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THE GULF STATES' SOVEREIGN WEALTH FUNDS: KUWAIT — A MODEL OF CONSISTENCY

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NOTE FROM THE PRESIDENT

There is much to learn from Kuwait given that it was the first Gulf state to establish a sovereign wealth fund. The Kuwaiti sovereign wealth fund represents the growth opportunities created when a country sticks to a conservative investment strategy. While the country has found economic success, questions remain about whether a different, more diversified investment strategy is best for the country.

This report analyses the successes and failures of the Kuwaiti sovereign wealth fund, and provides recommendations for the country to create the most economic growth from its oil revenues. The Gulf States' sovereign wealth funds series will continue in the coming weeks with reports on the United Arab Emirates, Bahrain, Qatar, and Oman.

Sincerely,

Yianni Nikolaou
Founder and President

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Founded in 1953, eight years before Kuwait's independence, the Kuwait Investment Authority is the world's oldest sovereign wealth fund. At the time of its founding, Kuwait was severely underdeveloped, but the Sheikh Abdullah Al-Salem had the forethought to establish a fund with a mission to "achieve long term investment returns on financial reserves… providing an alternative to oil reserves, which would enable Kuwait's future generations to face the uncertainties ahead with greater confidence."[1] As of 1976, the fund has been separated into two parts: the General Reserve Fund and the Future Generations Fund.[2] The General Reserve Fund serves as the treasurer and stabilization fund of the country as well as the primary repository of the state's oil revenues. It also is mandated to invest solely within Kuwait, other MENA countries, and hard currency assets rather than more risky international investments. In order for the Kuwaiti government to withdraw funds from the General Reserve Fund, the withdrawal must be approved in an annual budget passed by Parliament, making this fund a secure savings fund with a focus on long-term domestic stability and growth.[3]

The Future Generations Fund, on the other hand, is invested solely outside of Kuwait, in a variety of investment vehicles including typical stocks and bonds and alternative investments, including private equity, real estate and infrastructure. This allows the Future Generations Fund to focus less on internal development and more on creating steady revenues that will benefit Kuwait over a long-term investment horizon. When it was founded in 1976, 50 percent of the General Reserve Fund's assets were transferred to the Future Generations Fund, and every year since then at least 10 percent of the General Reserve Fund's net profits have been added to the Future Generations Fund as well as 10 percent of state revenues, much of which comes from oil revenues. In order to withdraw any of these funds, special legislation must be passed.[4] Both of these funds have strict regulations on contributions to and withdrawals from the funds by the government, fulfilling the International Working Group of Sovereign Wealth Funds' recommended policy-making guidelines as specified in the Santiago Principles, though these funds fall short of full compliance in other ways, including their transparency standards.[5]

A large part of the Kuwait Investment Fund's sustained success is its relative independence from domestic politics, which is also highly recommended in the Santiago Principles. To reduce the likelihood of major conflicts of interest between the Kuwait Investment Authority and officials with alternative agendas, the board consists of the Minister of Finance, the Minister of Oil, the Governor of the Central Bank of Kuwait, the Under Secretary of the Ministry of Finance, and five other Kuwaiti nationals from the private sector, three of whom may not hold any other public office. From this board, a Managing Director and deputies are selected, and the people holding these positions are not allowed to hold any other government positions or work for any other employers while serving.

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[1] Kuwait Investment Authority 2016b.
[2] Kuwait Investment Authority 2016c
[3] Kuwait Investment Authority 2016d.
[4] Kuwait Investment Authority 2016d.
[5] International Working Group of Sovereign Wealth Funds 2008

The presence of officials from the Ministry of Finance and the Central Bank is intended to insure that management of the fund prioritizes long term growth rather than rash spending, though the latter choice would be beneficial to other government officials trying to gain domestic support through unnecessary subsidies, ostentatious government projects, etc. Though there will be times when people on the board do try to withdraw funds for projects, the goal in choosing this type of board is that it will only do so when the Kuwaiti economy truly needs to be propped up in order to reduce domestic volatility.

