Could sovereign wealth funds be a new source of financial optimism for Turkey?

Mehmet Öğütçü and Alastair Newton[1]
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Abstract

Since the turn of the century, *Sovereign Wealth Funds* (SWFs) have proliferated thanks to a combination of surging energy prices and booming Asian exports. They are typically created when governments have a budgetary surplus and little or no international debt. Current holdings of almost $3 trillion will likely reach up to $12 trillion by 2015 thanks to the magic of compounding and the funds' new-found appreciation for equity investing.

The answer to the question of whether SWF's are indeed a new cause for financial optimism for Turkey rests largely, in our view, in Turkey's hands. There are investment opportunities in Turkey and the SWFs will continue to come if they are made welcome and Turkey's inter-governmental relations with these funds' capitals are effectively leveraged.

Keywords
Sovereign wealth funds, Turkey, foreign investment

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1 Mehmet Öğütçü and Alastair Newton are multinational group executives in London working for British Gas International and Lehman Brothers International respectively. They can be contacted through ogutcudunya@yahoo.co.uk and alastair.newton@lehman.com. This article is a contribution to the Forum Istanbul on 23-25 April 2008 and does not necessarily reflect the views of any organisation with which the authors are associated.

Introduction

If the data are anything to go by, Turkey has indeed become a major power in the world economy in terms of both total trade volume and inward foreign direct investment (FDI). In 2007, it boasted an impressive foreign trade volume of $277bn (though with a huge trade deficit of $62.8bn) and FDI inflows of $22bn (from a meagre $1.1bn in 1995). The Istanbul Stock Exchange was the fifth best performing among emerging market countries. And Turkey's GDP growth rate was 4.5 percent – one of the highest in the OECD world if still lower than growth lasting the previous three years (2006 - 6.9 percent; 2005 - 8.4 percent; 2004 - 9.4 percent). Yet, in common with other major economies Turkey's economic growth is widely expected to stutter this year thanks to a combination of internal factors – both economic and political – and the global slowdown.

For all the recent concern among the developed world's political classes and in the press, we believe that one potential reason for optimism at the global scale is the growing clout of so-called sovereign wealth funds (SWFs). The question we look to explore here is whether Turkey can attract more investment from these funds to help ensure its continued financial health through the current downturn and into the medium-term.

Grow, grow stronger

"SWF" as a term has only been around since 2005. But the first such fund dates back to 1953 – the Kuwait Investment Board, now worth approximately $250bn, set up to manage oil revenues even before Kuwait gained independence from the United Kingdom. For the fifty or so years which followed, these government funds were simply referred to as institutional investors or government institutions.

Since the turn of the century, such funds have proliferated thanks to a combination of surging energy prices and booming Asian exports, typically being created when government has a budgetary surplus and little or no international debt. Simon Johnson, the IMF's chief economist, thinks SWFs will be worth $10 trillion by 2012. Stephen Jen, an economist at Morgan Stanley who follows 29 SWFs, estimates their current holdings at almost $3 trillion; he projects that, thanks to the magic of compounding and the funds' new-found appreciation for equity investing, SWFs will control up to $12 trillion by 2015.

Although SWFs – combined with the closely related "diversified monetary authorities" (DMAs), eg the Saudi Arabian Monetary Agency – currently make up no more than 3% of the world's $165 trillion-worth of traded securities, they have a lot of firepower: more equity than (unleveraged) private equity and more funds than hedge funds. And they are growing fast (about 20% annually) – the Gulf's big funds could gain from oil and gas revenues another $300bn to manage this year alone. Add to that the growth of other state-owned financial assets looking to invest – pension funds (estimated at $22.7tr), mutual funds ($20.8tr), insurance assets ($20.5tr) – and the marvels of compound interest, and one soon gets to some very impressive numbers.

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	–
Total	**2,876.3**	–
of which oil- and gas-related	*2,103.4*	–

*Estimated, excluding Norway

†Includes Central Huijin Investment Co.

