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Sovereign Wealth Funds: Global and Domestic Implications of the Rise of a New Major Player in International Finance

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Global and Domestic Implications of the Rise of a New Major Player in International Finance

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ABSTRACT

The subject of petrodollar recycling has frequently captured the interest of academics, politicians and the media. Specifically, the issue typically boils down to one central question: where exactly are the petrodollars—revenue earned from the sale of oil—flowing? According to traditional scholars like Bernard Mommer and Terry Lynn Karl the recurring argument is that in oil-exporting nations, oil revenues are channeled directly into the hands of a few government officials resulting in corruption, inequality and economic decay.

However, the main limitation of this traditional argument is that it tends to focus solely on the dynamics between the national level and local communities. With the increasing trends of globalization and financialization, I find the traditional viewpoint to be outdated and too narrow in focus. Hence, I argue that when the perspective is expanded from the national to the international an intriguing aspect materializes: in reality, the majority of oil revenues are actually flowing out of the state and into global financial markets.

Before I examine how petrodollars reach international financial markets it is necessary to review the traditional literature regarding oil-exporting nations. Hence, section one assesses the classic tale of oil-exporters and concludes with the introduction of a new actor for managing oil revenues: Sovereign Wealth Funds (SWFs). Since they are a relatively unknown concept, section two serves as a general introduction to sovereign wealth funds. Next, section three elaborates on the previous discussion by providing an in-depth case study of the main Middle Eastern funds while section four examines the impact of these funds on international finance. Lastly, in section five I return to the traditional concept of the resource curse and examine how sovereign wealth funds impact their domestic economies.

Over the past ten years, the rise of sovereign wealth funds as major players in international finance has generated a wide array of sensationalist perspectives and has left the general public with a sense of confusion regarding the true nature of sovereign wealth funds. Thus, my goal is to provide a more realistic and pragmatic view of the role of sovereign wealth funds in both their international and national space.

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PREFACE

"Between corrupt mortgage brokers, feckless lenders, and risk-happy hedge funds, there's plenty to keep investors and policymakers up at night. But recently a new item has appeared on the list of things to worry about: so-called sovereign wealth funds, which are investment funds controlled by foreign governments."[1]

With headlines reading "The Invasion of the Sovereign Wealth Funds"[2] in the Economist, "Sovereign Wealth Funds Spark Concerns"[3] in the New York Times and "US Fears Over Sovereign Wealth Fund Threat 'Legitimate'"[4] in the Financial Times, the world was introduced to the next great villain of international finance. Sovereign wealth funds have all the ingredients for disaster: in the name of privatization and capitalism it is bad enough that they are the investment arms of foreign governments, but of even more concern in a post 9/11 world is that many of these 'foreign governments' belong to Arab, non-democratic, anti-western countries. Case closed? Not exactly.

Paradoxically, during the same timeframe (between 2007-2009) the exact same mainstream news outlets portraying sovereign wealth funds as the enemy ran articles entitled: "Superfunds to the Rescue"[5] (Economist), "Big Payday for Rescuers in the Crisis"[6] (New York Times), and "From Vultures to White Knights"[7] (Financial Times). Evidentially, the image and role of sovereign

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[1] James Surowiecki, "Sovereign Wealth World," The New Yorker (2007).
[2] The Economist, "The invasion of the sovereign-wealth funds," The Economist (2008).
[3] Dealbook, "Sovereign Wealth Funds Spark Concerns," The New York Times (2007).
[4] Stephanie Kirchgaessner, "US Fears Over Sovereign Wealth Fund Threat 'Legitimate', Says Official," The Financial Times (2007).
[5] The Economist, "Superfunds to the Rescue," The Economist (2007).
[6] Eric Dash, "Big Paydays for Rescuers in the Crisis," The New York Times (2009).
[7] The Financial Times, "From Vultures to White Knights," The Financial Times (2009).

wealth funds is unclear. Sovereign wealth funds have been cited as signifying everything from corruption, fear, and destabilization to globalization, cooperation and economic development. What exactly are these so-called 'Sovereign Wealth Funds' and more importantly: are they villains or are they heroes?

Surprisingly, the media hype surrounding sovereign wealth funds is a recent development. In fact, the term 'sovereign wealth fund' itself was only coined in 2005[8]. However, the aforementioned speculations stem from a much older debate concerning the flow of petrodollars—the revenue earned from the sale of oil. Specifically, the issue boils down to one central question: where are the petrodollars flowing? According to traditional literature, the recurring argument is that in oil-exporting nations, oil revenues are channeled directly into the hands of a few government officials resulting in corruption and inequality. In essence, traditional literature portrays oil as curse ultimately resulting in "rich countries with poor people."[9]

However, the main limitation of the traditional literature on oil-exporting nations is that it tends to focus solely on the dynamics between the national level and local communities. I argue that when the perspective is expanded from the national to the international an intriguing phenomenon materializes: in reality, the majority of oil revenues are actually flowing out of the state and into global financial markets. How exactly are these petrodollars reaching international

[8] Andrew Rozanov, "Who Holds the Wealth of Nations?," State Street Global Advisor (2005): 1-4.
[9] Joseph E. Stiglitz, "Making Natural Resources into a Blessing rather than a Curse," Covering OIl: A Reporter's Guide to Energy and Development (2005): 19.

financial markets? The answer is none other than the infamous sovereign wealth funds.

Again, we return to a rather prevalent and important question: what are sovereign wealth funds? Ultimately, this is a question with many answers. Are they extensions of corrupt authoritarian governments looking to maximize personal wealth over social welfare? Are they mechanisms for the Arab world to take over key US industries like defense and technology? Are they simply 'rational' investors, looking to maximize returns on investments? Or are they tools for economic development, seeking to eradicate the resource curse once and for all?

In order to discover the true nature of sovereign wealth funds, it is necessary to start from the very beginning. Hence, section one will commence with a look at the history of oil-exporting countries during the 20th century and the concurrent ascent of sovereign wealth funds. Section two will then serve as a general introduction to the concept of sovereign wealth funds. Section three will elaborate on the previous discussion by providing an in-depth case study of the main Middle Eastern funds while section four will examine the impact these funds have on international finance. Lastly, in section five we will return to the traditional concept of the resource curse and examine how sovereign wealth funds impact their domestic economies. All in all, it is my hope that by the end of this study the reader will walk away with a clearer, more realistic image of sovereign wealth funds. Albeit for better or for worse.

SECTION 1

The Classic Tale of Oil-Exporters

"Control over access to natural resources - and, therefore, to the territories where they are located - has been at the origin of countless conflicts, which can be traced back to the beginnings of civilization and have continued to exist up to the present."[10]

The classic story of oil-exporting countries revolves around the underlying concept of Sovereignty. At the most general level, the Treaty of Westphalia (1648) established that "states have sovereignty over the land and people in their territories."[11] More specifically, the sovereignty desired the most by oil-exporting countries is the acknowledgement of a state-owned natural resource (oil) and "the right to grant or deny access to this land."[12] Unfortunately, as most traditional literature highlights, the road towards sovereignty has been characterized by booms and busts. To illustrate these ups and downs, prominent scholars like Bernard Mommer and Terry Lynn Karl call attention to the different phases of oil regimes.[13] Furthermore, while the oil-exporting countries' initial struggle and successful emergence from domination experienced during the first oil regime is indeed significant, most traditional literature tends to concentrate on

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[10] Bernard Mommer, Global Oil and the Nation State (New York: Oxford University Press, 2002) 1-255.
[11] "Sovereignty" In, *The Dictionary of Human Geography*, 5th Edition, Derek Gregory, Ron Johnston, Geraldine Pratt, Michael J. Watts, and Sarah Whatmore (eds.) 706-707, Oxford, UK: Wiley-Blackwell.
[12] Mommer 2002, 98.
[13] Traditional Literature refers mainly, but is not limited to the following works: Bernard Mommer, Global Oil and the Nation State (New York: Oxford University Press, 2002), Terry Lynn Karl, The Paradox of Plenty: Oil Booms and Petro-States (Berkely: University of California Press, 1997), Jeffrey D. Sachs, Joseph E. Stiglitz Macartan Humphreys, Escaping the Resource Curse (New York: Columbia University Press, 2007), Thad Dunning, Crude Democracy: Natural Resource Wealth and Political Regimes (New York: Cambridge University Press, 2008).

the height of oil-exporting countries' sovereignty. Specifically, traditional literature emphasizes the phenomenon known as the resource curse whereby the abundant and plentiful oil revenues experienced by oil-exporting countries at the height of their sovereignty were initially perceived as a blessing and how these same revenues become a curse and ultimately result in "rich countries with poor people."[14] While there is abundant evidence supporting a theory of the resource curse, traditional literature tends to stop at this dismal conclusion; ultimately painting an incomplete, oversimplified picture. When reexamining what traditional literature overlooks, the future potential for oil-exporting nations appears to be more optimistic than initially expected.

Initial Struggle for Sovereignty

First Oil Regime: Absolute Minimal Sovereignty

The first oil regime began early in the 20th century with the initial discoveries of oil in the Middle East. Following the discovery of oil, concessions were granted under colonial and imperial control, establishing a period of foreign domination over oil-exporting countries. The first concession was the D'Arcy concession in 1901 when Persia was divided up between the British and the Russians[15]. Subsequently, other countries followed suit and eventually "every single concession covered a large part, if not all, of the national territory of these countries."[16] Furthermore, it is worth noting that many of these concessions were intended to remain in effect for the long run with some lasting between 75-100

[14] Stiglitz 2005, 19.
[15] Mommer 2002, 118.
[16] *Ibid.*

years. With German, British and Dutch interests all competing for concessions, it came as no surprise that the United States became interested as well. By 1928, "a U.S. - dominated alliance of British, Dutch, and U.S. oil companies" came together to form the International Oil Cartel (AKA the "Majors") and "controlled world oil production and set the world market price."[17] By controlling both production and prices, the "Majors" essentially controlled the entire oil industry (outside the United States). As a result, "the absolute dominance of the oil companies over the exporting states characterized this regime."[18]

The main thrust of the control was asserted outside of the US market due to the fact that the US market was more competitive thanks to the presence of several small independent oil companies. Furthermore, this increased competition in the United States resulted in a higher price of oil due to higher production costs. Hence, the "Majors" selected the price of oil to be in accordance with US prices because "oil production was significantly cheaper in all other oil-producing nations."[19] This difference between the high price of oil, in accordance with higher U.S. costs, and the low cost of production in oil exporting countries enabled the Majors to extract a surplus of profits.

Good news for the international oil companies, but what about the oil-exporting countries? Intrigued by the surplus profits, oil-exporting countries sought to increase their share of oil revenues as well. However, the advent of

[17] Fernando Coronil, The Magical State: Nature, Money, and Modernity in Venezuela (Chicago: University of Chicago, 1997) 53.
[18] Terry Lynn Karl, The Paradox of Plenty: Oil Booms and Petro-States (Berkely: University of California Press, 1997) 51.
[19] Coronil 1997, 53.

concessions introduced an important concept to oil-exporting countries: "the payment to landlords in exchange for access to sub-soil resources."[20] This is otherwise known as rent and in the case of oil-exporting countries the state was the landlord. Initially, the Majors came together in the Red Line Agreement of 1928 and agreed not to compete for concessions in an effort to limit the amount of ground rent allotted to landlords. The original rent or royalty was "set at 4 shillings per ton of oil and if profits were increasing it could increase to 6 shillings and 2 shillings if profits fell."[21] The rent was a flat rate (4 shillings per ton of oil) and was only allowed to fluctuate, albeit slightly, if the price of oil increased or decreased. Hence, the rent was dependent and determined by price, otherwise known as differential rents.[22] Thus, oil-exporting countries' ability to increase their oil revenues was sharply limited and dependent upon international oil companies' surplus profits.

Second Oil Regime: Increase in Bargaining Power

One of the main reasons why the "Majors" were able to exert so much control and dominance over the oil-exporting nations was the prevalence and nature of the colonial system. As Mommer states, "no modern sovereign country would ever hand over to a few private companies the control of its natural resources."[23] Hence, the decline in colonialism after World War II took a significant toll on "the major's" power and influence. In addition, "the emergence

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[20] "Thad Dunning, Does Oil Promote Democracy?: Regime Change in Rentier States (New York: Cambridge University Press, 2008) 39.
[21] Mommer 2002,120.
[22] Coronil 1997, 53.
[23] Mommer 2002, 161.

of independent oil companies into the world market increased competition and thus oil-exporting countries were able to improve their bargaining positions."[24] With more players entering the market, oil-exporting countries began to compare their concessions with their neighbors, in particular the royalties, and started to demand a greater share of the oil revenues.

Evidence of this increase in bargaining power on behalf of the oil-exporting nations is demonstrated by profit sharing agreements adopted in the early 1950s. After World War II, the price of oil nearly doubled and hence the ground rent was expected to rise to the standard upper limit of 6 shillings. However, the international oil companies already instituted a generous fifty-fifty profit sharing agreement with the government of Venezuela because they deemed this to be the ultimate fair compromise for both sides.[25] This fifty-fifty profit sharing agreement quickly became the gold standard across the Middle East as well. Hence, the international oil companies became aware of the increased bargaining power on behalf of the oil-exporters and used the fifty-fifty profit sharing agreement as an attempt to appease them.

Considering oil prices had been relatively stable throughout this time, the price collapse in 1959 was the catalyst for oil-exporting countries to take action. Since their rents were dependent and determined by prices, the decrease in prices illuminated how little control oil-exporters had over the fate of their own resources. Hence, in 1960 oil-exporting countries formed their own cartel otherwise known as the Organization of Petroleum Exporting Countries (OPEC).

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[24] Karl 1997, 51.
[25] Mommer 2002, 125-133.

"A cartel of landowners, not producers."[26] Initially, OPEC was established to promote price stability, however the desire to increase oil revenues enticed members of OPEC to increase prices in order to increase their own revenues. Hence, whereas oil-exporting countries' rent once was determined by price, OPEC was now driven to set a price determined by rent. This form of rent is known as an absolute rent because it reflects the power of the landlords in determining rent.[27] In sum, the creation of OPEC signified "the right of all countries to exercise permanent sovereignty over their natural resources."[28]

Height of Sovereignty and the Struggle to Retain it

Oil as a Blessing

The newfound ability and potential for oil-exporting countries to finally capitalize and profit from their natural resource endowments generated strong sentiments of optimism and hopes for prosperity. Terry Lynn Karl provides the best description of the significance of OPEC for oil-exporting nations:

> By seizing the institutional capacity to set prices for oil and by nationalizing their domestic production, these countries which had been virtual case studies of foreign domination in the past, finally appeared to gain control over their primary natural resource.[29]

After a many years of dominance, oil-exporting countries were finally not only able to control their own production, but now they were even able to control

[26] Coronil 1997, 54.
[27] "Rent" In, *The Dictionary of Human Geography*, 5th Edition, Derek Gregory, Ron Johnston, Geraldine Pratt, Michael J. Watts, and Sarah Whatmore (eds.) 644-645, Oxford, UK: Wiley-Blackwell.
[28] Mommer 2002, 151.
[29] Karl 1997, 3.

prices. The first major instance of this price control was when OPEC started to decisively raise the price of oil between 1970 and 1973 in an attempt to offset the devaluation of the US dollar.[30] The real tipping point occurred with the start of the Yom Kippur war on October 6th 1973.[31] In opposition to the US's support of Israel in the war, OPEC decided to exercise its bargaining power and instituted an embargo against Israel's supporters. Furthermore, OPEC raised the price of crude oil 17% to $5.12 per barrel on October 16th and again on December 22nd from $5.12 to $11.65 per barrel.[32] The Arab Oil Embargo eventually ended in on March 18th 1974, however the price increases generated extremely large revenues for oil-exporting countries. In fact, "in the brief period from 1970 to 1974 alone, government revenues of OPEC nations leapt *eleven fold.*"[33]

The traditional literature is keen to focus on this "golden period" because these revenues were expected to be the drivers of economic development, bringing prosperity and wealth to oil exporting countries. As Karl asserts, "new revenues from petroleum would provide the resources necessary to catch up to the developed world while simultaneously bringing political stability and a better life for the people."[34] However, in reality as Mommer points out, "the economic and political performance of the Third World oil-exporting countries after the OPEC

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[30] The devaluation of the US dollar occurred in 1971 after the United States discontinued the use of the Gold Exchange Standard, allowing the US dollar to float. Since oil is priced in terms of US dollars, oil-exporting nations' revenues decrease as a result of the depreciation.
[31] Energy Information Administration, "Annual Global Oil Market Chronology," 2007, 1-51.
[32] *Ibid.*
[33] Karl 1997, 3.
[34] *Ibid.*

revolution has been rather poor."[35] This phenomenon is what is widely referred to as the resource curse.

