

The Rising Kubers of the East

* Snehal Manjrekar

"Sixty years ago, we conducted a painful, expensive and accidental experiment called the Great Depression, with the Smoot Hawley tariffs to teach us the value of free trade. Let us not subject ourselves to another painful lesson in the value of direct investment and the free flow of capital by driving SWFs away", wrote Stephen Schwarzman (chairman & CEO of Blackstone) in an article, June 19, 2008, **Reject sovereign wealth funds at your peril**, Financial Times, was a naked expression and sheer appreciation of the massive changes encompassing financial landscape introduced by Sovereign wealth funds (SWFs). Call it a sinister or an angel of ministration, sovereign wealth funds has been an earth-shattering reality to the capitalist fraternity. The recent recapitalization of the highly illustrious Wall Street banks by SWFs can just be pronounced as the spectacular emergence of the state run funds, which have become the new inflection point of globalization. This capitalist shakeout is also perceived as the birth of a new phenomenon called cross-border nationalization in some circles, however, in other spheres it is looked upon as a robust stabilizing force on the global financial front. There exists an air of suspicion, confrontation, and consternation, which is coated with unverified and unconfirmed fears of seizure and monopolization. This article will voice out the well structured concerns attested by the west, along with the rock-solid bolstering, which the SWFs can promise, and eventually analyzing India's response to this watershed moment of global finance. So read on and determine whether these Eastern Kubers, (read as: SWFs) qualify to be the new flag-ship of the globalization or are regenerated apostles of imperialism.

Comprehending SWFs

SWF is a special purpose vehicle of the government, funded by foreign currency assets, with a higher risk tolerance and higher return expectation. The management of assets under SWF is separate from the management of the official reserves. Unlike official reserves, which are usually held in short duration US bonds, the SWF portfolio has a product mix of different asset classes spanning fixed income, equity, commodity, to the realty instruments.

Calling SWFs a new phenomenon would be highly erroneous, as these state run funds have been extant since the 1950s. However, 1970s witnessed the cessation of the **Bretton Woods system**. Former US president, Richard Nixon, then sand-witched between towering trade deficits and a dearer Vietnam War responded by terminated dollar's convertibility into gold. This move, which ceased the fixed exchange rate mechanism, lubricated an uninterrupted flow of capital across borders thus, ensuring holistic prosperity as apart from the industrialized nations, other countries gained enormously economically and technologically. The capital infusion in the form of direct investments and portfolio investments helped the emerging countries in accumulating humongous foreign exchange reserves in their kitty. Moreover, aversion to revaluation of their currencies vis-à-vis the greenback also helped them in running sustained current account surpluses, for instance China and South Korea. Interestingly, the astonishing spike in the commodity prices since the past decade or so has helped many Middle Eastern, few European, African, and some Asian countries to run monolith surpluses, which resulted in the savings exceeding investments.

Albeit today we have numerous SWFs managed by different countries, but the origin of the idea behind the inception of the fund is more or less the same; ensuring enhanced future for the future generations of their fellow denizens. Oil prices had a tempestuous run in the 1970s, when the oil had touched the magical simultaneously scary figure of \$100/bbl. However, the subsequent events in the next decade punctured the dream run in the oil trade and the prices demolished dramatically, leaving the oil producing nations bemused

* Market Analyst, Thomson Reuters, Pvt Ltd. Bangalore and Alumni IMER, Belgaum.

and worried about their future. Moreover, the rise of SWFs can also be attributed to a certain extent to the Asian and the Russian financial meltdown in the year 1997-98, during which, the affected economies learnt about the merits of exporting capital and the demerits of borrowing too much in a foreign currency.

In 1990, sovereign funds probably held, at most, \$500 billion; the current total is an estimated \$2-3 trillion and, based on the likely trajectory of current accounts, could reach \$10 trillion by 2012 according to one report from Mckinsey & Co. Currently, more than 20 countries have these funds, and half a dozen more have expressed an interest in establishing one. Still, the holdings remain quite concentrated, with the top five funds accounting for about 70 percent of total assets. Over half of these assets are in the hands of countries that export significant amounts of oil and gas. Norway has a large sovereign fund, as do places as disparate as Alaska, Canada, Russia, and Trinidad and Tobago. About one-third of total assets are held by Asian and Pacific countries, including Australia, China, and Singapore.