Source: Morgan Stanley

The basic statistics

- The global annual GDP is \$50trn.
- The top seven sovereign wealth organisations control each in excess of \$100bn, with some as high as \$700bn.
- Pension funds globally control \$20trn.
- Bank assets are estimated to be \$60trn.
- Equity market capitalisation around the world is \$50trn.
- Sovereign and non-sovereign debt aggregates is in excess of \$60trn.
- Private equity accounts for:
    - \$700bn of investor capital globally
    - 20 per cent of global mergers and acquisitions activity
    - 60 per cent of initial public offerings in the US
- There are 181 private equity funds around the world with more than \$1bn under management, compared to five in 1989. 4,000 buyout deals where completed by the private equity industry in 2006.

Who are the targets?

The funds' horizons in 2007 stretched into a range of sectors including consumer retail (10% of deals by value), communications and technology (4%) and industrials (4%), as they have also looked to diversify away from their traditional focus of government bonds into the full range of financial instruments. But it is in financial institutions where they really made a major impact last year with that sector accounting for a massive 63% of deals by value. We judge that such investments have been made primarily for the long-term value which they offer potentially; but, one way or the other, there does appear to have been an element of SWFs looking to play the “white knight” in an effort to soften concerns about them in some political circles in the OECD area.

That said; while SWFs may well continue to invest in financial institutions, such a disproportionate investment in one sector will, in our view, likely prove to be a product of the current times and, therefore, something of an anomaly. In that regard we find particularly interesting the fact that last year 11% of deals by value were in real estate with Dubai’s flagship property company, Emaar (which is 28% owned by Dubai Holding), alone engaged in an estimated $65bn-worth of foreign projects in economies ranging from India in the east to Morocco in the west via Turkey.

What are the motives of SWFs?

We entirely endorse the publicly stated view of European Commissioner Charlie McCreevy who noted in late February that: *“There is… no instance of sovereign wealth funds acting in any manner other than responsibly up until now”*. But it is difficult to counter categorically concerns that some SWFs may be motivated by factors other than straightforward return on investment. In addition to the sheer size of the funds, such concerns notably include: lack of transparency over both overall strategy and individual investments of SWFs; and concern over the quality of governance and regulatory oversight in the funds’ home countries; as well as fears that investment decisions may be influenced by “political” factors. Whether or not there is any justification for these, their impact risks being compounded by what we see as a rising tide of protectionism across OECD economies, coupled with residual “economic nationalism” in some.

In principle, the vast majority of modern economies welcome foreign investment. But, in politics, appeals to fear often “sell” better than those to reason and protectionism enjoys its own “logic”. The hypocrisy of erecting barriers to foreign investors while demanding open access to developing markets is self-evident (even if the likely consequent long-term damage to one’s own economy is less so). While every country therefore has legitimate concerns over national security and financial stability – as is underlined by the existence in the US of the *Committee on Foreign Investment in the United States* (CFIUS) and in Europe of a substantial body of regulation on free movement of capital in the EC Treaty – the case for additional regulation specifically aimed at SWFs is therefore far from clear-cut in our view.

New “rules of the game”?

Whatever their motives, SWFs look set to be around for the long-term and could be a significant influence prices and markets. We expect them to continue to diversify the range of their investments in terms of instruments, currencies and sectors. As they do so we believe they will usually be greeted with open arms – arguably underlined by recent Chinese investment in both Total and BP. For, as with private equity and hedge funds, anxieties about SWFs owe less to the reality than to a mix of secrecy and suspicion.

With a few exceptions, notably Norway which is widely held up as a model of transparency, it is not necessarily readily apparent what a SWF's objectives are, precisely how much money it manages and where it has made its investments. While this caused little concern as long as SWFs' focus remained largely on government bonds, as the funds have expanded into the full range of investment options, including hedge funds and private equity as well as growing in size and number, it is perhaps understandable that there have been calls for increased transparency and evidence of accountability despite the lack of evidence of anything other than responsible conduct to date.

