Chapter 5

Power Brokers: Global Influence of Gulf SWFs

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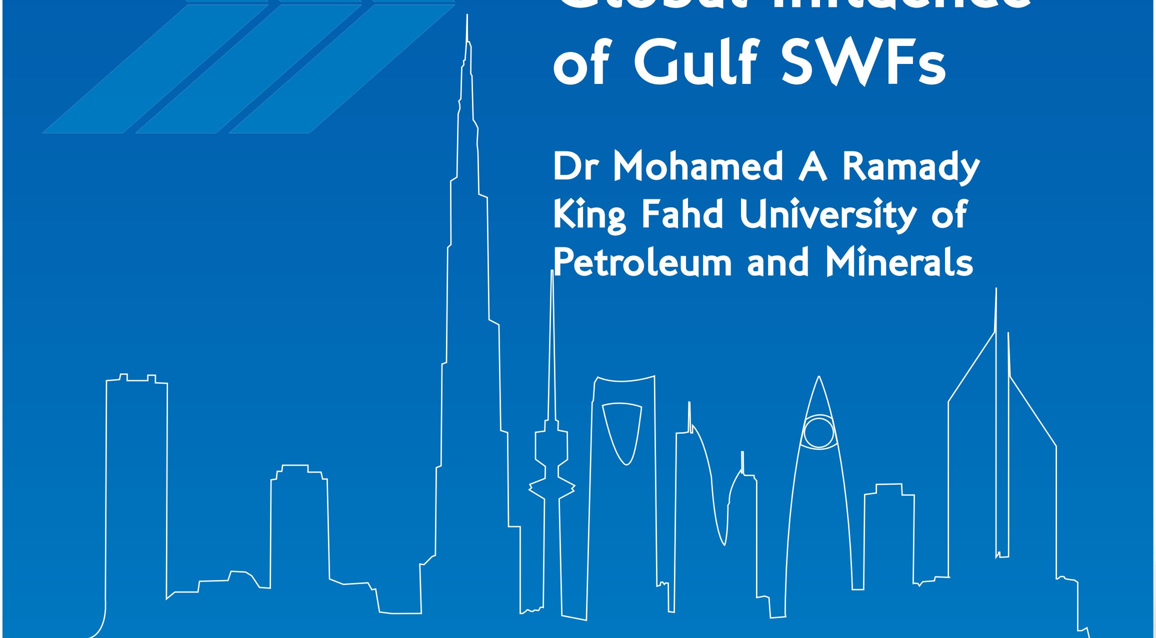

> *"When I had money, everyone called me brother…"*
>
> ***Polish Proverb.***

Overview

The unprecedented growth of Sovereign Wealth Funds (SWFs) and their increased activity in the global marketplace has generated a heated debate about the potential risks and opportunities for host and investor nations alike. This has brought to the surface an element of jealousy and fear on the one hand by host countries, and, in the wake of the current financial crises, some questioning of the wisdom of investing in shaky western corporations by investor nations. The custodians of the Gulf SWFs find themselves in a predicament that echoes some of the same arguments and fears of the 1970s era Arab oil producers' petro-dollar recycling debates. This time, unlike the 1970s when Western central banks "recycled" petro-dollar deposits as they saw fit, the Gulf SWFs owners have created institutionalised structures and professional management teams that make their own decisions on when and where to invest. It is this freedom to pick and choose amongst competing investment alternatives that is causing alarm from host countries at their loss of control of surplus funds.

The birth of the SWFs

The growth of SWFs has been somewhat erratic, with the first SWF being the Kuwait Investment Authority (KIA) in the 1950's to be followed by the Abu Dhabi Investment Fund (ADIA), in the 1970s. The 1980s saw the creation of the investment arm of Abu Dhabi's International Petroleum Investment Corporation in 1984, but it was in the late 1990s and this century that saw the emergence of the Qatari and Saudi SWFs. Indeed, out of the 44 non-pension global SWFs that existed by 2008, 24 had been established during the past eight years. The majority of these new SWFs, whether in the Gulf or elsewhere, were commodity demand-driven that helped commodity producers generate current account surpluses, or by dynamic growth economies such as China, India and Brazil. The size of these SWFs remains a matter of conjecture, but most commentators have suggested that SWFs will likely to continue to grow and solidify their position as significant global financial power brokers.

