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SOVEREIGN WEALTH FUNDS IN SMALL OPEN ECONOMIES

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The small open economies of the Gulf and Southeast Asia are pioneers in the establishment of Sovereign Wealth Funds (SWFs). The SWFs of countries like Qatar and Singapore are among the world's largest in terms of total asset size relative to Gross Domestic Product. This article looks at the different compulsions behind the setting up of SWFs by small open economies.

Sovereign wealth funds (SWFs) are not a new phenomenon for small open economies. Between the 1960s and 1980s, a significant number of small open economies such as Brunei, Singapore, Qatar, Kuwait, and Abu Dhabi established SWFs. This period saw dramatic changes in the global economy. It was a period of global inflation, increases in trade rivalries and protectionism, prolonged recession, volatile foreign-exchange markets, skyrocketing interest rates and debts, and structural adjustments.[1]

Policy makers in economies with excessive surpluses have to make choices regarding the allocation of these surpluses. Objectives such as return maximisation for future generations or the stabilisation of fiscal revenues as well as development considerations influence these choices and thereby the variations in SWFs.

[1] Peter Katzenstein, *Small States in World Markets: Industrial Policy in Europe*. (Ithaca: Cornell University Press, 1985).

Confronted with windfall revenues, many of these economies started to create SWFs in an attempt to adjust to the new international economic environment. For example, Kuwait created the Kuwait Investment Board in the early 1950s and the London Kuwait Investment Office in the early 1960s. In the 1970s, Qatar created the Qatar Investment Board — a predecessor of the Qatar Investment Authority. Likewise, Abu Dhabi created the Abu Dhabi Investment Authority (ADIA) in the 1970s, and the Singapore government established Temasek, a commercial investment company, in the same decade. In the 1980s, Singapore created the Government of Singapore Investment Corporation (GIC), and Brunei established the Brunei Investment Authority.

In small open economies, the most common form of organising government enterprises involves the establishment of development-type SWFs. Development SWFs are developmental vehicles that allocate resources for priority projects. Examples of state holdings that are described by the SWF literature as Development SWFs include: Temasek (Singapore), Qatar Investments under the Qatar Investment Authority, the Investment Corporation of Dubai, and Mumtalakat Holding (Bahrain).

Small open economies differ in terms of their resource endowment. While a number of them — specifically GCC economies and the island economies of the Pacific — are abundantly endowed with natural resources (e.g., oil, gas, phosphates), others, such as Hong Kong and Singapore, possess few natural resources. Differences in resource endowment generate distinct models of SWF capitalisation and different future growth scenarios.[2] Consequently, Qatar's SWF shares more similarities with the Abu Dhabi Investment Corporation (ADIC), in terms of structural constraints, than with Singapore's Temasek.

What is special about SWFs in some small open economies, like Qatar and Singapore, is that these entities are the largest SWFs worldwide in terms of total asset size vis-à-vis GDP.[3] Because these SWFs are so large in relative terms, their trajectories are particularly critical for the future well-being of these countries. In contrast to large economies such as the United States, small open economies are fully exposed to international price fluctuations and adjustment pressures through capital flows. Small open economies cannot influence the key macroeconomic variables such as prices, interest rates, or income beyond their borders.

International capital mobility, combined with a high degree of openness and limited domestic markets, puts pressure on governments of small open economies with low public deficits and large fiscal surpluses to recycle their surplus funds via SWFs. These large surplus funds may result from revenues from natural resources (e.g., oil), revenues from the public enterprise sector, a

[2] Patrick Schena, Juergen. Braunstein, and Asim Ali, "The case for economic development through sovereign investment: Minding the gap." *Global Policy Journal* (forthcoming).

[3] Juergen Braunstein, "The domestic drivers of state finance institutions: evidence from sovereign wealth funds." *Review of International Political Economy*, 1-24 (2017). Juergen Braunstein. "Understanding the politics of bailout policies in non-Western countries: The use of sovereign wealth funds." *Journal of Economic Policy Reform 20, no. 1* (2017): 46-63.

positive trade balance, or tax revenues. Small domestic financial markets constrain the recycling process. In order to recycle surplus funds, authorities can either develop their domestic financial markets or allocate the money to international markets. In contrast to larger economies, such as China, the option of channelling these funds into domestic investments is limited for small open economies because of the risk of creating bubbles. This makes international investments specifically attractive as a means of risk diversification for small open economies.

Among small open economies within similar macro-structural groupings (e.g., the city states of East Asia, the oil/gas-exporting economies of the Middle East, and the phosphate exporting island economies of the Pacific), there are significant SWF-type variations (see table). High levels of external pressure, such as increased capital mobility, currency volatility, and international competition, can influence whether or not a country decides to establish an SWF. The sources of external pressure relate to international financial and trade integration and industrial competition. Governments create particular types of SWFs to address aspects of international competition, diversification, currency volatility, and capital mobility that arise from these pressures.

