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THE GULF STATES' SOVEREIGN WEALTH FUNDS: THE UNITED ARAB EMIRATES

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NOTE FROM THE PRESIDENT

The UAE sovereign wealth fund presents a complicated scenario of multi-government control, massive oil revenues, and layers of investment vehicles, all of which make transparency and analysis difficult. Yet, it is well known that the UAE's funds have found great success and continue to diversify their domestic economies.

Can this growth be sustained? How can the UAE's sovereign wealth funds be reformed? This report seeks to answer these questions and more. The Gulf States' sovereign wealth funds series will continue in the coming weeks with reports on Bahrain, Qatar, and Oman.

Sincerely,

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Founder and President

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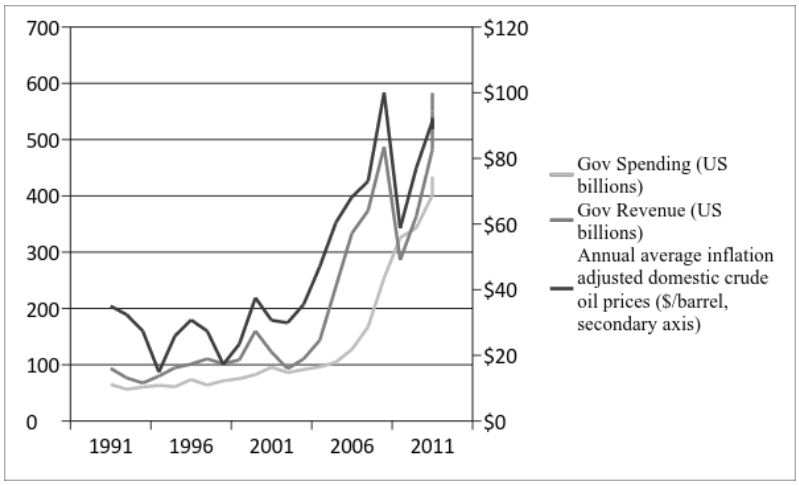
INTRODUCTION

To fully understand the goals of the Emirate of Abu Dhabi and Dubai's sovereign wealth funds with respect to the United Arab Emirates (UAE), one must first understand the way that the UAE is organized both financially and politically. The UAE is composed of seven different monarchical emirates, united in 1971 under a constitution that established the Federal Supreme Council, comprised of the rulers of the seven emirates. The Federal Supreme Council is given jurisdiction over foreign affairs, citizenship issues, education, public health, and other public services, but many other powers, including management of natural resources and wealth of the emirate, are left under the jurisdiction of the individual emirates.[1] Within the Federal Supreme Council, Abu Dhabi and Dubai have veto power over any new jurisdiction, and the leader of Abu Dhabi has traditionally served as leader of the Council though elections are held every five years.[2] Although institutions have been established to manage the legislative, executive, and judicial activities of the government, Abu Dhabi controls much of the Council's activity, due to its size, control over the oil wealth, and management of the majority of the sovereign wealth funds. Despite being only one of seven emirates, Abu Dhabi controls the majority of government operations and over 90 percent of the oil revenue, while the other emirates, namely Dubai, have more diversified sources of income based on the tourism, trade, and service industries.[3] For this reason, this report will focus primarily on Abu Dhabi's strategies to manage oil wealth.[4]

Figure 5: UAE Government Spending and Revenue on Oil Prices



Source: IMF Cross Country Macroeconomic Statistics

As seen in Figure 5, the UAE's government revenues have been highly correlated with oil prices historically, falling and rising at the same time from 1990-2010. They both fell dramatically in 2009 as a result of the global economic crisis, but after this point, the two lines intersect and revenue growth begins to outpace oil price growth. Though this turning point is rather recent, it does represent the significant strides that the UAE has made towards becoming more oil revenue independent in recent years, particularly after the formation of the Mubadala sovereign wealth fund.