Oil as a Curse

While oil was initially viewed as a blessing for oil-exporting countries, Joseph Stiglitz echoes traditional literature when he points out "it appears that, on average, resource-rich countries have performed worse than those with smaller endowments."[36] Specifically, "countries benefiting from a wealth of natural resources have experiences on average a lower economic growth rate than resource-poor ones over the past 30 years."[37] What specifically do low levels of economic growth entail? To elaborate, instead of economic growth and prosperity Karl describes that oil-exporting countries have experienced the following ailments:

> Poor economic diversification, dismal social welfare indicators, high levels of poverty and inequality, devastating environmental impacts, rampant corruption, exceptionally poor governance, and high incidences of conflict and war.[38]

Why have oil-exporting countries been unable to translate their massive amount of revenues into sustained increases in economic growth and prosperity? One commonly cited culprit is the so-called "Dutch Disease" whereby non-oil exports become non-competitive thanks to the oil sector driving up the exchange rate of the local currency.[39] The model developed by W. Max Corden and J. Peter

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[35] Mommer 2002, 233.
[36] Stiglitz 2005, 13.
[37] Philippe Le Billon, "The Resource Curse", Adelphi Papers 45.373 (2005): 11-27.
[38] Karl 2005, 22.
[39] *Ibid.*

Neary in 1982 assumes two sectors in an economy: the tradable sector (natural resources, agriculture and manufacturing) and the non-tradable sector (services).[40] When the price of a natural resource significantly increases, it impacts the economy in two ways. The first is the "spending effect" whereby the additional revenue causes an increase in the demand and price of non-tradable goods over tradable agriculture and manufactured goods (lagging sector). However, since the prices of tradable goods are set internationally, they remain unchanged. This results in a decrease in exports of the 'lagging' sector and an increase in imports to meet the rising demand.

The second effect is the "resource movement effect", whereby the resource boom causes a shift in labor and capital towards the natural resource sector away from other sectors of the domestic economy. As a result, "Output declines in the non-resource economy, but by more in tradables, where prices are fixed at world market levels."[41] The combined result of both effects is the decline in output of the lagging export sector (manufacturing and agriculture) and the appreciation of the real exchange rate—increase in the price of non-tradable goods compared to tradable goods.[42] Ultimately, Dutch Disease is one explanation why oil-exporting countries' lack economic diversification.

Another popular reason for oil-exporting countries' demise is the incentive for rent-seeking behavior. In "rentier states", where the primary source of

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[40] Otaviano Canuto, Ekaterina Vostroknutova, Milan Brahmbhatt, "Dealing with Dutch Disease," Economic Premise 16 (2010): 1-7.
[41] *Ibid.*
[42] *Ibid.*

government revenue accrues from natural resource rents, the government is completely dependent on the rents rather than on the taxation of its citizens. "The massive flow of natural resource revenues into the fiscal coffers of the state engendered perverse political as well as economic effects…fostered corruption, weakened accountability and heightened incentives for rent-seeking."[43] Therefore, the very presence of rents along with oil-exporting countries' desire to increase such rents creates a viscous circle with the wealth ending up in the hands of a few (government) while the rest of the population is left out. Ultimately, resulting in 'rich countries with poor people'.

Painting a Clearer Picture

What Traditional Literature Overlooks

To better understand the limitations of traditional literature on oil-exporting countries, we begin by identifying the primary focus of the majority of literature. For starters, they all correctly identify the shift in bargaining power over the 20th century from the Majors, ultimately to the oil-exporting nations. Next, traditional analysis heavily focuses on the height of the oil-exporting countries' sovereignty when the abundant and plentiful oil revenues were perceived as a blessing and how these same revenues became a curse and ultimately led to the downfall of many oil-exporting nations. What is most interesting and prominent is how traditional literature is quick to put the blame on political institutions and governmental policies as the reason why oil revenues often turn into a curse. Karl is the main advocate of this sentiment and states:

[43] Dunning 2008, xv.

> That the petro-state depends on revenues generated by a depletable commodity, that this commodity produces extraordinary rents, and that these rents are funneled through weak institutions virtually ensure that the public sector will lack the authority and corporate cohesiveness necessary to exercise effective capacity.[44]

Hence, traditional literature on oil-exporting countries tends to concentrate on the fact that the revenues are channeled into the hands of the few elite, resulting in corruption and inequality.

However, traditional literature fails to ask the most fundamental questions of all: if the money is not being channeled back into the state and reaching the citizens, then where exactly is it going? Whereas traditional literature tends to focus solely on the dynamics between the national level and local communities, the answer to this key question requires a shift from a national-scale to a global perspective. Indeed, in this age of increasing globalization the majority of this money is flowing out of the state into the global financial markets.

Shift in Perspective

The widespread increase in globalization and financialization around the world highlights the emerging importance and influence of international markets rather than governments. Out of the traditional literature, Bernard Mommer is the only one to highlight this important shift. His analysis embodies this trend by asserting that consuming countries and exporting nations interact and compete for power via the international financial markets.[45] As a result, Mommer claims that

[44] Karl 2005, 58.
[45] Mommer 2002, 232.

we have entered a new phase where the sovereignty of oil exporting countries is being threatened and gradually taken away by consuming nations' dominance of the global financial markets.

Traditional literature on oil-exporting countries paints a rather dismal picture of oil-exporting countries' pasts and eminent futures. While Mommer's argument is a step in the right direction by acknowledging an international scope, he paints the same dismal picture as other traditionalists by overlooking the ways in which exporting countries can link to international markets and to consuming countries and thus retain bargaining power. Most importantly, he underestimates the potential wealth and strategic use of oil-exporting countries' revenues. Hence, Mommer makes the same detrimental mistake as other traditional literature by not exploring the actual flow of these petrodollars.

When the increasing role of global markets and financialization is taken into account it does not come as a surprise that a significant proportion of oil revenues is channeled out of the oil-exporting country and into global financial markets. In sum, Mommer and traditional literature overlook oil-exporting countries' potential to be taken seriously as independent sovereign players in the global financial arena. In fact, if traditional literature expanded their perspective to include international financial markets they would find that in reality, many oil-exporting countries have already started to use their wealth to their advantage and have successfully secured themselves a seat at the table with other major players in international finance.

SECTION 2

Introduction to Sovereign Wealth Funds

"Paradoxically, despite the prospects of wealth and opportunity that accompany the discovery and extraction of oil and other natural resources, such endowments all too often impede rather than further balanced and sustainable development."[46]

When viewed only in terms of a domestic perspective, the history and future prospects of oil-exporting countries appears to be extremely bleak. However, once the perspective shifts from a local level to an international scale the picture looks drastically different. Although the players are the same as in traditional literature (Oil Exporters vs. Consuming Nations), the advent of globalization and financialization has created a new environment for them to compete: international financial markets. "By definition, economic and financial globalization—in particular the expansion of trade—necessitates that governments cede some portion of their domestic autonomy to the global marketplace."[47] Furthermore, globalization and financialization has opened up flows of capital, ideas, technology and people via access to international markets. Is this just a case of the same story, but different setting? According to Bernard Mommer it is because the exporting nations are once again losing the battle for power due to consuming nations' dominance of the global markets. However, after a closer look at the breakdown of assets in the international financial

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[46] Jeffrey D. Sachs, Joseph E. Stiglitz Macartan Humphreys, Escaping the Resource Curse (New York: Columbia University Press, 2007) 1.
[47] Adam D. Dixon & Ashby H. B. Monk, "Rethinking the Sovereign in Sovereign Wealth Funds," 3 August 2010. <http://ssrn.com/abstract=1652701>. Last Accessed: 25 April 2011.

markets, it may be the consuming countries' hegemony that is now being threatened. After all, with billions of dollars in oil revenues it was only a matter of time before oil-exporting countries realized their own potential to compete with other major financial players.

How exactly are oil-exporting countries competing with other financial giants? The answer lies in the creation of an entirely new set of financial actors: Sovereign Wealth Funds (SWFs). SWFs are a missing piece to the traditional puzzle of 'rich countries with poor people'. They are the primary vehicles for petrodollar recycling and allow exporting countries to successfully link to international markets and to consuming countries. SWFs finally allow oil-exporting countries to regain a sense of sovereignty by not only controlling their own wealth, but also using it to their advantage. In conclusion, Sovereign Wealth Funds and the countries they represent should be taken seriously as independent sovereign players in the global financial arena.

This section will thus serve as an introduction to Sovereign Wealth Funds. Given that SWFs are a relatively obscure concept, it is necessary to begin with a brief overview of SWF basics. As it turns out, SWFs are a rather heterogeneous group so while it is worthwhile to mention the different types of SWFs, the remainder of the study will only concentrate on the Sovereign Wealth Funds located in oil-exporting nations. The next part of this section will examine the emergence and evolution of Middle Eastern SWFs as major players in international finance.

Sovereign Wealth Fund Basics

The Term Itself:

Since it is a relatively obscure concept in general, Sovereign Wealth Funds require a brief introduction. In fact, one reason why SWFs are a reasonably unknown topic is because the term *sovereign wealth fund* did not even exist until 2005 when Andrew Rozanov of State Street Global Advisors coined the expression in an article entitled: Who Holds the Wealth of Nations.[48] Another contributing factor to their ambiguity is that there is no real agreed upon definition. However, if forced to hone in on a single definition the one listed in the Generally Accepted Principles and Practices of the International Working Group of SWFs is the most official and concise definition. As stated:

> **"**SWFs are defined as special purpose investment funds or arrangements, **owned by the general government**. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve **financial objectives**, and employ a set of investment strategies, which include **investing in foreign financial assets**. The SWFs are commonly established out of **balance of payments surpluses**, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and**/or receipts resulting from commodity exports**."[49]

To further clarify the above definition, the words in bold signify key defining features of sovereign wealth funds. In sum, sovereign wealth funds are the investment arms of governments charged with the responsibility of recycling wealth from commodity revenues or balance of payment surpluses by investing in

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[48] Andrew Rozanov, "Who Holds the Wealth of Nations?," State Street Global Advisor (2005): 1-4.
[49] International Working Group of Sovereign Wealth Funds, "Sovereign Wealth Funds: Generally Accepted Principles and Practices "Santiago Principles"," 2008. My emphasis added.

foreign financial assets. The asset classes range from equities (**stocks**), fixed-income (**bonds**), real estate and alternatives (**derivatives** & **hedge funds**).[50]

Financial Resources:

Not all sovereign wealth funds are the same. In fact, it is a rather heterogeneous category. For simplification purposes, SWFs are typically classified by the following two characteristics: how the funds are financed and the function of the fund. The primary form of SWF taxonomy is according to where their funding comes from. In terms of financial resources, SWFs can be categorized into either a commodity fund or a non-commodity fund.

A sovereign wealth fund is a commodity fund if it receives its "financial resources from the export of raw materials owned by the state or from taxes/royalties related to their sale."[51] It does not come as a surprise that the most common form of commodity SWFs receive their financing from petroleum revenues. Thus, the majority of these funds are located in the Middle East, specifically in the same oil-exporting nations perceived to be doomed by the resource curse. Furthermore, commodity funds constitute the majority of SWFs at nearly 60%.[52] While the remainder of this study will be focused on this type of

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[50] Stock: ownership of a corporation represented by shares that signify a part of the corporation's assets and earnings. Bonds: Interest-bearing securities issued primarily by governments and companies and are regarded as a low-risk investment. Derivative: a financial security, like options and futures, whose value is derived in part from the value and characteristics of another underlying asset. Hedge Funds: aim to maximize their returns on investments by employing a range of risky techniques like speculation and hedging. Source: Harvey, Campbell R. "Stock." "Bond." "Derivative." "Hedge Fund." *Forbes Financial Glossary*. Forbes.com. Web. <http://www.forbes.com/tools/glossary/index.jhtml.> Last Accessed: 21 Apr. 2011.
[51] Curzio & Miceli 2010, 24.
[52] *Ibid.*

SWF it is worthwhile to mention the other type and all of the possible functions to gain a thorough understanding of the subject.

The other major genre of SWFs is the non-commodity funds, which receive their financial resources from "non-energy current account and other **balance-of-payments surpluses**[53] accumulated, as well as privatization revenues and other fiscal proceeds."[54] This type of SWFs is most prevalent in the East Asian countries that experienced rapid economic growth and massive balance of trade surpluses from exporting manufactured goods. These countries set up such funds as a way to manage their newfound wealth.

Multiple Functions:

Sovereign wealth funds can provide a wide variety of functions. After looking at a funds' financing the next step is to look at the function of the specific fund. To simplify, the International Monetary Fund categorizes SWFs according to five different purposes.

[53] When more money is flowing into a country from abroad than is going out of a country during the same time period. Source: "Balance of Payments." *Economic Terms A-Z.* The Economist Newspaper Limited. Web. <http://www.economist.com/research/economics/alphabetic.cfm?letter=B#balanceofpayments>. Last Accessed: 21 Apr. 2011.

[54] Curzio & Miceli 2010, 24.

The following table summarizes each function:

Stabilization Funds	**Savings Funds**	**Reserve Investment Corporations**	**Development Funds**	**Pension Reserve Funds**
Stabilize and insulate fiscal policies from fluctuations in the prices of raw materials	Convert non-renewable resources into financial wealth for the benefit of future generations	These assets are counted as official reserves, but are managed separately and more aggressively	Finance socio-economic development projects	Use sources other than normal pension schemes in order to ease pension indebtedness

Adapted from: Alberto Quadrio Curzio & Valeria Miceli, Sovereign Wealth Funds: A Complete Guide to State-Owned Investment Funds (Harriman House LTD, 2010) 25.

It is important to note that both commodity and non-commodity sovereign wealth funds can and often utilize a combination of the aforementioned motives. In general, commodity SWFs tend to exhibit stabilization & savings functions while non-commodity SWFs tend to be more aligned with reserve investment corporations. Lastly, development and pension reserve funds have been observed in both commodity and non-commodity funds. This study will elaborate further on the stabilization and saving functions in the next section and discuss development funds in the final section.

When looking at the wide variety of definitions, functions and classifications of sovereign wealth funds it is obvious that their heterogeneity is a large contributor to their ambiguity. For the purpose of looking at the evolution of oil-exporting nations in the Middle East, the most relevant type of sovereign wealth funds are commodity funds. Thus, the following section will elaborate of the evolution of such funds and how they fit into and extend the oil-exporting nations' battle for sovereignty.

Rise of Sovereign Wealth Funds in the Middle East

Now that the concept of sovereign wealth funds has been introduced, it is time to return to the evolution of oil-exporting nations in the Middle East, insert sovereign wealth funds into the equation and observe the effects on their struggle for sovereignty. More specifically, will the addition of sovereign wealth funds project the same dismal outcome as depicted in traditional literature or will it reveal a more optimistic reality?