Morgan Stanley have placed the value of SWFs assets at around $ 3 trillion by 2007 and estimated this to increase to $ 15 trillion by 2015. The Arab Gulf countries estimated share is around $ 1.5 trillion, which is still a modest amount relative to the larger pool of managed funds by western institutions. According to analysts, this amounts to around $ 21 trillion managed by investment companies, and around $ 15-16 trillion by insurance and pension funds.

The debate concerning the influence and financial clout of the Gulf SWFs in particular, centres around accusations of a lack of transparency in the management of these funds as well as a lack of self- regulation which might cause financial volatility if they remain unregulated. How this debate plays out is important for both investing and recipient countries in order to avoid protectionism and barriers against SWF investment that might prove detrimental to the globalisation process. Even those who are fearful of SWFs financial power grudgingly agree that SWFs bring benefits to the global economy, as they behave as private funds. As such, it is argued they should receive the same treatment as private funds in the international financial markets.

Forming the SWF club

The SWFs have not taken such criticisms lying down and decided that there is strength through numbers. The recent launch of the Santiago Principles by the International Working Group (IWG) of Sovereign Wealth Funds was a step forward to foster trust and confidence in investment and risk management practices of SWFs. The aim of the "Santiago Principles" was to identify a framework of generally accepted principles and practices that reflect appropriate governance and accountability arrangements. However, after a follow-up meeting in Kuwait in Spring 2009, it still remains unclear what exact direction the IWG would take towards implementing the Santiago Principles.

Transparency and self-regulation works both ways, and SWFs have been particularly bruised by investment losses, registering a sharp drop in the value of their western placed assets. This has prompted some SWFs in arguing that prudent governance and accountability was not followed in the advanced financial markets and they should not be preached at by those who failed. The size of the estimated Gulf SWFs losses are hard to ascertain, but are probably severe as some Gulf SWFs had opted to invest significant portions of their portfolios in high-risk equity investments. Some SWFs announced their losses, with the Kuwait Investment Authority (KIA) declaring it lost around $ 30.7 billion from March to December 2008 while the Qatar Investment Authority (QIA) admitted to a 20% drop in the value of its assets. Only Saudi Arabia, with its more conservative investment policy in US Treasuries, saw the value of its investment portfolio managed by SAMA, rise to around $ 500 billion by year end 2008, up from $ 385 billion in the previous year.

Such losses and the continuing impact of the global financial crises and credit rationing, has prompted some SWFs to reconsider their strategy and invest part of their windfall in their domestic economies. No less than the International Monetary Fund (IMF) has publicly stated that Gulf SWFs can play an important role in stabilising regional economies amid the ongoing global financial crises, and the IMF urged such a move to domestic investments as a "temporary measure" from pure profit maximisation in order to support "broader macroeconomic financial stabilisation objectives". Some Gulf SWFs such as the QIA and KIA have bought local bank shares to prop up domestic market confidence and the IMF has recommended that in order to achieve such domestic investment support the Gulf SWFs need to ensure they hold sufficient liquid assets to take on their stabilisation role without realising losses.

The outcome of the current global financial crises is still uncertain and this uncertainty is also generating a debate on whether the role of the Gulf SWFs should be focused on domestic economic projects as a fiscal stabilising tool to promote economic growth when private sector demand slows. Saudi Arabia seems to have moved towards this model, but the larger Gulf SWFs such as QIA and ADIA, with smaller domestic economies and absorptive capacities, are still outward investment oriented, unless the Gulf oil countries move towards inter-GCC sovereign wealth investments. To date, most inter-GCC financial investment flows have been private sector driven, and it might be a long time before sovereign inter-GCC investments will become of any significance.

Gulf SWFs: Opportunists or Saviours?

