# SOVEREIGN WEALTH FUNDS IN THEORY AND PRACTICE

JAN ANDER, PETR TEPLÝ

KAROLINUM

**Sovereign wealth funds in theory and practice**

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# CONTENTS


**LIST OF PICTURES** ---------- 7
**LIST OF TABLES** ---------- 9
**LIST OF ABBREVIATIONS** ---------- 10

1. **THEORETICAL PART** ---------- 13
1.1 LITERATURE REVIEW ---------- 13
1.2 DEFINITION OF STATE SOVEREIGN FUNDS ---------- 15
1.3 RISE, DEVELOPMENT AND ROLE OF SWFs ---------- 17
1.3.1 Santiago Principles ---------- 19
1.3.2 Individual objectives of funds ---------- 19
1.4 TYPES OF SWFs BASED ON SOURCES OF CAPITAL ACCUMULATION ---------- 20
1.5 TYPES OF SWFs BASED ON INVESTMENT PURPOSES ---------- 21
1.5.1 Basic profile of SWFs ---------- 21
1.5.2 Difference between SWFs and pension funds ---------- 22
1.6 POSITION OF SFWs WITHIN GLOBAL INVESTORS' PORTFOLIO ---------- 23
1.7 INVESTMENT STRATEGY ---------- 23
1.8 INVESTMENT TRENDS ---------- 26
1.9 MACROECONOMIC IMPACT OF SWFs ON HOME AND HOST COUNTRIES ---------- 29
1.9.1 Impact on changes in currency rates, prices of assets and commodities ---------- 30

1.9.2 Impact and effect of investment decisions of SWFs on their performance ---- 31
1.10 OVERVIEW OF SELECTED SWFs ---- 32
1.10.1 Analysis of Government Pension Fund (GPF) ---- 32
1.10.2 Abu Dhabi Investment Authority (ADIA) Fund ---- 39
1.10.3 China Investment Corporation (CIC) Fund ---- 41
1.10.4 Fundo Soberano do Brasil (FSB) ---- 42
1.11 OVERVIEW OF RECENT SWFs TRANSACTIONS ---- 42

2. **EMPIRICAL PART** ---- 47
2.1 INTRODUCTORY COMMENTS AND METHODOLOGY ---- 48
2.2 ANALYSIS OF VOLUME OF SWFs' ASSETS ---- 49
2.3 ANALYSIS OF SWFs' TRANSPARENCY ---- 52
2.4 INDICES OF SWFs' TRANSPARENCY ---- 53
2.4.1 The Peterson Institute's Index of Transparency ---- 53
2.4.2 Linaburg-Maduell Index of Transparency (LMTI) ---- 53
2.5 ANALYSIS OF SWFs FROM THE INSTITUTIONAL VIEW ---- 55
2.6 ANALYSIS OF DEVELOPMENT OF SWFs' ASSETS IN THE 2008–2010 PERIOD ---- 56
2.7 MACROECONOMIC IMPACT AND POTENTIAL RISKS OF SWFs ---- 63
2.7.1 Macroeconomic impacts ---- 63
2.7.2 A case study: Merger Tinto – BHP Billition ---- 67
2.8 ANALYSIS OF THE IMPACT OF FUNDS ON THE INCREASE OF NATIONAL WEALTH ---- 68
2.8.1 SWFs as saving institutions ---- 68
2.8.2 Profitability of SWF investments: public versus private sector ---- 69
2.8.3 Political context ---- 71
2.8.4 Tax policy ---- 71
2.8.5 Value of a fund and impact on wealth growth ---- 73
2.8.6 Measuring efficiency of funds ---- 75
2.9 SWFS AND GLOBAL DISBALANCES ---- 79
2.10 THEORETICAL EXAMPLE: POSSIBILITY OF SETTING UP A SWF IN THE CZECH REPUBLIC ---- 80
2.10.1 Economic crisis – good chance to introduce changes ---- 83
2.10.2 Theoretical example of setting up a SWF in the Czech Republic ---- 84
2.10.3 Revenues of a SWF in the Czech Republic ---- 88

