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AN INTRODUCTION TO THE GULF STATES' SOVEREIGN WEALTH FUNDS

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NOTE FROM THE PRESIDENT

What are sovereign wealth funds? How do they operate? What is their purpose? These questions and more are covered in this introduction to CID's series on the Gulf States' sovereign wealth funds. In this report, the fundamentals of sovereign wealth funds are explored, and the theoretical framework through which the Gulf countries' funds will be analyzed is established.

This introduction will be followed in the coming weeks by analyses of the sovereign wealth funds of Saudi Arabia, Kuwait, the United Arab Emirates, Bahrain, Qatar, and Oman.

Sincerely,

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INTRODUCTION

In the early 1970s, most countries in the Gulf region experienced exceptional economic growth due to their newly discovered oil and gas resources and a spike in oil prices. This caused many to see the oil-exporters of the Gulf as full of economic and geopolitical potential. During this peak, infant mortality in the Gulf was halved, life expectancy rose, and adult literacy increased dramatically.[1] Forty years later, most of those countries have struggled with domestic instability and the economic growth that was once so promising has stagnated and declined.[2] The Gulf countries' failure to rise has meant a significant loss of economic potential, increased global instability, and ultimately the loss of thousands of lives.[3] Many theories have attempted to explain the MENA countries' stagnation and decline, blaming poor leadership, the "resource curse," corruption, religious sectarianism, colonial history, population growth, etc. Though these theories may each explain some aspects of individual countries' decline, they have fallen short of generating feasible policy recommendations.

One of the most indisputable characteristics of the Gulf Cooperation Council countries (Kuwait, the United Arab Emirates, Saudi Arabia, Bahrain, Qatar, and Oman) is that a large portion of their gross domestic product (GDP) comes from oil and gas revenues. These revenues are in turn highly dependent on oil and gas prices, which are extremely volatile and responsive to international instability. Dependency on such a volatile source of income makes it extremely difficult for these countries to plan for the future and manage their wealth efficiently; they have historically over-spent during times of oil windfalls, leaving themselves vulnerable to oil price shocks like that of the early 1980s or to regional turmoil, as in the Gulf War. This uncertainty in turn leads to a volatile domestic market, reduced long term investment both from domestic and foreign sources, and more economic and political instability. This series of reports will examine one of the most common tools used to promote for stabilization and growth – sovereign wealth funds – how they have been implemented in different countries, and how their characteristics have led to their success or failure, particularly as regards their compliance with the Santiago Principles.

Introduction to Sovereign Wealth Funds

Since the oil price boom of the 1970s, oil and natural gas exporting countries in the Gulf region have faced a number of challenges when dealing with their natural resource wealth. These challenges are, to a certain extent, unavoidable, but the policies put in place by individual governments can have an immense impact on their effects. An increasingly popular approach to stabilizing government revenue in the face of price instability is the "sovereign wealth fund," which generally takes a certain percentage of domestic commodity revenue, invests it in a diversified portfolio, and therefore mitigates the overall risk inherent in having a large amount of wealth focused in one type of investment.

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[1] Wheeling Jesuit University 2016. Commins 2012, 211.
[2] Abed 2003.
[3] Hertog 2009.

In 1953, the first sovereign wealth fund was formed in Kuwait as a way to invest oil wealth in a diversified portfolio and thereby reduce the Kuwaiti economy's dependence on oil revenues.[4] In total, the KIA currently manages about US$592 billion which is either invested in long-term, low risk international portfolios or in the domestic economy.[5] In 1986 government income from investments started to exceed oil revenue and it has continued to display strong returns, with the Kuwait Investment Office acting as the country's central bank. Despite a few incidents of mismanagement, it has reduced volatility, released cash for domestic projects, and acted as a back-up source of government funds when assets are frozen, as in the 1990 invasion by Iraq.[6]

Since 1952, hundreds of other sovereign wealth funds have been formed, both to manage oil revenues and other revenue windfalls in a variety of countries around the world.[7] Over 40 of these funds were formed since 2005, showing a renewed interest in this method of managing government wealth, particularly in the Gulf Region. As defined by the Sovereign Wealth Fund Institute, a sovereign wealth fund is:

> "is a state-owned investment fund or entity that is commonly established from balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, governmental transfer payments, fiscal surpluses, and/or receipts resulting from resource exports. The definition of sovereign wealth fund excludes, among other things, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, state-owned enterprises in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals."[8]

This definition can include stabilization funds, savings/future generations funds, pension reservefunds, reserve investment funds, and strategic development sovereign wealth funds; each of which can be funded either through revenue from commodity exports or through government budget surpluses. This thesis will primarily examine savings and strategic development funds in the oil-exporting countries of the Gulf, their legal framework, how they have been managed since their formation, where their funds are spent domestically and internationally, and their abilities to promote stable economic growth through diversification away from dependence on oil wealth.