Although SWFs account for less than 2% of the global traded financial securities, their significance in the global economy is increasing rapidly. While SWFs are accused of being opaque in their investment strategy and their ultimate goal, yet over the past two years, especially at the height of the global financial and credit crises, SWFs from the Gulf played an important saviour role for many distressed western financial institution, easing liquidity pressures in the international banking system

Table 1: Investment of Gulf Sovereign Wealth Funds 2007-2008

Date of Investment	Investment of SWFs in Financial Institution	Amount
May 2, 2007	Dubai International Capital buys an undisclosed stake in British bank HSBC Holdings .	n/a
June 10, 2007	Mubadala, a branch of Abu Dhabi Investment Authority, signs agreement with General Electric of USA to establish financial services company in UAE, and also acquires stakes in GE. (Other unspecified stakes are made in EADS and Rolls Royce).	$ 8 billion
July 13, 2007	Dubai International Capital purchases a 2.87 % stake in one of India's largest banks, ICICI Bank.	$ 750 million
July 23, 2007	Qatar Investment Authority buys 8% stake in British bank Barclays.	$ 2 billion
Sept. 20, 2007	Abu Dhabi-based Mubadala Development Co. buys a 7.5% stake of the management operations of Carlyle Group, and a stake in Ferrari of 5% for an undisclosed amount.	$ 2 billion
Sept. 20, 2007	The Qatar Investment Authority acquires a 20% stake in the London Stock Exchange and nearly 10% of Nordic bourse operator OMX.	$ 1.35 billion
Oct. 29, 2007	Dubai International Capital, acquires 9.9% stake in Och-Ziff	$ 1.3 billion
Nov. 26, 2007	Abu Dhabi Investment Authority acquires a 4.9% stake in Citigroup.	$ 7.5 billion
Dec. 10, 2007	Undisclosed strategic investor in the Middle East from Saudi Arabia invests in UBS.	$ 1.77 billion
Nov. 11, 2008	Qatar Investment Authority, Abu Dhabi and Challenger (Qatar Royal Family vehicle) buy mandatory convertible loans and reserve capital investments in Barclays, raising their stake to 32% of Barclays Bank.	$ 11.8 billion

Sources: Financial Times, Dealogic, Thomson Financial, AP Research 2007.

Table 1 above illustrates the key Gulf based SWF investments made in the international financial system. Without such Gulf SWF support, the cost of bailouts to Western taxpayers and their governments of distressed financial institutions would have been far greater than the multi-billion dollar bailout support extended.

From Table 1, we note that the most visible deals in term of name recognition were made by Abu Dhabi and Qatar, who acquired important stakes in financial institutions such as Barclays and Citigroup, but other western household names have been targeted. Just as in the era of the first oil price shock of 1973-1974 when the world was talking about "petrodollar recycling", the Gulf SWFs now face pressures of a similar kind. While the earlier era discussed the issue in terms of "financial assets", the current debate is in terms of "real assets" and the ownership of household names by Gulf SWFs. This makes SWF investment decisions more direct and somewhat threatening to host countries, as it places a "human face" on these investments, compared with the more anonymous and bland petrodollar purchases of government bonds of the earlier petro-dollar recycling era. In both cases, the issue seems to be debated from the viewpoint of Western countries, and Arab interests are hardly voiced.

Centrality of commodity prices

The future of Gulf SWFs is inherently tied to the fortunes of commodity prices, specifically oil prices. Since 2003, countries whose economies depended on the export of oil and gas have enjoyed a revival in their fortunes and accumulation of large external reserves. However, energy dependency is both a blessing and a curse. The choices faced by the oil producers in ending energy dependency have been well researched, and studies show that the boom in oil prices does not guarantee economic sustainability for these countries, most of which face hard policy choices over domestic consumption, development spending and rates of economic growth.

In general, development based on the export of hydrocarbons presents serious challenges. In the short term, spending the revenues that accrue from oil and gas exports can cause inflation and stimulate unsustainable government expenditure and subsidies. In the long term, depletion of the hydrocarbon reserves will limit what the hydrocarbon sector can do for the rest of the economy. The exploitation of resources may, however, become a cure for the problems of underdevelopment and poverty which affect many hydrocarbon exporting countries, if the resources are used to develop the non-hydrocarbon potential of their economies so as to replace hydrocarbon income in the long term.