3. **EXECUTIVE SUMMARY** ---- 111

4. **BIBLIOGRAPHY** ---- 113

5. **APPENDICES** ---- 117

**INDEX** ---- 131

## LIST OF PICTURES

**Picture 1** High exposure in foreign currency and no liabilities
**Picture 2** Tolerance of high investment risks and long-term investment period
**Picture 3** Number of SWFs set up between 1953 and 2009
**Picture 4** Financial intermediators according to assets under management as of December 31, 2012
**Picture 5** Index of investment preference into industries and spheres as of December 31, 2009
**Picture 6** Index of investment preference into industries and spheres as of December 31, 2010
**Picture 7** Volume of over-boarder SWF transactions performed between 1995–2009
**Picture 8** Investments according to stocks interest
**Picture 9** SWF Investments according to target states
**Picture 10** SWF investments according to regions
**Picture 11** Index of cumulative abnormal revenue
**Picture 12** Classification of GPF revenues based on type of investments
**Picture 13** Scheme of corporate governance NBIM
**Picture 14** Expected real revenues of GPF versus structural budget deficit of Norway
**Picture 15** Relation of ADIA fund and state finances of Abu Dhabi Emirates
**Picture 16** Primary investments of CIC (as of December 31, 2007)
**Picture 17** Overview of SWFs based on transactions performed in first half of 2010 (USD billion)
**Picture 18** Size and concentration of SWFs over the world
**Picture 19** Development and estimated volume of SWF assets including a ratio between commodities and non-commodities in 2000–2013
**Picture 20** SWFs investments based on countries from 1986 to 2012
**Picture 21** Strategy and transparency of SWFs
**Picture 22** Development of performed SWF transactions based on a number and value of capital
**Picture 23** Percentage change of stocks value from the date of investment till the end of 2009
**Picture 24** Investment trends of SWFs in the period from 2003 till the first half of 2010
**Picture 25** Value of SWFs' investments based on sectors between 2007 and 2009
**Picture 26** Value of SWFs' investments based on sectors between the first half of 2009 and the first half of 2010
**Picture 27** Development of surpluses of the balance of payments – states with a democratic regime and others

**Picture 28** Transparency of funds – states with a democratic regime and others
**Picture 29** Oil price prediction until 2035
**Picture 30** Results of the 4-factor analysis of SWF benefits
**Picture 31** Development of volume of GPF assets in thousands NOK
**Picture 32** Value of the Temasek fund portfolio (billion USD)
**Picture 33** Investment portfolio of Temasek
**Picture 34** Benchmarking of efficiency of SWF and S&P 500 within 2008–2010
**Picture 35** Portfolio profile of SWF and investment funds in average numbers
**Picture 36** Accumulated revenue of GPF in CCY/* (since set-up)
**Picture 37** Excess Return GPF in % (quarterly since set-up)
**Picture 38** Global current account imbalances
**Picture 39** Political governance and motivation of politicians
**Picture 40** Profit and loss account of ČKA between 2001 and 2007
**Picture 41** International Reserves of ČNB between January 1, 1994 and December 31, 2012
**Picture 42** Financial results of ČEZ in 2007–2010
**Picture 43** Financial results of ČEPRO in 2007–2010
**Picture 44** Financial results of MERO in 2007–2010
**Picture 45** Financial results of Letiště Praha, a.s., in 2007–2010
**Picture 46** Financial results of České aerolinie, a.s., in 2007–2010
**Picture 47** Financial results of ČEB in 2007–2010
**Picture 48** Financial results of EGAP in 2007–2010
**Picture 49** Financial results of ČMZRB in 2007–2010
**Picture 50** Model of financing a SWF in ČR (first year)
**Picture 51** Basic alternative 2005 and 2010, balance % of GDP annually

## LIST OF TABLES

**Table 1** Basic profile of types of funds
**Table 2** The largest stock held by GPF as of December 31, 2012
**Table 3** The largest bond interests held by GPF as of December 31, 2012
**Table 4** State budget and GPF – main chapters (in bill. NOK)
**Table 5** Overview of investment portfolio (according to assets groups)
**Table 6** Overview of investment portfolio according to regions)
**Table 7** Transaction database Monitor FEEM SWF
**Table 8** TOP 10 largest SWF transactions in 2010 (based on volume of assets)
**Table 9** Volume of SWF assets based on countries and regions as of December 31, 2012
**Table 10** LMTI principles
**Table 11** Classification of SWFs based on availability of information
**Table 12** Financial help to key world banks in the 2007–2009 period
**Table 13** The 4-factor model of evaluation – University of Chicago
**Table 14** Income from the sale of property and shares since the beginning of transformation in 1991–2010 (in CZK thousands)
**Table 15** Overview of large-scale privatization account as of December 31, 2010 (in CZK thousands)
**Table 16** Theoretical basic capital of the state SWF as of December 31, 2010