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[1] "UAE Government: Political System." UAEinteract.

[2] Sara Bazoobandi. "The Political Economy of the Gulf Sovereign Wealth Funds: A case study of Iran, Kuwait, Saudi Arabia, and the United Arab Emirates." Routledge Studies in Middle Eastern Economics. 2013. Page 74.

[3] Oxford Business Group 2016.
Bazzoobandi 2012, 75.

[4] Abu Dhabi's other sovereign wealth funds include the Abu Dhabi National Energy Company, the Abu Dhabi Investment Company, and the International Petroleum Investment Company, but these organizations are focused almost exclusively in reinvesting their oil wealth into further development of the oil and gas industry, so their activities are not relevant to oil wealth diversification. Similarly, the Emirates Investment Authority and the Investment Corporation of Dubai serve as active managers of their governments' investments rather than diversification funds, so they are also excluded from this analysis.

THE ABU DHABI INVESTMENT AUTHORITY

As previously mentioned, a key component of a sovereign wealth fund's success in managing oil wealth in a way that best serves the long-term growth of the nation is its transparency. Following the Santiago Principles by publishing frequent reports that show the fund is following a sound legal system not only serves to reduce corruption, but it also encourages other foreign investors' trust in the country's stability and trustworthiness, which in turn leads to higher foreign investment and overall growth.[5] Unfortunately, Abu Dhabi is not very transparent in its wealth management activities. The Abu Dhabi Investment Authority (ADIA) has never published an annual report, and very little information regarding its investments, inflows, or outflows is available. Even its size is unknown, and estimates vary from US$600 billion to US$900 billion.[6] The Abu Dhabi Investment Council also owns a number of other sovereign wealth funds: Mubadala (estimated US$60 billion in assets), the Abu Dhabi National Energy Company (US $9 billion), the Abu Dhabi Investment Company (US$7 billion), and the International Petroleum Investment Company (US$6.5 billion), most of which have separate subsidiaries or foreign investment branches.[7] Combined, this makes Abu Dhabi's oil wealth extremely difficult to track, and the idea that significant funds are slipping through the cracks and into particular individuals' private bank accounts is not a far-fetched one.

Some attempts have been made, at least domestically, to give the appearance of transparency. In 1985, the Abu Dhabi Accountability Authority was formed "as an independent body reporting to His Highness the Crown Prince of Abu Dhabi to oversee public spending and ensure that the Emirate's funds are managed legitimately. Along with auditing government sectors and investigating corruption, it claims to ensure that "public resources and funds are managed, collected, and expended efficiently, effectively, and economically," which includes auditing the activities of Abu Dhabi's sovereign wealth funds.[8] A key flaw in this accountability system is that most of the reports produced by the Abu Dhabi Accountability Authority go directly to the Crown Prince, and are not released to the public, with the exception of selected excerpts. As a result, the organizations being audited are not held to worldwide best-practice standards or are accountable to the citizens of Abu Dhabi. Thus, any corruption that would hurt the Emirate from the perspective of the Crown Prince will likely be minimized, but if the Crown Prince does not see an issue as being particularly important, the world may never know about serious scandals or misconduct. Not only does this reduce the accountability of the royal family to its citizens, but it makes it extremely difficult to measure how well Abu Dhabi's sovereign wealth funds' money is spent and whether it is effective.

With between US $600 and US $900 billion in estimated assets under management, the Abu Dhabi Investment Authority (ADIA) is the world's second largest sovereign wealth fund, after Norway's Government Pension Fund, and whether its funds are invested properly and with good intentions is important to both the UAE and the global economy.[9] The ADIA was founded in 1976, soon after the UAE gained independence, with a mission to "sustain the long-term prosperity of Abu Dhabi by prudently growing capital through a disciplined investment process and committed people who reflect ADIA's cultural values."[10]

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

[6] Seznec 2008, 97.
Sovereign Wealth Fund Institute 2016c.