Scholars explain SWF variations by examining a set of macro-level variables in a given socio-economic context, taking into account factors such as an ageing population and the need for economic diversification in order to create new jobs.[4] Some of these scholarly accounts are prescriptive and offer a set of operational roadmaps to policy makers considering the establishment of an SWF. For example, Das et al offer recommendations to policy makers by drawing on best practice derived from the experiences of existing SWFs and macroeconomic and financial theory.[5] They outline five different types of SWF variation: reserve investment corporations, pension reserve funds, fiscal stabilisation funds, fiscal savings funds, and development funds. In order to strengthen their insights from best practice experience, Das et al. highlight the importance of institutional arrangements as well as the need for adequate reserve and foreign debt levels when setting up a SWF. Their suggestion that "policymakers should optimally consider both their sovereign assets and liabilities together with their macroeconomic objectives, when setting up a SWF" draws attention to the central role of macro-economic factors.[6]

But domestic macro-economic factors are not the only ones influencing the structure of SWFs. As governments realise the potential impact of global finance on domestic institutions they respond with the creation of SWFs. Monk describes SWFs as self-insurance mechanisms for governments to manage uncertainty by maximising state autonomy.[7] As such, SWFs can be described as the "insurer of last resort". As a means of self-insurance, SWFs can serve two

[4] Edwin Truman, *Sovereign wealth funds: Threat or salvation?* (Washington, DC: Peterson Institute, 2010).
[5] Das et al., "Setting up a Sovereign Wealth Fund: Some Policy and Operational Considerations," *International Monetary Fund*, 09/179 (2009): 1–21, Working Paper.
[6] Ibid.
[7] Ashby Monk, 'Sovereignty in the Era of Global Capitalism: The Rise of Sovereign Wealth Funds and the Power of Finance', *University of Oxford*, *Geography Department (2010)*, pp. 1–42, Working Paper.

functions that would appear to be contradictory. These are (i) safeguarding domestic institutions and commitments (e.g., macro-economic stability, superannuation commitments) against pressures from international financial forces; and (ii) at the same time, taking advantage of these forces by deploying a substantial part of sovereign wealth towards international financial markets in order to maximise their premiums.[8] According to Monk, in fulfilling these two functions, SWFs are "desired form[s] or instrument[s] of nation-state investment".[9] This explanation indicates that SWFs are structural mechanisms that support existing domestic commitments and institutions of nation states against the pressures of globalisation.

Furthermore, SWFs serve as substitutes or institutional complementarities for missing or underdeveloped domestic market institutions. From such a perspective, the major reason behind the establishment of sovereign investment corporations, such as Singapore's GIC, China's Investment Corporation, and the Korean Investment Corporation, would be to recapitalise and develop an underdeveloped or non-existing financial market. As for stabilisation SWFs, these could be seen as institutional structures aimed at smoothening fiscal revenues in countries such as Qatar, Kuwait, Bahrain, Saudi Arabia, and the UAE, which lack extractive institutions (i.e., a taxation system).

During the 2000s, virtually all of the small open economies established SWFs.[10] What makes the study of SWFs in small open economies especially interesting is their relative and absolute weight in their domestic economic contexts. In terms of absolute weight, SWFs of small open economies account for nearly half of the 20 largest global SWFs.[11] In terms of size relative to domestic economic indicators, SWFs from small open economies surpass those of larger economies. While the Chinese Investment Corporation — with assets of US$332 bn — is equivalent to around 6 per cent of China's GDP (2010), Temasek's and GIC's combined asset size is equivalent to 135 per cent of Singapore's GDP. The same pattern holds for SWFs of other small open economies such as the GCC economies and the island economies in the Pacific (see table). There are only two small open economies where the SWF is equivalent to less than 20 per cent of the GDP. In 21 of the 30 small open economies, the SWFs are significantly larger, with their size relative to GDP ranging from more than 20 per cent to more than 300 per cent.

[8] Ibid.
[9] Ibid.
[10] The notable exceptions are Luxembourg and Macao, which to date have not created SWFs. But recently there have been debates in both economies on the creation of SWFs from a conversation with an official from the Luxembourg Central Bank in December 2014 and "Monetary Authority says Sovereign Wealth Fund could be created", *Macau Daily Times*, July 29, 2014.
[11] SovereigNet database, 2017

Table. *Small open economies and their SWFs as a proportion of their GDPs.*

Small open Economy	SWFs	Size of SWF in US$ bn	% of GDP (in PPP terms)
Abu Dhabi	ADIA	773	311
	ADIC	90	36
	IPIC	68.4	28
	Mubadala	60.9	25
Dubai	Investment Corp of Dubai	70	65
Bahrain	Mumtalakat	10.5	30
Kuwait	Kuwait Investment Authority	548	330
Qatar	Qatar Investment Authority	170	86
	Qatar Holding	n/a	n/a
	Qatar Diar	n/a	n/a
Brunei	Brunei Investment Agency	40	178
Singapore	GIC	320	94
	Temasek	177	52
	Monetary Authority of Singapore	273	80
Hong Kong	Hong Kong Monetary Authority	400.2	105
Equatorial Guinea	Fund for Future Generations	0.08	0.4
Kiribati	Revenue Equalization Fund	0.6	86
Trinidad & Tobago	Heritage and Stabilization Fund	5.5	20
East Timor	Timor-Leste Petroleum Fund	16.6	65
Sao Tome & Principe	Permanent Fund for Future Generation	n/a	n/a
Mauritius	Sovereign Wealth Fund	n/a	n/a
Tonga	Trust Fund	n.a	n.a
Tuvalu	Trust Fund	0.103*	300
Papua New Guinea	Mineral Resources Stabilisation Fund	Abolished in 2001	
Nauru	Phosphate Royalties Trust Fund	n/a	n/a
Marshall Islands	Compact Trust Fund	0.063	55
Micronesia	Compact Trust Fund	0.087	38
Palau	Compact Trust Fund	0.153	105
Palestinian Authority	Palestine Investment Fund	0.7	10

Source: Braunstein, J, “Understanding the politics of bailout policies in non-Western countries: The use of sovereign wealth funds,” *Journal of Economic Policy Reform 20, no. 1* (2017): 5.

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