## LIST OF ABBREVIATIONS

**CalPERS** Californian Public Employee's Retirement System
**CDM** Consensus Demand Meter
**CFR** Council on Foreign Relations
**ČNB** Czech National Bank
**DECS** Debt Exchangeable for Common Stock
**DJIA** Dow-Jones Index Average
**EIA** Energy Information Administration
**ER** Excess Return
**ESA 95** European System of National and Regional Accounts
**FED** Federal Reserve System
**FEEM** Fondazione Eni Enrico Mattei
**GAPP** Generally Accepted Principles and Practices
**GDP** Gross Domestic Product
**GLC** Governmnet Linked Company
**IFSL** International Financial Services London
**IMF** International Monetary Fund
**IMFC** International Monetary and Finance Committee
**IPO** Initial Public Offering
**LMTI** Linaburg Maduell Transparency Index
**MSCI** Morgan Stanley Capital Index
**NBIM** Norges Bank Investment Management
**NOK** Norwegian Krone
**OECD** Organization of Economic Cooperation
**PAYG** Pay as you go
**PES** Advisory Board of the Czech Minister of Finance
**PI** Petersson Institute
**PPRF** Public Pension Reserve Fund
**ROA** Return on Assets
**ROE** Return on Equity
**S&P 500** Standard and Poor's Index
**SEA** Sovereign External Assets
**SEC** Security and Exchange Commision
**SPF** Sovereign Pension Fund
**SSRF** Social Security Reserve Fund
**SWE** Sovereign Wealth Enterprise
**SWF** Sovereign Wealth Fund
**TARP** Trouble Asset Relief Program
**TCUK** The City UK
**TSR** Total Shareholder Return
**UAE** United Arab Emirates
**WA** Wealth Added Framework

# INTRODUCTION

Sovereign Wealth Funds (hereafter referred as "SWFs") have been currently becoming a more and more important part of the international financial system. These institutions administrated USD 6.1 trillion under their asset management as of the end of 2013. SWFs are the funds owned by a state, set up for various macroeconomic purposes. Usually, they are financed through the transfer of foreign currency assets which are mainly long-term investments abroad. Even though their significance has been growing especially in the last years, SWFs do not represent a new phenomena and some of the funds from Kuwait, Abu Dhabí and Singapore have been existing for tens of years. The high prices of oil and other commodities, financial globalization and a permanent global disharmony result in a quick accumulation of foreign currency assets, especially in those states exporting oil and in some Asian countries. The growing number and size of SWFs in those countries and their growing role in international markets are a secondary effect.

In recent years people significantly changed their view on SWFs as investors. While these funds were regarded as unsought investors before the global crisis, in 2008 they were enabled to enter the largest American banks. This fundamental turnaround had to do with the need for failing financial institutions to gain financial means and in those days SWFs were the only ones which were willing to take over high risks and to provide those means. SWFs can be officially regarded as standard players in the world financial market since 2008, when they accepted the principles of its functioning (the so called Santiago Principles). By setting up a SWF, their home countries gain many economic and financial advantages, for instance easier depositing of revenues and easier inter-generation transfer of revenues from non-renewable resources. From the point of view of international financial markets, these state investment funds can more easily attain better allocation of revenues from commodities surpluses in various countries and, at the same time, they can increase the liquidity of the market even at times of a world financial crisis. The increasing impact of SWFs also raises a number of questions, eg. about their transparency, size and investment strategies.

The aim of our publication is to provide a reader with some information on SWFs as a growing phenomenon in the global financial market including all macroeconomic and microeconomic connections. In this work[1], we analyze the establishment, development, current and future tasks of SWFs. We also discuss relevant basic concepts of this sphere because the issue of SWFs is not, in fact, covered in the Czech literature at all. The publication is divided into three main chapters: theoretical part, empirical part and concluding remarks.

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1 An earlier version of this work was published in Czech in Karolinum Press in the year of 2011.