[7] Seznec 2008, 101.

[8] Abu Dhabi Accountability Authority 2015.

[9] Sovereign Wealth Fund Institute 2016c.

[10] Sovereign Wealth Fund Institute 2016c.

According to its website, the Abu Dhabi Investment Authority "has no visibility on either the spending requirements of the Government of Abu Dhabi or the activities of other Abu Dhabi entities established by the Government to make investments."[11] This does not seem realistic since the Chairman of the Board of Directors is Sheikh Khalifa bin Zayed Al-Nahyan, the ruler of the emirate of Abu Dhabi and the president of the UAE.[12] The Vice Chairman, Managing Director, and three other members of the ten member board are also members of the Al-Nahyan family and close relatives of Sheikh Khalifa bin Zayed Al-Nahyan.[13]

There is no set percentage of the government revenue that is to be set aside in the Abu Dhabi Investment Authority, as is specified for the Kuwait Investment Authority, but the UAE Constitution does specify that the Emirate's government is to provide the ADIA with funds that are surplus to its budgetary requirements and other funding commitments. If the government is not required to allot a certain amount to the fund each year, there is no incentive for it to give to the fund; if the allotment is based solely on a government surplus, the government may have a perverse incentive to spend on unnecessary or frivolous projects rather than putting the money away. On the other side, the ADIA "is required to make available to the Government of the Emirate of Abu Dhabi, as needed, the financial resources to secure and maintain the future welfare of the Emirate." Both of these are vague regulations, which leave the fund vulnerable to manipulation by the state. When the government holds this power to take from the fund whenever necessary, the fund can lose its effectiveness as a stabilization tool.

MUBADALA

Formed in 2002 with the mandate to "strengthen Abu Dhabi's growth potential, and to help the government meet its socioeconomic targets," Mubadala is Abu Dhabi's second largest sovereign wealth fund.[14] Rather than taking a hands-off investment approach by avoiding owning significant parts of any specific company, as most other sovereign wealth funds tend to do, Mubadala takes an active investment approach and attempts to guide the management of the companies with which it partners. While Mubadala does invest its US$60 billion in assets under management globally, it is largely focused on investing within the UAE, supporting infant industries and promoting growth within the country. For example, in 2013 Mubadala worked with Dubai Aluminum and Emirates Aluminum to create Emirates Global Aluminum, which was the largest industrial merger in the history of the UAE. Rather than serving as a savings fund, collecting steady returns for use by future generations, Mubadala is much more focused on delivering "strong social returns to Abu Dhabi and the United Arab Emirates."[15]

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[11] Abu Dhabi Investment Authority 2016.

[12] Bazoobandi 2012, 82.

[13] Bazoobandi 2012, 82.

[14] Mubadala 2016a.

[15] Mubadala 2016b.