The Kuwait Investment Authority has not always been successful in its mission to separate bank and state, leading to scandals involving risky deals, fraudulent behavior, and large losses. For example, in the late 1980's, Spain's economy experienced a boom, and the KIO (the London-based office of the Kuwait Investment Authority) invested heavily in various Spanish industries, including Torras Hostench, a paper maker which subsequently acquired multiple other companies, becoming the conglomerate known as Grupo Torras.[6] The KIO's total investment in Grupo Torras was estimated to be over US$5 billion, making it one of the Kuwait Investment Authority's largest and most risky investments. Through Grupo Torras, the Kuwait Investment Authority invested heavily in multiple large and ostentatious projects based in Spain, including the Gate of Europe towers in Madrid.[7]

In 1993, the KIO filed a lawsuit claiming that "through the use of various shell companies, fictitious loans, fraud and embezzlement, the former Torras management conspired to steal at least US$500 million between May 1988 and May 1992."[8] The targets of this suit were the Sheik Fahad Mohammed al-Sabah, the former chairman of the KIO and the cousin to the then-Emir of Kuwait; Fouad Khaled Jarrar, the former vice president of the KIO; and Javier de la Rosa, the Spanish financier who managed Grupo Torras during the scandal and had previously been known to be unscrupulous with his investments.[9] This fraud and embezzlement went unnoticed for years due to a convergence of events: the Spanish boom and bust, negligent monitoring of risky investments, and attention being focused on the Iraqi occupation of Kuwait during the Gulf War.

The Kuwait Investment Authority and the KIO blamed the incident almost entirely on Mr. De la Rosa and the Spanish managers of the Kuwaiti investments, but Sheik Fahad Mohammed al-Sabah and Fouad Khaled Jaffar were also found guilty of fraud, with Fouad Khaled Jaffar earning two years in prison.[10] Mr. De la Rosa, who was also sentenced to fifteen years in prison, did claim, however, that the implication of these two members of the royal family was magnified as a way for figures in Kuwait to harass the ruling al Sabah family. This incident demonstrated the potential for fraudulent activity and serious embezzlement of funds, particularly when members of the royal family are involved in managing the funds rather than overseeing their hired investment managers. It also showed the need for a consistent, long-term investment strategy rather than investments in risky, short-lived booms, and the need for careful auditing of the fund's activities.

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[6] Al Husaini 2000.
[7] Al Husaini 2000.
Tremlett 1994.
[8] Cohen 1993.
[9] Cohen 1993.
[10] Jannesen 2004.
Martinez 2016.

Currently the fund is audited regularly by the Board Audit Committee, the State Audit Bureau, an internal audit, and jointly by two of the "Big Four" auditing firms, as a way to hedge against the type of fraud seen in the KIO scandal. The leadership of the Kuwait Investment Authority has also become more insulated from the Kuwaiti government, with the primary investing office located in London, making the Kuwait Investment Authority resemble a typical investment management bank much more than a government agency. This separation is meant to ensure that investments are made based purely on potential for returns rather than on domestic politics, particularly within the Future Generations Fund. If this effort to maintain separation is not consistently made, sovereign wealth funds can easily become a tool for governments and members of royal families to support their allies, flaunt their wealth, or benefit individuals in power rather than stabilizing domestic wealth in a way that will benefit their country and its future. These were clearly concerns when the most recent Kuwait Investment Authority guidelines were being laid out, and when describing its investment strategy, the Kuwait Investment Authority reaffirms that it "has based its investment decisions exclusively on commercial considerations, not on the political or foreign policy interests of the state of Kuwait."

Not only does the Kuwait Investment Authority have to monitor its investments to ensure it achieves its goal of stable domestic growth, but it must also monitor withdrawals from the fund. As mentioned, removing assets from the General Reserve Fund requires the passage of an annual budget by the Kuwait National Assembly, which is meant to ensure some level of liquidity while requiring forethought and due legal process. The regulations on transferring funds from the Future Generations Fund are even stricter, requiring specific legislation. This type of legislation has only been passed once, during the Persian Gulf War in 1990. Before the Iraqi invasion, the Future Generations Fund's assets were estimated to be about US$100 billion, but by the 1994 it had shrunk to about US$35 billion.[11] During this conflict, holding assets overseas proved to have another benefit when then President Bush froze all U.S. held Kuwaiti and Iraqi assets to ensure that Saddam Hussein would not have access to the billions in Kuwaiti assets held abroad.[12] This ability to control the foreign reserves even when the Kuwaiti government was in exile was not only useful to the Kuwaiti government during the conflict, but it showed foreign investors that Kuwaiti wealth was a reasonably safe investment; even when under foreign attack, the wealth was kept safe through foreign holdings and diversification.[13] The regulations of withdrawals of funds are intended to make the General Reserve Fund and Future Generations Fund more stable government funds than can be found in most natural resource-rich countries, but this effort would be futile if the Kuwait National Assembly's authority were dependent on the support of the ruling al-Sabah family. Thankfully, Kuwait has "perhaps the most independent parliament in the Arab World," and members of the royal family are not allowed to serve in the parliament, which helps to check the royal family's control of the funds and keep the fund management somewhat separated.[14]