League of nations

Sovereign-wealth funds

Latest

Country: name	Assets* \$bn	Inception year
UAE: Abu Dhabi Investment Authority	875.0	1976
Norway: Government Pension Fund - Global	380.0	1996
Singapore: GIC	330.0	1981
Saudi Arabia: various	300.0	na
Kuwait: Reserve Fund for Future Generations	250.0	1953
China: China Investment Corporation†	200.0	2007
Singapore: Temasek Holdings	159.2	1974
Libya: Oil Reserve Fund	50.0	2005
Qatar: Qatar Inv. Auth.	50.0	2005
Algeria: Fond de Régulation des Recettes	42.6	2000
US: Alaska Permanent Fund Corporation	38.0	1976
Brunei: Brunei Inv. Auth.	30.0	1983
Other	171.4	-
<i>of which oil- and gas-related</i>	2,103.4	-

*Estimated, excluding Norway

†Includes Central Huijin Investment Co.

Sources: Morgan Stanley

Capitalistic shakeout!

The made in America, subprime mortgage crises, which originated in late 2006 but solidified in 2008, left the heavyweights and the behemoths of the wall street bleeding financially. Every major Wall Street bank from Citi to Lehman Brothers from Merrill Lynch to Morgan Stanley, discovered holes in their balance sheets due to ludicrous and excessive exposure to ***toxic assets*** thus triggering battery of defaults on the debts issued by them. The situation was overwhelming as bailing out so many of the capitalistic champions at once would have been a Herculean task to Ben Bernanke and his team. Fortunately, for the list of affected Wall Street banks the SWFs arrived mirroring the army choppers disposing much needed cash to help the Wall Street soldiers recover from the credit crunch fiasco. The events that unfolded subsequently witnessed massive recapitalization of the Wall Street banks. Some of the opportune rescue acts were, the infusion of \$6.6 billion and \$14.5 billion respectively, in Citi and Merrill Lynch from Asia and the Middle Eastern SWFs.

Interestingly, the emergence of SWFs on the Wall Street is being perceived as an spectacular turnaround by the outside world, in sharp contrast, among the US senators it has been an ostracized episode and all of sudden the same Asian and Arab governments became infidels who had been pumping billions of dollars in the US financial assets (predominantly in the US treasuries), thus industriously financing the US current account deficits. Also these funds reflect strongly America's flawed and inept policy of importing more than it exports. High energy prices have yielded trillions for oil and natural gas producers, from Norway and Russia to the Middle East, while the American thirst for imports of other goods and services has built up the reserves of China, Japan and other exporting giants in Asia

These king-sized changes in the global financial landscape has made the US and some European powers, like the French and the Germans et al, ultra-cautious about the motive behind the investments made by the Asian and the Middle Eastern funds. Neither their chief concern that these investments might result in colonization of economies, cannot be completely written off, simultaneously, nor the facts with regards to the dwindling value and quality of the US financial assets can be termed as irrational. Nobody can rule out the possibility of say Kremlin getting the prized access to the physical distribution of some of the biggest energy players in Western Europe, only to manipulate them to ensure the rise of its domestic jewels. Neither can anybody negate the threats, which the British banking sector witness amidst a possible takeover of some major English banks led by consortia of state-run funds say from Algeria, Saudi Arabia, and China. But as said earlier this is not a situation that would crop up with certainty. Of late, the economic climate replete of negative real interest rates and fragile dollar has ensured that the returns on the US treasuries depleted with an incredible consistency as a result of which monthly purchases of US financial assets have decreased dramatically from a peak of more than \$100bn in the summer of 2007 to less than \$65bn by February 2008. Wearing protectionist disposition under such sensitive situations will only threaten the financing of their current account deficit.

Sarboxing SWFs: Antithesis to intelligence

As apparent as it can get, the European powers along with the IMF are under serious contemplation of chalking out best practices guide for SWFs. The objective is to architect a mechanism with in which the funds will be asked or in its practical sense coerced to operationalize. There is nothing wrong about follow-our-guidelines approach, which is under construction in the western world, however, as the basis upon which (suspicion, fear, envy) the new guidelines will be formed it will be more a set of regimented restrictions than humble and instrumental guidelines per se. Post the notorious Enron episode, looks like the Americans have earned the reputation of creating guidelines

to terrorize the financial world elements. Sarbanese Oxley Act (2002) was one such anathema and menace through which the enterprises operating in the US are still laboring to recover. No wonder such iron-clad policies have seen New York falling behind London in attracting new investors and companies. There are talks also about NY missing out on creative energy, which has ensured London's windfall success of late thus galvanizing the British capital as the topmost global financial centre to the world.