Oil prices since 2005 exceed those of the 1970s and early 1980s in inflation-adjusted terms. The recent spike in prices reflected the end of the structural surplus of oil production capacity, which has dominated the world oil market since the second oil shock of 1979-81. During this period of surplus, oil exporters sought to cooperate within OPEC to protect revenues by managing supply. The challenge has now changed: what investments will best increase capacity, and how should the surplus revenues which are now being generated be managed? Growth can be constrained by depletion and rising domestic demand. This will happen, within varying time frames, as (a) country production flattens and falls and (b) continuing domestic consumption absorbs more of each country's production. The task is extremely difficult because of uncertainty over future additions to their oil and gas reserves, and over future international prices. The sharp fall in oil prices from peaks of $ 147 per barrel in 2008 to $ 55 per barrel levels in 2009 illustrates the extreme volatility and uncertainty facing oil producers.

To invest or not to invest?

Some governments are questioning whether to avoid or delay investment in further increases in energy production, which would contribute to financial surpluses but not necessarily develop the non-hydrocarbon economic sectors. As such, building up foreign investments through SWFs could provide a strategic hedge against the uncertainties of future reserves and prices.

According to recent studies there is a limited window of opportunity which exists before the "crunch point" comes, when support from hydrocarbon production levels off and eventually declines in each country. In economic terms, a country's economic dependence on the hydrocarbons sector is best measured in terms of two deficits. Where government revenue generated by the non-hydrocarbon sectors of the economy does not pay for government expenditure in those sectors, a "non-hydrocarbon fiscal deficit" appears, and where the foreign exchange generated by exports from the non-hydrocarbon sectors cannot cover imports to these sectors, a "non-hydrocarbon current account deficit" is created. Government hydrocarbon revenues and exports finance these two deficits, with any overall surplus being invested abroad and overall deficits being covered by foreign borrowing. The ratios of the deficits to government expenditure and imports respectively are measures of the dependence of the countries on hydrocarbon revenues. Countries which fail to adjust will be unable to sustain their present trends in economic growth. The ultimate "resource curse" is that the resource dependence cannot outlive the resource. This Catch 22 situation has been learned by Gulf countries.

Oil producers, especially those in the Gulf who have not diversified their economies sufficiently to withstand oil price shocks such as Saudi Arabia, and to a much lesser extent, the UAE and Kuwait, are faced by difficult choices in whether to continue to produce oil at lower prices or "keep oil-in-the-ground". Investment funds have two advantages over "oil in the ground": (a) they provide an income which is not directly dependent on oil and gas prices, (b) the capital sum provides a strategic hedge against the failure of oil prices to rise, and the failure of the non-hydrocarbon economy to make the changes necessary to replace oil and gas income during the transition from oil dependence.

There is thus a case for the oil- and gas-exporting countries to consider the build-up of investment funds as a strategic objective in its own right, not merely as a by-product of surpluses generated by a combination of production policy and international market prices. They also carry some risks: currency and financial market risks and, in extreme circumstances, the risk of exposure to foreign financial sanctions. The 2008 and 2009 global financial tsunami meltdown has vividly brought these realities home by forcing some hard headed rethinking of SWF investment strategies: are these short or long term?

These uncertainties are now forcing some Gulf SWFs to ponder existing long-term investment strategies. According to press reports, several of the SWFs have suffered heavy losses on equity investments. ADIA in particular, has publicly commented that it is reviewing its long term strategy of asset allocation to assess whether changes are warranted. Whether such reassessment includes divesting away from the dollar is a strategic decision, as most of the oil producers are predominantly dollar-based. The public announcements from the Arabian Gulf, particularly from Abu Dhabi and Saudi Arabia, is that they are likely to continue making dollar-based investments, because their revenues are dollar-denominated. The decision to divest from the dollar will not be an easy one, as any significant divestment will cause a further erosion in SWFs' asset values.

We love you, but ...