In the first chapter we focus on SWFs from the theoretical point of view, we present an overview of literature, explain basic concepts, SWF's investment strategies, pending trends and key transactions. In the second chapter we deal with SWFs from the empirical point of view. We analyze the development of these funds in recent years (including their impact on economy), two indices of SWFs' transparency and main SWFs' macroeconomic impact and potential risks. In this chapter we also discuss the theoretical possibility of setting up a SWF in the Czech Republic. In the third chapter we summarize this work and present our main conclusions and recommendations. We believe that this publication will be useful, not only for specialists, but also for those readers who want to get acquainted with this issue.

Prague, June 2014
Jan Ander
Petr Teplý

# 1. THEORETICAL PART

In this first chapter we focus on SWFs from the theoretical point of view. We provide theoretical background needed for the following empirical analysis. We present an overview of literature, explain basic concepts and SWF's investment strategies. Finally, we discuss pending trends and analyse key transactions.

## 1.1 LITERATURE REVIEW

Despite the fact that SWFs have been running on the market for several tens of years, this issue is not much covered in the Czech or foreign literature, even though recently there have been more and more new publications and analyses on this issue. One of the first more complete studies on SWFs was done by the McKinsey Global Institute (Farrel et al., 2007), in which these state investment funds were mentioned in the context of their growing force and impact resulting from increasing oil prices which created a significant source of their revenues. Other studies and analyses are developed by renowned international institutions, for example the International Monetary Fund (IMF) and the Organization of Economic Cooperation and Development (OECD), the Morgan Stanley bank, specialized institutions like the Sovereign Wealth Fund Institute in Las Vegas, Fondazione Eni Enrico Mattei (FEEM) under the University of Turino, Council on Foreign Relations (CFR), Peterson Institute or directly by universities (University of Washington, University of Michigan, University of

Oxford and others). Many central banks intensely deal with the funcioning of SWFs. It is not only those banks which run SWFs, like the Norwegian central Norges Bank, but also, for example, the central bank of Finland, which analyses the potential political impact of the funds from Russia and China (Rautava, 2008), the central bank of Spain, the American FED of Chicago (Paulson, 2009) or the European Central Bank (Beck et al., 2008). The issue of SWFs, in fact on the accumulation of foreign currency reserves in newly developing economies, is also discussed by Jeanne and Carrol (2009) who develop their own motivation models explaining why countries should hold their foreign currency assets. By means of their models they also try to answer the topical questions of why the capital flows from developing into developed countries and what will the impact of capital absorption be on the global financial disharmony in the long term. The study by Allen and Caruany (2009) can be considered a key study from the view of assessing the impact on public wealth.

We will not find many references to SWFs in the Czech specialized literature. One of the first Czech economists to point out the activities of SWFs, was Michl (2007, p. 1). In his article he states:

> In the old days these funds mainly used to buy state bonds – to the general satisfaction of world power politicians, who had thus a strong party interested in financing budget deficits. These days everything gets more complicated, as the funds are turning into a predator going uncompromisingly for the interests of most renowned world companies.

Mejstřík and Teplý (2008) regard SWFs as one of most dynamic players in the global market and they stress their role at rescuing the American banks Citigroup, Merill Lynch and Morgan Stanley. They also point out a fundamental change in the approach of the American government, which enabled SWFs to enter the banks, even though, not a long time before, it forced the company of Dubai Ports World to sell five American ports which this company gained through the purchase of the American company P&O in 2006.

Tomšík and Zamrazilová (2009) mention state sovereign funds on a general level in their report. The books by Ander and Teplý (2011) as well as by Černohorský and Teplý (2011) belongs to the earliest publications which refer to SWFs. The authors define SWFs as "investment funds owned by a state and set up for various macroeconomic reasons, which are usually financed through the transfer of foreign currency assets invested abroad for a long time" (p. 140). Their book is, in its own way, quite pioneering in relation to current trends in financial markets. This publication is trying, to a certain extent, to follow the ideas of the above mentioned authors. Last but not least, Ander and Teplý

(2011) analyze SWF in a global context and discuss the theoretical possibility of setting up a SWF in the Czech Republic.[1]

## 1.2 DEFINITION OF STATE SOVEREIGN FUNDS

There are many definitions of SWFs. For example, the British think tank The City UK (TCUK, 2010, p. 2) offers the following definition:

> SWFs are defined as investment funds determined for special purposes. They are generally owned by governments. They are set-up mainly for macroeconomic reasons. State investment funds hold, manage and administer assets for the purpose of attaining financial goals. Their investment strategies also involve investments into foreign financial assets. These assets are usually kept aside from surpluses of balance of payments, official financial transactions in foreign currency, privatization revenues, fiscal surpluses and revenues from commodities exports.