Moreover, the recent *financial pearl harbor*, the financial holocaust, as described by the astute investor Warren Buffet, that saw the dismantling of Lehman Brothers, nationalization of Fannie Mae and Freddie Mac, along with the backbone-breaking bailout of American Insurance Group in the US has threatened the very existence of its prized investment banks, along with spreading a shadow of self-doubt and fear in the minds of the existing hedge funds, private equity groups and the smaller banks and lending institutions. The situation warrants rationale policy-making and not hysteric decisions. Currently all that the US requires is the much needed access to capital. The blow to confidence, which this crisis has created, has already made the foreigners skeptical about the vibrancy of America's financial system and the quality of their assets. This certainly doesn't augur well for the US as that would mean financing their deficits would require a strenuous effort. We already have reports of the emerging markets heavyweights divorcing the greenback and embracing euro due to the sheer volatility that dollar has displayed. In the recent developments there has been a massive exodus of the SWFs from greenback to the euro. According to Financial Times article, **July 16, 2008 Sovereign funds cut exposure to weak dollar**, the Chinese State Administration of Foreign Exchange (SAFE), the regulator in charge of managing the world's largest foreign exchange reserves has been holding talks with Europe-based private equity firms about putting billions of dollars into their latest funds, precisely because these funds are not dollar-denominated. While one big sovereign fund in the Gulf has cut its dollar-denominated exposure from more than 80 per cent a year ago to less than 60 per cent. There are reports that Russia and China are also contemplating the replacement of greenback with the Euro for trade settlements. Iran and Belarus are the other two nations who have known to have switched over to the Euro, thus making the single currency their new reserve currency. Apart from the currency volatility, on the other hand, some of the SWFs are already chewing the losses incurred through the historic capital injection stunt in some of the US institutions. The classic example is, China Investment Corporation, which invested \$3 Billion in Blackstone earlier this year only to see its investments erode by nearly 50%. There are talks that the Chinese government has been grossly disappointed due to the capital erosion and as per some circles have also severely lamented and warned their indigenous funds against investing in any more US assets.

Speaking straight from the shoulders, the efforts collectively invested by the US and the western European governments in clipping the wings of SWFs through regulatory guidelines also gives it a look of a financial seclusion or financial apartheid of the emerging markets heavyweights. History is evident that the SWFs have not imposed their will or national interests in any of the investments made by them in the so called developed world. They have showed the attributes of decent investors with a long-term and non-interventionist approach. Despite of this the imaginary suspicion of the western politburo has ensured that the SWFs have not received the kind of credence and respect of which they are incontrovertibly worthy. However, as said earlier the fears expressed by the western politburo cannot be completely disregarded but policing SWFs investments would be highly unfair. The free market economics merely teaches us that countries with exemplary human capital and productivity will always attract money from around the world. The process is purely economic in nature as it rewards those who are truly exceptional. However, the capital infusion needs to be managed brilliantly by the recipient central bankers in order to avoid and prune inflationary pressure and excessive overheating of the economy. The process helps in the global capital allocation in the

intelligent centers of excellences, and the motive of investments is remotely that of espionage or sabotage. The negativism displayed by the developed world toward the capital inflow from the developing economy's SWFs could also be attributed to the massive imbalances it creates within the economy.

In an enriching article, October 8 2008 **Asia's Revenge**, By Martin Wolf, Chief economist of Financial Times, great emphasis has been laid on how the capital-export from developing to the developed world has hampered the developed economies and concluded that the recent crisis in the developed world is caused to a certain extent due to the massive and unstinting capital infusion from the developing economies. China, despite of being one of the largest importers of oil, ran the world's largest surplus in 2007 with \$372bn a whopping 11% of its GDP. It was also greater than the surpluses recorded by Japan (\$213bn) and Germany (\$185bn). Martin Wolf also mentioned about an International Monetary Fund report, in 2007, which said the combined global surplus figure reached a mammoth \$1,680bn. Among the top tens were China, Saudi Arabia, Russia, Norway, Kuwait, and United Arab Emirates among others. Since the year 2007 US alone assimilated 44% of that total and the rest was gulped by the UK, Spain, and Australia, the other economies that witnessed US-style housing related problems. There are indeed numerous reasons on how and why these capital inflows were not managed and balanced properly by the central banks of the developed world. Pushing the blame entirely on the developing economies for destabilizing the developed economies is certainly not the correct conclusion to arrive at. The recycling of capital from the developing countries either through central bank investments or SWFs investments, into the developed world is the natural process of globalization. The essence lies, not in making the markets inaccessible, but to ensure continuous enrichment of the monetary policy. Probably the US bankers went little crazy with loose monetary policy that resulted in lower real interest rates when the world was submerged with liquidity and access to capital was as simple as having a walk in the park. The easy access to capital further fostered the debt-culture in the developed world as more and more people started relying on debt way too much to finance their living. As the access to debt was so effortless that the need for saving was never felt.

