Capital flows and emerging market economies: a larger playing field?

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Summary

• The build-up of foreign exchange reserves to match trade surpluses is giving China and the oil-exporting countries a relatively new role as well as presenting a strategic challenge. Indeed any swing in the policies and investment strategies of these countries could have uncertain consequences for global capital flows as well as trade.

• So far exchange rate management has been largely geared to maintaining dollar pegs, which has undoubtedly influenced both trade and capital flows. However, this policy may already be changing as the continuation of large trade surpluses is not necessarily in the interests of the ‘surplus’ countries any more than it is in the interests of the United States to accumulate large trade deficits.

• The contradiction between the large external surpluses and the needs of domestic development is now evident, and a shift in the use of surpluses and in the ‘tools’ used to control domestic liquidity and stabilize the balance of payments is under way.

• Anecdotal evidence and recent trends in capital flows leave little doubt about the intention of countries with large external surpluses to switch to more ‘aggressive’ investment strategies – i.e. looking for a return, rather than being directed purely on the basis of liquidity considerations.

• Sovereign Wealth Funds are likely to capture the key changes underling current trends in global capital flows. Their already considerable size is likely to grow in the years ahead.

• The relatively more important role of direct investments in foreign countries is likely to create market volatility and political instability, and therefore requires careful management and coordinated action.

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Globalization is driving activity

The recent market turmoil triggered by the crisis in the US sub-prime mortgage market has put the accent not only on how dangerously integrated global capital markets are, but also on the fact that most of the liquidity, which is part of the backdrop – and the solution – to the current US (and UK) debt problem, is generated in countries with a surplus in their current accounts. The supply of cheap money – itself a product of the current prosperity – brings to the global financial scene emerging-market countries with large surpluses and raises the issue of the implications of enlargement of the capital market – is it becoming a larger playing field?

We live in a period of prosperity. The world economy is in its strongest state for thirty years. Increased integration among the world’s main regions – Europe, Asia and the US – along with the expansion of global markets and the emergence of large economies have contributed significantly to global growth in the last decade. And trade is the main force behind this expansion. (See Figure 1.)

FIGURE 1: WORLD GDP GROWTH AND TRADE

The US, EU, Japan and China contribute the most to world trade growth, with an aggregate import level of about US$4 trillion in 2006. China, in particular, contributed significantly to this growth in 2006, with total imports of over US$600 billion – considerably less than the US and EU, but slightly more than Japan. In 2001–05 China’s total imports averaged just under US$400 billion a year (compared with about US$1,600 billion for the US). China’s total imports are expected to double during the period 2006–10, up to an average of about US$800 billion a year, while the US increment may be slightly smaller at around 30–40% (with average total imports of US$2,100 billion a year). China is the great success story of our time, and trade is one of the main drivers of its economy. Over the last 30 years, sustained economic reforms and a policy of openness have managed to engineer rapid economic growth on a scale unprecedented in history. Between 1978, when Deng Xiaoping launched China on the path of economic reform, and 2005, China’s real GDP has grown about twelvefold (National Bureau of Statistics of China, 2006: 24; Lardy, 2006: 1). In the decade 1996–2006 China enjoyed annual average growth of about 9%. As a result its share of global GDP grew from 0.5% in 1980 to almost 5%, making China the world’s fourth-largest economy in GDP terms.

The other key feature of the current economic expansion is that it has been happening in a low-inflation environment. (See Figure 2.) This contrasts significantly with the 1970s and 1980s when double-digit inflation was the norm, rather than the exception, in developed countries. A number of factors, among which trade, once again, is prominent, help to explain why recent high oil prices have not fed through to consumer prices. Along with central banks’ improved use of monetary policy tools and management of price expectations, cheap goods from China and other emerging economies that rely on a large supply of labour have flooded global markets, thereby curbing inflationary pressures coming from the energy and commodity side. As labour costs are so much lower in China, keeping wage inflation under control has become critical for maintaining export competitiveness. Despite recent pressures, consumer price inflation remains at historical lows in both the US and the Eurozone.