Unfortunately, restricting the budget is one of the only real powers that the parliament has; most of its strength comes from being able to curb the al-Sabah family's power, but it is limited in its ability to create new legislation. This leads to a stalemate in which the Emir only proposes limited actions that are beneficial to the royal family and the parliament displays its power by shutting down those proposals. In return, the Emir is able to dissolve the parliament, which has become a fairly common action (it has happened nearly every year in recent years) and requires new elections before the government can go back to functioning normally.[15]

[11] Marshall 1997.
[12] Farnsworth 1990.
[13] Habibi 2008, 39.
[14] Brown 2001, 16-17.
[15] Kinninmont 2012, 2.

Clearly, there are some serious problems with this system, including incentivizing parliamentarians to pass extravagant public spending legislation in order to gain support for the next election, but it is still much more democratic than the authoritarian rule of some of the other Gulf States.[16] It has some influence in limiting the funds that will be withdrawn from the Future Generations Fund and General Reserve Fund, but whether it will be able to function successfully when Kuwait's economy needs the funds to manage future volatility is uncertain. Hopefully when the country truly needs to withdraw assets from these funds to maintain stable economic growth, the royal family and the elected parliament will be able to unite and make the best decision for Kuwait.

After the 2009 economic crisis, most Gulf States, including the UAE and Qatar, were quick to withdraw funds from their sovereign wealth funds in order to support the domestic economy, but withdrawals from the Kuwait Investment Authority were delayed due to prolonged negotiations, demonstrating the potential problems that overregulation of the withdrawal of funds can cause. In early 2010, the parliament finally approved a four-year, US$105 billion spending plan to mitigate the negative effects of the global economic downturn, but this delay was inefficient and costly.[17]

The Kuwaiti government is currently considering passing legislation to once again withdraw assets from the Future Generations Fund, this time to cover the budget deficit due to low oil prices. If successful, this legislation would liquidate the lowest performing assets, amounting to US$30 billion of the fund's current US$600 billion, and this money would be used to maintain a healthy annual budget and continue large infrastructure projects being planned.[18]

The Kuwaiti government does have to be careful with this type of legislation, however, and only pass it when necessary. There will certainly be times when injecting funds into the domestic economy will be beneficial, but if done too often, it could become a tool to gain support for the Kuwaiti leadership by essentially buying off their constituents. One domestic spending tool that is extremely common in the oil-exporting countries of the Middle East is the use of oil subsidies, and Kuwait is no exception. Many citizens feel that they are entitled to the oil produced by their countries, and subsidizing the price of energy is one way in which these governments help satisfy this expectation. These subsidies are a fairly simple way of gaining domestic support, but cutting them back is not nearly as easy. Nigeria faced weeks of paralyzing protests when President Goodluck Jonathan tried to cut subsidies in January 2012, and countries in the Middle East have faced protests when officials have simply hinted at the possibility of trimming subsidies, despite facing budget deficits which will harm the domestic economy in the long term.[19, 20] The intractability of subsidies make them a suboptimal spending option, though their tangibility makes them popular. If government officials were given the freedom to withdraw funds from the Kuwait Investment Authority whenever they wanted, it is likely that they would increase subsidies even more in order to gain support and quell public dissatisfaction, despite negative long term effects.

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[16] Kinninmont 2012, 8.

[17] Baghat, 2011, 24.
Institute of International Finance 2014, 17.

[18] Reuters 2015.

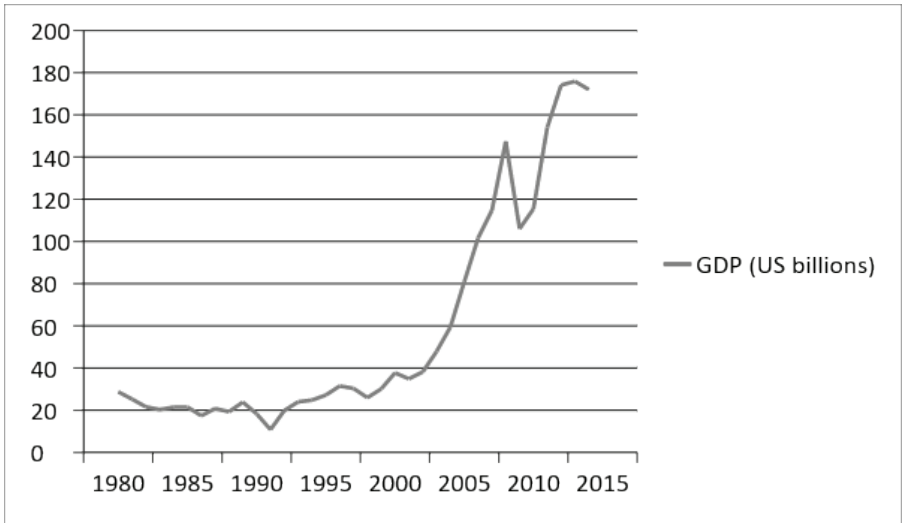
[19] International Institute for Sustainable Development 2012, 34.

