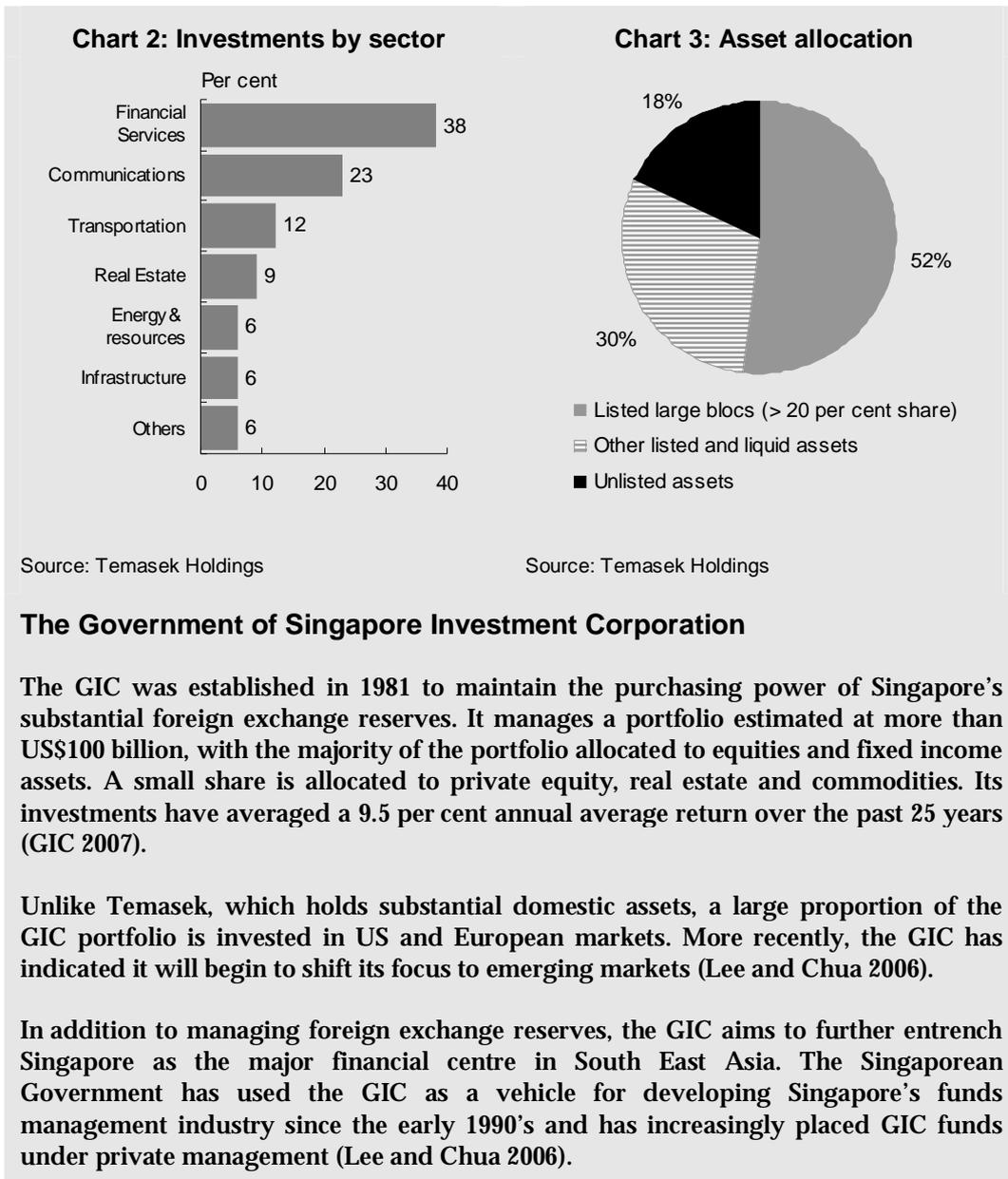
#### **Temasek Holdings**

Temasek Holdings was established in 1974 to better manage investments and assets previously held by the Singapore Ministry of Finance. The fund is accountable to the Singaporean Government for its overall performance. As the only shareholder, the Government's role is to ensure that a competent board is in place, while investment decisions are the responsibility of management (Temasek Holdings 2007).

The majority of Temasek's assets are located in Asia, accounting for around 80 per cent of the fund's total portfolio value. Around half of its Asian portfolio is invested within the Singaporean domestic market. Temasek adopts a long-term approach to investment, with a focus on both listed and private equity, and real estate investments. Over the past three decades it has reported an annual average return of around 18 per cent (Temasek Holdings 2007).