Emerging from the Shadows: 1953 - 2002

The creation of the Kuwait Investment Authority (KIA) in 1953 can be viewed as the origins of the concept of sovereign wealth funds even though the official terminology was not coined for another fifty-three years. KIA was established in order to "invest surpluses derived from oil revenues so as to reduce Kuwait's dependence on exhaustible fossil reserves, thus lessening the effects of price oscillation."[55] This quote captures the essence of oil-based sovereign wealth funds. Sovereign wealth funds gave oil-exporting nations a way to convert revenues from a non-renewable source (oil) into renewable financial assets (primarily low risk assets like treasury bonds).

Another way to look at the rise of Middle East-based sovereign wealth funds is by looking at the strong correlation between the rise in the price of oil

[55] Curzio & Miceli 2010, 4.

and the number of funds established.[56] The first significant price increase was between the 1970s and 1980s when the price increased from less than $5 a barrel to more than $35.[57] This is referred to as the golden years, as previously mentioned, when oil-exporting countries experienced a rapid accumulation of wealth and literally had more money than they knew what to do with. Initially, OPEC countries "expanded domestic spending by about 50% a year between 1974 and 1979, enriching the elite, but spawned white-elephant projects and fuelled inflation of more than 15% a year."[58] As previously mentioned, since the price of oil is set in terms of US dollars, oil-exporting countries accumulated massive reserves of US dollars while the purchasing power of the domestic currency was eroded.

However, when observed more closely some countries started to reverse this inflationary trend by accumulating foreign assets signaling evidence of foreign direct investment. "Revenues were partially spent domestically, with the resulting push of domestic inflation. Consequently oil revenues were increasingly allocated to foreign direct investment."[59] In short, by focusing only on the domestic picture, the traditional literature fails to see the increasing proportion of oil revenues that were actually flowing outside the country. By creating a vehicle to manage foreign direct investment (SWFs), rentier states found a way seek insulation from price volatility by diversifying their economies away from oil.

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[56] A graph of the history of world oil prices along with a list of the specific SWFs established can be found in the appendix.
[57] Curzio & Miceli 2010, 5.
[58] The Economist, "The Devil's Excrement: is oil wealth a blessing or a curse?," The Economist (2003).
[59] Curzio & Miceli 2010, 6.

The time to test the ability of sovereign wealth funds to help protect oil-exporting nations from oil price volatility came with the price collapse in the 1980s when the price of oil fell to below $20 a barrel. Following the oil booms of 1973 and 1979 the high price of oil led to a reduction in demand and ultimately overproduction. At first, OPEC tried cutting production in order to maintain the high prices. Ultimately, they were unable to maintain the high price of oil and in 1986 world oil prices fell over 50%.[60] "These downward price fluctuations reinforced the belief of governments running SWFs that their income should not depend solely on oil and natural gas."[61] Hence, more countries started creating SWFs in order to provide stabilization during price fluctuations.

During the first phase in the rise of sovereign wealth funds, SWFs got off to a slow start. Between 1953 and 2002, only 27 funds were established.[62] Before they emerged as financial giants, they were extremely passive and conservative in their investment strategies. For instance, their portfolios were comprised entirely of low-risk (and thus low-yield) US government securities. Thus, their low-profile persona during this first period kept them hidden in the shadows.

However, the increasing globalization in the 1990s further facilitated and encouraged investment in the international financial markets. "The globalization of the world economy has made it dramatically easier for investors around the

[60] EIA 2007, 11.
[61] Curzio & Miceli 2010, 6.
[62] *Ibid.*

world to get in the game."[63] During the next phase in the rise of Middle Eastern SWFs, this is exactly what they did: get in the game. Between 1998 and 2004 twelve more sovereign wealth funds were established. Considering the surge in the price of oil from less than $20 at the end of 1998 to $40 a barrel in 2004 and total assets held by SWFs estimated at $895 billion by 2004, it comes as no surprise that sovereign wealth funds started to gain attention.[64]

In the Spotlight: 2005 - 2009

Once again, because of an increase in the price of oil from $60 a barrel in 2005 to $147 in 2008 the value of SWFs' assets multiplied.[65] Furthermore, 19 more SWFs were established during just these four years. Although the number of sovereign wealth funds and the value of their assets increased exponentially, their behavior remained relatively the same until 2005. Up until this point in time, SWFs "tended to invest very conservatively, tended to invest close to home, and tended to invest in emerging economies."[66] The year 2005 marks two significant changes in the investment patterns of SWFs, namely in the recipients of their investments and the size of their transactions.

As previously mentioned, all SWFs tended to invest close to home, particularly in Asia. "In dollars, from 1994 to 2004, SWFs invested just under

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[63] Richard Goldberg, The Battle for Wall Street: Behind the Lines in the Struggle that Pushed an Industry into Turmoil (Hoboken: John Wiley & Sons, Inc., 2009) 9.
[64] Curzio & Miceli 2010, 9.
[65] Curzio & Miceli 2010, 10.
[66] Veljko Fotak, William Megginson, William Miracky Bernado Bortolotti, Sovereign Wealth Fund Investment Patterns and Performance (Milano: Fondazione Eni Enrico Mattei, 2009)10.

US$15 billion in Asia and less than US$1 billion elsewhere."[67] However, after 2005 SWFs shifted their investment strategies and found more opportunities to invest their massive amounts of wealth in the United States and Europe. "In 2008, only US$3.5 billion was destined for Asia, US$11 billion to the EU, US$30 billion to the United States and US$1.5 billion to other countries."[68] The increased emphasis on investing in Western nations took SWFs from the shadows to front and center on the world stage.

In addition to turning their attention to the Western hemisphere, sovereign wealth funds specifically took a keen interest in the financial sector. At first, western institutions were hesitant to receive investments from SWFs due to their relatively unknown nature and fear of a foreign entity controlling domestic institutions. As noted in the Economist, "In principle everyone welcomes foreign investment. But when the money belongs to other governments, people—especially politicians—are not always so sure."[69] However, with the onset and height of the financial crisis in 2007-2008, attitudes from the West towards SWFs drastically changed most likely out of desperation. As Richard Goldberg highlights, "meaningful pools of liquidity are out there in the form of petrodollars and sovereign wealth funds."[70] With the West suffering from a **liquidity**[71]

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[67]Curzio & Miceli 2010, 11.
[68] *Ibid.*
[69] The Economist, "Asset-Backed Insecurity," The Economist (2008).
[70] Goldberg 2009, 14.
[71] The degree to which an asset can be exchanged for cash (liquidated). Cash is the most liquid asset while more complex financial instruments like derivatives are considered much less liquid. Source: "Liquidity." *Economic Terms A-Z.* The Economist Newspaper Limited. Web. <http://www.economist.com/research/economics/alphabetic.cfm?term=liquidity#liquidity>. Last Accessed: 21 Apr. 2011.

drought and SWFs swimming in an endless sea of money the solution seemed obvious. As a result, "from 'barbarians' they became lenders of last resort for the shaky financial sector."[72]

The numerous high profile deals between SWFs and major Western financial institutions signifies the successful evolution of SWFs from relatively unknown entities to major players in the world of international finance. More important, after years of struggling to emerge from the shadow and dominance of the West, the rise of sovereign wealth funds as major financial players has given oil-exporting nations a new found sense of sovereignty and bargaining power. Due to the heterogeneous nature of SWFs, it is necessary to further narrow our focus in order to better assess the role of oil-exporting sovereign wealth funds. Hence, the next section will take a closer look at the three most prominent SWFs in the Middle East in terms of their participation in global financial markets.

[72] Curzio & Miceli 2010, 13.

SECTION 3

The Major Players in International Financial Markets

"Around 45% of SWFs came from oil rich countries at the end of 2007. This is a clear indication of the magnitude and the financial power of the GCC (Gulf Corporation council) originated SWF. Despite the relatively smaller GDPs and economies compared to the industrialized nations, GCC has an extensive financial power."[73]

On May 25th 1981, Kuwait, Oman, Bahrain, Qatar, Saudi Arabia and the United Arab Emirates came together to form the Gulf Corporation Council (GCC) in order to foster cooperation and unity among Member States.[74] Between 2004-2007, the countries constituting the GCC collectively invested approximately $140 billion overseas.[75] To put this number into perspective, it is estimated that GCC originated SWFs have assets ranging between US$980 billion and US$1,478 billion.[76] These impressive numbers, coupled with the numerous high profile investments in Western financial institutions, signified the transition of Middle Eastern sovereign wealth funds from relatively unknown entities to frontrunners in the global financial markets.

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[73] Mehmet Asutay, "GCC Sovereign Wealth Funds and Their Role in the European and American Markets," Equilibri 12.3 (2008): 335-354.
[74] The GCC Charter states that the basic objectives are to effect coordination, integration and inter-connection between Member States in all fields, strengthening ties between their peoples, formulating similar regulations in various fields such as economy, finance, trade, customs, tourism, legislation, administration, as well as fostering scientific and technical progress in industry, mining, agriculture, water and animal resources, establishing scientific research centers, setting up joint ventures, and encouraging cooperation of the private sector.
Source: The Cooporation Council for the Arab States of The Gulf, Foundations and Objectives, <http://www.gcc-sg.org/eng/index895b.html?action=Sec-Show&ID=3>.) Last accessed April 17, 2011.
[75] Nimrod Raphaeli & Bianca Gersten, "Sovereign Wealth Funds: Investment Vehicles for the Persian Gulf Countries," Middle East Quarterly (2008): 45-53.
[76] Curzio & Miceli 2010, 49.

While GCC sovereign wealth funds were extremely active and successful in 2007, they started to suffer along with the rest of the financial world with the onset of the financial crisis at the end of the year. "GCC countries suffered during the 2007-2009 crisis because of the fall in the price of oil, the tightening of international credit conditions, the collapse of the real estate market and the increased vulnerability of domestic banks."[77] Just as the failure of many US financial institutions during the financial crisis spurred debate and harsh critique of the banking industry, the losses incurred by GCC SWFs hurled them into a very similar situation.

This section will present a more in-depth look at the main GCC sovereign wealth funds and their participation in global financial markets. While the previous section served as a brief introduction to SWFs, in order to asses the potential impact of the funds on global financial markets three of the key GCC SWFs will be examined in detail. The three key GCC sovereign wealth funds we will look at are: The Kuwait Investment Authority (KIA - the oldest SWF), The Abu Dhabi Investment Authority (ADIA - the largest SWFs), and The Qatar Investment Authority (QIA - the new comer). The next part of this section will look at both sides of the debate concerning SWFs' role and impact on global financial markets as well as the funds' response.

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[77] *Ibid.*

Case Studies of the Main Middle Eastern SWFs

The following case study will provide a more detailed picture of the inner workings of the three main GCC sovereign wealth funds targeting international markets. For each of the three funds the following aspects will be taken under consideration: history of the fund, mission statement & objectives, investment strategy & portfolio characteristics, and high profile transactions.

Kuwait Investment Authority: The Oldest SWF

History

Kuwait was the first country to realize the importance of transforming oil wealth from a depleting asset into renewable financial assets. In 1953 the Kuwait Investment Board was created to fulfill this goal. Although the actual SWF, the Kuwait Investment Authority (KIA), was not created until 1982, the investment board managed the assets of Kuwait in the same fashion as a sovereign wealth fund. Hence, this is why KIA is considered the oldest sovereign wealth fund.[78]

Today, KIA is comprised of two main funds: the General Reserve Fund (GRF) and the Future Generations Fund (FGF).[79] While the General Reserve Fund is the recipient of state oil revenues, the Fund for Future Generations is only

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[78] Mauro F. Guillén, "The Brave New World of Sovereign Wealth Funds," Wharton Leadership Center and the Joseph H. Lauder Institute of Management & International Studies (2010): 1-69. Web. <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2499>. Last Accessed: 22 Apr. 2011.

[79] Bader M. Al Sa'ad, "Overview on the Kuwait Investment Authority and Issues Related to Sovereign Wealth Funds," Speech. First Luxembourg Foreign Trade Conference. Luxembourg. 9 Apr. 2008. Web. <http://www.kia.gov.kw/En/Press_Room/Speach_MD/Pages/default.aspx>. Last Accessed: 22 Apr. 2011.

to be touched in the event of a state emergency. "The government invests 10% of all state revenues, including 10% of the income earned by the General Reserve Fund, every year into the Fund for Future Generations."[80] Overall, KIA acts as an asset manager and the funds belong to the state. The estimated value of KIA's assets under management is US$295 billion.[81]

Mission

KIA's mission as stated by managing director, Mr. Bader M. Al Sa'ad, is "to achieve a long term investment return on the financial reserves entrusted by the State of Kuwait to the Kuwait Investment Authority by providing an alternative to oil reserves, which would enable Kuwait's future generations to face the uncertainties ahead with greater confidence." [82]

Investment Strategy

KIA has historically been a very conservative investor, preferring low risk US debt securities—Treasury bills, notes and bonds—to all other asset classes. The fund's investment strategy remained mostly unchanged until 2004 when Bader al Sa'ad took over as managing director. He discovered many comparisons between KIA and Ivy League endowment funds, mainly that they both had long-term horizons and conservative methods except that the latter was experiencing higher rate of returns. The difference was that the endowment funds

[80] Guillén 2010, 31.
[81] Bernardo Bortolotti, Velijko Fotak, William Miracky Victoria Barbary, "Sovereign Wealth Fund Investment Behavior Semi-Annual Report," 2010, 29. Web. <http://www.feem.it/userfiles/attach/2010102015964Monitor-FEEM_SWF_ReportH1-2010.pdf>. Last Accessed: 25 Apr. 2011.
[82] Bader M. Al Sa'ad 2008, 2.

were investing in real estate, **private equity**[83], hedge funds and emerging markets while KIA was not.[84] Hence, KIA increased its portfolio allocations in equities, "alternative instruments (private equity, hedge funds and derivatives) and its exposure to emerging markets, at the same time reducing US debt securities."[85] KIA's current portfolio allocation is 55-65% equities, 8-12% bonds, 8-12% real estate and alternative assets and cash at 3-7%.[86]

KIA also pursues a strategy of diversifying investments geographically. It is estimated that KIA aims to invest 76-86% equally between the United States and Europe, 13-17% in Asia and Japan and 4-6% in emerging markets.[87] Furthermore, about 50% of its investments are managed by external fund managers in order to remain passive investors and avoid taking too large of a controlling stake in a company.[88] Another aspect supporting their passive approach to investing is that they are not allowed to use leverage - the practice of borrowing money to raise additional capital.[89]

High Profile Transactions

Evidence of the strength and resiliency of KIA is exemplified by two of its most prominent assets: British Petroleum and Daimler AG, the German car

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[83] When a firm's shares are held privately and not traded in the public markets. It is less liquid than publicly traded equity so investors can earn a higher rate of return because of the increased risk. Source: "Private Equity." *Economic Terms A-Z.* The Economist Newspaper Limited. Web. <http://www.economist.com/research/economics/alphabetic.cfm?letter=P#privateequity>. Last Accessed: 21 Apr. 2011.
[84] Guillén 2010, 41.
[85] Curzio & Miceli 2010, 49.
[86] *Ibid.*
[87] Bortolotti, Fotak, Miracky, Barbary 2010, 29.
[88] Curzio & Miceli 2010, 49.
[89] *Ibid.*

manufacturer. KIA's 7.1% stake in Daimler AG dates back to 1969 and even when the company suffered losses due to the failed acquisition of Chrysler in 1998, KIA maintained its stake in the company.[90] Furthermore, in response to the British Prime Minister at the time, Margaret Thatcher's call for privatization in the late 1980s, KIA increased its stake in BP to 22%.[91] However, this sparked great concern regarding KIA's motives and although KIA asserted that it would not to play a controlling role in BP it agreed to reduce its stake to 3.3%. KIA's investment in Daimler AG demonstrates its ability to maintain long-term investments and its willingness to appease political pressures is evident in the case of BP.