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[4] Kuwait Investment Authority 2015a.

[5] The Sovereign Wealth Fund Initiative 2011.

[6] Reuters 2008.

[7] KPMG 2014, 103

[8] Sovereign Wealth Fund Institute 2016a.

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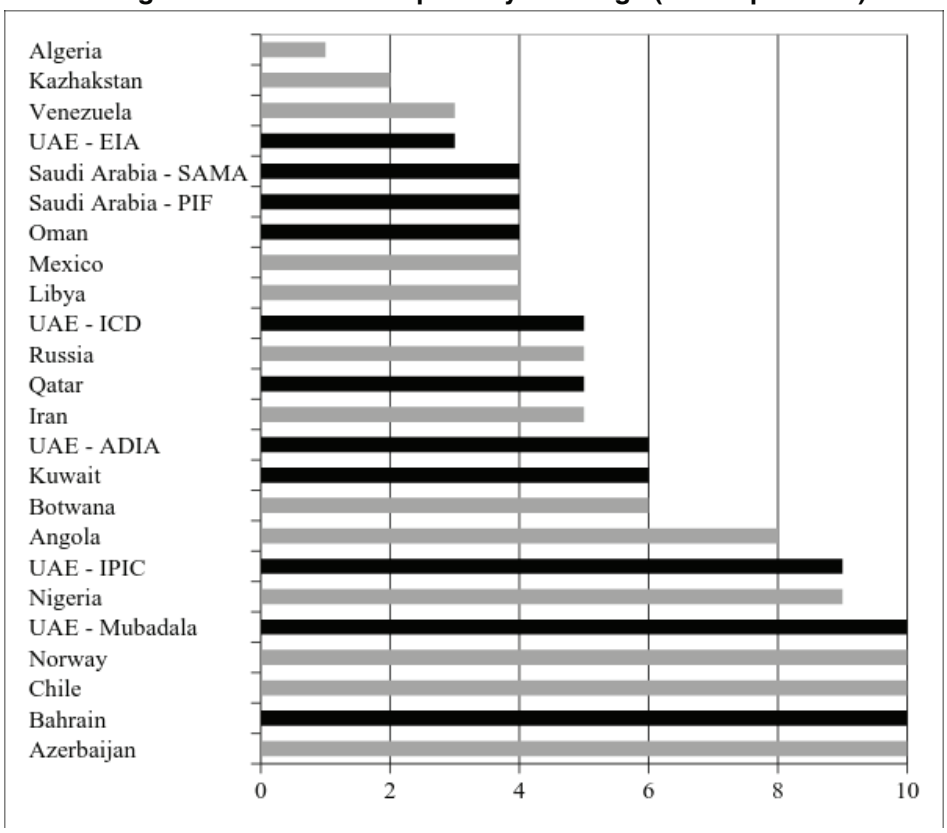
One of the biggest challenges in studying these funds is the lack of transparency regarding their sizes, asset allocations, and spending patterns. The Sovereign Wealth Fund Institute uses the Linaburg-Maduell Transparency Index to rank sovereign wealth funds on a scale from 1-10, with 1 being the least transparent and 10 being the most transparent (see Figure 1). Based on their rankings, only two of the oil-exporting gulf countries (Bahrain and the UAE) have funds that exceed the 8-point minimum needed to qualify as "adequately transparent," and even then, only half of the UAE's funds pass the test.[9]

Figure 1: Sovereign Wealth Fund Transparency Rankings (as of April 2015)[10]



Source: The Sovereign Wealth Fund Institute Linaburg-Maduell Index

Since these commodity-based sovereign wealth funds are so secretive about their assets under management and where the assets are invested, nearly all information about them is speculative. In 2007, Morgan Stanley published an article titled "How Big Could Sovereign Wealth Funds Be by 2015?" and concluded that they could reach US$12 trillion by 2015, about 50 percent of which will come from oil-exporting countries, although that includes Russia, Norway, and other oil-exporters outside the Gulf with sovereign wealth funds.[11]

[9] Sovereign Wealth Fund Institute 2016b

[10] The sovereign wealth funds discussed in this paper are highlighted in black

[11] Morgan Stanley 2007.