On the other hand, Bart Chilton, a commissioner with the US Commodity Futures and Trading Commission (CFTC), connected the skyrocketing oil prices to the speculative investments by the SWFs in the US oil futures, in May, this year. According to an article in the special report on the world economy, Oct 11, 2008, **Of froth and fundamentals**, The Economist, investments in commodity-linked instruments touched a staggering \$270 Billion, in June 2008 from a mere \$10 Billion in 2002, as revealed by Barclays Capital. That resulted in the commodity futures contracts quadrupling since 2001. The bank also claimed that the notional over-the-counter commodity derivatives rose 15-fold to \$9 trillion. Critics argue that excessive speculation has added as much as \$35 to the price of a barrel of crude oil. It is understood that the CFTC has commenced with a U.S.-wide investigation into the crude oil and related derivative markets instruments to determine whether there was price manipulation during the unprecedented run that saw the price on the New York Mercantile Exchange climb from around \$60 (U.S.) a barrel in the 2007 spring to the record \$145 in July 2008. The investigation, though, is not based on firm evidences and has not yet traced any linkages between SWFs money and the spiralling oil prices. The US CFTC's move of taking this proactive initiative of unearthing the spiking oil prices should be welcome, however, the investigation looks very discriminative as the other prime suspects, including, hedge funds are missing off their *usual suspects* list. Discriminative moves like these would not bear any fruits for the developed world, especially, when they are in the process of seeking an answer on how the global finance can be brought back to life. The actions like Congress's vote recently to end the so-called "**Enron exemption**," would go a long way in saving global finance from the crony capitalists rather than cornering the rising heroes of the developing world, as saving the system would require a hand-in-glove style of working between different economies around the world.

Connecting Preferences

In a turbulent world as it is now, investments from SWFs possess the potential of helping the developed world refinance the massive debts on which they operated smoothly all these years. The market crisis has completely dried up the liquidity around much of the developed world. Interbank markets are pessimistic and banks are hoarding cash instead of lending among each other and to the businesses and the general public. In an environment like this the much needed cash injection from the cash-rich SWFs will help the developed world in the following manner:

- 1) Energize the interbank markets thus releasing a stream of cash back into the system. This will be achieved through accepting investments in financial institutions. The move would be instrumental, particularly, during the moments of market crisis.
- 2) SWFs investments, with stakes in businesses, will reduce their dependency on interbank markets and provide a salient means of financing their working capital requirements including payroll.
- 3) To a larger extent it would help the businesses prune their dependency on the capital markets and financial institutions thus lessen the burden off the apex banking authorities.
- 4) The investee companies and institutions will have access to capital at minimal cost as against the comparatively substantial cost incurred in tapping capital markets and private investors.
- 5) SWFs investments in private equity companies would also help in harboring the growth of new businesses. This is imperative as private equities depend heavily on banks for their leverage. The capital infusion through SWFs would be a spectacular alternative, especially, in the current context where the banks all over the world are in the process of redeeming their confidence in lending.
- 6) The developed world institutions would also stand to gain if they can persuade the SWFs to allocate some portion of their mammoth reserves to the IMF and the World Bank portfolio, thus making them an important cog in the wheel of global finance. Doing this would also help in tackling the current problem of global finance (read as: illiquidity). The crisis has helped in unlocking various misconceptions about the abundance of liquidity in the markets. Satyajit Das (*a risk consultant and author of Traders, Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives*), expressed it clinically through the article, October 21 2008, **Insight: Shattered illusions of liquidity**, "The perceived abundance of liquidity was, in reality, merely an illusion created by high levels of debt and leverage as well as the structure of global capital flows. As the financial system de-leverages, it is becoming clear, unsurprisingly, that available capital is more limited than previously estimated". Post crisis the phase of clinical deleveraging of global financial institutions would leave the global financial markets liquidity lean and thin.