Now we turn to some of KIA's more recent investments. As two of the largest US financial institutions, Citigroup and Merrill Lynch, were rapidly being engulfed by the financial crisis, they desperately sought liquidity injections to stay afloat. Where did they turn? They went to sovereign wealth funds like the Kuwait Investment Authority. In January 2008, KIA invested nearly $3 billion in Citigroup and $2 billion into Merrill Lynch prior to Merrill's takeover by Bank of America.[92] KIA was expected to wait for its **preferred shares**[93] to **convert**[94] into

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[90] Sven Behrendt, "When Money Talks: Arab Sovereign Wealth Funds in the Global Public Policy Discourse," Carnegie Papers 12 (2008): 1-25.
[91] *Ibid.*
[92] Eric Dash, "Big Paydays for Rescuers in the Crisis," 6 December 2009, The New York Times. Web. <http://www.nytimes.com/2009/12/07/business/global/07bank.html>. Last Accessed: 13 February 2011.
[93] A security that shows ownership in a corporation and gives the holder a claim on earnings and assets in the event of liquidation, *prior* to the claim of common stock holders. Source: Harvey, Campbell R. "Preferred Stock." *Forbes Financial Glossary*. Forbes.com. Web. <http://www.forbes.com/tools/glossary/search.jhtml?term=preferred_stock.> Last Accessed: 21 Apr. 2011.

common stock in accordance with their long-term passive strategy. However, in December of 2009, less than two years after the deal was brokered, KIA decided to sell its stake in Citigroup for about $4.1 billion, resulting in a profit of $1.1 billion.[95] Along with the profit came attention from the media, politicians and market experts.

Abu Dhabi Investment Authority: The Largest SWF

History

After the rise in oil prices in 1970s, in 1976 Sheikh Zayed bin Sultan Al Nahyan replaced a part of Abu Dhabi's department of finance known as the Financial Investments Board with the Abu Dhabi Investment Authority (ADIA), in an effort to preserve the future wealth of Abu Dhabi. Seeing as the fund is an oil-based commodity fund, it receives its financial resources from dividends transferred by the Abu Dhabi National Oil Company (ADNOC) into the fund: 70% of any budget surplus.

The value of the fund's assets has been estimated to be between US$282 billion and US$627 billion.[96] As is the case with most sovereign wealth funds, it is difficult to give an exact estimate of the fund's assets because the fund does not disclose this information to the public. However, ADIA took a step towards greater transparency last year when they published their first ever-annual review.

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[94] A security that can be converted into common stock at the option of the security holder and includes convertible bonds and convertible preferred stock. Source: Harvey, Campbell R. "Convertible Security." *Forbes Financial Glossary*. Forbes.com. Web. <http://www.forbes.com/tools/glossary/search.jhtml?term=convertible_security.> Last Accessed: 21 Apr. 2011.
[95] *Ibid.*
[96] Curzio & Miceli 2010, 51.

Although it does not contain the overall size of its holdings or specific balance sheet details, it does provide helpful insight in terms of their general investment strategy.

Mission

As stated in ADIA's 2009 annual review, "The Abu Dhabi Investment Authority is a globally-diversified investment institution whose sole mission is to invest funds on behalf of the Government of the Emirate of Abu Dhabi to make available the necessary financial resources to secure and maintain the future welfare of the Emirate."[97]

Investment Strategy

ADIA carries out this mission by maintaining a diversified portfolio across geographies, sectors and asset classes including public listed equities, fixed income, real estate, and private equity. As stated in their 2009 annual review, "ADIA's investment strategy involves looking beyond individual economic cycles and focusing on strategies aimed at capturing secular trends and outperforming the market over the long term."[98] Furthermore, ADIA's decisions are based purely on its economic objectives of delivering sustained long-term financial returns and ADIA does not seek active management of the companies it invests in.[99]

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[97] Abu Dhabi Investment Authority, "ADIA Annual Review 2009," 1-28. Web. <http://www.adia.ae/En/pr/Annual_Review_Website2.pdf>. Last Accessed: 25 Apr. 2011.
[98] *Ibid.*
[99] *Ibid.*

ADIA's mission and general investment strategy as stated above has remained relatively unchanged for over thirty years and has greatly attributed to its success and reputation as the largest and most renowned sovereign wealth fund in the world. When ADIA was first established in 1976, it was primarily focused on equities and bonds, treasury, finance and administration, real estate and local and regional investments.[100] Up until the early 1990s the fund's investment strategy was vigilant and conservative meaning that they invested primarily in low-risk liquid assets like treasury bills and avoided high profile investments.

Eager to seek out higher returns, ADIA started to pursue a more aggressive approach by diversifying across asset classes. As a result, by 2000 ADIA aimed for a portfolio of: stocks in developed markets (45-55%); stocks in emerging markets (8-12%); **small-cap stocks**[101] (1-4%); government bonds (12-18%); corporate and other bonds (4-8%); Alternative investments (5-10%); real estate (5-10%); private equity (2-8%); infrastructure (0-4%); and cash (0-5%).[102] Furthermore, ADIA also continued to diversify the geographic distribution of their investments: 35-50% in North America, 25-35% in Europe, 15-25% in emerging markets and 10-20% in developed Asia.[103]

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[100] *Ibid.*
[101] Refers to stocks with a relatively small market capitalization. The exact definition can vary, but generally it is a company with a market capitalization of between $300 million and $2 billion. Source: "Small-Cap." *Investopedia Dictionary*. Investopedia. Web. <http://www.investopedia.com/terms/s/small-cap.asp>. Last Accessed: 21 Apr. 2011.
[102] Rawi Abdelal, "Sovereign Wealth in Abu Dhabi," Geopolitics 14.2 (2009): 317-327.
[103] Bortolotti, Fotak, Miracky, Barbary 2010, 29.

High Profile Transactions

Even with a more diverse portfolio, ADIA's low profile investment strategy remained under the radar until November 2007 when ADIA emerged to the public by purchasing 4.9% of Citigroup, the failing Wall Street Bank, for an estimated $7.5 billion. As one of the largest deals ever pursued by a sovereign wealth fund, this can be considered the catalyst that catapulted SWFs into the spotlight. The deal specified that sometime between March 2010 and September 2010 ADIA would convert its shares into common stock at a price between $31.83 and $37.24 with an annual **coupon**[104] of 11%.[105] However, not everything went according to plan and Citigroup stock plummeted to a low of 3.41 per share. Unlike KIA, ADIA did not have the option to convert from preferred to common stock at any time it pleases to cut its losses. Hence, ADIA is now looking at up to a $4.8 billion **paper loss**[106] when it is forced to convert to shares at a price almost 10 times higher than its current value. Although KIA ended up with a profitable deal with Citigroup, this potential loss has also hurled ADIA into the spotlight right next to KIA.

[104] The periodic interest payments made to the bondholder during the life of the bond. Source: Harvey, Campbell R. "Coupon." *Forbes Financial Glossary*. Forbes.com. Web. <http://www.forbes.com/tools/glossary/glossary.jhtml?letter=C>. Last Accessed: 21 Apr. 2011.

[105] Abdelal 2009, 320.

[106] Unrealized capital loss on securities held in a portfolio, based upon a comparison of the current market price to the original cost. Source: Harvey, Campbell R. "Paper Loss." *Forbes Financial Glossary*. Forbes.com. Web. <http://www.forbes.com/tools/glossary/glossary.jhtml?letter=P>. Last Accessed: 21 Apr. 2011.

Qatar Investment Authority: The New Comer

History

Out of the three major funds discussed, the Qatar Investment Authority is the most recent addition to the group of GCC sovereign wealth funds. QIA was founded by the Qatari Government in 2005 and headed by the country's prime minister, Sheikh Hamad bin Jassim as-Thani. "Qatar has huge gas reserves as much as one third of the world's total gas reserves lies within its territory."[107] The Prime Minister recognized the nation's rapid accumulation of wealth and made it a priority to preserve these funds for future generations. The fund is currently estimated to manage US$70 billion dollars,[108] which may appear small in comparison to KIA and ADIA, however QIA is making up for lost time with a series of high profile investments.

Mission

QIA's mission, as defined on the company website, is to "secure the future prosperity of its people by building up a diversified asset base to complement its wealth of natural resources."[109] With one of its main goals being economic diversification, the fund is looking to further develop the country's infrastructure, education and health facilities. This strong emphasis on economic diversification makes QIA stand out a bit from more traditional SWFs like ADIA and KIA and has led to a slightly different investment strategy as well.

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[107] Qatar Investment Authority, Economic Backdrop of Qatar, <http://www.qia.qa/QIA/about.html#history>. Last Accessed: 25 Apr. 2011.
[108] Bortolotti, Fotak, Miracky, Barbary 2010, 29.
[109] Qatar Investment Authority, Mission , <http://www.qia.qa/QIA/about.html#Mission>. Last Accessed: 25 Apr. 2011.

Investment Strategy

QIA's general investment strategy is similar to that of KIA's and ADIA's in that it also carries out its mission by building a strong global portfolio diversified across asset classes and geographies. "Although the QIA was formed as recently as 2005, it has already built up a strong track record of diversified investments, ranging from listed securities, property, alternative assets and private equity as well as local strategic sectors."[110] Although exact percentage breakdown of QIA's portfolio is not available to the public, the fund mainly invests in equities, fixed income, private equity and direct investment in order to diversify its oil and natural gas wealth. Falling in line with KIA and ADIA, QIA invests all around the world with investments in The United States, Europe and Asia. Finally, QIA is also driven by strict commercial and financial motives in order to secure its reputation as a world-class financial investor.

High Profile Transactions

While KIA and ADIA started off as extremely passive and conservative investors and gradually expanded their appetite for risk, QIA came out of the gate in full force. It has gained significant attention in such a short time span by pursuing several high profile deals simultaneously. The first mega deal that brought QIA into the spotlight came only two years after their creation with the purchase of a 20% stake in the London Stock Exchange for US$2 billion dollars in September 2007.

A statement from QIA states:

> This is a key investment for Qatar Holding and QIA, and one that it intends to hold for the long term. The QIA group sees itself as a shareholder that will provide stability and support for the Board's strategy of developing further its business and thereby reinforce the City of London's position as the world's top global capital market.[111]

The next flashy deal came in 2008 when Barclays, a British bank suffering from losses, decided to seek new funds by issuing $8.9 billion of new shares. QIA purchased the new shares along with other institutional investors. In a similar fashion to KIA, QIA later decided to sell a $2.1 billion stake in the British bank and come out with a profit around $985 million.[112] Ironically, QIA made a quick turn around with this profit and channeled it into a US$3.7 billion investment in the British supermarket chain, Sainsbury. With so many high profile deals on the table, it is evident that QIA is pursuing a more aggressive investment strategy than its predecessors with hopes of becoming just as successful.

Traditional vs. Progressive Sovereign Wealth Funds

With the sharp increases in oil prices in the 1970's and again in the early 2000's two generations of sovereign wealth funds have emerged. The group of SWFs established in the 1970s, including KIA and ADIA, are considered to be

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[111] Qatar Investment Authority, "Statement by the Qater Investment Authority," 20 September 2007, Wall Street Journal, <http://online.wsj.com/public/resources/documents/Qatar_statement.pdf>. Last Accessed: 25 Apr. 2011.

[112] Thomson Reuters, "Qatar's Barclays Stake Sale Stokes Sainsbury Talk," 20 October 2009, Forbes.com, <http://www.forbes.com/feeds/afx/2009/10/20/afx7018856.html>. Last Accessed: 25 Apr. 2011.

traditional SWFs in that they adhere to a conservative, passive and relatively low profile investment strategy. In contrast, the second generation of SWFs, like QIA, have emerged full force with a higher preference for risk and flashy investments. A report by the consulting firm, Monitor, observed this phenomenon: "These new funds have tended to take a more active investment approach, borrowing to invest in high-profile assets, rather than relying on their own capital accumulations."[113] This is otherwise known as leverage, a practice that traditional sovereign wealth funds steer away from due to the higher exposure to risk. The trend of moving from a conservative to an aggressive position in the markets was not limited to sovereign wealth funds. In fact, the increasing financialization between 1990s and 2000s led to an overall increase in the appetite for risk for all investors. This behavior is especially typical during a period of economic boom.

When comparing the two traditional sovereign wealth funds, KIA and ADIA are roughly 90% identical.[114] They both pursue long-term, relatively conservative approaches seeking high returns, but without directly investing in companies and without seeking controlling stakes or board representation in a company. They both make their investments by using external account managers. One slight difference is that KIA prefers to invest in funds of hedge funds while ADIA typically invests directly in hedge funds. In contrast, newer funds are seeking to take a more active and aggressive approach by making large investments directly in high profile companies with the hope of achieving even higher returns.

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[113] Guillén 2010, 42.
[114] *Ibid.*

Regardless of the type of investment strategy, what has become evident is that both traditional and newer sovereign wealth funds have acquired a preference for high profile investments in major Western companies, especially financially troubled ones. Such investments have catapulted SWFs from the shadows and into the public spotlight and consequently ignited a debate regarding their role and impact on global financial markets. The next section will take a closer look at both sides of this heated debate, specifically whether or not sovereign wealth funds are a stabilizing or destabilizing force on the international financial markets.

SECTION 4

Potential Impact of Sovereign Wealth Funds on Global Financial Markets

Sovereign wealth funds' emergence as major financial players did not progress gradually over their fifty plus years of existence, rather this phenomenon has come into fruition quite rapidly only over the past decade. Although SWFs started to engage and participate in the global financial markets in the early 2000s, it was not until the onset of the financial crisis that their prowess was actually recognized:

> During 2007-2008, called upon by Western governments and institutions, they initially helped both their public image and the struggling economies of Western nations by contributing to recapitalize their crisis-stricken banks and by investing in important but troubled financial companies.[115]

The ability of a foreign entity to rescue some of the most prominent Western financial institutions that could not save themselves, secured SWFs a position at the table of the major financial players of the world. At the same time, it also caught the attention of Western governments, media and the general public and consequently ignited a debate regarding the impact of sovereign wealth funds on global financial markets. More specifically, the debate boils down to the question of whether or not sovereign wealth funds act as a stabilizing force or destabilizing force on international markets. This section will explore both sides

[115] Curzio & Miceli 2010, xii.

of the debate, the general consensus and finally the reactions of sovereign wealth funds.

Sovereign Wealth Funds as Stabilizing Forces

Generally speaking, financial markets and economies experience periods of stability intertwined with phases of booms and busts. Over the past century we have seen an example of this phenomenon with a period of general stability from 1933 - 1973 and the economic boom in the mid 1990s-mid 2000's followed by the onset of the global financial crisis in 2007. The evident cyclical nature of the financial markets creates an opportunity for the major market players to decide how they want to react.

Typically, financial actors practice pro-cyclical behavior meaning that when times are good, they like to ride it out and get the most out of the boom as they can. For instance, when interest rates rise in a boom, banks more often than not decrease excess reserves in order to turn the reserves into profitable assets by extending more loans or making further investments. In terms of the recent financial crisis, the over eagerness of banks to extend loans was great news for those who needed credit the most, but who were the least likely to get it. "Readily available credit enabled many consumers with poor credit scores to obtain mortgages, classified as "subprime" because they were considered to be in the riskiest category of loans."[116] Most of these loans were **adjustable rate**

[116] Guillén 2010, 43.

mortgages[117] (ARMs) because with the steadily increasing housing prices, ARMs gave subprime borrowers the incentive to refinance at more attractive rates. However, as housing prices started to decline in 2006 these subprime borrowers were unable to repay their loans to the banks and many major providers of subprime loans started to collapse because they did not have enough reserves to cover the losses.