[20] The Guardian 2012.

Managing Volatility In Crises

Due in large part to the way that the Kuwait Investment Authority was established, Kuwait has been largely successful in mitigating volatility through various shocks, including the Iraqi Invasion in the 1990s and oil price fluctuations. It has historically maintained substantial stores of fairly liquid capital which has been relatively accessible when the State of Kuwait has most desperately needed it.

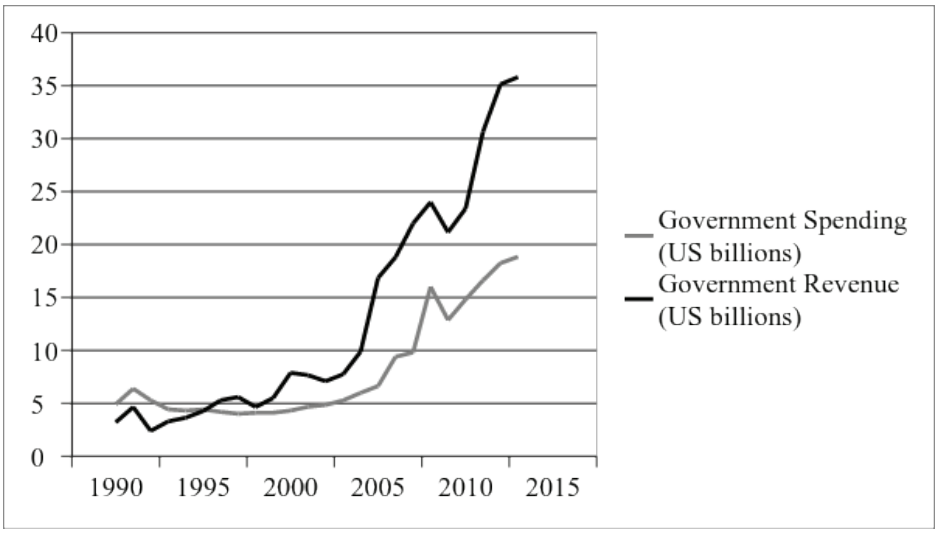
Figure 2: Kuwait GDP per capita (1980-2014)



Source: World Bank National Accounts Data. 2015.

This graph demonstrates that there was a dip from 1990 to 1991 during the Gulf War, with GDP going from US$18.2 billion to US$10.8 billion GNI per capita, but GDP moved back up to US$19.9 billion the next year and maintained steady growth. This rebound was due in large part to the fact that funds from the Kuwait Investment Authority were withdrawn and injected into the domestic economy, stabilizing government spending despite domestic turmoil and decreased government revenues

Figure 3: Kuwait Government Spending and Revenue (1990-2013)