Clay Lowery in his work for Morgan Stanley (Jen, 2007, p. 1)) provides a different definition according to which "a state sovereign fund is a governmental investment instrument, which is financed through revaluation of foreign currency assets and which administers these assets separately from official state reserves."

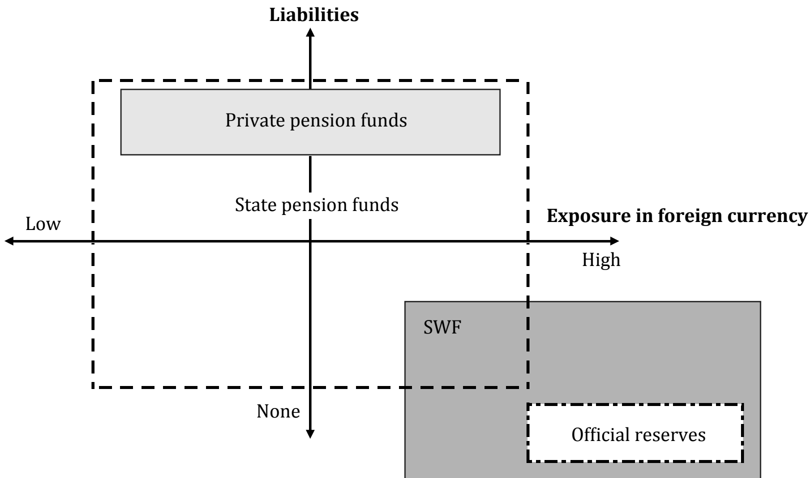
In line with this definition, SWFs have five basic features:

1) independency,
2) high exposure in foreign currency,
3) no explicit liabilities,
4) tolerance of highly risky behaviour,
5) long-term investment period.

Clay Lowery further distinguishes between two basic parameters of SWFs: level of exposure in foreign currency (Foreign Currency Exposure) and explicit feature of any liabilities (Explicit Liabilities) related to the fund (**Picture 1**). Governmental foreign currency reserves (Official Reserves) are, according to the definition, out of 100% in foreign currency. They have no direct liabilities, even though indirectly they are primarily financed from home governmental bonds used for funding foreign currency operations. SWFs do not necessarily have to have a 100% exposure in foreign currency but this exposure should be mainly in foreign currency. For example, the Singaporean Temasek Holdings,

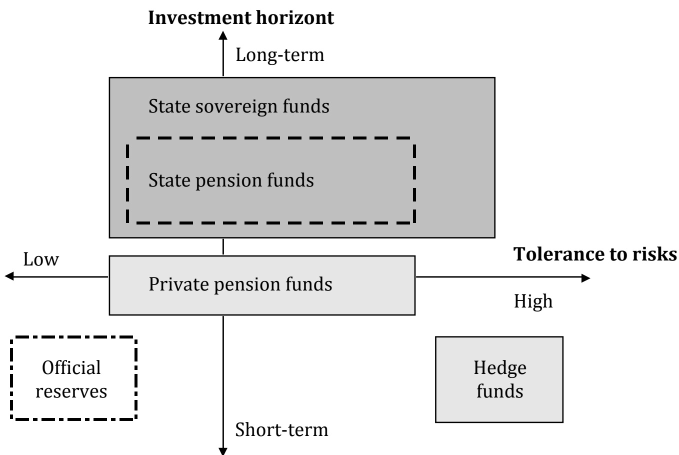
1 This book folows the work by Ander and Teplý (2011) and develops some other aspects related to SWFs.

**Picture 1: High exposure in foreign currency and no liabilities**




Source: Jen (2007)

**Picture 2: Tolerance of high investment risks and long-term investment period**




Source: Jen (2007)

Malaysian Khazanah Nasional BHD and Canadian Fonds des générations (Quebec) do not have 100% assets in foreign currency.

Liabilities are the second parameter. Independent pension funds (the so called Sovereign Pension Funds, "SPF") have explicit or expected pension liabilities, while state investment funds do not (**Picture 2**). Of course, there is a certain overlap between state investment funds and SPF. The Singaporean GIC or Norwegian GPF are the best examples.