In addition, the subprime crisis also highlighted the dangers of another financial practice known as **securitization.**[118] In the case of subprime mortgages, securitization was the practice whereby after the banks issued a mortgage they would turn around, repackage it and sell it as a mortgage-backed security. Essentially, securitization allows for a bank to transform a liability into a moneymaking asset. Once these original sub-prime mortgages started to default, investors around the world started to question the stability of the US financial system and their mortgage-backed investments and started to retreat. As a result,

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[117] A mortgage that features predetermined adjustments of the loan interest rate at regular intervals based on an established index. Source: Harvey, Campbell R. "Adjustable Rate Mortgage." *Forbes Financial Glossary*. Forbes.com. Web. <http://www.forbes.com/tools/glossary/glossary.jhtml?letter=A>. Last Accessed: 21 Apr. 2011.

[118] Turning a future cashflow into tradable, bond-like securities. The benefits of securitization include: issuers gain instant access to money for which they would otherwise have to wait months or years, and they can shed some of the risk that their expected revenue will not materialize. Sellers, like investment bank, are able to finance their customers without tying up large amounts of capital and investors gain the risk-reducing benefit of diversification by holding this new sort of asset. However, the risk is that the future cashflow underlying the securities may flow earlier or later than promised, or not at all. Source: "Securitisation." *Economic Terms A-Z*. The Economist Newspaper Limited. Web. <http://www.economist.com/research/economics/alphabetic.cfm?letter=S#securitisation>. Last Accessed: 21 Apr. 2011.

credit started to dry up, banks were no longer able to extend loans and the system as a whole was in desperate need of liquidity. Where did troubled banks and institutions find massive pools of liquidity when they were in need? Sovereign wealth funds.

Anti-Cyclical Behavior

One of the key differences between sovereign wealth funds and other major investment vehicles, and the reason why they were able to rescue failing western institutions, boils down to their unique investment strategy. "SWFs are recognized as contributing to the stability of the financial system due to their long-term horizons, the greater diversification of their portfolios, their average low level of indebtedness and the absence of liquidity risks."[119] Unlike Western banks that are more focused on making a profit based on short-term trends, SWFs are able to withstand crises because they are more interested in long-term trends rather than cycles of booms and busts. As a matter of practice, SWFs invest in all types of asset classes as well as geographic locations, so if one asset class goes bust (like subprime mortgages) the other assets will be able to insulate the fund. Furthermore, as demonstrated by KIA and ADIA, SWFs typically do not engage in leveraging their assets, unlike the overleveraged banks in the US and thus do not have to worry about an absence of liquidity.

All of the aforementioned elements of SWFs' unique investment strategy have allowed sovereign wealth funds to inherently engage in anti-cyclical

[119] Curzio & Miceli 2010, 122.

behavior. Meaning that, "they are well placed to withstand market pressures in times of crisis, contribute to stabilizing financial markets and provide new sources of liquidity for global capital markets."[120] SWFs are anti-cyclical in this way because in times of crisis, when the majority of financial markets are sucked dry of credit and liquidity, SWFs are still able and willing to invest in these troubled institutions, rather than hibernating and waiting for a boom period to make a move.

This exact behavior was exhibited in 2008 when SWFs made capital injections into failing Western banks, "providing sought-after liquidity and contributing to easing financial market turmoil."[121] Furthermore, as Richard Goldberg asserts it in his book, *The Battle for Wall Street,* "sovereign wealth funds are international capital dealers-open for business, open to all takers."[122] The majority of Western financial institutions do not practice the same investment strategies as SWFs and are thus unable to demonstrate anti-cyclical behavior. In retrospect of the financial crisis, the inherent anti-cyclical nature of sovereign wealth funds has bestowed upon them the ability to be strong stabilizing forces in the global financial markets.

Mutual Interdependence

Thanks to their anti-cyclical role in global markets, sovereign wealth funds were able to provide liquidity to Western institutions on the verge of failure

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[120] Gawdat Bahgat, "Sovereign Wealth Funds: An Assessment," Global Policy 1.2 (2010) 165.
[121] Curzio & Miceli 2010, 122.
[122] Richard Goldberg, The Battle for Wall Street (Hoboken: John Wiley & Sons, 2009) 123.

during the recent financial crisis. However, sovereign wealth funds did not make these investments as a form of charity. In fact, the only reason why they made the investments in the first place was because they saw an opportunity to potentially make a profit in the long run. KIA and QIA's profitable returns on their investments in Citigroup and Barclays respectively, can be viewed as evidence of this claim. This leads to a very important aspect of SWFs' beneficial role in international finance, namely mutual interdependence. "Not only do Western countries need the liquidity of SWFs, as proven by the financial crisis, but SWFs also need Western countries to keep their markets open to foreign investment."[123]

This sense of mutual interdependence creates an environment where if one side turns its back on the other, it is a lose lose situation for all. Hence, both Western institutions and GCC sovereign wealth funds have an incentive to continue to work together and engage in cross border investments. Not only can both gain financially speaking, but this interdependence creates a spillover effect into the political arena as well. "SWFs consolidate peaceful relations between nations by facilitating interdependence between home and recipient countries…investment across borders binds us together by creating actors with much to lose from political tension."[124] Thus, not only do sovereign wealth funds contribute to stability in the global financial markets, but by doing so they also promote stability in terms of international relations and diplomacy. This point is of particular relevance in terms of the importance of fostering healthier and stronger ties between the Western world and the Arab world.

[123] Curzio & Miceli 2010, 133.
[124] Bahgat 2010, 165.

Sovereign Wealth Funds as Destabilizing Agents

Although GCC sovereign wealth funds were initially welcomed and praised as lenders of last resort during the 2007-2008 **credit crunch,**[125] the very fact that they are the investment arms of foreign governments ignited a series of concerns. "When you have private investors who are basically disciplined by the market, that's a different kind of investment than if you have SWFs that are basically an arm of a government."[126] Hence, it does not come as a surprise that the concerns expressed regarding the impact of sovereign wealth funds on global financial markets are more political fears rather than financial.

Threat of Political Motivations

The main reasons for concern, stem primarily from the fact that they are a government entity rather than a private financial institution, they originate in regions like the Middle East which typically represent unstable, autocratic and undemocratic regimes, and that there is very little published to the public regarding their balance sheet and investment strategies. All of the above seemingly worrisome characteristics of GCC sovereign wealth funds have culminated into a single concern with regards to the overall motives of SWFs. Specifically, the main concern for sovereign wealth funds critics is the degree to which SWFs are politically motivated rather than financially.

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[125] When banks suddenly stop lending, or bond market liquidity evaporates, usually because creditors have become extremely risk averse. Source: "Credit Crunch." *Economic Terms A-Z.* The Economist Newspaper Limited. Web. <http://www.economist.com/research/economics/alphabetic.cfm?letter=C#creditcrunch>. Last Accessed: 21 Apr. 2011.

[126] Mehmet Asutay, "GCC SWFs and Their Role in the European and American Markets," Equilibri (2008).

One of the main political concerns is that sovereign wealth funds could potentially take advantage of the sheer size and value of their financial resources by purchasing larger stakes in Western companies, ultimately trying to take full control of the companies they invest in. More specifically, "critics worry about SWFs accumulating too large a stake in US financial interests."[127] While the U.S. indeed wanted and needed help from GCC SWFs in order to keep key financial institutions afloat, they started to panic and wonder how much foreign investment is too much?

Along the same lines, the next worry regarding the motives of GCC sovereign wealth funds is the fear that they might try to target strategic industries for political reasons. The main industries of concern are advanced technology, energy and defense. "SWFs blur the line between public and private investment…Western nations worry about the security implications of foreign countries, including Persian Gulf states, acquiring important positions in key industries and companies."[128] This is a legitimate concern considering the potentially disastrous result if foreign governments were to use their sovereign wealth funds to acquire knowledge of sensitive sectors of the US economy.

Sovereign Wealth Funds' Response to Concerns

With the onset of globalization, "developing countries were urged to open up their economies and financial system to catch up with the Western world."[129] For years the West was the main champion and supporter of promoting free trade

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[127] Goldberg 2010, 125.
[128] Asutay 2008, 11.
[129] Asutay 2008, 15.

and maintaining open economies. Did the West mean to say that it welcomes free trade and investment, but only from other Western democratic nations?

After sovereign wealth funds came to the rescue of failing Western financial institutions, they were not necessarily expecting praise or gratitude, but they certainly were not expecting to receive so much political backlash. At the same time, the West was not anticipating the emergence of oil-exporting nations as financial giants. "Since the early 2000s western policy makers and the general public have been surprised by the emergence of financial powerhouses from oil exporters, while these investors have been shocked by the antagonistic reception they have received in the US and some European countries."[130]

In general, "SWF executives argue that a close examination of their track records demonstrates their abstention from political interference and that their investments are driven by commercial interests."[131] Specifically, Muhammad al-Jasser of the Saudi Arabian Monetary Agency explains that simply because of the countries they represent "it is like the SWFs are guilty until proven innocent."[132] Similarly, the head of the Kuwait Investment Authority, Bader al-Saad exclaims, "Why is everybody after sovereign wealth funds? What have they done? Did they misbehave in any country where they invested in?... All they are talking about is a fear of something that did not happen and will not happen."[133] Lastly, the CEO of Bahrain Mumtalakat Holding Co., Talal al-Zain, echoed his fellow executives'

[130] Bahgat 2010, 163.
[131] Bahgat 2010, 170.
[132] *Ibid.*
[133] Ariana Eunjung Cha, "Foreign Wealth Funds Defend U.S. Investments," Washington Post Foreign Service (2008). Web. <http://www.washingtonpost.com/wp-dyn/content/article/2008/03/26/AR2008032603422.html>. Last Accessed: 25 Apr. 2011.

sentiments saying, “I hope the hype about the sovereign wealth funds doesn’t close the market, because that would be a shame.”[134]

Reality of the Debate

In reality, the fear that sovereign wealth funds are a destabilizing force on international financial markets has been greatly exaggerated in public debate, to the point where the concerns have increasingly overshadowed the clear and evident stabilizing role of SWFs. Furthermore, although the fears sound serious and could potentially be a reason for concern, at this point there is not nearly enough evidence to support the claim that SWFs are destabilizing forces on global financial markets.

On the contrary, the evidence clearly sways in favor of the argument that sovereign wealth funds contribute to the stability of the financial system. In fact, it is very difficult to identify any occasion where a SWF took advantage of their power for political gain in a host country. Furthermore, the majority of sovereign wealth funds only take minority stakes in a company and do not seek board representation. In short, “these funds are looking for investments, not control.”[135] This is inherent in the overall fact that sovereign wealth funds behave as ‘rational’ investors, seeking to maximize returns while minimizing risk.

While the argument claiming that sovereign wealth funds are politically motivated turns out to be founded upon fear itself rather than evidence, there is one real potential risk looming in the debate. The real risk is the rise of

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[134] *Ibid.*
[135] Goldberg 2010, 125.

protectionist[136] measures as a result of the xenophobic attitudes of the west. "SWFs are concerned that the tight scrutiny of their activities could fuel sentiments of economic nationalism and trigger protectionist measures against the free flow of capital."[137]

Although the threat of protectionist policies is a concern for SWFs, paradoxically it would be the West who would be hurt the most by such measures. "Such fear is forcing the SWFs to be invested in other countries and in non-US firms, thereby protecting and improving some other countries' way of life at the expense of ours."[138] Furthermore, "by making itself an anti-Arab bastion, the US is cutting itself off from better integration into the world economy and ultimately giving up market share for its goods and services to its competitors.[139]

In fact, in response to the surge of xenophobic attitudes in the West, sovereign wealth funds have already started to reassess their investment strategies. More and more, SWFs are decreasing their investments in the West and increasing investments in emerging markets, like Asia, where they can capitalize on much higher growth rates and enjoy a welcoming investment environment. Unfortunately, in reality, the potential fear the West should really be concerned about is that the next time they find themselves in dire need of

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[136] Opposition to free trade. Although intended to protect a country's economy from foreign competitors, it usually makes the protected country worse off than if it allowed international trade to proceed without hindrance from trade barriers. Source: "Protectionism." *Economic Terms A-Z.* The Economist Newspaper Limited. Web. <http://www.economist.com/research/economics/alphabetic.cfm?letter=P#protectionism>. Last Accessed: 21 Apr. 2011.

[137] Bahgat 2010, 170.

[138] Jean-Francois Seznec, "The Gulf Sovereign Wealth Funds: Myths and Reality," Middle East Policy (2008), 98-106.

[139] *Ibid.*

liquidity, just as they did during the 2007-2008 financial crisis, their sovereign wealth fund friends might not be as eager to bail them out. One can only imagine the actual destabilizing effects this would have on international financial markets.

Up to this point, we have discussed the basic characteristics of sovereign wealth funds, followed by an in-depth case study of three main Middle Eastern SWFs and explored both sides of the debate regarding their potential impact on international financial markets. After broadening the scope to include the world of global finance we can now return to the traditional literature on oil-exporting nations and readdress the arguments in light of this new perspective. Thus, in the next section we will turn our attention from international financial markets back towards the domestic economies of SWFs' home countries.

SECTION 5

Impact of Sovereign Wealth Funds on Regional and Domestic Economies

The main objectives of the Middle Eastern SWFs are to secure long-term wealth for future generations, generate funds necessary for future pension and healthcare liabilities, and minimize their countries' reliance on oil income. However, the funds also face domestic political pressures to support local economies and achieve short- term returns. This pressure has become more pronounced in the wake of the global financial crisis, which broke out in 2008.[140]

Between 2005-2008, the rise of GCC sovereign wealth funds as major players in international finance as well as the numerous high profile deals pursued attracted an immense amount of attention and critique. While the initial debate focused primarily on the impact of sovereign wealth funds on global financial markets, another debate was unfolding as a result of the losses incurred by SWFs during the financial crisis. The fact that SWFs and their home economies suffered as a result of the global financial crisis proved that despite their massive wealth and ability to bail out Western institutions, they were not invincible and completely immune to global recessions. As a result, SWFs faced a new internal pressure to aid their domestic economies: "Why were the SWF's available to rescue Western Banks but not to invest strategically at home?"[141]

> SWFs have not been forced to rethink their strategies by the losses they have sustained or a lack of attractive opportunities. Rather they have been constrained by economic and political factors, which have forced many funds to look to investing at home to help develop and diversify, or to bail out and support flagging local financial sectors and stock markets.[142]

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[140] Guillén 2010, 40.
[141] Curzio & Miceli 2010, 152.
[142] Guillén 2010, 51.

After 2008, in response to both the external criticism and domestic pressures GCC sovereign wealth funds were forced to rethink their strategies, primarily in a geographic sense. In response to the external pressures and protectionist sentiments from the West, we have already seen and continue to see GCC SWFs investing more and more in emerging markets, like Asia, where they can earn a higher rate of return and have their investments welcomed. In addition, in response to the mounting domestic pressures SWFs had to take into account the long-term development needs of their own countries and regions. Either traditional SWFs made adjustments to include domestic considerations or new SWFs were created as sovereign development funds with the primary focus of domestic development.