Importantly, the rise of SWFs would result in changes that would also influence the global financial system widely. George Hogue (*Senior Portfolio Manager and Global Investment strategist at State Street Global Advisors*) wrote passionately about these likely changes in the global financial sphere in a Financial Times article, **September 3, 2008 Market insight: Sovereign funds should be watched with caution**, which are as follows:

1) Rise in US real yields:

Foreign official institutions like central banks hold 32 per cent of the roughly \$4,500bn in marketable US debt held by the public; 85 per cent of these holdings are in the form of Treasury notes and bonds. In a recent study of the US Treasury market, University of Virginia scholar Frank Warnock found that foreign buying of US Treasuries has kept long-term US interest rates

about one to one-and-a-half percentage points lower than otherwise. To the extent foreign central banks reduce their purchases of US securities and that SWFs sell Treasury notes and bonds to diversify, US real yields could rise.

2) Price/Earnings ratio expansion through an accentuation on a global market portfolio:

Capital market theory holds that a world market portfolio is most efficient. A working hypothesis is that SWFs will, over time, sell US Treasuries and reallocate to global equities and bonds in proportion to world market weights. If all SWFs were today to index 60 per cent of their assets to the FTSE Global All Cap Index, they would collectively own about 4.6 per cent of each of the 7,805 companies in the index. Given prospective flows and supply/demand dynamics, there is, therefore, scope for global price/earnings ratios to expand.

3) Development of new asset classes:

Many SWFs originate in developing countries. Middle East funds may promote regional markets and new instruments such as (sukuk) Islamic bonds.

4) Massive inflows into the resource-rich countries/funds:

China's voracious demand for commodities may lead to a strategic focus on emerging markets (particularly resource-rich markets and Asia) and the infrastructure required to get materials to market.

Trusting a new animal

"A government is a different type of animal in the investing world," "We call them sovereign wealth funds, but once you're operating outside your own borders, you're not sovereign in the same sense." In deed that was a very interesting way in which SWFs were described by Edwin Truman, senior fellow of the Peterson Institute for International Economics.

The very fact that the money involved in SWFs belongs to a government of a foreign nation has heightened the concerns of the developed world. Pragmatically speaking, history is evident that no SWF has hitherto, implicated itself in a monkey business through its investment in developed countries. As has been communicated and made clear from the intent the primary objective of SWFs is to ensure enriched returns on the capital employed rather than using the capital for espionage or sabotage. Speaking straight from the shoulders, the concerns expressed by the west apropos seizure of their prized assets through spy-like actions by the SWFs sounds more like a James Bond movie story far fetched from reality. The developed world already has in place the essential regulatory environment to safeguard their strategically crucial assets, for instance, the Committee on Foreign Investments in the United States (CFIUS), which focuses on the role of investments by the foreign governments et al. Hence calling for more regulation would be a mere antithesis to capitalism and free market spirits. The readers should ponder over the following points to decide over how SWFs should be perceived:

- 1) The model of regulation should be restricted only to those sectors which are very sensitive for the effective functioning of the economy and the overall safety of the country, for instance, defense, ports, telecom et al.
- 2) The recipient country, if required, should devise a cap limit on the investments from the SWFs so as to ensure the ownership cap of the SWFs does not reach to an alarming level.
- 3) The SWFs should not be coerced to clarify their investments on the international scale and the performance of the investments. The reason behind not imposing this criterion is as majority of the surplus money that would be flowing into the developed world would be from countries where there is a dislike for the principles of the developed world. For instance, the residents of the GCC countries may not necessarily appreciate substantial investments in

say the US, or the UK, or for that case Israel as that would be a vastly unpopular move in the eyes of the general public. Moreover, the recent events, like the capital erosion on the capital employed by China and some Middle Eastern funds post- the subprime crisis in the US would create a massive uproar in the home country. Hence sharing the information like performance on the capital employed, and the composition of their investments in terms of currency, country, sectors et al may not be a prudent measure. Soon after the subprime crisis hit the US investment banking, China and Middle Eastern funds poured approximately \$60 Billion since 2007. As per an article featuring SWFs on the Business Week issue (Sep 29, 2008, Sovereign Funds: Twice Shy) the Mc Kinsey & Co estimates, that since June 2008 the value of the \$60 Billion invested in 2007 in the US Financial Services Industry has eroded by \$14 Billion. However, stiff reporting standards to the local authorities must be compulsory to ensure the funds are not swindled and used for espionage or sabotage purposes.