FIGURE 2: WORLD GDP GROWTH AND INFLATION

If trade is the main driver of global economic activities, it is also one of the drivers of capital flows and the resulting imbalances between countries with a surplus in their trade balance and countries with a deficit. This situation is epitomized by China and the US. In 2006, China’s strong export growth resulted in a trade surplus of US$210 billion while America’s strong import growth produced a trade deficit of US$844 billion. Trade imbalances have widened substantially in the last decade. In 1995, for instance, the US trade deficit amounted to US$174 billion while China’s surplus was a mere US$18 billion. Similarly, oil-exporting countries are experiencing large trade surpluses. For instance, Russia’s trade surplus was US$140 billion in 2006.
Over the last few years there have been commensurately large expansion of capital flows and huge build-ups of foreign exchange reserves\(^1\) to match trade surpluses. Although net capital inflows remain close to their long-run average relative to aggregate GDP, gross capital inflows and outflows are at record highs, especially in Asia. Current account surpluses/deficits have been widening as a result, creating an ever greater need for financial market development around the world. For instance, in 2006 China and the main oil exporters had an account surplus of average 15% of GDP – a large increase from 2002. This compares with the US’s deficit of 6.1% of GDP, or US$811 billion.

In this paper we look at the relatively new role of China and oil exporters in terms of global capital flows and the strategic challenge that this poses. Any swing in the policies and investment strategies of surplus countries could have uncertain consequences for global capital flows as well as trade. So far exchange rate management has been largely geared to maintaining dollar pegs, which has undoubtedly influenced both trade and capital flows. However, this policy may already be changing as the continuation of large trade surpluses is not necessarily in the interests of the surplus countries any more than it is in the interests of the United States to accumulate large trade deficits. What both China and the oil economies need in the long run are financial-sector reforms that encourage stronger domestic demand growth, reduce their large trade surpluses and generate domestic development and jobs.\(^2\)

Hence we argue that the contradiction between the large external surpluses and the needs of domestic development is now evident, and a shift in the use of surpluses and in the ‘tools’ used to control domestic liquidity and stabilize the balance of payments is under way. Shifting from holding foreign exchange (FX) reserves and debt securities to more active fund management which involves equity stakes in foreign companies is likely to create market volatility and political instability, and therefore requires careful management and coordinated action.

### Surging capital flows

In the last three decades total global capital inflows have been rising faster than trade, initially benefiting from bilateral flows within the OECD (Table 1). They rose from under $1 trillion a year in 1990 to over $4 trillion by 2000. Developing-country inflows also rose, from under $25 billion a year in the late 1980s to $150–250 billion in 2000. This is a major change compared with just twenty years ago, at the start of the current phase of globalization, with fast financial integration. As a result, total market activity is much larger.

Capital flows can be classified into three main groups: foreign direct investment (FDI), portfolio investment and banking operations and FX management. They reflect the complexity of the world economy as well as the international nature of big business, and are driven by increased economic integration. For instance, the surge in FDI is driven by cross-border activity to match ‘assets and liabilities’ or ‘cost base-to-sales’ and by market consolidation through mergers and acquisitions (M&A). The need to access new markets often drives brownfield investments. The expansion in world trade mainly drives banking operations and trade finance, while foreign exchange reserves management is a necessary tool for emerging market economies to maintain currency stability in the face of widening trade surpluses and capital inflows.

As we discussed in the previous section, the emerging economies of Asia, together with oil exporters (Russia and OPEC), are some of the main players in the world economy and on global markets, because of the size of their capital flows and the dynamics behind them. Net capital outflows from Asia, Russia and OPEC combined now amount to about $1 trillion per annum, reflecting the size of their aggregated current account surpluses. Most of these capital flows are directed towards the US market.\(^3\)

In 2006 the US paid about US$604 billion on foreign-owned assets in the US, although the income receipts on US-owned assets abroad were higher, at US$647 billion (US Bureau of Economic Analysis). This means that the US, despite its large current account deficit, still earns more from investments abroad than it has to pay to foreign investors for holding assets in the US. This is mainly because foreign investors tend to invest in low-risk debt securities whereas US investments abroad are mainly FDI and portfolio investments in equities.\(^4\) IMF figures on the breakdown of capital account by type of transactions show that of the stock of US assets abroad, about 22% are direct investment, 20% are portfolio investment and the rest is mostly banking operations and FX management. Of the foreign assets in the US, almost 60% are portfolio investments compared with 10% in direct investments. Direct investments and portfolio investments in the equity market tend to have higher returns than debt securities.