The high oil prices experienced in the 1970s and between 2002-2008 not only generated massive revenues for GCC countries, but also generated a familiar and inevitable question: to what extent will these oil revenues be used to address and alleviate the GCCs' economic setbacks? While the answer to this question varies from country to country, a few common features have historically characterized the GCC economies. Namely, a high dependency on oil, high reliance on expatriate labor, a young and rapidly expanding national labor force and dominant public sector overshadowing a weak private sector.[143] This section will begin by providing an overview of the traditional long-term economic development goals aimed at addressing the aforementioned concerns. This will be followed by an examination of the current economic landscape in three of the

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[143] Ibrahim Saif, "The Oil Boom in the GCC Countries, 2002-2008: Old Challenges, Changing Dynamics," Carnegie Papers 15 (2009): 1-36.

main GCC oil-exporting countries: Kuwait, Qatar and UAE. Finally, this section will conclude with a closer look at the extent to which two traditional funds (KIA & QIA) and one new sovereign development fund (Mubadala) are addressing these long-term development goals and domestic pressures.

Long-Term Development Goals of GCC Economies

While the GCC economies have experienced common setbacks over the years, such as the dependence on oil, an underdeveloped private sector and overreliance on foreign workers, they also face a common set of long-term goals to potentially overcome the aforementioned challenges. The primary long-term economic goals are economic diversification away from oil, the expansion of the non-oil private sector and the attraction of strategic foreign direct investments.

Economic Diversification

The primary overarching long-term development goal for all oil-exporting nations is economic diversification. Once oil was discovered, GCC countries became completely dependent upon oil, with petroleum contributing to well over half of **GDP**[144] and to nearly all of the government revenues (as previously discussed, this is otherwise known as a rentier state). As is often the case, it is riskier to put all of your eggs in one basket rather than spread out across multiple baskets. This is especially true when the resource a country's economy depends

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[144] The market value of final goods and services produced over time including the income of foreign corporations and foreign residents working in a given country, but excluding the income of the given country's residents and corporations overseas. Source: Harvey, Campbell R. "Gross Domestic Product." *Forbes Financial Glossary*. Forbes.com. Web. <http://www.forbes.com/tools/glossary/glossary.jhtml?letter=g>. Last Accessed: 21 Apr. 2011.

on is non-renewable and the price is determined in international markets. "Because of the boom-and bust- cycles associated with many world commodity markets, the rent-producing sector can be a highly unreliable source."[145] Hence, the extreme volatility of oil prices makes it a very risky commodity to depend upon.

The aforementioned risks facing oil-based economies gave GCC countries the desire to find ways to "extend economic life beyond finite oil resources."[146] In other words, GCC countries soon realized the strong necessity to diversify their economies away from oil. There are two main ways to diversify an economy. The first method is the diversification of income in an effort to insulate a country from volatility and risk. This has been accomplished primarily by investing abroad via sovereign wealth funds. Income diversification promotes fiscal stability by insuring that a country generates revenue from a wide variety of activities rather than relying on a single source. This is the same reason why investors pursue a diversified portfolio, because if one asset suffers the other assets act as a buffer and keep the investors afloat.

The second method of economic diversification is the diversification of production. This is primarily accomplished by investing domestically in a country. While income diversification promotes fiscal stability, production diversification aims to promote social stability by targeting the labor markets. The primary consequence of oil-exporting nations' lack of economic diversity is massive domestic unemployment. Over the past thirty years, the Arab region has

[145] Dunning 2008, 269.
[146] Tristan Cooper, "The Best Way to Diversify," The Financial Times (2010).

seen improvements in terms of basic economic benchmarks such as a reduction in infant mortality coupled with a slight decrease in the fertility rates. “The result is a rapidly expanding population, with vast numbers of young people.”[147] The problem is that “in order to provide enough jobs for the young, their economies would have to grow at rates similar to those of China and India, and so far they haven’t.”[148] Thus, even though many Arab countries have expanded their higher-education system to accommodate their growing young population, the problem is that there are simply not enough jobs to employ them after graduation. “Unlike in the United States and other Western countries, the unemployment rate *increases* with the level of educational attainment.” [149]

Private Sector Expansion

Furthermore, the citizens who are lucky enough to be employed work predominantly in the public sector. The private sector is relatively underdeveloped and is heavily dominated by foreign workers, all further contributing to high levels of domestic unemployment. “Expatriate workers now account in most GCC countries for about three-fourths of the total workforce. These countries have maintained an open-door policy to attract expatriate labor.”[150] Hence, the rapidly expanding local workforce coupled with limited employment opportunities in the private sector has generated massive amounts of

[147] John Cassidy, "Prophet Motive: The economies of the Arab world lag behind the West. Is Islam to blame?," The New Yorker (2011): 32-35.
[148] *Ibid.*
[149] *Ibid.*
[150] Ugo Fasano & Zubair Iqbal, "GCC Countries: From Oil Dependence to Diversification," International Monetary Fund. (2003). Web. <http://www.imf.org/external/pubs/ft/med/2003/eng/fasano/index.htm>. Last Accessed: 25 Apr. 2011.

unemployment. Therefore, the main long-term development goal for oil-exporting nations should be to reduce unemployment by focusing on expanding and developing a strong private sector, specifically labor-intensive manufacturing and service sectors. More specifically, the emphasis should be placed on developing so called strategic sectors like "agriculture, food processing, the water sector, education, health care and renewable energy."[151] These are all industries that produce social benefits to the greater population and can lead to a reduction in a wide variety of economic indicators like poverty, disease, illiteracy and unemployment.

Attract Foreign Direct Investment

Lastly, one of the key goals for developing economies is to attract foreign direct investment. Once the basic foundation of an economy has been developed or in this case once an economy has started to diversify its production, it can start to attract foreign direct investment to further develop the domestic economy. Along with the much-needed inflow of foreign capital and funding, some of the greatest byproducts of foreign direct investment include "technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development…all of these contribute to higher economic growth."[152] In conclusion, only by pursuing the dual goals of income and production

[151] Curzio & Miceli 2010, 152.
[152] Organization for Economic Co-Operation and Development, "Foreign Direct Investment for Development," 2002. Web. <http://www.oecd.org/dataoecd/47/51/1959815.pdf>. Last Accessed: 25 Apr. 2011.

diversification can GCC countries truly achieve economic diversification and ultimately economic growth.

Current Economic Landscape & GCC SWF Responses to Domestic Pressures

On the surface, the boom in oil prices from 2002 to 2008 greatly strengthened and rejuvenated the GCC economies on a macro level. For the six GCC countries, "real gross domestic product (GDP) growth reached an average of 8 percent a year over the 2002–2007 period while average GDP per capita across the six countries grew about 32%."[153] While these are indeed impressive measures of economic growth, they tell us very little about the progress, or lack thereof, GCC countries have made in addressing their long-term development goals. The following section will examine the current economic situation, beyond economic growth indicators, for Kuwait, Qatar and the United Arab Emirates. In addition, it will also assess the role each country's sovereign wealth fund is playing in addressing the long-term goals.

Kuwait

As a country slightly smaller than the state of New Jersey, Kuwait has managed to compensate for its small geographic size in lieu of its enormous oil-based wealth. Before the discovery of oil in 1938, Kuwait's economy was based almost entirely on the pearling industry.[154] From the discovery of oil onward and even up to present day, the economy of Kuwait is extremely dependent upon oil.

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[153] Saif 2009, 6.
[154] US Library of Congress, Overview of Kuwait Economy, 17 April 2011 <http://countrystudies.us/persian-gulf-states/20.htm>. Last Accessed: 25 Apr. 2011.

With the possession of about 9% of world oil reserves, "petroleum accounts for nearly half of GDP, 95% of export revenues and 95% of government income."[155] Hence, the stability and strength of the domestic economy remains closely linked with world oil prices.

The large oil revenues have allowed Kuwait to enjoy the 8th highest GDP per capita in the world, however growth in per capita income is only a measure of economic growth, not a measure of economic development. As a result, "Kuwait has done little to diversify its economy."[156] In fact, because Kuwait has very limited industry outside of oil it is forced to import almost all agriculture and manufactured goods. Furthermore, around 60% of the labor force is comprised of non-Kuwaitis, contributing to an unemployment rate of around 2.2%. While an unemployment rate of 2.2% is not considered high, the fact that the majority of the labor force is still comprised of foreign workers is still a cause for concern. Despite having an extremely young and literate population (94.4%), Kuwait does not have the industry diversification or investment in human capital to make use of its population's potential.

The main setback for the Kuwaiti economy is the extremely underdeveloped private sector. "The total number of private enterprises is around 25000, of which 2700 or about 1% has around 10 employees, 60% have less than

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[155] Central Intelligence Organization, World Factbook: Kuwait, 13 January 2011, <https://www.cia.gov/library/publications/the-world-factbook/geos/ku.html>. Last Accessed: 25 Apr. 2011.
[156] *Ibid.*

30 and 15% have less than 50 employees."[157] Furthermore, the majority of these small private enterprises are concentrated in the tourism, construction and financial services industries. Lastly, only around 5% of Kuwaitis are employed in the private sector as compared to 95% in the public sector.[158]

The Kuwaiti government has recognized the urgent need for economic diversification and thus recently passed an economic development plan "that pledges to spend up to $130 billion in five years to diversify the economy away from oil, attract more investment, and boost private sector participation in the economy."[159] While this plan appears to encompass the general long-term development goals facing most oil-exporting countries, only time will tell if the plan is implemented to the full extent. If it is, the benefits the plan could bring to Kuwait's economy are undeniable.

Kuwait Investment Authority

The official self-stated role of KIA in the local economy is as follows:[160]

- Promotes and supports institutionalization of the market by setting up funds and companies to promote and finance local business, and participates in the launching of local investments with feasible economic returns
- Helps develop the role of local financial companies by giving them the opportunity to manage some of their investments locally and abroad

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[157] Dr. Waleed Al-Saif, Creation: The Experience of Kuwait Small Profects Development Company, 2004. Web. <http://www.sbaer.uca.edu/research/icsb/2004/paper80.pdf>. Last Accessed: 25 Apr. 2011.
[158] *Ibid.*
[159] *Ibid.*
[160] Kuwait Investment Authority, KIA Role in Local Economy, 2008, <http://www.kia.gov.kw/En/About_KIA/KIA_Role/Pages/default.aspx>. Last Accessed: 25 Apr. 2011.

- Maintains the private sector's regeneration through privatization programs that KIA is committed to undertake
- Provides liquidity to the State's Treasury when needed
- As detailed in the role of the Local Investment Department, KIA has set up several companies in the last few years, primarily to promote investment in Kuwait.

The Kuwait Investment Authority, as the oldest sovereign wealth fund, was created to invest abroad in order to diversify the local economy. While KIA has indeed contributed to the fiscal stability of Kuwait by boosting the government's revenues significantly over the years, it was not established to engage directly in domestic investments. However, in the wake of the global financial crisis, traditional funds like KIA, who have been primarily internationally focused, have received a new wave of domestic pressure to rethink their strategies with the direct needs of the local economy in mind.

While many traditional sovereign wealth funds have long been critiqued for not directly investing in the local economy and thus not benefitting the people of the country, KIA was the first of the traditional funds to actually give in to domestic economic concerns. "In December 2008, the KIA launched a fund on behalf of the Kuwaiti government to stabilize the local stock market, which had fallen 38% in 2008."[161] In addition to this stabilizing move in 2008, managing director, Bader al-Saad, asserts that KIA is looking to play a larger role in strengthening the private sector, developing local human capital and facilitating the transfer of technology. However, Al-Saad also acknowledges the difficulty of this role: "we don't want people criticizing us for not investing locally, but if we

[161] Guillén 2010, 50.

did, we would find ourselves competing with the private sector."[162] Thus, KIA's strategy is to complement the private sector by investing in the sectors it shies away from instead of directly competing with it.

One excellent example of how KIA is strategically complementing the Private sector is its creation of the Kuwait Small Project Development Company (KSPDC). In 1997 KIA established KSPDC as a venture capital firm in order to assist young Kuwaiti nationals establish their own small-midsize enterprises. As a matter of practice, KSPDC can provide a maximum of 80%, up to 400,000 dinars, of the capital needed to start a business. Gradually, KSPDC works with the entrepreneur until he or she is able to buy them out.

Kuwaiti national, Bedoor al Mutairi is just one of several entrepreneurs to benefit from KSPDC's support. After experiencing the frustrating and negative connotation associated with women riding in taxis in Kuwait (due to the conservative values of Kuwaiti society) Mutairi asked herself: "why does someone not start a taxi company with women drivers for an exclusively female clientele?"[163] Mutairi soon realized that a similar concept was already in place in Dubai, Tehran and Beirut and with the support of KSPDC, she was able to bring the same opportunity to Kuwait. "Companies that sell products and services to women are clamoring to have their brochures placed in the cabs and Ms al Mutairi gets about 20 calls a day from Kuwaiti women saying they want to try the

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[162] Dubai Chamber of Comerce & Industry, "Kuwait Investment Authority on the Move," DCCI Library Newsletter 12 (2006).
[163] James Calderwood, "Women Line up to Hail Kuwait's Pink Taxis," 20 January 2010, The National, 18 April 2011 <http://www.thenational.ae/news/worldwide/middle-east/women-line-up-to-hail-kuwaits-pink-taxis?pageCount=2>. Last Accessed: 25 Apr. 2011.

service."[164] Hopefully Mutairi's successful business venture will inspire other young Kuwaitis to follow in her footsteps.

While KIA does explicitly lay out its role in the local economy, it has always maintained a very passive and indirect approach to local investments up until the financial crisis. Although KIA stepped in when the Kuwaiti economy was suffering, it will most likely continue to prefer its traditional role of investing abroad over taking a more aggressive approach to domestic development. However, the creation of subsidiaries in order to complement and support the growth of the private sector, such as the Kuwait Small Projects Development Company, illuminates how KIA does greatly impact the domestic economy of Kuwait, albeit indirectly.

Qatar

Like many other Middle Eastern countries, Qatar too started out as a poor nation with an economy based solely on pearling up until the discovery of oil in 1940. After gaining independence in 1971, Qatar continued to suffer due to the siphoning off of petroleum revenues the hands of a corrupt Amir until 1995 when he was overthrown. Starting in 1995 Qatar embarked on a process of economic transformation to "transform its former rent-based economy into a knowledge-based, service-orientated society."[165] The most obvious result of this transformation is the fact that even despite the global financial crisis, Qatar has

[164] *Ibid.*
[165] Bertelsmann Stiftung Transformation Index (BTI), "BTI 2010: Qatar Country Report," 2009.

the world's highest growth rate at an impressive 19.4% and the highest GDP per capita in the world of $145,300.[166]

Although Qatar has indeed undergone a major transformation, there are still areas in need of improvement. Today, "economic policy is focused on developing Qatar's nonassociated natural gas reserves and increasing private and foreign investment in non-energy sectors."[167] This is crucial due to the fact that oil and gas still account for more than 50% of GDP, 85% of export earnings and 70% of government revenues.[168] In addition, the country could benefit from increased diversification by further developing its service sector and agricultural sector, which represent 21.1% and .1% respectively.[169]

Qatar Investment Authority

In comparison with traditional sovereign wealth funds like KIA and ADIA, the Qatar Investment Authority best exemplifies the second generation of SWFs, characterized by a much more active and aggressive investment style when compared to their predecessors. Although only recently established in 2005, QIA has rapidly become notorious for making large, high profile investments in European companies such as Volkswagen, Credit Suisse and Barclays. In fact, QIA was the most active SWF investor throughout the global financial crisis

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[166] Central Intelligence Agency, CIA World Fack Book: Qatar, 27 January 2011, <https://www.cia.gov/library/publications/the-world-factbook/geos/qa.html>. Last Accessed: 22 Apr. 2011.
[167] *Ibid.*
[168] *Ibid.*
[169] *Ibid.*

because while most funds significantly cut back on investments, QIA continued to pursue an active investment strategy.