- 4) In its truest sense SWFs per se doesn't form part of any industry for which it should be subjected to any regulatory environment. Basically, as their objective is to enhance the returns on the capital employed they may not find the idea of investing in the developed world under stricter regulation and oversight agreeable. Rather, they would be more than happy to invest in their own backyard, the Asian, Middle Eastern and the African countries, where their investments would be welcomed and appreciated as against suspected as would be the case in the developed world.
- 5) Interestingly, I strongly feel, there is a greater requirement in regulating the investments of government owned funds in the developing countries and not the developed world. The recent events like China's investment in Costa Rica's government treasuries with an unreasonable demand of shifting loyalty from Taiwan to China, in particular, should be scrutinized (see: **China's cheque-book diplomacy: An exception in SWF saga, page 15**). The underdeveloped countries, especially, the sub-Saharan African nations are the sitting ducks for the government funds that have inferior interests playing on their mind. China has from time to time provided the world with numerous examples, like the Costa Rica one to put their international aspirations under scanner. Their humongous investments in Sudan, Libya, and other oil-rich but highly instable and unregulated nations looks dubious than investments made with a human-face. Hence, the developed world need to channelize their energies on architecting a regulatory mechanism to administer such investments in the world's troubled and lightly regulated states.
- 6) Another sensible reasoning against the need to scrutinize the SWFs investments in the developed world is the simple reason that no country would like to see themselves subjected to global financial apartheid, by making investments driven by espionage and sabotage in the developed world. Moves like these would also attract heavier embargo with regards to trade, services, and would permanently hamper the diplomatic ties. It would be highly nonsensical for any government owning a SWF to indulge in an act of making speculative investments in any country with intent of harming the prized jewels of that host country, other than surely Taliban.

Accommodating a new sword in the box?

It is an incontrovertible fact that the west cannot undermine the rise of the developing economies. The west has enjoyed a considerably greater influence in the world affairs for ages and decades together. The world is dynamic per se, and the rise of the developing countries should be celebrated as the outcome of the process of globalization, which was brought to life by the western apostles of free market policies and capitalism. Appreciating the developing world economies is in a way an act of saluting the very process of capitalism and globalization. The western world during their moment of glory redefined the rules of trade and business to accommodate their interests and even forced

upon their ideas on the Third world, in exchange, for assistance, be it political, monetary, or commerce. Now the time has come to perceive the developing world economies as partners rather than as followers. The global financial crisis that is staring us in our face can best be resolved through co-coordinated endeavors between the developed and the developing world. The developed world must be sapient in harnessing the growth of the developing economies and invite for the necessary inputs in terms of ideas and suggestions on how the global financial system can be co-created. It could be as simple as urging the SWFs to increase their allocation to the global institutions like IMF and the World Bank to ensure there are adequate level of contingent-capital reserves to aid the demolishing countries or channelizing the funds into Millennium Development Goals, thus taking their practical insights on how the world can be made void of hunger and disease by offering some incentive to them. United States again, need to play a critical role in helping the rest of the developed world comprehend the SWFs in its purest form. US have been interacting with SWFs since quite sometime now and have received opportune capital injections from these SWFs in its major institutions. No wonder that albeit, there are few who suspect the motive of SWFs investments, but some circles in the US politburo, including the Treasury head, Henry Paulson and the deputy Robert Kimmitt, appreciated the professionalism among the Chinese and Russian SWF managers on their visit of these countries at the start of 2008. "When I was in China and Russia, I was struck by the degree to which, although I was talking to government officials, it was like talking to asset managers, Robert Kimmitt said. Hence, the situation demands cautious handling of the new winners of globalization (read as SWFs) in order to ensure the global financial system remains intact thus diluting the chances of an emergence of financial apartheid, which we certainly cannot expect to happen when the global finance is in a severe need of fresh insights and ideas to regenerate itself from its own ashes. Probably, SWFs posses those phoenix-like characteristics, who knows?

Indianising SWFs

India's foreign exchange reserves have recorded impressionable improvements since the country witnessed the forgettable balance of payments problems in 1991-92. Today India has become the forth largest foreign reserves holder in Asia, after China, Japan, and Taiwan with foreign reserves close to \$300 Billion. However, massive inflow of foreign reserves has of late resulted in the rise of inflationary pressures. The Indian inflation surged to over 12% this July. The events like these have fortified the need of a SWF, through which, the government can export some amount of money to other alternatives, apart from the US treasuries, to earn greater returns of the capital. The gains from such a move can then be recycled in improving the quality of infrastructure, for instance, as investing the reserves directly back into the home projects would inflate inflationary pressures. The recent years have also solidified the clamors for capital account convertibility, thus simplifying the investment procedures for outward investments. However, the country remains divided in its views as the example of its South-Eastern neighbors, dating back to the Asian financial meltdown is fresh in everyone's mind. Amidst all these concerns and doubts, the Indian government, earlier this year, declared the urge to roll out a SWF with an initial corpus of \$5 Billion. The move should be viewed as one that is historical and significant in nature. Historical, as that would remind the Indians that they have come a long way from the Balance of payments crisis that mortified the nation in 1991-92, and significant as the fund can be used to enhance the returns on its foreign reserves without tampering the economic stability at home.