In addition to maximising returns to its shareholder, Temasek's investment strategy has also focused on developing expertise in particular domestic industries. For example, around 60 per cent of Temasek's investments are in the financial and communication sectors (see Chart 1), reflecting the Singaporean Government's aim to enhance Singapore's role as a regional financial centre (Temasek Holdings 2007).

Temasek manages a portfolio of more than US\$100 billion and has tended to take reasonably large stakes in the companies in which it invests — around 50 per cent of Temasek's portfolio comprises holdings in companies in which it has a stake of greater than 20 per cent (see Chart 2). Moreover, it has a controlling interest in a significant number of these companies (Temasek Holdings 2007).



## How important are SWFs?

Most SWFs in existence today have either been established by oil-exporting countries or by East Asian countries with large current account surpluses (see Table 1). At present, SWFs derived from oil and gas exports are estimated to hold more than half of total SWF assets under management, with another third estimated to be held by Asian and Pacific countries, including China and Singapore (Johnson 2007). In the future, East Asian SWFs are expected to become increasingly important, with private sector projections suggesting that China's SWF could overtake the Abu Dhabi Investment Authority as the world's largest SWF by around 2009 (Jen 2007).

**Table 1: Largest sovereign wealth funds (assets under management)**

Country	Fund name	Assets (\$US bn)	Inception year	Source of funds
UAE	Abu Dhabi Investment Authority	250 to 875	1976	Oil
Norway	Government Pension Fund	300	1996	Oil
Saudi Arabia	Saudi Arabian funds (various)	250+	n/a	Oil
Kuwait	Kuwait Investment Authority	160 to 250	1953	Oil
China	China Investment Corp.	200	2007	Non-commodity
Russia	Stabilisation Fund of Russ Fed.	120	2004	Oil
Singapore	Government Investment Corp.	100+	1981	Non-commodity
Singapore	Temasek Holdings	100+	1974	Non-commodity
Australia	Australian Future Fund	54	2006	Non-commodity
Qatar	Qatar Investment Authority	50	2005	Oil
Algeria	Revenue Regulation Fund	40	2000	Oil
US (Alaska)	Permanent Fund Corporation	35	1976	Oil
Brunei	Brunei General Reserve Fund	30	1983	Oil
South Korea	Korea Investment Corporation	20	2005	Non-commodity
Malaysia	Khazanah Nasional	18	1993	Non-commodity
Kazakhstan	Kazakhstan National Fund	18	2000	Oil
Canada	Alberta Heritage Fund	15	1976	Oil
Venezuela	National Development Fund	15	2005	Oil
Iran	Oil Stabilisation Fund	13	1999	Oil
New Zealand	Superannuation Fund	11	2001	Non-commodity

Source: IMF GFSR (Sep 2007), The Economist, Truman (2007), futurefund.gov.au, nzsuperfund.co.nz.

In aggregate, SWFs are estimated to currently control anywhere from US\$1.9 trillion to US\$2.9 trillion in assets worldwide.<sup>7</sup> This is greater than the asset pool managed by the global hedge fund industry (US\$1-1.5 trillion), but it represents less than 2 per cent of total global financial assets or around ten times less than the assets under management of mature market institutional investors (US\$53 trillion).<sup>8</sup> There is no doubt, though, that these funds are currently growing very rapidly — Jen (2007) estimates that SWFs

<sup>7</sup> The International Monetary Fund (IMF) estimates that in 1990, SWFs probably had no more than US\$500 billion in assets under management (Johnson 2007).

<sup>8</sup> IMF Global Financial Stability Report, September 2007 (Chapter I, p 45).

could be as large as official reserves in five or six years' time, and could control as much as US\$12 trillion by 2015.<sup>9</sup>

There has been some debate over what the growing importance of SWFs may mean for the prices of various asset classes. While SWFs are generally thought to pursue relatively conservative asset allocation strategies, any shift in assets from official reserves to SWFs is likely to lead to a net increase in investment in risky assets. Private estimates have suggested that these portfolio shifts may put some upward pressure on the prices of riskier asset classes, such as equities, and downward pressure on bond prices (and, thus, upward pressure on yields).<sup>10</sup> However, actual price outcomes will occur in the context of a highly dynamic international financial system where overall demand for financial assets, including fixed interest securities, will be expanding. Furthermore, the rise of the East Asian SWFs is symptomatic of broader imbalances in the global economy — if these imbalances are reduced through, for example, increased investment in emerging Asia (excluding China) and/or an unwinding of the US current account deficit, then growth in assets controlled by East Asian SWFs will be moderated and asset price effects diluted.