However, this does not mean that the country of Qatar did not feel the effects of the global financial crises. Similarly to KIA, in 2008 QIA was also called upon by the local Qatari government to invest "$5.3 billion into the local financial sector to buy a 20% stake in all the banks listed on the Qatar stock exchange."[170] Although QIA is part of the second generation of sovereign wealth funds, its main credo is still to build a global investment portfolio in order to achieve income diversification for the country of Qatar. In other words, although it is much more aggressive than its traditional predecessors, it has not shifted its core purpose and it will not operate as a development fund in wake of the financial crisis. Instead, what these second generation SWFs have started to do to respond to local pressures is to designate a preexisting segment of the fund to engage in domestic development. For QIA, this role was assigned to its real estate development arm Qatari Diar.

Qatari Diar is "fully owned by the Qatar Investment Authority and was founded to support Qatar's rapidly expanding economy and to provide structure and quality control for the country's real estate development priorities."[171] The most prominent example of Qatari Diar's mission in terms of domestic development was its $26 billion deal with "Germany's national railway operator, Deutsche Bahn AG (DB), to build a railroad network over 15 years" in a joint

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[170] Guillén 2010, 50.
[171] Qatari Diar, Company Profile, 2010, <http://www.qataridiar.com>. Last Accessed: 22 Apr. 2011.

venture with the Qatar Railways Development Company.[172] The railroad network will include a metro system in the city of Doha, a light rail in Lusail as well as a high-speed line between Qatar and its neighbors Bahrain and Saudi Arabia. The benefits of this joint venture are indeed quite significant:

> By increasing Qatar's links to regional markets and improving export routes this project is central to the diversification of the emirate's economy, which is largely reliant on oil exports. The cooperation will also include DB providing vocational training in the rail sector for young Qataris, helping the transfer of valuable expertise to the local population.[173]

By embodying the key long-term development goals such as production diversification, job creation, and knowledge and technology transfer, Qatari Diar's joint venture is an excellent example of an investment made in order to truly advance the long-term development goals of Qatar.

United Arab Emirates

One of the greatest stories of state transformation is that of the UAE. Over thirty years ago in 1971, seven tiny tribal states in the Persian Gulf came together to form the United Arab Emirates. Over the next thirty plus years, the UAE managed to transform itself from a poor, desolate fishing and pearling community into a modern state rivaling many Western nations. "Not too long, there were no air-conditioned buildings in the UAE - in fact, there was no electricity network to provide relief from the searing heat of the summer months.

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[172] William Miracky & Bernardo Bortolotti, "Back on Course: Sovereign Wealth Fund Activity in 2009," Monitor Group, 2010. Web. <http://www.monitor.com/Portals/0/MonitorContent/imported/MonitorUnitedStates/Articles/PDFs/Monitor_SWF_Back_on_Course_05_13_2010.pdf>. Last Accessed: 26 Apr. 2011.

[173] *Ibid.*

Suddenly all this changed with the discovery of oil."[174] After witnessing fellow oil-exporting countries' tribulations after the discovery of oil, the UAE was determined to follow a different, more prosperous path. As Sheikh Abdullah bin Zayed Al Nahyan, UAE Minister of Information and Culture, states "the social and cultural well-being of our society has been the target of our planning, and all other aspects of our development, be they economic, political, social or environmental, stem from this consideration."[175]

To what degree has the UAE succeeded in their mission? For starters, from 1995 to 2008, UAE GDP increased more than 500% from $46 billion to $240 billion.[176] This tremendous growth can be attributed to fact that the country has the fifth largest oil reserves in the world. One of the greatest pieces of evidence demonstrating the UAE's success in achieving economic diversification is that unlike Qatar and Kuwait, it has been able to reduce the portion of GDP based on oil and gas to 25%.[177] This is due to the "progressive economic agenda built around economic liberalization, diversification and enhancing the role of the private sector."[178] The Emirate of Dubai is an excellent example of this policy due to focusing "its attention of the development of the services sector, tourism

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[174] UAE Interact, UAE: Thirty Years of Transformation and Progress, 12 April 2001, <http://www.uaeinteract.com/docs/UAE_Thirty_years_of_transformation_and_progress/1391.htm>. Last Accessed: 26 Apr. 2011.
[175] *Ibid.*
[176] Central Intelligence Agency, CIA World Fact Book: UAE, 13 January 2011, <https://www.cia.gov/library/publications/the-world-factbook/geos/ae.html>. Last Accessed: 22 Apr. 2011.
[177] *Ibid.*
[178] *Ibid.*

and large-scale real estate projects."[179] Some of the most notorious projects include the world's only seven-star hotel, the Burj al-Arab, or the world's tallest tower, the Burj Dubai, and the infamous Palm Islands, the largest man-made islands in the world.[180]

However, despite all of the UAE's tremendous strides in economic development, it too was not immune from the global financial crisis in 2008. After 2008, the UAE's growth rate started to slow along with the majority of countries around the world. Furthermore, while Dubai has become a symbol of modernity, massive financial wealth and prosperity it was also hit the hardest out of the Emirates due to its prominent real estate and finance sector. Large-scale projects were not able to receive funding due to severely depressed real estate prices, prompting worries about the future of Dubai. Luckily, Dubai received funding from the central banks as well as its neighboring Emirate, Abu Dhabi.

Even with all of the remarkable growth experienced by the UAE over the past thirty plus years, the recent global financial crisis revealed that there is still plenty of work to be done. "Dependence on oil, a large expatriate workforce, and growing inflation pressures are significant long-term challenges."[181] To address these long-term concerns, the government has implemented a plan focusing on "diversification and creating more opportunities for nationals through improved

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[179] Bertelsmann Stiftung Transformation Index (BTI), "BTI 2010: UAE Country Report," 2009.
[180] WalletPop , The Wonders of Dubai, 18 April 2011 <http://www.walletpop.com/photos/amazing-dubai-building-photos/>. Last Accessed: 26 Apr. 2011.
[181] Central Intelligence Agency, CIA World Fact Book: UAE, 13 January 2011, <https://www.cia.gov/library/publications/the-world-factbook/geos/ae.html>. Last Accessed: 22 Apr. 2011.

education and increase private sector employment."[182] Given the country's track record and consistent emphasis on socio-economic development, the plan will hopefully lead the UAE to even more success and prosperity in the future.

Mubadala Development Company

Due to the fact that most sovereign wealth funds, especially first generation, but also second generation funds, are not designed or willing to actively engage in direct investments in the local economy, a new generation of sovereign wealth funds has emerged to fill this position.

> Beyond achieving high returns on investments, some of these funds were specifically tasked by their governments to transfer technology, build infrastructure, establish health and transportation services and create new industries, basically to contribute to the development of the nation.[183]

Since the Abu Dhabi Investment Authority, the largest sovereign wealth fund in the world, "as a matter of practice, does not invest in the UAE,"[184] in 2002 the government of Abu Dhabi created separate entity known as the Mubadala Development Company in order to facilitate the diversification of Abu Dhabi's economy.

Mubadala is "a business development and investment company whose mandate is to expand not just the emirate's wealth but also to create industries that will develop the economy."[185] It is primarily focused on targeting key industries such as energy, healthcare, aerospace, information and telecommunications,

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[182] *Ibid.*
[183] Guillén 2010, 42.
[184] Abu Dhabi Investment Authority 2009, 4.
[185] Guillén 2010, 33.

infrastructure, real estate and hospitality and services.[186] On one hand, Mubadala acts like more traditional SWFs by pursuing high profile, long-term international investments with the goal of receiving a high rate of return. However, the difference is that it will not make an investment that will not deliver "strong social returns to Abu Dhabi and the United Arab Emirates."[187] Social benefits include knowledge and technology transfer, employment opportunities for citizens and attracting further direct investment.

The best example of what Mubadala and other sovereign wealth funds of this type are aiming to achieve is the extremely high profile $8 billion joint venture between Mubadala and General Electric in 2008. "The venture is focused on diverse initiatives including commercial finance, clean energy research and development, aviation and corporate learning."[188] The benefits for Mubadala and the UAE include the following: knowledge transfer via an established training program sponsored by GE, technology transfer in terms of clean energy and aviation technology as well as infrastructure, job creation and industry development. At the same time, the joint venture provides significant benefits for GE as well including the fact that Mubadala became a top ten shareholder in GE and that the partnership will open up access for GE to a new market and a new region altogether. All in all, the Mubadala Development Company represents the ideal marriage between income diversification as well as production

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[186] Behrendt 2008, 8.
[187] Mubadala Development Company, The Mubadala Story, 2010, <http://mubadala.ae/about/history/>. Last Accessed: 22 Apr. 2011.
[188] General Electric, "GE and Mubadala Launch Multi-Billion Dollar Global Business Partnership," Press Release, <http://www.genewscenter.com/content/detail.aspx?releaseid=3873&newsareaid=2&menusearchcateg oryid=>. Last Accessed: 22 Apr. 2011.

diversification and will continue to provide meaningful contributions to not only the UAE, but to the entire region as well.

The main takeaway message regarding the significance of the global financial crisis is realization that sovereign wealth funds "were no different from other institutional investors; they had not been immune from the ravages of the recession"[189] and more importantly it revealed that their own domestic economies were in significant need of assistance. Besides the suffering experienced in the local financial sectors, the crisis revealed the primary long-term development goals for the countries including knowledge and technology transfer, private sector development, and huge overall need for job creation. Pressure and critique mounted as many locals were witnessing sovereign wealth funds bail out failing Western institutions without bailing out their own domestic economies, prompting SWFs to reassess their investment strategies.

In terms of the first generation of SWFs, although some like KIA helped financially prop up the local financial industry, their role has remained basically unchanged: they were not established to perform direct local investment. However, after further examination we discovered a trend of indirect domestic investment on behalf of both traditional funds like KIA and second-generation funds like QIA. For KIA, this meant the establishment of a separate entity to promote the growth of emerging private enterprises while QIA opted to allocate a pre-existing section of the fund to carry out direct local investments. Furthermore, when SWFs like ADIA were completely reluctant to change their investment strategy to include domestic investments, the government established

[189] Miracky & Bortolotti 2010, 17.

a third generation of SWFs, like Mubadala, as a designated direct investor. What all three funds have in common is the fact that although some are more focused on domestic economic development, all three remain very active abroad.

The difference between the three generations of SWFs in terms of their impact on domestic socio-economic development is the degree to which the fund combines income diversification and production diversification. Traditionally, SWFs have only been successful in terms of income diversification because their main goal has been to turn oil, a depletable and non-renewable asset, into a financial asset. While this is key for income diversification, the problem is that financial assets are just as depletable and non-renewable as oil. In other words, they do not count as real investments. "Wealth cannot simply be created by financial and/or monetary devices. Wealth can only be created by adding to the real assets on the ground."[190] Thus, only the sovereign wealth funds that 'add real assets on the ground' like, knowledge and technology transfer, job creation and industry development can truly claim that they are successfully promoting and achieving economic development.

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[190] Hazem El-Beblaw, " Chapter 3: Arab Wealth: Financial Versus Real Asset," Managing Arab Sovereign Wealth in Turbulent Times—and Beyond 16 (2009).

Concluding Thoughts:

More often than not, the media is prone to framing relatively unknown concepts in terms of good and bad in an attempt to simplify an issue for the public. However, the problem with this method is that it also leads to a detachment from rational thought in lieu of sensationalist rhetoric. Unfortunately, sovereign wealth funds are the latest victim of the polarizing treatment by the media and consequently their image has been reduced to simply: villains or heroes. However, because SWFs are a heterogeneous and complex class of investors, it is neither realistic nor pragmatic to view SWFs in terms of good or bad. Thus, throughout this study it has been my goal to explore the various images of sovereign wealth funds in an attempt to isolate sensationalist claims. As a result, we are left with a more rational and realistic perspective of what sovereign wealth funds truly symbolize.

Represent Shift in Global Financial Power

Early in the 20th century, the world experienced a major power shift from the dominance of oil consuming countries by 'the Majors' to the increased sovereignty of oil-exporting countries via the formation of OPEC. With the commencement of the 21st century, the world witnessed another significant shift in financial power and redistribution of global wealth. With rising oil prices, oil-exporting nations once again accumulated massive revenues and emerging markets, particularly Asian countries, were experiencing rapid economic growth. At the same time, Western developed countries like the United States and Europe were experiencing current account deficits and an ensuing financial crisis. While

Western financial institution largely dominated the 20th century, the financial crisis exposed their weaknesses and provided an opportunity for new players, specifically oil-exporting countries and emerging markets, to enter the international markets and compete for financial clout.

One can say that sovereign wealth funds capitalized on this opportunity and emerged as major players in international finance. While this symbolizes the geographic shift in financial power from the West to the East, it is also indicative of another change. Since SWFs are an extension a government, their rise represents a more general trend of the rise in state-capitalism as opposed to traditional free-market capitalism. "This emerging and growing framework is at sharp variance with today's general conception of a market-based global economy and financial system."[191] For many, this 'variance' has been the main cause for concern regarding the motives of SWFs. While the West in particular is uncomfortable with the prospect of foreign governments dominating global financial markets, the real fear is the potential for protectionist backlash if the West is unable to come to terms and adapt to the financial landscape of the future.

Behave as Rational Investors

Although the West is concerned about the potential for sovereign wealth funds to be manipulated in order to achieve political motives there is little evidence to date to validate this fear. In fact, "empirical evidence indicates that SWFs have behaved as economically rational investors who seek to maximize

[191] Bahgat 2010, 162.

their profits through the proper combination of risk and return."[192] They pursue long-term investments, a highly diversified portfolio both geographically and by asset class, they have low levels of debt by avoiding the practice of leveraging and they minimize exposure to liquidity risks by maintaining an excess level of reserves. All of the aforementioned attributes allowed SWFs to exhibit anti-cyclical behavior during the recent financial crisis and confirmed their role as a stabilizing force on global financial markets.

All in all, sovereign wealth funds should be viewed as a rational institutional investor. Although all types of investors have been the subjects of critique during the financial crisis, there are some positive attributes separating sovereign wealth funds from other type of financial investors. Thus, sovereign wealth funds think the world should "relax a little. We are only thinking about noncontrolling, conventional investments. We're not the sell-side firms, thinking 'proprietary trading'. We're not the exchanges, thinking 'consolidation'. We're not the private equity firms, thinking 'management control'. And we're not the hedge funds, thinking 'leverage.'"[193] While the world of finance is far from perfect, SWF's clean track record should speak for itself and they should at least be treated to the courtesy of innocent until proven guilty.

Reinforce State Sovereignty

Whenever the issues of oil-exporting nations and petrodollars are brought to the table the most popular question raised is the following: how are the petrodollars being invested? According to traditional literature, there is only one

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[192] Curzio & Miceli 2010, 200.
[193] Goldberg 2009, 132

avenue for petrodollars to flow and that is directly into the corrupt coffers of the national government. As a result, oil-exporting countries inevitably fall victim to the resource curse. By expanding the scope of traditional literature to include the role of global financial markets, sovereign wealth funds emerged as the main vehicle for petrodollar recycling.

Without a doubt, the rise of Sovereign Wealth Funds secured them a seat at the table with the other major players in international finance. However, what has this emergence meant for the SWF's domestic economies and home countries? To address this question I sought out to explore the extent to which sovereign wealth funds could serve as tools for economic development. However, sovereign wealth funds, at the core, were not established to engage *directly* in domestic development. While the financial crisis of 2008 led many SWFs to restructure and reconsider the pressing needs of their domestic economies it wasn't necessarily their responsibility to intervene. Thus, when SWFs received criticism for not investing enough in their local economies, the age-old problem regarding the efficiency of petrodollar recycling appears to remain unchanged. However, this is not entirely bad news. On the flip side, we did see the development of a new type of sovereign wealth fund, sovereign development funds, whose responsibility is to pursue only investments that are in line with long-term economic development.