The consequences of these surging capital flows are twofold. First, the US enjoys a surplus in the investment income account, and this somehow defuses concerns over the large current account deficit. However, such a position is sustainable – and it has been so over the last

<table>
<thead>
<tr>
<th>TABLE 1: GLOBAL FLOWS - TRADE AND CAPITAL</th>
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<td>------------------------------------------</td>
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<tr>
<td>Goods trade (exports)</td>
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<td>Total capital inflows</td>
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Sources: IMF, UNCTAD, Oxford Economics.
three decades – as long as foreign investors keep investing in low-return debt securities and do not switch their portfolio allocation to equities, or increase FDI flows in the US. Second, such large, and increasingly larger, capital flows require markets that are able to process large volumes and international transactions.

Global wealth is expanding

The background to the surge of global capital flows is the rise in global wealth which, in turn, is a consequence of the almost uninterrupted expansion of the world economy. This has resulted in an increase in the proportion of this wealth that each country invests abroad. By cross-checking figures provided by Oxford Economics (Rossi, 2007) with ‘quotes’ from the IMF and Bank for International Settlements (BIS) datasets – with the proviso, however, that available information on this kind of data is poor and only refers to financial activities – we have estimated that world total financial wealth for 2005 stands at US$162 trillion (Figure 3). The distribution by activity is fairly balanced, with one-third in equity holdings, slightly more than one-third in the bond market (37%) and slightly less in cash (31%). The geographic distribution sees one-third of the global wealth in the hands of US companies and individuals. The Eurozone and Japan own about 22% and 20% respectively, and the rest of the world 26%.

FIGURE 3: WORLD FINANCIAL WEALTH ESTIMATES, 2005

How is this global financial wealth allocated? Most of it goes to the US market, followed by the Eurozone. (See Figure 4.) These two markets are larger than the total amount of wealth owned by Americans and Europeans. In a sketchy way this suggests that they absorb some of the global wealth which cannot be allocated in other markets.

Without attempting to draw firm conclusions from patchy evidence, it is nevertheless worth stressing here the interplay of two distinct trends in the demand for investment instruments and the supply of such instruments. The former is driven by the existence of large pools of savings in some countries; the latter is constrained by underdeveloped and shallow financial markets in the same countries. As a result capital tends to flow where investment opportunities are available, i.e. to the US and, to a lesser extent, Europe. In other words, in an increasingly open and integrated world economy the identity S-I is reconciled at the global rather than national level.

Reserve holdings and government investment funds

The obvious implications of this excess of savings in some parts of the world are low long-term interest rates – a ‘conundrum’ for a country such as the US, with a large current account deficit – and abundant liquidity. The unfolding of the global imbalances is a topic which has been dominating the economic debate for the past four years. Several factors have been thought to be in play at once – rather than just the US’s excessive consumption, on the one hand, and China’s ‘mercantilist’ policies, on the other – and these factors are believed to have contributed to maintaining the ‘stable disequilibrium’ for quite a long time. The crisis of the sub-prime mortgage market, however, now raises the question of whether a crisis will be triggered by factors other than the trade imbalance between the US and China.

Less obvious are the structural changes that may be looming. Besides the fact that the world’s biggest economy – and the only superpower – borrows from emerging economies to support household consumption and public spending, what are the implications of developing countries, especially China, controlling large chunks of global liquidity? With US$20–30 billion per month in trade surplus and FDI inflows, what is the financial ‘power’ that this country – as well as others with substantial surpluses – can wield, especially given the very low savings rate in some developed economies, notably the US?
FX reserves holdings and government investment funds are the main vehicle through which Asian economies and oil-exporting countries channel their external surpluses, with the result that these surpluses have been invested largely through the official rather than the private sector. Reserves accumulation, in particular, has been the main feature of the Asian economies since the financial crisis of 1997. It provides a means to stabilize the exchange rate, to keep it at a level consistent with export growth and to provide enough liquidity in case of a balance-of-payments crisis, as all these countries are softly pegged to the dollar and therefore potentially prey to speculative attacks.