## Financial stability implications

*'Analysing changes in the international investor base and investment allocation behaviour is fundamental to understanding the build-up of strengths and weaknesses in international financial markets'* (International Monetary Fund *Global Financial Stability Report*, April 2007).

As has occurred with the emergence of other large investor groups — such as hedge funds — questions are being asked about what the emergence of SWFs as an important investor class will mean for global financial markets. Given the sheer volume of capital controlled by some SWFs, most concerns have centred around a lack of transparency and whether portfolio adjustments could cause sudden reversals in capital flows and abrupt price changes, with potentially destabilising effects on both asset markets and whole economies (see, for example, Garten (2007) and IMF *Global Financial Stability Report*, April 2007 (Chapter II, p 85)).

At the outset, it is important to note that there are good reasons to be comforted by the growing importance of this investor class. As a group, SWFs are thought to be relatively conservative, long-term investors. Similar to other institutional investors with long investment horizons (such as pension funds and life insurance companies),

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9 At end-2006, the total stock of global reserves (less gold) stood at US\$5.6 trillion (IMF *Global Financial Stability Report*, April 2007).

10 See, for example, Miles and Jen (2007).

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SWFs should have the ability to absorb a greater degree of short-term asset return volatility and may be prepared to buy during periods of asset price weakness, thereby providing market liquidity in times when it is most needed.

In contrast to highly-leveraged investment funds, such as hedge funds, SWFs are not likely to be forced by capital requirements or investor withdrawals to liquidate positions rapidly.<sup>11</sup> Most SWFs are not thought to be significantly leveraged in the normal sense, although foreign exchange-based SWFs, with their matching liability profiles, are fully leveraged.<sup>12</sup> While these funds are unlikely to be subject to margin requirements, this leverage may still pose a macroeconomic risk if the value of their underlying assets were to deteriorate significantly.

Concerns over the potential for abrupt changes in SWF asset allocation strategies to lead to periods of heightened financial market volatility can only be valid if their investment decisions are not based on purely commercial (market-based) motives. Given that most SWF portfolios are either run by a stand-alone investment manager or by well-regarded private fund managers and investment consultants, it is somewhat difficult to see these funds acting any differently from other market participants.

The typical SWF does not publicly disclose much substantive information on its asset allocation approach, the size (and type) of its individual holdings or its investment returns, nor its corporate governance processes or risk management techniques. With very little known about these funds, some commentators and policymakers have expressed concerns over the potential for minor comments or rumours to lead to periods of heightened volatility as market participants react to what they perceive SWFs to be doing (see, for example, Lowery (2007)).

Such concerns, however, are not dissimilar to those previously expressed in relation to hedge funds which have, at least to date, been proven to be largely unjustified. Indeed, the emergence of hedge funds as an important investor class may have actually made the financial system less volatile (see, for example, Warsh (2007)). Moreover, there may be good reasons for less than full disclosure of SWF investment activities — given the size of some SWFs, and their ability to have a material influence on the prices of

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11 Highly leveraged asset management funds can, at times, be subject to redemption pressures. Specifically, if on-balance-sheet liquidity is insufficient to meet large redemptions, these institutions can only meet investor withdrawals with the forced sale of their securities, potentially affecting other funds and creating conditions favourable to a market crash (IMF Global Financial Stability Report, April 2007, pages 83-84).

12 There is some anecdotal evidence to suggest that certain SWFs have placed investments with other leveraged funds, while one SWF recently invested directly in a major private equity fund.

particular securities, other investors may attempt to 'shadow' their portfolio adjustments with the aim of earning windfall profits.

Overall, SWFs present few direct threats to financial stability. Indeed, from a financial stability perspective SWFs should not generally be viewed any differently from most other market participants — many of these funds share broadly similar objectives, management and motivations with other institutional investors in the private or public sectors, such as insurance and pension funds. While some have suggested that poor public disclosure may lead to periods of market instability, such concerns have previously been expressed in relation to hedge funds with seemingly little justification. Moreover, these concerns need to be balanced against the fact that full public disclosure may not be optimal either, given the risk that full disclosure of SWFs' investment activities may lead to gaming practices by other investors.

## The politicisation of global capital flows

Attempts by foreign interests to purchase controlling stakes in strategic industries or iconic domestic companies can sometimes cause broadly based domestic concerns. Resistance can be even stronger if the purchaser is an overseas government and can raise suspicions over whether the purchase is being pursued for strategic or other non-commercial reasons. While SWFs are not new, as they grow in size and importance it seems inevitable that their activities will be subject to increasing scrutiny by the governments and citizens of the countries in which they invest.