Transparency to discredit protectionism

Central to the response to those calls is the ongoing work of the International Monetary Fund (IMF) on a voluntary code of conduct, which we expect to reach fruition by the time of the Fund's annual meeting this fall. Sensibly, in our view, the IMF has sought to adopt an essentially "bottom-up" approach to this work, kick-starting it with a meeting in Washington at which all the major SWFs and their respective finance ministries were represented. The detail of the code remains unclear at this stage in the work but, to judge by calls from politicians in both Europe and the US, we would expect it to call for SWFs to make public the following:

- the size and source of their assets;
- the currency composition of their investments;
- the regulation and oversight under which they operate in their home country;
- the overall objectives of their investment(s); and,
- the general principles of their relationship with government.

The extent to which SWFs – and/or their respective finance ministries, which may be even more important – are willing/able to comply with these principles remains to be seen, whether incorporated into a code of conduct or not. Recent statements from officials connected with SWFs have suggested that they may be reluctant to accept "rules of the game" which are not applied equally to hedge funds and private equity. And the former Chief Executive of Norges Bank Investment Management, Knut Kjaer, has suggested that *"particular regulations for SWFs would be a step in they wrong direction"*, calling instead for discussion of *"what conditions are needed for the professional management of publicly owned financial assets".* Mr Kjaer goes on to sum up what may be a key argument from SWFs as follows: *"Regulation of SWFs risks creating inefficiency by curbing market forces at a time when we need to strengthen both the power and the professionalism of capital owners"*.[2]

Arguably, long-standing rules set out under the auspices of the OECD – including in the related area of State-Owned Enterprises – on how host countries treat sovereign investors support this position – especially since these rules are widely accepted among OECD member states. Most countries, for example, limit who can own banks because governments often guarantee deposits and because confidence in banks underpins the financial system. Similarly, most countries curb ownership of defense technology and utilities. Thus, with clear, predictable and universally applicable rules

[2] See "Do not regulate wealth funds, improve them" by Knut Kjaer, Financial Times, 14 April 2008.

already in existence, the need for a handbook of new restrictions is open to question; as is the substantive case for special consideration for SWFs.

Nevertheless, perceptions and confidence matter so it may be very much in the best interests of SWFs – and potential host countries – for the funds to go along with the proposed IMF voluntary code. The hosts stand to benefit from the funds' capital. Meanwhile the funds can hope to be better placed to negotiate the vagaries of the potential host country's domestic politics – after all, they are "sovereign" only at home and abroad someone else wields the power.

SWFs and Turkey

Even putting the current downturn to one side, there are many reasons why we believe Turkey should proactively court SWFs into its economy. Notably, Turkey faces huge current account and trade deficits in a global environment, marked by signs of significant slowdown this year and in 2009 when it will be hard to continue attracting both direct and portfolio investments to finance these deficits. SWFs from Russia, the Gulf and Asia will therefore find a warm welcome waiting from Turks keen on bridging this gap. Equally, Turkey's improved business environment and enhanced economic and strategic ties to the Gulf, Russia and Asian surplus countries could well result in substantial SWFs inflow.

Two prominent Gulf SWFs are already active in Turkey; the Kuwait Investment Authority (KIA) and Dubai Holding (DH). KIA owns the Cevahir shopping mall in Istanbul, for which it paid $750 million in 2006 through its London-based subsidiary St. Martin's Property. And, in addition to the Emaar development noted above, Dubai Holding's (DH) international property development subsidiary, Sama Dubai, became involved in 2005 in a joint $5bn investment venture with the Istanbul Metropolitan Municipality, the first project of which is the multi-use Dubai Towers Istanbul (though this project has hit some legal obstacles). Close government-to-government relations between Turkey and many SWF home countries should be instrumental in attracting more funds for property, infrastructure investments and the expected privatization of Halkbank and Vakifbank, as well as in energy-sector as minority partners.

All that being said, there is still a great deal of work to be done by both the authorities and the domestic business community to overcome the past perception of Turkey as an economy which has not been particularly welcoming to foreign investment. Though recent years have seen a significant improvement in that regard, for the Turkish economy to benefit significantly from SWF investment this improved image needs to be carefully nurtured or risk the funds turning to other opportunities in the region and more widely. So, the answer to the question of whether SWF's are indeed a new cause for financial optimism for Turkey rests largely, in our view, in Turkey's hands. For it is clear to use that the investment opportunities in Turkey means that the SWFs will continue to come if they are made welcome and inter-governmental relations are effectively leveraged.