Reserve accumulations have been growing at a faster pace in the last few years than used to be the case. Compared with the total official reserves of US$4.6 trillion that prevailed at end 2005, the world’s official reserves have risen by over US$1 trillion in little more than a year and were about US$5.7 trillion by the end of May 2007 (IMF figures). (See Figure 5.) They have been growing at roughly US$60–65 billion a month, with China accounting for about 30% of these increases. China’s foreign reserves – mostly in US dollars – now exceed US$1 trillion, bringing the total reserve holdings of emerging Asia to well over US$2 trillion. The Central Bank of Russia has had to buy up more than US$100 billion in foreign reserves so far this year on the back of the country’s large trade surplus and capital inflows. Russia’s official reserves are now a little over US$400 billion – the third-largest in the world.

**FIGURE 5: OFFICIAL RESERVES HOLDINGS**

Sources: Oxford Economics/Hayer Analytics.

Sovereign wealth funds (SWF – assets held by governments in another country’s currency), although similar in origin and composition to reserves holdings, are driven not so much by concerns over the stabilization of the exchange rate and the prevention of financial crises. They respond, rather, to the long-term development needs of countries that depend on natural resources, in particular oil, as their main source of revenue. Oil-dependent economies need to smooth their revenues over a long period of time and to use such revenues to diversify their economies. External surpluses, therefore, are channelled into government investment funds and usually held in the form of stocks, bonds or property. As these funds are blended with the massive pool of private capital, it is extremely difficult to monitor their currency and asset compositions, let alone their size. It is estimated, however, that just over US$2 trillion may be currently held in these funds (Jen, 2007a).

**Are the new players changing the playing field?**

The seeming contradiction between the large external surpluses and the needs of domestic development highlights the problems inherent in a strategy of asset accumulation rather than investment, and, in the case of China, of ‘mopping up’ excess liquidity through sterilization – i.e. the central bank withdraws the excess liquidity generated by capital inflows by issuing notes and bonds. Not only there is an opportunity cost attached to reserves accumulation, but there is also a currency risk which becomes more relevant as the accumulation progresses. Given the size of their external surpluses, how plausible is it for China and oil-exporting countries to keep accumulating dollar reserves and low-return dollar-denominated assets? Moreover, with reserves now exceeding the level necessary to provide a safety net in case of a balance-of-payments crisis, for how long can surplus countries afford the costs and risks of such an exchange rate strategy? And what would be the implications of a portfolio diversification that reduces exchange rate risk exposure and better reflects country weighting?

In the case of China, encouraging capital outflows by opening up the capital account and promoting private overseas financial and foreign direct investments, in addition to enhancing consumption, would narrow the current account surplus and reduce domestic liquidity without a further build-up of central bank foreign exchange reserves. However, given the prevalent expectations of a yuan appreciation, capital outflows may not materialize even in the unlikely event of all restrictions to capital outflows being removed. Another way to control the growth of official reserves is to encourage the acquisition of foreign companies in strategic sectors and invest in infrastructure.

All this, however, does not mean a sudden halt in reserves accumulation or a substantial diversification in the reserves holding, which could trigger a chain reaction in neighbouring countries and panic in the foreign exchange markets. Rather, changes in the pace of accumulation and a rebalancing of portfolios would be limited to new reserves inflows. Such a strategy would have the added advantage of implementing the ‘managed’ appreciation of the yuan – the first step towards a flexible exchange rate in line with the Chinese government’s policy objectives and defusing pressures from the US government and even indirectly encouraging capital outflows.

There are already clear signs of one form of stabilizer for the balance of payments – reserves management – being swapped for another – capital outflows. Indications of such a shift are in the recent trend of FDI flows. While
FDI inflows continue to outstrip FDI outflows (US$334 billion and US$117 billion respectively in 2005), the pace of growth of the latter has been stronger: inflows grew from about US$50 billion and outflows from about US$163 billion respectively in 2002. This trend is even more evident for China where FDI outflows grew from US$2 billion in 2002 to US$11 billion in 2005 while FDI inflows increased at a slower pace – from US$52 billion to US$72 billion over the same period.

These outflows will almost certainly rise markedly over the next couple of years. With deposits of some US$4 trillion – almost double China’s GDP – bottled up in domestic banks and monthly surpluses of US$20–25 billion, assuming current exports growth rates and FDI inflows, China surely has the capacity to generate serious capital outflows. Indeed, assuming that half of the monthly surplus will continue to be channelled into FX reserves, the rest can be used for direct investment or portfolio investments abroad. And US$10–15 billion per month could buy China several large US or EU companies as well as funding aid and several projects in Africa. Similarly, oil funds, which are currently around US$845 billion, could easily grow by US$200–300 billion a year over the medium term (Jen, 2007a).