An Indian SWF can also be used effectively in funding the acquisition interests of the national companies. In the recent years we have seen the Indian bidders easily elbowed out by the mighty Chinese counterparts in international deals, particularly, the deals in the resource-rich nations. An Indian SWF makes immense of sense for its citizens and India Inc. for the below mentioned reasons:

- 1) The companies, particularly, with interests in the resource-rich nations can gain the much needed financial succor from the fund in winning the competitive bidding abroad for oil and gas production and exploration and coal fields et al.

- 2) The enterprises would be able to tap the SWFs reserves to fund other high profile acquisitions without paying punishing rates as usually happens with the funds furnished by the foreign banks. The classic example would be that of Tata Steel, which acquired Corus, an England based Anglo-French steel giant for \$12 Billion last year, had to agree on paying heavy on the pockets rates on the loan received from a consortium of American Investment banks, including Goldman Sacs.
- 3) The emergence of an Indian SWF would help the companies in reducing their reliance on the Indian banks and the capital markets, which are failing consistently in feeding the insatiable aspirations of India Inc.
- 4) The access of SWF money would also help the nation in channelizing funds in greater numbers of R&D projects, thus helping in enhancing the national productivity.
- 5) The Indian SWF can also play a major role in nurturing the Small and Medium Enterprises (SME) by allocating a portion of its corpus to shore up their R&D efforts. This would be very critical as normally the SMEs labor hard in gaining access to capital due to their ordinary ratings, through external commercial borrowings or other forms of fund raising tools from abroad.

However, rolling out a state-run fund in a country where bureaucratic corruption has been appallingly high, demands for the enactment of strenuous governance and surveillance mechanism. For this to achieve certain initiatives like making the Prime Minister, the President along with the Finance Ministry members of Board of Directors would go a long way in ensuring foolproof protection of the SWF corpus and greater oversight. For greater set of instrumental ideas, probably, the Ministry of Finance can be devolved with the task of forming out regulatory guidelines for the managers of SWFs.

China's Cheque-Book diplomacy – An exception in SWF saga?

In an article published September 11, 2008, **Beijing uses forex reserves to target Taiwan, Financial Times, unearthed the Chinese Cheque-Book diplomacy, where in the State Administered Foreign Exchange (SAFE), the Chinese government institution, managing the world's largest foreign reserves, was reported to have used the foreign reserves to persuade Costa Rica in shifting loyalty by disconnecting their ties with Taiwan.** SAFE was the entity chosen by the Chinese authorities to buy \$300m in Costa Rican government bonds in two lots in January 2008 and January 2009, in return for a switch over of Costa Rica's diplomatic ties from Taiwan to China as was reported by Financial Times in another article published, September 11, 2008, **Beijing's shadowy fund for buying assets. The article also revealed that** according to Chinese media reports, SAFE has also used a shadowy Hong Kong subsidiary to build stakes of less than 1 per cent in numerous companies listed in the UK, including **BHP Billiton, Rio Tinto, Unilever, Tesco, British Gas, Cadbury, Royal Bank of Scotland and Barclays Bank**, as well as in other markets. The account of SAFE's investments in the top European companies is as mentioned below:

SAFE, the Chinese government agency that supervises the world's largest foreign exchange reserves, has bought stakes of less than 1 per cent in nearly 50 UK-listed Companies. The following is a list of its UK financial holdings.