In 2009, Deutsche Bank estimated that the total assets under management of commodity-based sovereign wealth funds amounted to about US$1.65 trillion, making up an estimated 1.5 percent of the total assets in the global banking sector, 2.5 percent of world GDP, and 115 percent of total hedge fund assets when the study was published.[12] The report further stated that the total commodity sovereign wealth fund estimate of US$1.65 trillion would likely increase to US$7 trillion by 2019.[13] US$1.2 trillion of the originally estimated US$1.65 trillion in assets under management was attributed to Saudi Arabia, Abu Dhabi, and Kuwait. To put this in perspective, the combined GDPs of these three countries in 2009 was US$2.542 trillion. It should be noted that these estimates were made while oil prices were much higher than they currently are, so the researchers assumed oil-producing countries would have higher revenues to add to the sovereign wealth funds than they currently do.

The following series of reports shows that the investments of sovereign wealth funds can not only have a massive impact on the world economy, but they control a significant portion of the wealth in these countries, and how they are managed is crucial to the countries' success. In order to clarify what exactly good management is, the Santiago Principles were laid out in 2008 by the International Monetary Fund and the International Working Group of Sovereign Wealth Funds. These principles are as follows:

1. The legal framework for the sovereign wealth fund should be sound and support its effective operation and the achievement of its stated objective(s).

2. The policy purpose of the sovereign wealth fund should be clearly defined and publicly disclosed.

3. Where the sovereign wealth fund's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.

4. There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the sovereign wealth fund's general approach to funding, withdrawal, and spending operations.

5. The relevant statistical data pertaining to the sovereign wealth fund should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.

6. The governance framework for the sovereign wealth fund should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the sovereign wealth fund to pursue its objectives.

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[12] Kern 2009, 5.

[13] Kern 2009, 7-8.

7. The owner should set the objectives of the sovereign wealth fund, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the sovereign wealth fund's operations.

8. The governing boy(ies) should act in the best interest of the sovereign wealth fund, and have a clear mandate and adequate authority and competency to carry out its functions.

9. The operational management of the sovereign wealth fund should implement the sovereign wealth fund's strategies in an independent manner and in accordance with clearly defined responsibilities.

10. The accountability framework for the sovereign wealth fund's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.

11. An annual report and accompanying financial statements on the sovereign wealth fund's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.

12. The sovereign wealth fund's operations and financial statements should be audited annually in accordance with recognized international or national accounting standards in a consistent manner.

13. Professional and ethical standards should be clearly defined and made known to the members of the sovereign wealth fund's governing body(ies), management, and staff.

14. Dealing with third parties for the purpose of the sovereign wealth fund's operational management should be based on economic and financial grounds, and follow clear rules and procedures.

15. Sovereign wealth fund operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.

16. The governance framework and objectives, as well as the manner in which the sovereign wealth fund's management is operationally independent from the owner, should be publically disclosed.

17. Relevant financial information regarding the sovereign wealth fund should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.

18. The sovereign wealth fund's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.

19. The sovereign wealth fund's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.

20. The sovereign wealth fund should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.

21. Sovereign wealth funds view shareholder ownership rights as a fundamental element of their equity investments' value. If a sovereign wealth fund chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The sovereign wealth fund should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding.

22. The sovereign wealth fund should have a framework that identifies, assesses, and manages the risks of its operations.

23. The assets and investment performance (absolute and relative to benchmarks, if any) of the sovereign wealth fund should be measured and reported to the owner according to clearly defined principles or standards.

24. A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the sovereign wealth fund.[14]

The purpose of the Santiago Principles is to encourage not only transparency, but the type of institutional framework that will promote sound investment practices and a focus on long-term economic growth. As such, it encourages strict legal guidelines on withdrawals from sovereign wealth funds, specific requirements regarding contributions to the fund by the government, and accountability through external audits and public disclosures. According to the International Working Group of Sovereign Wealth Funds, abiding by these guidelines will not only increase stability, but will also gain these sovereign wealth funds respect in the international financial community, in turn encouraging "an open and stable investment climate" with minimal protectionism.[15]

In addition to analyzing the unique economic challenges that face the Gulf Cooperation Council countries, the following reports will examine their sovereign wealth funds with respect to their transparency, compliance with the Santiago Principles, and how their investments have impacted both government revenues and domestic growth.

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[14] International Working Group of Sovereign Wealth Funds 2008, 7-9

[15] International Working Group of Sovereign Wealth Funds 2008, 4.

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