In conclusion, the expansion of the narrow traditional perspective to a new international one highlights a wide array of implications for both global financial markets and the home countries of sovereign wealth funds. First, sovereign wealth funds represent a general shift in financial power away from the West and towards emerging markets. While this trend has sparked fears and concerns regarding the potential political motivations of SWFs, their track record demonstrates that these fears have been overstated. While sovereign wealth funds should not be viewed in terms of villains or heroes, they should be taken seriously as major financial players.

Furthermore, they symbolize the fact that oil-exporting nations learned from the mistakes they made in previous booms and decided to save revenues for the future in lieu of excessive spending in the present. Not only do sovereign wealth funds secure their nations' wealth for future generations, but also most importantly, their role as major players in international finance reinforces oil-exporting countries' sense of sovereignty and power on the world stage.

Lastly, when it comes to the potential role of sovereign wealth funds in economic development the answer is not as conclusive. Traditional sovereign wealth funds, like ADIA, do not *directly* contribute to the long-term development goals of their country and thus should not be viewed as tools for economic development. However, while the goal of my thesis was not to evaluate the effectiveness of SWFs as tools for economic development, I do want to highlight the potential for a new type of development strategy that is aligned with global financial markets. All in all, while the impact of sovereign wealth funds on international financial markets and their domestic economies may continue to evolve, it is important to continue to evaluate SWFs in a realistic and pragmatic manner rather than fall victim to sensationalist claims.

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APPENDIX

Table 1: List of Largest Sovereign Wealth Funds by Year Established

LARGEST SOVEREIGN WEALTH FUNDS BY YEAR ESTABLISHED				
Country	**Fund Name**	**Assets $ Billion**	**Year Established**	**Type**
Kuwait	Kuwait Investment Authority	$260	1953	Oil
Kiribati	Revenue Equalization Reserve Fund	$0.40	1956	Phosphates
US – New Mexico	New Mexico State Investment Council	$13.80	1958	Non-Commodity
Singapore	Temasek Holdings	$145.30	1974	Non-Commodity
US – Wyoming	Permanent Wyoming Mineral Trust Fund	$4.70	1974	Minerals
UAE – Abu Dhabi	Abu Dhabi Investment Authority	$627	1976	Oil
US – Alaska	Alaska Permanent Fund	$39.70	1976	Oil
Canada	Alberta's Heritage Fund	$14.40	1976	Oil
Oman	State General Reserve Fund	$8.20	1980	Oil & Gas
Singapore	Government of Singapore Investment Corporation	$247.50	1981	Non-Commodity
Brunei	Brunei Investment Agency	$30	1983	Oil
UAE – Abu Dhabi	International Petroleum Investment Company	$48.20	1984	Oil
Chile	Social and Economic Stabilization Fund	$21.80	1985	Copper
Norway	Government Pension Fund – Global	$556.80	1990	Oil
China – Hong Kong	Hong Kong Monetary Authority Investment Portfolio	$292.30	1993	Non-Commodity
Malaysia	Khazanah Nasional	$36.80	1993	Non-Commodity
Botswana	Pula Fund	$6.90	1994	Diamonds & Minerals
China	SAFE Investment Company	$347.1**	1997	Non-Commodity
Venezuela	FEM	$0.80	1998	Oil
Iran	Oil Stabilisation Fund	$23	1999	Oil
Azerbaijan	State Oil Fund	$21.70	1999	Oil
China	National Social Security Fund	$146.50	2000	Non-Commodity
Algeria	Revenue Regulation Fund	$56.70	2000	Oil
Kazakhstan	Kazakhstan National Fund	$38.60	2000	Oil
Trinidad & Tobago	Heritage and Stabilization Fund	$2.90	2000	Oil
Ireland	National Pensions Reserve Fund	$33	2001	Non-Commodity
UAE – Abu Dhabi	Mubadala Development Company	$13.30	2002	Oil
New Zealand	New Zealand Superannuation Fund	$12.10	2003	Non-Commodity
Australia	Australian Future Fund	$72.90	2004	Non-Commodity
Nigeria	Excess Crude Account	$0.50	2004	Oil
Qatar	Qatar Investment Authority	$85	2005	Oil
South Korea	Korea Investment Corporation	$37	2005	Non-Commodity
East Timor	Timor-Leste Petroleum Fund	$6.30	2005	Oil & Gas

UAE – Ras Al Khaimah	RAK Investment Authority	$1.20	2005	Oil
Libya	Libyan Investment Authority	$70	2006	Oil
UAE – Dubai	Investment Corporation of Dubai	$19.60	2006	Oil
Bahrain	Mumtalakat Holding Company	$9.10	2006	Oil
Vietnam	State Capital Investment Corporation	$0.50	2006	Non-Commodity
Indonesia	Government Investment Unit	$0.30	2006	Non-Commodity
Mauritania	National Fund for Hydrocarbon Reserves	$0.30	2006	Oil & Gas
Oman	Oman Investment Fund	n/a	2006	Oil
China	China Investment Corporation	$332.40	2007	Non-Commodity
China	China-Africa Development Fund	$5.00	2007	Non-Commodity
UAE – Federal	Emirates Investment Authority	n/a	2007	Oil
UAE – Abu Dhabi	Abu Dhabi Investment Council	n/a	2007	Oil
Russia	National Welfare Fund	$142.5*	2008	Oil
France	Strategic Investment Fund	$28	2008	Non-Commodity
Saudi Arabia	Public Investment Fund	$5.30	2008	Oil
Brazil	Sovereign Fund of Brazil	$8.60	2009	Non-Commodity
Saudi Arabia	SAMA Foreign Holdings	$439.10	n/a	Oil
	Total Oil & Gas Related	**$2,520.20**		
	Total Other	**$1,792.90**		
	TOTAL	**$4,313.10**		

*This includes the oil stabilization fund of Russia.
**This number is a best guess estimation.
***All figures quoted are from official sources, or, where the institutions concerned do not issue statistics of their assets, from other publicly available sources. Some of these figures are best estimates as market values change day to day.

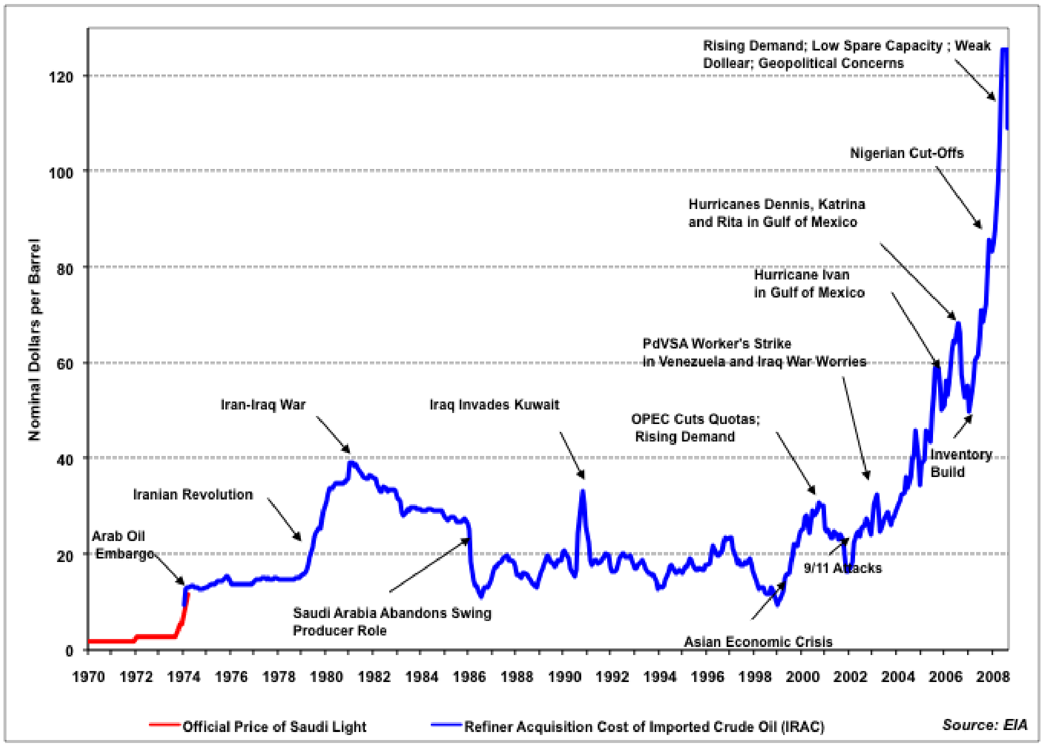
Source: "Sovereign Wealth Fund Rankings." Sovereign Wealth Fund Institute. Mar. 2011. Web. 24 Apr. 2011. <http://www.swfinstitute.org/fund-rankings/>.

Table 2: Main Investments by GCC SWFs in Western Financial Institutions (2007-2008)

Sovereign Wealth Fund	Target of Investment	Value in USD Billion
Abu Dhabi Investment Authority (ADIA)	Citigroup	7.6
Kuwait Investment Authority (KIA)	Merrill Lynch	3.4
Qatar Investment Authority	London Stock Exchange	2.0
Mubadala Development Company	The Carlyle Group	1.35
Dubai International Capital	HSBC	1.0
Qatar Investment Authority	Credit Suisse	.603

Adapted from: Roland Beck & Michael Fidora, The Impact of Sovereign Wealth Funds on Global Financial Markets (Frankfurt: European Central Bank, 2008) 11. & M. Asutay, GCC SWFs and Their Role in the European and American Markets (UK: Equilibri, 2008) 7.

Figure 1: World Nominal Oil Price Chronology: 1970-2007



Source: U.S. Energy Information Administration, "Annual Oil Market Chronology," 2008, Energy Information Administration, <http://www.eia.doe.gov/cabs/aomc/overview.html>. Last Accessed: 23 April 2011.

Summary of Capstone Project

As a double major in Economics and International Relations, oil has been of the most frequently discussed and reoccurring topics in my academic career. Specifically, most conversation revolved around petrodollars—the revenues generated from oil—and the degree to which they were being recycled efficiently. A general trend started to emerge in that regardless of how many times the subject of petrodollars was mentioned, the argument always took the same form: although a massive amount of revenue was generated for members of the Organization of Petroleum Exporting Countries during the 1973 oil boom, they were always channeled directly into the hands of the elite and resulted in widespread inequality, corruption and economic decay. Up until my junior year I was satisfied and accepted this conclusion at face value. However, three little words changed my entire perspective and became the subject of my Senior Capstone Project: Sovereign Wealth Funds.

I was first introduced to the concept of Sovereign Wealth Funds when I was given the largest SWF in the world, The Abu Dhabi Investment Authority, as my client and asked to assess the degree to which the fund recycles petrodollars efficiently. I was expecting to write the same traditional argument namely that as an extension of the government, the oil revenues channeled into SWFs like the Abu Dhabi Investment Authority, either ended up in the pockets of the fund's leaders or wasted on lavish inefficient projects. On the contrary, I was shocked to discover that the majority of oil revenues were actually being channeled through these so-called sovereign wealth funds into global financial markets. This discovery became the basic premise and topic of the first section of my Capstone: The traditional literature on oil-exporting nations failed to notice this phenomenon because they were limiting their perspective to the national and local level. Hence, the aim of my thesis was to examine how the discussion of oil-exporting country's revenues changes once the scope is expanded to an international perspective.

In order to assess the implications that arise from this shift in perspective, I separated my Capstone into five main sections. As previously mentioned, the first section serves as a review of the traditional literature regarding oil-exporting nations. It assesses the classic tale of oil-exporters and concludes with the introduction of a new actor for managing oil revenues: Sovereign Wealth Funds (SWFs). Although the first SWF dates back to 1953, they remained relatively in the shadows until roughly ten years ago. In fact, the term *sovereign wealth fund* itself was only coined recently in 2005. Hence, since they are a relatively unknown concept, section two serves as a general introduction to sovereign wealth funds. Generally speaking, sovereign wealth funds are the investment arms of governments charged with the responsibility of recycling wealth from commodity (oil) revenues by reinvesting it in international financial markets. While there are many different types and variations of sovereign wealth funds, for the purpose of this study, I focused only on oil-based commodity funds located in the Middle East.

To gain a better understanding of the nature of sovereign wealth funds, in section three I took a closer look at the three most prominent SWFs in the Middle East in terms of their participation in global financial markets. I discovered two trends after examining the history, mission statement and investment strategies of The Kuwait Investment Authority (KIA - the oldest SWF), The Abu Dhabi Investment Authority (ADIA - the largest SWFs), and The Qatar Investment Authority (QIA - the new comer). The first discovery was an increased appetite for risk on behalf of all three SWFs, with newer funds like QIA demonstrating more aggressive and progressive investment behavior than the more reserved and traditional funds like KIA. Regardless of the type of investment strategy, what is evident is that both traditional and newer sovereign wealth funds have acquired a preference for high profile investments in major Western companies, especially financially troubled ones.

Investments like ADIA's 7.6 billion dollar investment in Citigroup and KIA's 3.4 billion dollar investment in Merrill Lynch not only signified the successful evolution of sovereign wealth funds from relatively unknown entities to major players in the world of international finance, but they also ignited two heated debates. The first is the topic of the fourth section of my Capstone and regards the potential impact of SWFs on global financial markets. Specifically, do SWFs represent a stabilizing or destabilizing force on international financial markets? On the one hand, SWFs were viewed as stabilizing forces on the market by providing much needed liquidity to failing Western financial institutions. On the other hand, the very fact that they represent a foreign government conjured up xenophobic sentiments regarding the potential of hidden political motivations.

The second debate and topic of the last section of my Capstone, considers what this emergence has meant for the domestic economies and home countries of sovereign wealth funds. It is a return to the more traditional context by asking to what extent do the investments of sovereign wealth funds provide socio-economic benefits to their citizens? The rise of SWFs along with the financial crisis of 2008 led SWFs to restructure and reconsider the pressing needs of their domestic economies and citizens. In terms of the older, more traditional sovereign wealth funds like ADIA, their role has remained unchanged: they were not established to perform direct local investment. On the other hand, in response to an underdeveloped private sector, a rapidly growing national labor force and a high dependence on foreign labor, funds like KIA established a separate entity to promote the growth of emerging private enterprises while some like QIA opted to allocate a pre-existing section of the fund to carry out direct local investments. Lastly, since most traditional sovereign wealth funds were not designed nor intended to directly achieve socio-economic objectives, we have seen the development of a new kind of SWF created with the sole purpose of investing domestically.

The expansion of the narrow traditional perspective to a new international one highlights a wide array of implications for both global financial markets and the home countries of sovereign wealth funds. To commence, sovereign wealth funds represent a general shift in financial power away from the West and towards emerging markets. While this trend has sparked fears and concerns regarding the potential political motivations of SWFs, their track record demonstrates that these fears have been overstated. While sovereign wealth funds should not be viewed in terms of villains or heroes, they should be taken seriously as major financial players. Furthermore, it is also important to acknowledge the new found sense of sovereignty and bargaining power accompanying this position as well. Lastly, when it comes to the potential role of sovereign wealth funds in economic development the answer is not as conclusive. While the goal of my thesis was not to evaluate the effectiveness of SWFs as tools for economic development, I do want to highlight the potential for a new type of development strategy that is aligned with global financial markets. All in all, while the impact of sovereign wealth funds on international financial markets and their domestic economies may continue to evolve, it is important to continue to evaluate SWFs in a realistic and pragmatic manner rather than fall victim to sensationalist claims.