

Sovereign Wealth Funds - Australia

Key Points

There have been recent reports that the Commonwealth Government should save some of the tax revenue that it derives from a terms of trade boom in a Sovereign Wealth Fund (SWF). The most notable recommendation was made by the head of the OECD, Angel Gurria, who called for a counter cyclical 'Chilean style' fund to smooth macroeconomic fluctuations ([link to article](#)).

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What is a Sovereign Wealth Fund?

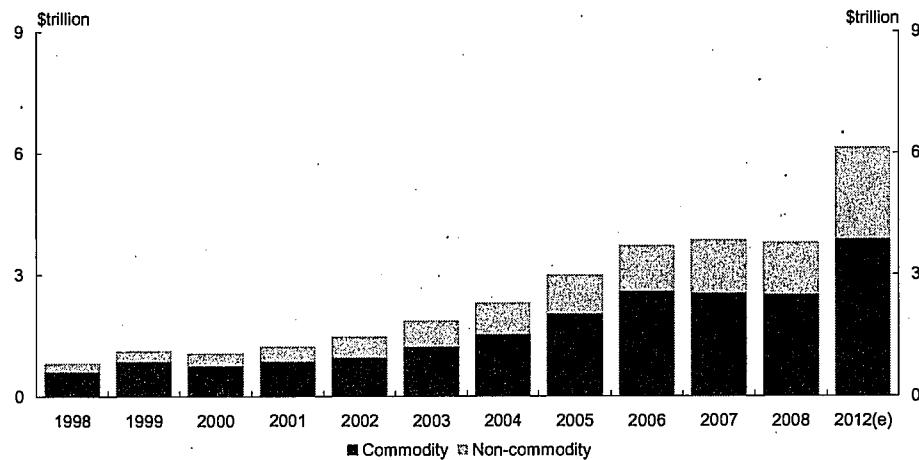
SWFs are typically funded from one of two broad sources. Those funded from revenue windfalls from commodities, such as Norway's Government Pension Fund – Global, and those funded from non-commodity sources, such as China's Investment Corporation. Non-commodity SWFs are typically funded from excess foreign exchange reserves held at the central bank. Non-commodity SWFs are expected to grow in significance as countries like China look to invest their large accumulation of excess foreign reserves (see chart 1).

The Future Fund was established in April 2006 to meet the unfunded public sector superannuation liabilities of the Australian Government. The bulk of the fund's money came from fiscal surpluses and proceeds from privatisations. While the Government owns the fund, an independent Board of Guardians supervises it¹. The role of the Board of Guardians is to decide how to invest the money in the future fund.

While SWFs are difficult to define given the myriad of funding sources, institutional structures and investment purposes, it is estimated that they hold around US\$4 trillion in assets (Maslakovic, 2010). International Financial Services London (IFSL) estimate that SWF assets under management could reach over US\$6 trillion by 2012 (Maslakovic, 2010). While SWFs may seem large in dollar terms, they are very small when compared to mature asset management classes, such as pension funds, who manage around \$29 trillion in assets (Maslakovic, 2010). Even though SWFs make up a relatively small proportion of global financial assets, their exponential growth mean that SWFs are likely to play a bigger role in global financial markets in the future.

¹ Further information can be found at www.futurefund.gov.au

Chart 1: Assets held by commodity and non-commodity SWFs



(e) Estimate only.

Source: Maslakovic, 2010.

Why set up a sovereign wealth fund?

Fernandez *et al.* (2008) outline three major reasons why SWFs are typically set up:

- **Revenue stabilisation** – Economies that are dependent on revenue from a particular commodity are exposed to movements in world commodity prices. The aim of establishing a SWF in these countries is to protect the government's ability to maintain public spending in response to adverse changes in commodity prices. When commodity prices are high, the government will set aside some of these 'surplus funds' in an investment vehicle for a time when commodity prices fall. Should commodity prices fall, the government will maintain or increase expenditure, using its SWF to fund its budget deficit.

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- **Wealth or risk/return optimisation** - Many countries hold reserves in excess of the level required for managing external shocks. These countries may wish to use to access higher returns by investing in more risky assets than short-term government securities. The Greenspan-Guidotti Rule states that a central bank should hold enough foreign reserves to cover all short-term external debt². Observing this rule, covering all short-term debt plus three months of imports would require China to hold around US\$600 billion, less than a quarter of what it held in foreign reserves in 2009 (Peoples Bank of China, 2009) (see chart 2).
- **Future generations** - SWFs form part of a country's national capital³. Extracting and selling natural resources amounts to running down national capital, unless receipts are fully reinvested in financial, physical, environmental or human capital. By creating a SWF, a country is able to preserve its national capital in the form of net financial assets for future generations to enjoy.