Switching portfolio composition and investment strategies

Anecdotal evidence and recent trends in capital flows leave little doubt about the intention of countries with large external surpluses to switch to more ‘aggressive’ investment strategies – i.e. looking for a return, rather than being directed purely on the basis of liquidity considerations. As we discussed in the previous sections, the size of reserves holdings has now encompassed precautionary motivations and liquidity objectives, and is well above the level necessary to provide a safety net in the event of financial turbulence. Thus the focus has moved away from currency stabilization and onto development strategies. As managing reserves seems increasingly less appropriate to stabilize the balance of payments and to reduce domestic liquidity, diverting some of the new inflows of FX reserves to sovereign wealth funds is becoming a plausible option for surplus countries.

SWFs are therefore likely to capture the key changes underlying current trends in global capital flows. Their already considerable size (Table 2) is likely to grow even more in the years ahead. Drawing from Asia’s large surpluses means that going forward the portion of government funds derived from oil and gas export proceeds, which currently account for about two-thirds of the total, will drop to about 50% by 2015, with the other half derived from the proceeds from Asian manufacturing exports (Jen, 2007a). Stephen Jen estimates that diverting reserves into government funds would increase the total size of the latter, from the current estimated total size of about US$2.3 trillion, by about US$500 billion a year, and that they would become as big as the world’s total official reserve in about five years. As China is expected to play a larger role in this process, the Chinese government investment fund is likely to become the second-biggest fund in the world, overtaking the current top three funds – ADIA, GIC and Norway’s GPF.

So far SWFs have been a vehicle for the accumulation of low-risk and low-return securities, mirroring, to some extent, the official reserves. As their size grows, these funds will become more like private mutual funds and even hedge funds. In Russia, for example, from February 2008 both the Reserve Fund and the Future Generations Fund (FGF) will be invested in a wider array of assets, including equities and oil options, rather than almost exclusively in foreign currencies and sovereign bonds.

**TABLE 2: GOVERNMENT INVESTMENT FUNDS (THE BIGGEST EIGHT)**

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<thead>
<tr>
<th>Country</th>
<th>Fund name</th>
<th>US$ million</th>
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<tbody>
<tr>
<td>UAE</td>
<td>ADIA</td>
<td>2,279,866</td>
</tr>
<tr>
<td>Singapore</td>
<td>GIC</td>
<td>875,000</td>
</tr>
<tr>
<td>Norway</td>
<td>Government Pension Fund – Global</td>
<td>330,000</td>
</tr>
<tr>
<td>China</td>
<td>State FX Invest Corp + Hueijing Co</td>
<td>300,000</td>
</tr>
<tr>
<td>Russia</td>
<td>Stabilization Fund</td>
<td>100,000</td>
</tr>
<tr>
<td>Singapore</td>
<td>Temasek Holdings</td>
<td>100,000</td>
</tr>
<tr>
<td>Kuwait</td>
<td>Kuwait Investment Authority</td>
<td>70,000</td>
</tr>
<tr>
<td>Australia</td>
<td>Australia Future Fund</td>
<td>40,000</td>
</tr>
</tbody>
</table>

Source: Jen, 2007b.

China, in its turn, recently established the State Foreign Exchange Investment Corporation (SFEIC) to manage China’s FX reserves and merged the new company with the Central Huijing Holding Company, which it bought from the People’s Bank of China and turned into the solely owned subsidiary of SFEIC.17 The new agency has ministerial-level status and reports to the State Council.18

As a result investment strategies and attitude to risk will become more relevant, and hence asset and currency diversifications. It is reasonable to assume that such a shift will have huge implications – not only economic but in terms of market dynamics and international and domestic politics – even if it is difficult, at this stage, to track them all analytically.

**New rules of the game?**

The emergence of SWFs is relatively new, with little anecdotal evidence and almost no statistical information to support a deep understanding of it. It is therefore difficult to provide a detailed analysis of its likely implications. However, the sheer size of such funds suggests that they could become a source of financial instability.