Due to their need for ensured liquidity and security, the governmental foreign currency reserves have a very short-term investment period and low tolerance of credit risks. This is the reason why most of state reserves, denominated in bonds, are placed on large and liquidity markets. Both types of the funds, SWFs as well as SPFs, have a longer-term investment period, which can be even some tens of years. State investment funds may have higher tolerance of risks than SPF.

## 1.3 RISE, DEVELOPMENT AND ROLE OF SWFs

The first sovereign fund, as it is known these days, was Kuwait Investment Board, which was set up in London in 1953 by sheikh Abdullah Al-Salem Al--Sabah so that he could invest surpluses of revenues from oil export. However, due to the fact that Kuwait was a British colony until 1961, the first really independent state fund was set up in 1956 by Kiribati state, a small island in the Pacific. The fund served to optimize revenues from phosphate mining (guano). In those days, as well as these days, this fund has been called the Revenue Equalization Reserve Fund. The present assets administered by this Kiribati fund (USD 400 million) are almost six times higher than the GDP of the country in 2008 (USD 71 million).

The year of 1974 represents another milestone in the development of sovereign funds, as in 1974 the Ministry of Economy of Singapore set up the Temasek Holdings fund. It was also at that time when the government of Kuwait and Libya carried out, through confidential transactions of their family members, a purchase of minority interests of the German Daimler and Krupp companies. These capital investments, in those days very controversial in Germany, were later transferred into Kuwait and Libyan state investment funds. Two years after this purchase, the fund called Abu Dhabi Investment Authority was set up in the United Arab Emirates to administer fast accumulating surpluses of revenues from oil export. Singapore was the first country which set up a SWF in 1980, and in 1981 its government set up the Singapore Investment Corporation (SIC), in order to ensure a long-term growth of investments returnability. Originally, SIC was a private company. The most important event which had to do with state investment funds happened in 1987. At that time the Kuwait Investment Authority (KIA) obtained a 21.7% interest of the British Petroleum within the unsuccessful privatization. The British government insisted that KIA had to lower its interest in the following year down to 9.9%. Even though unwillingly, the fund did so, under very advantageous conditions.

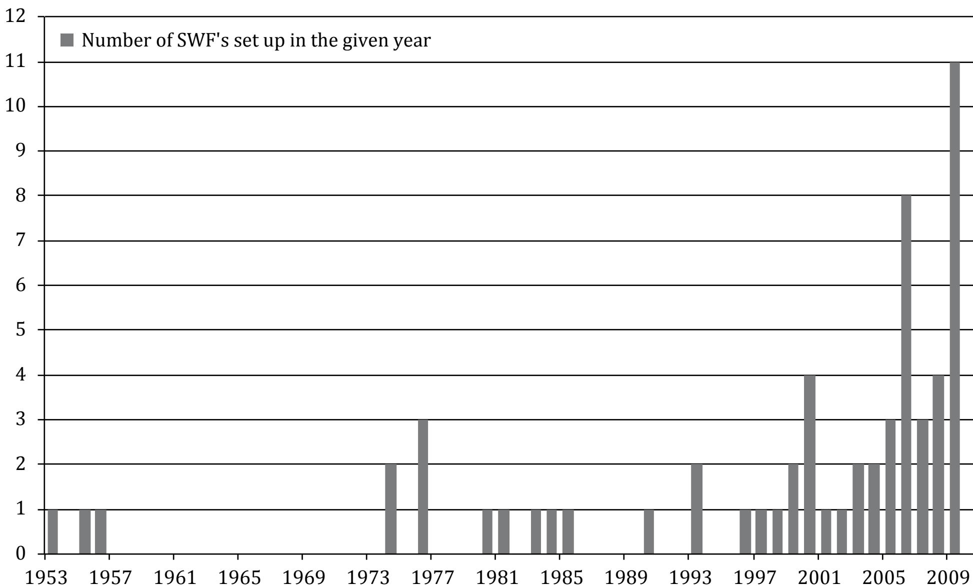
The year 1990 represents another milestone in the rise of SWFs. In that year the Norwegian government set up a fund, originally called the Oil fund, to administer continually growing revenues from oil export from the North Sea.

In 2006 the fund was renamed Pension Fund-Global which became a part of a wider reform of the Norwegian pension system. Inspite of its name, the fund has no explicit pension liabilities. Instead of that, the Norwegian state pension is paid out of the sister fund FSM, formerly known as National Insurance Fund.