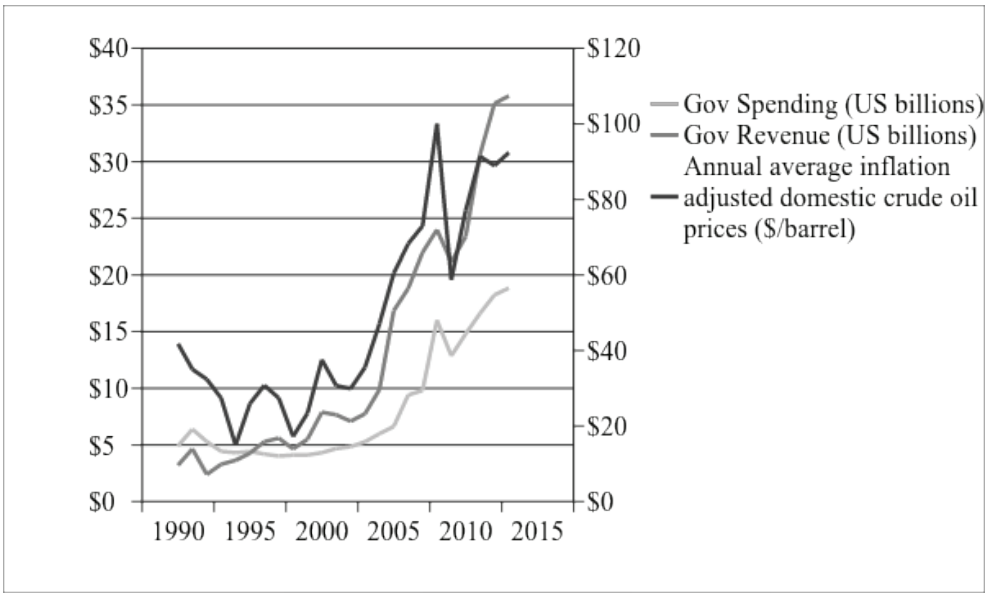


Source: IMF Cross Country Macroeconomic Statistics

Figure 3 displays government spending alongside government revenues starting in 1990. It is clear that the Kuwaiti government was running a deficit during the early 1990s to pay for defense spending and to maintain some stability during the Iraqi Invasion. By 1996, revenue outpaced expenditure and Kuwait has maintained a growing surplus since. From 2007 to 2008, there was a slight increase in revenue (US$21.98 billion to US$23.994 billion), while government spending almost doubled (US$9.8 billion to US$16 billion).

After the global economy was affected in 2008 by the Great Recession and oil exporting countries were faced with plummeting oil prices, however, government revenue dipped more than government spending did (a 24.4 percent drop versus a 13.4 percent drop). This increased spending and subsequent dip shows that, although the Kuwaiti government may have overextended its spending during the worldwide economic growth period leading up to 2008, it was able to keep that spending level relatively steady even while revenues decreased, primarily due to its consistent government surpluses and savings mechanisms in the Kuwait Investment Authority.

Figure 4: Kuwait Government Spending and Revenue overlaid with Oil Prices (1990-2013)



Source: IMF Cross Country Macroeconomic Statistics, U.S. Energy Information Administration

Figure 4 also shows government revenue and expenditure, but overlaid with the inflation adjusted price of oil. This graph emphasizes the volatility of oil prices over time and how government revenue follows this pattern fairly closely, though the volatility is somewhat lessened. Government spending, on the other hand, has maintained a relatively constant level of growth, with the exception of the 2008 spike. Spending has also grown at a much lower rate than revenue, showing that the Kuwaiti government has been wary of over-spending even during periods of economic success.

Conclusion

Overall, the Kuwaiti government has managed its oil wealth wisely over the years, from being the first to establish a sovereign wealth fund to maintaining high levels of contributions to this fund over time. Though this conservative strategy has worked well for the country thus far, Kuwait should use its Future Generations Fund to diversify its domestic economy as well rather than relying on the consistent returns of the General Reserve Fund to propel the nation through economic downturns. As will be examined in the coming reports, most other Gulf countries have made concentrated efforts in recent years to grow their education, banking, trade, and tourism sectors in order to diversify their sources of GDP away from oil.[21]

The International Monetary Fund predicted that Kuwait's GDP would grow by 1.8 percent in 2015, far below its average of 4.8 percent growth per year from 2000 to 2010 and the Gulf's average predicted growth of 4.5 percent in 2015.[22] Its significant capital reserves will prevent the State of Kuwait from any serious deficits in the medium-term, but avoiding risky investments in its own economy will also prevent the state from any remarkable growth. In 2010, it announced a five-year development plan that included US$107 billion of investments in the domestic economy, but nearly every aspect of the plan was delayed due to disagreements between the government and the parliament.[23] The 2015 World Bank Doing Business Survey ranked Kuwait in the lowest half of all countries in the categories of "Ease of Doing Business," "Starting a Business," and "Enforcing Contracts."[24] Unless Kuwait streamlines its business sector and encourages investment away from the oil and gas sector with the funds in the Future Generations Fund, it is likely to stagnate and fall behind the progress of the other Gulf States. There is a fine line between saving to the point that the domestic economy begins to shrink and spending too much on domestic investment, but it appears that Kuwait's wealth management strategy falls under the first category. Its self-control and consistency is commendable, but it should focus on encouraging the domestic economy if it is to achieve long-term economic growth.

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[21] Al Asoomi 2012.

[22] Liam Denning 2016.

[23] Townsend 2015.

[24] World Bank 2015.

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