Crisis Brings Sovereign Funds Back Into Favour

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It's hard to imagine a starker contrast. Over the summer Sovereign Wealth Funds (SWFs) found themselves in the firing-line of controversy, stirred in part by the prediction (by Morgan Stanley's Stephen Jen) that they would increase fivefold by 2015 to reach a combined value of twelve trillion US dollars.

Usually moderate observers such as Jeffrey Garten (Yale) and Martin Wolf (Financial Times) called for curbs on the activities of SWFs to contain the rise of 'state capitalism', and Germany contemplated the launch of a "counter-fund" in order to protect its national champions.

With the autumn, everything changed.

SWFs were now having a soothing effect on panic-prone markets, and brought welcome equity support to banks whose solvency had become less certain: Abu Dhabi at Citigroup, China at Morgan Stanley, Singapore at Barclays, Merrill Lynch and UBS.

China Investment Corp, the newly created Chinese SWF, launched a charm offensive in December with the European tour of its head Lou Jiwei, greeted in Paris by Christine Lagarde, the Finance Minister. The Financial Times, which two months previously had been expressing its concern about SWFs, concluded that the fear should be of 'too little sovereign investment, rather than too much.'

Woe betide any bank missing out on the manna. The New York Times reported the newly fashionable quip on trading floors: 'Shanghai, Mumbai, Dubai – or goodbye'.

The anti-SWF protectionist push, which seemed likely six months ago, has not come to pass – for the time being. At the very moment when SWFs expanded as a result of high oil prices and global imbalances, the crisis underlined the benefit of having at hand these long-haul investors, capable of rapidly mobilising huge amounts for deals with a high risk of short-term loss.

The funds themselves have done their chances no harm by displaying skill and professionalism. Whereas they were given the example of the Norwegian government fund, which limits its holdings to a maximum 5% of the target's equity, they realised that the new environment provided an opportunity for bigger stakes.

At the same time, they have striven to convince doubters that their purpose is entirely financial, and that they would not be take their stakes hostage to political or geostrategic aims, in particular by refraining from claiming board seats even of companies where they have become the largest shareholder. In November, Lou Jiwei explicitly cited the Abu Dhabi Investment Authority's investment in Citigroup as a model for its 'stabilising' role.

Russia has been the exception, with the sometimes ambiguous language of its financiers, some of whom are close to the intelligence community. But Russian funds account for less than 5% of documented SWFs and, even if the gas bonanza continues, its colossal need for domestic infrastructure investment make it unlikely that the relative weight of Russia's SWFs would rise dramatically.

The surge in SWF activity in 2007 has thus been dedramatised in the short term. This is good news for anyone who favours an open economy. But this situation may yet be temporary, for three reasons.

First, what has worked in the US and UK might be trickier elsewhere, especially in a continental Europe which is still suspicious of foreign investment. Indeed, the first real political clash has been about the investment in (Swiss) UBS. In France, rumours of a Kuwaiti investment in the savings banks network were immediately denied. Germany, with several banks in trouble but also a recent upsurge in 'economic patriotism', could be another hot spot.

Second, if the crisis continues, SWFs may be criticized for having invested too early, and their stance as passive shareholders might become harder to sustain.

Third, the US election campaign might cause anxiety to resurface over America's loss of leadership in a financial world which has become multipolar.

At the start of 2002, America's share of aggregate capitalisation of the FT Global 500 largest companies was 57%, Europe's share 29% and the share of emerging countries 3%. Today, the shares are, respectively, 38%, 32% and 17%.

This radical rebalancing process is bound to be painful Therefore, regardless of issues of governance or usefulness, the rise of SWFs is unlikely to be viewed everywhere with complete equanimity.

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