This is not so much because of the impact of portfolio diversification on the dollar and the government bond markets. With most assets held in dollars and dollar-
denominated debt securities, portfolio diversification would happen slowly and mainly on new capital inflows, so as to avoid a sudden drop in the dollar and hence a net loss, given the exposure to the dollar. But this is a difficult balancing act which implies good management of expectations and a good understanding of collective action problems. As the action of each player bears consequences for all others, any unexpected move – for instance, widening the fluctuation bands, diversifying reserves composition or intervening less – could generate sudden panic and trigger huge losses. Indeed everybody would move out of dollars to avoid being left with considerably depreciated reserves. Speculators could also have a go at triggering a market reaction. Of course some volatility is almost inevitable, especially in the currency and sovereign bonds markets where these funds’ exposure to the dollar and dollar-denominated securities is an invitation to traders to guess whether and how portfolios would be diversified. What is critical, however, is the avoidance of market panic that can trigger a widespread financial crisis. Transparency in exchange rate and monetary policies is therefore needed to manage expectations and avoid adverse reactions. Ideally, all players should coordinate their actions and clearly communicate their strategies and intended outcomes.

Equally important are the political implications of the likely shift of the investment focus of these funds from the FX and bonds markets to equity acquisition. This seems particularly relevant for China, even if it is not the only case. Recent official FDI deals and M&A interest leave little doubt about Beijing’s future aspirations and ambitions. These outflows of capital, besides reducing pressures in the Chinese banking system and curbing the central bank’s involvement in the US government bond market, may create political and business links to recipient countries.

The implications of this have not gone unnoticed, even if most state investments have been busily channelled into surrounding Asian states such as Pakistan, Malaysia and Singapore, ensuring minimal cultural friction and hostility. However, it is the politically sensitive investments in Europe and the US which, though relatively few in number, are the more significant and have already triggered loud and uncompromising reactions.

China’s interest in acquiring stakes in strategic industries in developed countries came to prominence in the China National Offshore Oil Corporation’s proposed investment in Unocal in 2005, which collapsed, and Lenovo’s takeover of IBM PC activities in December 2004. In May 2007 China announced it would spend US$3 billion on a 9.9% share in Blackstone Group, a large US investment company. This was followed a few months later by the China Development Bank’s €2.2 billion investment in Barclays Bank. The terms of this deal are significant, as they include the presence of a representative of China Development Bank on the Barclays board. This shows Chinese investors’ interest in being part of the decision-making process of overseas firms – rather than just contributing the finance – and may be the beginning of a trend which could spread concern and harden protectionism in Europe and the US. Apart from the UK’s relatively open approach towards foreign ownership so far, all other developed economies show an increasing inclination to shield their strategic assets from foreign takeovers.

This trend is likely to continue, given the large increase of financial power in the hands of some developing countries. As they need to acquire knowledge and resources, they are likely to use their funds to buy stakes in high-value companies in developed economies and in extracting companies in the developing world. However, the pattern is not so clear cut with regard to what motivates China’s acquisitions in developed and developing countries. For instance, when Chinese oil companies invest in Africa, they do not usually operate the blocks themselves. They have to cooperate with OECD companies and in the process they can access cutting-edge technology and gain the benefits of technological knowledge-sharing and expertise.

The risk of financial protectionism and political backlash is clearly high. There are no easy solutions, but improvements in the transparency of SWFs might diminish the risk. At the moment these funds are unregulated, with no obligation to disclose their investment strategies, or the size, composition or performance of their portfolios. Lack of transparency adds to concerns about these funds being use for political rather than simply financial ends, for example by gaining control of another country’s strategic industries. Being clear on investment goals, managing expectations correctly and increasing accountability could help make some controversial acquisitions more acceptable in the recipient countries.

It would be equally helpful if these funds severed their links with the government of the country of origin and operated as limited companies. A similarity – in juridical terms – to pension funds or mutual funds would appease concerns about a foreign government acquiring equities in another country’s companies. China’s decision to establish SFEIC outside the central bank was a first step in this direction. However, even if SFEIC is likely to ‘subcontract’ a large portion of its assets to external, professional managers (Henderson Insights 2007), its board is made up government officials who have to report to the State Council.

Finally, the US and European governments should clearly define the concept of strategic assets and ring-fence companies and assets that cannot be bought by foreign investors – or define how big a stake foreign investors could acquire. At the moment there is rather a contradiction between the principle that any asset is sellable in a market economy and what is common practice. The investment committee of the OECD already
has an ongoing dialogue of regulators on issues of national security interests, with the aim of raising the transparency of decision-making of government agencies on this matter and avoiding any discriminatory approach. More concerted efforts in this direction should be made. Defining boundaries would, once again, help shield developed countries from accusations of selective bias towards foreign buyers and developing countries from accusations of using business to pursue their geo-political ambitions. Most of all it would help manage expectations in an unambiguous way.