Some developed countries are reportedly considering strengthening regulatory frameworks for vetting potential acquisitions of domestic companies by foreign government-controlled entities, including SWFs. The German government is reportedly considering introducing new legislation to block state-controlled foreign investments, particularly those made by SWFs. The Financial Times has reported that 'the European Commission has launched an inquiry into whether vast state-controlled investment funds from Russia, China and the Middle East threaten the continent's single market'. The US has also recently revised legislation governing its Committee on Foreign Investment in the United States, with a particular focus on the role of investments by governments (Truman 2007; p 7). Some European countries are also reportedly proposing the use of 'golden shares' which would allow governments to block takeovers of domestic companies without requiring a majority holding in those companies.

As SWFs continue to grow in size and diversify into new markets and asset classes, these pressures may intensify and could result in an increase in 'financial protectionism'. This financial protectionism could infect both source economies (due to perceptions of unequal treatment) and host economies (due to concerns about the need

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to protect strategic industries). Such a trend is ultimately likely to be welfare-destroying, particularly if it were to 'spill over' into non-official financial flows or into more traditional trade protectionism.

In most cases, a specific regulatory response from host economies may not be justified. Most investments by SWFs take the form of portfolio investments and rarely amount to a controlling stake. As already noted, SWFs are generally run by independent investment teams, or by private fund managers and/or investment consultants and, as such, are likely to behave similarly to most other market participants. It is important, as far as possible, to use existing processes to assess these investments rather than create new legislation that targets SWFs in general, or even specific SWFs. That is not to say, however, that a host country may not have legitimate cause for concern in some circumstances.

Efforts to increase transparency and accountability in SWF management would help to temper the concerns of countries in receipt of investments by SWFs. Indeed, a small but growing number of SWFs are disclosing more substantive information on their objectives, investment strategies and returns.<sup>13</sup> This trend may continue to gather pace in response to both domestic and international pressures, although a strong case can be made for establishing international standards on 'best practice' SWF management.

While the manner in which these funds are managed is ultimately up to their own sovereign governments (which are unlikely to welcome moves to restrict the way in which they make their international investments), a government entity that operates outside its own borders is no longer 'sovereign' in all respects and will be better served by seeking cooperative solutions (Truman 2007). Moves to increase transparency may help to dispel some of the misgivings about the motivations for SWF investments in particular assets or industries. Greater transparency may also help to deter SWF investment managers from taking imprudent risks with the money they manage.

## Governance as a key risk

SWFs are typically not regulated by their domestic financial authorities and the extent of indirect regulation may also be limited. As such, these funds may not be subject to the same degree of market discipline that is imposed on private investment managers,

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13 For example, Norway's Government Pension Fund-Global makes public extensive information on its investment strategy and investment results on a quarterly basis, and annually provides information on its holdings of the bonds and equities of individual countries and corporations. Singapore's Temasek Holdings recently began publishing an annual report containing considerable detail on its investments. In July 2007, the Kuwait Investment Authority revealed for the first time the size of its total holdings (Truman 2007, pages 8-9).

relying instead on oversight by domestic citizens or bureaucracies. One likely consequence is that risk management practices and fiduciary controls may not be as strong as they could be, particularly if it is assumed that a SWF is backed by an implicit sovereign guarantee.

In addition, there are related concerns over the potential for SWFs to be subject to rent-seeking or political interference. While it remains to be seen whether such concerns are justified, there is clearly some scope for improving the institutional arrangements under which these funds operate.

Other risks associated with SWFs include the potential for inappropriate fiscal loosening, possibly outside the scrutiny of the budget process, and distortionary resource allocations at the national and global level from those funds which may not be managed to maximise economic returns in the medium to long term. These risks are likely to be greater where governance structures are poor, and where sovereign funds are not invested through intermediary asset managers accountable only for producing specific risk-adjusted returns.

## Moving towards an international consensus

Developing an international consensus around standards for SWFs may be helpful in improving the institutional arrangements under which SWFs operate, strengthening governance structures and reducing the risk of a protectionist backlash against SWF investments. International financial institutions, such as the IMF, may be the most appropriate vehicle through which to develop a substantive set of international standards, particularly as they have already developed a number of voluntary transparency initiatives that are relevant for SWFs.<sup>14</sup>

Indeed, in November 2007, the IMF convened its first annual *Roundtable of Sovereign Asset and Reserve Managers*. The Roundtable — which is ‘designed to facilitate the exchange of ideas and experiences in [sovereign] asset and reserve management’ — provides a vehicle for the IMF to progress work on a set of best practices for SWFs.<sup>15</sup>

These standards could include, but not necessarily be confined to, the following:

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14 These include the IMF’s *Guidelines for Foreign Exchange Reserve Management*, the *Code of Good Practices on Fiscal Transparency*, and the *Guide on Resource Revenue Transparency* (IMF Global Financial Stability Report, September 2007, Chap I, page 50).

