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Sovereign Wealth Funds in Latin America

ESADEgeo Position Paper 17

June 2011

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Sovereign Wealth Funds in Latin America

Sovereign wealth funds (SWF) are more fashionable than ever. They have just burst on the Spanish scene with heavy investment, particularly in Banco Santander and Iberdrola, by Qatar's SWF, Qatar Holdings. Total investment of €2,000m in each instance. These investments were also driven by an interest in Latin America, an emerging region in which Arab funds in particular seek to increase their stake.

There are about fifty SWFs at present and another fifteen countries are considering setting one up. A host of countries including Algeria, India, South Africa, Indonesia, Japan and Israel are candidates for an instrument of this type. Some Latin America countries such as Chile, Trinidad and Tobago, and Venezuela, already have SWFs. Brazil joined them in 2010 with reserves of more than \$250,000m, and at the end of the year, Peru, Colombia, Panama and Bolivia began to discuss creating one.

All these countries have plentiful reserves and, particularly in the case of the Andean countries, now face the challenge of how to deal with the boom in raw materials. Their investments and exports focus heavily on these commodities with low value added and employment rates. They are therefore considering how they can make the most of this boom to boost their productivity and diversify their economies, as yet an unanswered question. Sovereign wealth funds can be strategic vehicles for this, providing that they are well structured and staffed with first-rate mechanisms and professionals.

This is precisely what Chile managed to do so masterfully. In the middle of the last decade, Chile created two sovereign wealth funds with strict rules, and top-quality human and institutional capital, all of which converted this Latin American country into a world benchmark in terms of sovereign wealth funds on a par with Norway. Chile's SWFs are governed by a stringent tax responsibility law passed in 2006, making it compulsory to pay 0.5% of the GDP from the previous year into the first fund (Pensions Reserve Fund); to use the next 0.5%

of the surplus GDP to capitalise the Central Bank; and to pay any surplus above this amount into the second SWF (Economic and Social Stability Fund).

Several lessons are to be learned from the successful experience of this Latin American country. This first is that this type of instrument is inextricably linked to fiscal policies. The second is that extremely stringent regulatory and institutional frameworks are needed, particularly in the case of emerging countries. Finally, it is equally necessary to staff the institution with suitable human resources. In the case of Chile, under both the previous and current governments, the SWFs were staffed by excellent professionals and economists, starting with the past (Andrés Velasco) and present (Felipe Larraín) ministers of finance responsible for supervising the funds, both doctors in economics with many years' experience.

The Chilean SWFs are not, however, strategic funds, i.e. intended to foment business diversification and development. Some emerging countries, such as the Emirates, Singapore and Malaysia have, however, created strategic SWFs specifically designed to develop business and diversify production. One could imagine Chile creating a third SWF for this purpose. The beauty of the Chilean system is that it has the potential to provide the right incentive structure to do so: one could imagine the three existing successive strata funded by tax surpluses being followed by a fourth acting as a strategic fund. This fourth fund would only be activated if the first three were fulfilled, i.e. once a considerable fiscal surplus is generated. This strategic fund could then work like a fund of funds to speed up production diversification into technology industries or even industrial suppliers of the mining industry, for example.

It is interesting to note that despite being the world's foremost copper producer and exporter, there is no Chilean multinational on a worldwide scale supplying this industry with vehicles, excavators or explosives. They are all foreign companies: Caterpillar and Joy Global are listed in New York, Komatsu in Tokyo, Atlas Copco and Sandvik in Stockholm; Boart Longyear, Leighton and Orica are Australian; Weir Group, Scottish; Hatch, Canadian; and Orica, South African. All these firms generate a great deal of employment and considerable

value added. The Chilean firm Codelco, the world's number 1 producer of copper, employs just under 20,000 persons, i.e. far fewer than Swedish multinationals Sandvik (44,000 employees) and Atlas Copco (30,000 employees). Its earnings are a seventh of Caterpillar's, which also employs about five times more staff.