Endnotes

1 The International Monetary Fund defines official reserves as ‘external assets that are readily available to and controlled by monetary authorities for direct financing of payments imbalances, for indirectly regulating the magnitudes of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes’. Total reserves comprise gold, foreign currency assets, reserve positions in the IMF and Special Drawing Rights (IMF, 1993: 97).

2 Perhaps, given the crisis of the sub-prime mortgage sector, financial-sector reforms of a different kind are necessary in countries where consumer credit may be excessive.

3 Catherine Mann calculated that the share of new portfolio investments rose from about 10% in 1993–95 to almost 80% in 1998–2000 (Mann, 2003). See also Gräf, 2007.

4 These, of course, do not always pay a higher return, but have an expected higher return as they are riskier.

5 Property holdings, for example, are excluded.

6 This seems consistent with the ‘asset shortage’ theory of Ricardo Caballero (Caballero, 2006).

7 A country’s current account balance corresponds to the difference between exports and imports (of goods, services and investment income) plus net transfers. In an open economy, there is an identity of investment (I) and saving (S), and the current account balance \((X – M)\) is the difference between national saving and investment \((S – I)\). If national saving exceeds investment, there is a current account surplus. Conversely, if investment exceeds saving, there is a current account deficit. Since both the public and private sectors can invest and save, the current account balance must be equal to the sum total of the financial balances \((S – I)\) of the private and public sectors. The financial balance of the public sector is equal to the aggregate national budget balance.

8 The corollary to low nominal interest rates has been the increase in asset prices and the increased appetite for risk-taking.

9 For an overview of the debate on global imbalances see Xafa, 2007.

10 In the majority of cases sovereign wealth funds correspond to natural-resources exporters. However, some have been established by countries that have few resources, or even none – such as Singapore.

11 For example, Russia’s Oil Stabilization Fund (OSF) was established in January 2004 with the aim of stabilizing the monetary impact of changes in oil prices. The tax proceeds above the threshold of US$27 a barrel were saved in the OSF. The OSF formed a part of the total official reserves of US$357 billion, which makes Russia the world’s third-largest holder of official reserves. As of 1 April 2007, the OSF had US$109 billion invested in sovereign bonds of the US (45% of the total), Eurozone (45% of the total) and the UK (10% of the total). In April the Duma approved the transformation of the OSF to split it into a Reserve Fund and a Future Generations Fund (FGF). This structural change will come into effect on 1 February 2008 (see Jen, 2007c).

12 The Governor of the People’s Bank of China, Zhou Xiaochuan, recently commented that China now has enough foreign currency reserves and that steps would be taken to contain the rate of their rise in future. China Daily, 21 March 2007.

13 For the emerging markets FX reserves accumulation for precautionary reasons is typically about 4–6 months of imports.

14 The acquisition of foreign companies in strategic industries is a sub-class of the broader policy of searching for higher risk-adjusted returns – in other words, SWFs invest overseas and sometimes, not always, they do it in strategic sectors. For infrastructure, in particular, there is a dual logic: invest in strategic infrastructure at home, where the short-run returns, by the way, may not be very high, if indeed they are positive at all, and in infrastructure that provides a good return overseas (in particular in regulated sectors).

15 In principle these activities could be carried out using the official reserves through the China Hueijing Holding Company.

16 Of course this is true only for countries that keep intervening in the currency markets. For those, such as Japan, that have stopped market interventions any portfolio rebalancing will involve sales of portions of their reserves holding.


19 This may be the reason why Japan has been avoiding any mention of government wealth funds. Given that the Bank of Japan is no longer accumulating FX reserves, any movement would imply a diversification away from the dollar.

20 The Blackstone investment, on the other hand, is in non-voting shares.

21 One exception is the Norwegian Petroleum Fund, which is obliged to publish details of its performance on a quarterly basis.

22 For further details see the Project on Freedom of Investment, National Security and ‘Strategic’ Industries, http://www.oecd.org/document/7/0,3343,en_2649_34889_37363207_1_1_1,00.html.
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References


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