15 ‘IMF Convenes First Annual Roundtable of Sovereign Asset and Reserve Managers’, IMF Press Release No. 07/267, November 16, 2007

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- SWFs should be governed by clear objectives determined by their sovereign governments, and rules and operations for the SWF should be transparent and free from political interference;
- SWFs should have an explicit investment mandate and clearly articulated asset management strategy;
- There should be regular public disclosure and reporting, and SWFs should be subject to independent audits and evaluations of their investment performance;
- SWFs should, in general, limit the size of their holdings in any one company to minority, non-controlling, stakes. Alternatively, SWFs should only invest in equity that does not have control rights attached to it (that is, non-voting shares); and
- The leveraging of SWF investment portfolios should be limited.

While the majority of SWFs currently in existence do not conform to the above guidelines, there are some exceptions. Norway's Government Pension Fund is regarded as the most open and transparent of the bigger long-established SWFs. Australia's Future Fund is also an example of an open and transparent SWF governed by strong fiduciary controls (see Box 2). Such funds can provide useful models for the development of international standards on 'best practice' SWF management.

## Box 2: Australia's Future Fund

Established in April 2006, the Future Fund is a dedicated asset fund that aims to offset the largest liability on the Australian Government's balance sheet — unfunded public sector superannuation. The Future Fund's investment mandate provides a mechanism for the Government to articulate its expectations for returns on the Fund and its tolerance for risks. Under the investment mandate the Board is directed to:

- seek long-term real returns of at least 4.5 per cent to 5.5 per cent and minimise the probability of losses subject to achieving at least this benchmark;
- establish an internal limit on holdings of any listed company in order to ensure that it does not trigger the takeover provisions under the *Corporations Act 2001* or hold a stake of more than 20 per cent in any foreign listed company;
- act in a manner that minimises the potential to cause any abnormal change in the volatility or efficient operation of Australian financial markets or adversely affect the Government's reputation in these markets; and
- have regard to international best practice for institutional investment in determining its approach to corporate governance principles.

The Board is supported in its functions by the Future Fund Management Agency which acts on the investment directions of the Board. The Government has retained the right to direct the Board by changing the investment mandate. However, there are strong protections against the misuse of this power — if the Board considers that the new mandate is inconsistent with the basic objectives of the Fund it has the right to table a submission to Parliament opposing the change. This transparency is aimed at reducing the risk of politically motivated investments while protecting the capability of the Fund to pursue investment strategies with a long-term horizon. New legislative provisions have also been passed which prohibit the Government issuing directions which require the Fund to invest in specific assets, businesses or activities.

The corporate governance framework of the Future Fund reflects the Board being part of the General Government Sector but also having investment powers and responsibilities beyond those usually provided to departments of state. As such, under the Future Fund legislation, the Board is subject to requirements based on both the *Financial Management and Accountability Act 1997* and *Commonwealth Authorities and Companies Act 1997*.

The operations of the Fund, Board and Agency are subject to the reporting and audit requirements of the FMA Act. The Australian National Audit Office is responsible for auditing the financial statements relating to the Fund. An annual report covering the performance and activities of the Board, Agency and Fund (including financial statements) is required to be prepared and tabled in Parliament and the Board is required to attend senate estimates hearings. The Board is also required to formulate and make public its investment strategy and its approach to managing risks.

## Conclusions

Sovereign wealth funds are an important and rapidly-growing investor class. As they continue to grow in size and influence, their activities will inevitably be subject to increased scrutiny by governments of the countries in which they invest. While the activities of these funds present few direct threats to financial system stability, it is incumbent upon the international community to manage the rise of this investor class in such a way as to avoid an increase in 'financial protectionism'. The quality of SWF governance is also important as it will influence resource allocation effects and the extent of risks from inappropriate fiscal loosening in the future.

There is clearly some scope for improving the institutional arrangements under which these funds operate, and the development of international standards of 'best practice' SWF management (under the auspices of the IMF) would be a positive step forward. Greater transparency and accountability may ultimately be in these funds' best interests and would help to assuage concerns of host economies over the motivations for SWF investments in particular assets or industries.

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