Table 1: Examples of SWF sources and purposes

Purposes/sources	Commodity revenues	Fiscal sources	Foreign reserves
Revenue stabilization	Russia: Reserve Fund Kuwait: Reserve Fund Mexico: Oil Stabilization Fund		
Future generations / public pensions	Russia: National Prosperity Fund Kuwait: Future Generation Fund Norway: Government Pension Fund	Australia: Future Fund New Zealand: Super Fund	
Management of government holdings	Mubadala Saudi Arabia: Public Investment Fund	Singapore: Temasek Malaysia: Khazanah Vietnam: State Capital Investment Corporation	China: Bank holdings managed by CIC
Wealth or risk/return optimization	Abu Dhabi Investment Authority (ADIA) Brunei Investment Authority (BIA) Qatar Investment Authority (QIA)	Singapore: Government Investment Corporation (GIC)	Singapore: Foreign reserves managed by CIC Korea: Foreign reserves managed by KIC China: Foreign reserves managed by CIC

Source: Fernandez *et al.*, 2008.

² For further information see Jeanne *et al* (2006).

³ National Capital can be defined as the sum of net financial assets, physical capital stock (e.g. real estate, machines, and plantations), the unused (clean) environment, human capital and unexploited natural resources.

International Sovereign Wealth Funds

Economic and Social Stabilization Fund (Chile)

Chile's first SWF, the Copper Stabilisation fund, was created in 1985. It was closed in 2006 after the Chilean Government passed legislation that created two new SWFs. The first of these is the Pension Reserve Fund (PRF) which is essentially a Savings Fund (no withdrawals are allowed for ten years). The fund received seed money of \$600 million in 2006. 0.2 per cent of the previous year's gross domestic product (GDP) is added to the fund each year. If the actual fiscal surplus exceeds 0.2 per cent of GDP, the PRF receives a contribution equivalent to the surplus, up to a maximum of 0.5 per cent of GDP.

The second fund of these funds, the Economic and Social Stabilization Fund (ESSF) was created in 2007. It receives fiscal surpluses that are above 1 per cent of GDP each year. The fund came into existence with a one-off transfer of \$5 billion from the closure of the Copper Stabilization Fund. The ESSF currently holds around \$21.8 billion.

Norway Government Pension Fund – Global

The Government Pension Fund - Global is a SWF established in 1990 by the Norwegian Government and has around US\$445 billion in assets (SWFI, 2010). The fund is not actually a pension fund as it derives its endowments from oil profits by charging for exploration licenses and taxing oil production. The revenue from the petroleum sector is now in its peak period and will decline over the next few decades. All of the fund's assets are invested offshore.

Abu Dhabi Investment Authority

The Abu Dhabi Investment Authority (ADIA) is the largest SWF in the world with an estimated \$627 billion in assets (SWFI, 2010). The fund was created in 1976 and its main source of funds is revenue from oil exports. Until 2006, ADIA investments were exclusively in foreign assets. The fund now invests both domestically and internationally.

Permanent Reserve Fund (Alaska)

The \$40 billion Alaskan Permanent Reserve Fund was set up in 1976 for the purpose of intergenerational wealth transfer. Owned by the state of Alaska, the fund's regulatory framework allows State legislature to spend only the income from the fund's investments. The principal amount cannot be spent without a vote.

In 2007, the Fund paid \$1,654 to each Alaskan resident. The Fund receives 25 per cent of sale proceeds from oil, gas and other minerals from Alaska. Its investment goal is to earn a real rate of return of 5 per cent.

China Investment Corporation

The China Investment Corporation (CIC) was established in 2007 with \$200 billion of seed money and is owned by the Chinese Government. The fund was established to diversify investment of foreign exchange reserves and to seek better returns from overseas markets. A secondary objective of the CIC is to strengthen the domestic financial system by recapitalizing domestic banks.

To raise funds for the CIC, the Chinese Government issued a special treasury bond and used the proceeds to buy foreign reserves from the central bank. It is expected that the Chinese government will increase the asset base of the CIC by issuing more treasury bonds.

Though its investment practices are not known, the fund is modelled on Singapore's GIC and Temasek Holdings. It is estimated that up to \$90 billion of its fund could be invested in international financial markets in a diverse portfolio consisting of equity, fixed income, real estate, private equity and other alternative assets.

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⁴ See ABARE (2010) for further details.

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Conclusion

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