There is no lack of wealth in Latin America, which is undeniably a blessing. However, apart from Mexico and Brazil, which have a wide range of industries, there is little product diversification. On average, raw materials still account for more than 50% of the region's exports, and investments of more than 150,000m are expected in these sectors in the next five years. Having raw materials is not a curse, it all depends what is done with them, as demonstrated by highly developed economies that are very dependent on raw materials such as Norway, Australia and Canada. When all is said and done countries with, say, lithium (e.g. Chile, Argentina and Bolivia) must ask themselves where they want to be in the value added chain. Do they want to be in the lithium commodity market, estimated to be worth more than \$1,000m? Or in the lithium battery market, estimated to be worth more than \$25,000m? Or even in the market for electric cars using lithium batteries, reckoned to be worth \$200,000m?

Part of the answer may be to create strategic funds, in which respect the experience of other countries, particularly on the Arabian peninsula and in Southeast Asia can provide a useful benchmark. In the Emirates, the Mubadala fund, for example, is Abu Dhabi's vehicle for its oil industry diversification strategy. This \$10,000m fund created in 2005 is owned by Masdar, a city aiming to be the Silicon Valley of renewable energies. It entered into investments and strategic agreements with multinationals such as General Electric (with a 0.7% stake in the US giant) which set up R&D centres in the Masdar complex. Mubadala and GE's joint venture created an investment fund now worth \$2,000m. The Emirates were then able to establish themselves as an aerospace hub in association with the European multinational EADS (Airbus), in which another Arab SWF, Dubai International Capital, has a stake of more than 3%. Strategic agreements with multinationals such as the French firm Veolia Water and, in late 2010, Indra, the Spanish IT company, also went from

strength to strength hand in hand with Mubadala. In 2010 Mubadala also aimed an aggressive diversification strategy at emerging markets and signed agreements with Malaysia's SWF (\$7,000m).

Singapore and Malaysia are other interesting examples of successful strategic wealth funds. Temasek, the SWF created by Singapore in 1975, has been a cornerstone of that country's industrial development. It has 380 employees, many of whom are foreigners (one of its two chairpersons is American and the other, French), and was handling some \$190,000m at the close of 2010. Its portfolio still focuses mainly on Singapore (32% of its total assets), the country where it operated as a private equity fund and contributed to the growth of national giants: in 2010, Temasek still had stakes in six of Singapore's top ten multinationals. This SWF has been, for example, a shareholder since 1993 and a driving force of multinationals such as SingTel, one of the telecom giants operating in Australia and India (where it is the second largest shareholder in Bharti Airtel, India's leading telecom multinational). Since 1975 it has also been a cornerstone in the growth of the Keppel Corporation, a globalised supplier of infrastructures to the oil industry with almost 40,000 employees. It contributed to the expansion of Hyflux, a water treatment multinational established just two decades ago and now operating in Southeast Asia, the Middle East, North Africa, Europe, China, India and the USA.

Khazanah, Malaysia's SWF handling some \$30,000m, also made strategic investments in about fifty companies including Axiata, one of the world's largest telecom groups (the main shareholder with 45% of all shares), and Proton, now the largest car manufacturer on Southeast Asia (owning 42% of its capital). It has stakes in airports, airlines, hospitals and banks spanning Malaysia, the area accounting for 90% of its portfolio. It also undertook international expansion in keeping with the country's industrial strategy aimed at positioning it as the region's healthcare hub. This led to its taking control of Parkway Holdings in 2010 the main private hospital operator in Asia, for the record amount of some \$3,500m. Encouraged by these successes, Malaysia created another sovereign wealth fund in late 2009, 1Malaysia Development Berhad, and used this SWF to boost cooperation agreements with Qatar's SWF (creating a vehicle for joint

investment of \$5,000m) and with the oil company PetroSaudi International (to invest \$2,500m).

These examples show the extent to which sovereign wealth funds can be strategic agents in an economy's diversification and growth. In the case of Latin America, Brazil has used the BNDES like a sovereign wealth fund, producing giants such as Vale and Petrobras in the commodities market, and also in cutting-edge industries such as aeronautics with Embraer. Countries such as Peru and Colombia, heavily dependent on raw materials, are now debating whether or not to set up sovereign wealth funds. They could emulate Chile when designing their strategies, or look further afield, towards the Emirates or Singapore or Malaysia, and structure a framework that would also enable them to create a strategic fund, something that Chile itself might wish to consider.

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