Stocks held : 47
 Total value : £3.352bn
 Percentage of UK ,arlet: 0.1982%

SAFE investments in UK-listed companies			
Company	Sector	Index	Value (£000)
Royal Dutch Shell Plc	Oil & Gas	FTSE100	590,934
Cadbury Plc	Food Producers & Processors	FTSE100	78,982
Aviva Plc	Insurance	FTSE100	138,065
International Power Plc	Electricity	FTSE100	56,601
National Grid Plc	Utilities - Other	FTSE100	168,550
Severn Trent Plc	Utilities - Other	FTSE100	26,653
Morrison (WM) Supermarkets Plc	Food & Drug Retailers	FTSE100	66,275
Lonmin Plc	Mining	FTSE100	44,806
Legal & General Group Plc	Life Assurance	FTSE100	52,993
British Energy Group Plc	Electricity	FTSE100	59,273
Marks & Spencer Group Plc	General Retailers	FTSE100	35,077
Tesco Plc	Food & Drug Retailers	FTSE100	225,347
Tate & Lyle Plc	Food Producers & Processors	FTSE250	13,887
Capita Group Plc	Support Services	FTSE100	31,448
Drax Group Plc	Electricity	FTSE100	19,470
Sage Group Plc	Software & Computer Services	FTSE100	18,399
WPP Group Plc	Media & Entertainment	FTSE100	46,415
Barclays Plc	Banks	FTSE100	174,968
Old Mutual Plc	Life Assurance	FTSE100	36,754
Provident Financial Plc	Speciality & Other Finance	FTSE250	6,176
RSA Insurance Grp	Insurance	FTSE100	31,925
BG Group Plc	Oil & Gas	FTSE100	241,817
InterContinental Hotels Group Plc	Leisure, Entertainment & Hotels	FTSE100	13,980
Punch Taverns	Leisure, Entertainment & Hotels	FTSE250	4,965
HBOS Plc	Banks	FTSE100	104,504
Unilever Plc	Food Producers & Processors	FTSE100	122,036

Misys Plc	Software & Computer Services	FTSE250	5,674
Rentokil Initial Plc	Support Services	FTSE250	7,719
Whitbread Plc	Leisure, Entertainment & Hotels	FTSE100	12,091
Firstgroup Plc	Transport	FTSE100	12,905
Wolseley Plc	Construction & Building Mats	FTSE100	16,251
Electrocomponents Plc	Support Services	FTSE250	4,261
Mitchells & Butlers Plc	Leisure, Entertainment & Hotels	FTSE250	7,592
IMI Plc	Engineering & Machinery	FTSE250	8,206
Reckitt Benckiser Group Plc	Personal Care & Household Products	FTSE100	108,861
British Sky Broadcasting Group	Media & Entertainment	FTSE100	43,437
Rio Tinto Plc	Mining	FTSE100	279,097
Enterprise Inns Plc	Leisure, Entertainment & Hotels	FTSE100	8,484
Segro Plc	Real Estate	FTSE250	11,749
BHP Billiton Plc	Mining	FTSE100	188,320
Royal Bank of Scotland Group Plc	Banks	FTSE100	172,698
Hays Plc	Support Services	FTSE250	7,108
Smiths Group Plc	Aerospace & Defence	FTSE100	20,137
Kesa Electricals Plc	General Retailers	FTSE250	3,981
G4S Plc	Support Services	FTSE100	14,667
Schroders Plc	Speciality & Other Finance	FTSE100	6,602
Vedanta Resources Plc	Mining	FTSE100	1,912

Source: Thomson Reuters

Extracted from Financial Times article, SAFE investments in UK-listed companies, September 12, 2008.

China and Taiwan have for years used aid payments, infrastructure projects and the like as incentives for small countries like Costa Rica to take their side. The agreement, signed on June 1 2007 by Yang Jiechi, China's foreign minister, and Bruno Stagno Ugarte, foreign minister of Costa Rica, explicitly links the foreign policy switch to China's purchase of \$300m in government bonds and a grant of \$130m.

In an exchange of letters from January this year between Fang Shangpu, Safe's deputy administrator, and Costa Rica's finance minister, Safe promised to buy government bonds under the terms of the 2007 agreement, but included a clause demanding Costa Rica take "necessary

measures to prevent the disclosure of the financial terms of this operation and of Safe as a purchaser of these bonds to the public”.

Albeit, SAFE only seems to have bought small slices of western companies so far. Moreover, there is no suggestion that it has invested in anything of great sensitivity or strategic importance. However, the move certainly demonstrates potential dangers. This shows that it is ready to invest as a means of applying political pressure.

It is no doubt that the greater-than-needed foreign reserves is resulting in some countries using finance as a tool to serve their undeclared political aspirations. China, is certainly one such classic example. Over the years the developed world institutions have advised China on letting the renminbi to appreciate further against the dollar, thus reducing its current account surpluses and, above all, relax capital controls to allow private investors to invest abroad to save its economy from growing beyond proportion. However, keeping in mind the influence, which China now enjoys in the world, no country from the developed world could exert any pressure on the Chinese government to comply on the same.

In order to shield the emerging and underdeveloped countries from falling prey to such imperialist political aspirations of mighty economies, there requires a coordinated effort from the developed economies in designing strenuous oversight on the investments made by governments in such countries. The underdeveloped countries are much more susceptible to such speculative investments due to absence of mechanisms and policy guidelines in general and fragile economical position, in particular.

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