On those days SWFs were regarded as long-term investors with a low aversion to risks, which related to their relatively risky investments into stocks, hedge funds and private equity funds. However, in order to accept SWFs as a due institutional investor and a significant participant of international currency markets, the International Monetary and Finance Committee created the International Working Group consisting of the funds' representatives, in order to make relationships official, coordinated and easier and in order to set the so called best practices. This group, on its meeting in Santiago de Chile in 2008, accepted a document describing basic rules of running funds, known as "**Santiago Principles**".

Many new funds were set up in the second half of 2008 and in 2009. Among these, we can name for example the French strategic investment fund. It was set up with a volume of financial means of roughly USD 26 billion and with the aim of helping to stabilize French companies and to finance innovative projects. Also, the Brazilian fund, was set up in 2009, in order to give protection against future financial crises and in order to help Brazilian companies develop their

**Picture 3: Number of SWFs set up between 1953 and 2009**




Source: Clark et al. (2009)

businesses and expand abroad. Among other countries, which set up or are planning to set up a SWF, there are Angola, Bolivia, Canada, India, Japan, Nigeria, Tchaj-wan and Thailand.

### 1.3.1 SANTIAGO PRINCIPLES

The preambule of the document of establishment of the International Working Group of Sovereign Wealth Funds (2008, p. 1), called the Santiago Principles, states:

> Sovereign wealth funds (SWFs) are special funds set up for the purpose of making investments. They are in the ownership of governmental institutions. Governments set them up for macroeconomic reasons. The aim of state investment funds is to hold and administer assets to attain planned financial objectives through various investment strategies, by means of which they invest into foreign financial assets. SWFs have various legal, institutional and administrative structures. They make a heterogenic group which involves funds ensuring fiscal stability, savings of financial means, reserve funds for corporate investments, development funds and reserve pension funds without explicit pension liabilities.

This document states Generally Accepted Principles and Practices (GAPP) which result from the main objectives of state sovereign funds. There are three key areas involved in these principles: i) legal framework, objectives and coordination with macroeconomic policy, ii) institutional framework and structure of management, iii) investments and risk management.

The generally accepted objectives are as follows:

- to help maintain the stability of the global financial system and free flow of capital and investments;
- to ensure that all valid regulatory requirements, regarding transparency in those countries, in which funds make investments;
- to invest in line with economic rules in relation to financial risks and returnability;
- to provide a transparent and clear management structure, which determines relevant operational check-ups, risks management and responsibilities.

### 1.3.2 INDIVIDUAL OBJECTIVES OF FUNDS

Objectives set from the “individual perspective” of a home country can also be regarded as relevant objectives of funds:

- higher revenue – use of the opportunity to increase revenues from foreign currency reserves through investments into "no-risks" assets;
- accumulation of liquidity means for future generations after mineral resources are depleted;
- macroeconomic stability – states dependent on export of raw material use liquidity of funds to eliminate risks of price fluctuation of given commodities;
- support of home industry – funds are partially used, for instance, for the support of scientific and technical development of a given country.

## 1.4 TYPES OF SWFs BASED ON SOURCES OF CAPITAL ACCUMULATION

Based on the origin of wealth accumulation, we distinguish between two types of SWFs:
- *commodity*: foreign currency sources from large volumes of oil export and from other non-renewable resources (eg. Norway, Russia, Middle East);
- *non-commodity*: foreign currency reserves from a large surplus of current account of balance of trade and foreign currency policy (eg. China, Singapore).

Apart from others, one of the differences between commodity and non-commodity funds is that administration of non-commodity funds usually involves foreign currency interventions. These interventions mean issuing bond securities, which enables the balancing of inflation pressures. The revenues from such funds are primarily used to pay up interests of these issued bonds. Of course, with commodity funds, these capital costs do not have to be expended.

The third type of revenues for the SWF's capital accumulation is represented by the surpluses from the so called renewable resources from state-owned, in fact state-managed, companies and holdings (Government Linked Companies – GLC). They are mainly profits, dividends, etc. The Singaporean Temasek fund is a typical representative of this third type. These two last sources, especially the sources from GLC, are regarded to be key sources, and we will mention them later in relation to the project of implementing SWF in the financial system of the Czech Republic.