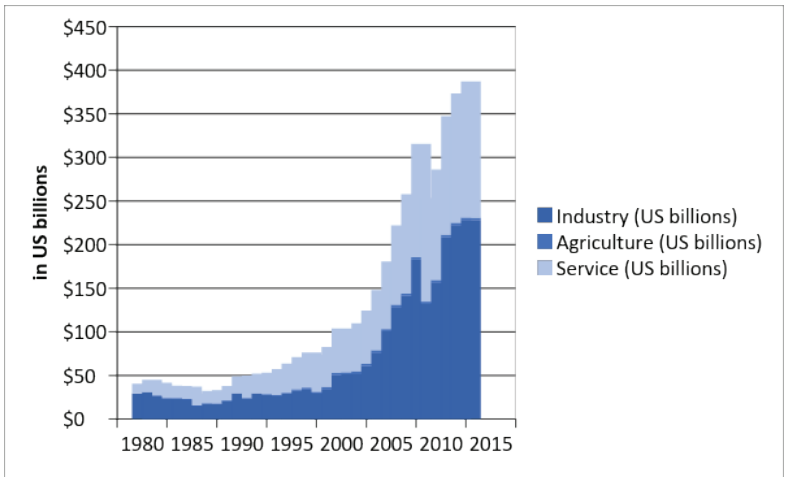
One of Mubadala's biggest investment projects to date is Masdar City, a planned city eleven miles east of the city of Abu Dhabi designed in collaboration with a British architecture firm and the Massachusetts Institute of Technology and meant to rely entirely on solar energy and renewable energy sources. This project is estimated to cost between $18 and $22 billion.[16] Two years after its initiation in 2006, the global financial crisis postponed the project's completion by up to ten years, and the current low oil prices are threatening to further affect the project. The first operational organization in the new city was the Masdar Institute of Science and Technology, and the city is planned to be a hub of scientific advancement, focused primarily on renewable energy and sustainability, with current projects researching desalination techniques, waste management, and sustainable agriculture.[17] While this project does have potential for extremely high returns, both financially and scientifically, it is quite risky. Masdar City could provide critical solutions to climate change, but it could also turn into an unremarkable experiment which essentially wastes US$ 20 billion of the UAE's wealth.

Though Masdar City is Mubadala's biggest project to date, it is not the only extravagant project started in the UAE in recent years. While the country can afford these demonstrations of wealth right now, and they may bring in significant tourism and foreign investment income, they are not the types of investments that have a high probability of creating steady returns through future economic downturns.

CONCLUSION

In recent years, the UAE's inflation adjusted GDP has grown at an estimated rate of 3.6 percent, while non-oil sector growth has been growing at a rate closer to 5 percent.[18] Figure 6 displays total GDP from 1980-2013 as a function of its different industries, with value added from the oil and gas industry included in "Industry" and retail, transport, professional services, personal services, trade, etc. categorized as "Service." While "Industry" has grown over the years at a compounded annual growth rate of 6.4 percent over the 33 years displayed, "Service" has outpaced it at 8.4 percent.

Figure 6: UAE Total GDP by Sector [19]



Source: World Bank 2016a, World Bank 2016b, World Bank 2016c.

[16] Anderson 2013.

[17] Locke 2008.

[18] Barakat 2015.

[19] The Agricultural Sector's contribution to GDP is negligible and therefore excluded in this figure

Abu Dhabi's sovereign wealth fund strategy is much more focused on diversification through domestic development than other Gulf countries which tend to prioritize long term diversification away from oil dependency through investment in foreign assets. To diversify within the UAE's economy, Abu Dhabi has focused on expanding its healthcare, biotechnology ,financial services, telecommunication services, and tourism sectors to make itself more attractive to foreign investment and the international business community.[20] As oil reserves are depleted and oil prices become more volatile due to high market supply or instability in the Middle East, this diversification of income within UAE may serve to take the UAE away from oil dependency. However, these extravagant investments do represent high levels of risk and if the funds are not adequately managed, they may do more harm than good.

The UAE has a very small population and the 21st highest GDP per capita in the world as of 2014, so it has significantly more tolerance for wealth mismanagement by the government than a poorer country, but it should be cautious with how funds are transferred to and from the government and the sovereign wealth funds (ideally structuring these regulations in accordance with the Santiago Principles) if it is to maximize its future growth.

The United Arab Emirates has also never had to withstand the direct impact of a significant regional conflict, as Kuwait and Saudi Arabia have, which means that emergency withdrawals have never been needed. To some extent, the UAE will be able to grow and withstand oil price and supply shocks based on its domestic diversification, but investing in the domestic economy diminishes the diversification purpose of sovereign wealth funds to some extent. On the one hand, this strategy does diversify income sources away from dependency on oil revenues, but it does not reduce dependency on a strong domestic economic position. One can only hope that in difficult times such as the current oil plunge that the sectors the UAE has invested in over the recent years will continue to show strong growth.

[20] Government of Abu Dhabi 2008.

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