The acceptance of oil producer's SWFs might not come easy, as some western governments are now seriously considering creating their own SWFs to match those from developing countries and so appease growing concerns about the activities of foreign SWFs in their backyard. The French economy Minister Largarde called the idea of setting up a French SWF "seductive", and comes on the heels of French President Sarkozy who had earlier issued stern warnings about the dangers of some foreign SWFs as being "extremely aggressive". If the French decide to go ahead, then other European countries, who have so far adopted a more benign approach to SWF activities, might be tempted to reconsider their position and plan for their own sovereign funds. Even the European Commission joined the act, with the EU President Jose Barroso saying that Brussels could not allow non-European funds to be run in "an opaque manner or used as an implement of geo- political strategy." That worry was probably directed at Russia's growing oil and gas revenue clout, rather than Middle East SWFs. Whether the statement was directed to the Russians or not, it does little to ease the feeling of Gulf SWFs that, while they are not wanted, their money is loved by the west.

Controls on the horizon

Some countries are now introducing more stringent laws for acquisitions. In 2007, the US Congress passed the Foreign Investment and Security Act with the new law focusing not only on ownership, but of a more loosely defined concept of "control." This has implications for those thinking of more investment in the US – in the past, transactions involving a passive investment or a minority shareholder would have fallen outside of the scope of the Committee on Foreign Investment in the United States (CFIUS), even if the investor exercised de facto control of the company. This could now change.

The future of SWFs remains open – torn between those who believe in globalisation and free market economics and those unhappy with globalisation, de-nationalisation, distrust of markets, etc. In the final analysis, assumptions about SWFs intentions and effect remain unproven. Are SWFs agents of state powers or do they operate as another large investor? The world's economy goes through phases of dominance of one country over others. Just as Japanese investments in the 1980s raised exaggerated concerns then, we seem to be entering another period where free trade and open investment, especially from a resurgent China and OPEC members, are being questioned.

For SWFs to succeed in the long term, they certainly need to be more open about their intentions, as in the case of Norway and lately Singapore. At the same time, those countries that are effectively calling for barriers to be put up against SWFs, must realise that from the experience of the past 20 years, countries that have embraced globalisation grew faster than those that kept foreigners out, although the recent financial turmoil in the world also vividly demonstrated the contagion effect of too close an attachment to globalised economies.

Conclusion

Over the past few years, SWFs have gained importance in the global economy; predominantly, due to global macroeconomic imbalances between debtor nations and nations with liquidity surpluses. China, for instance, enjoys a huge excess of foreign exchange reserves. In June 2007, China's international reserves amounted to $ 1.3 trillion, more than the estimated Gulf SWF funds, if SAMA's $ 500-odd billion investments are excluded as the Saudi Monetary Agency does not operate like an SWF. At present, other emerging nations are benefiting from huge streams of revenue from oil and gas sales which has benefited Gulf SWFs. Emerging economies are gradually becoming important players in the global economy.

There are sound financial motivations for the growth of SWFs. The main driving force of their investing in the global market is in securing higher returns. Political considerations have brought fear among western countries; the argument is that governments could use SWFs to seize control of strategic companies in sensitive sectors for their own purposes. SWFs, especially from Gulf oil producers, are expected to rise in number, volume and buying power. Therefore, fostering a code of conduct that can allay the concerns of host and investor nations is in the interest of the global economy. However, in fostering greater transparency and accountability for SWFs, effective international co-operation among financial market participants is also needed if the Gulf SWFs are to be welcomed as partners rather than as grudging short term saviours. The IMF certainly believes SWFs can be important partners in global financial stability and that their relative size and influence in global markets will remain significant. In its most recent Middle East regional economic outlook the IMF also underscored a major trump card of Gulf SWFs: they will likely to continue to maintain longer investment strategies than most investors.

SWFs are here to stay and will become an important feature in global economic and political considerations for a long time to come. It behoves western governments to understand that, unlike the 1970's petrodollar recycling era, this time round the Arab Gulf SWFs want their voices to be heard in the debate. The alternative for some, especially for countries such as Saudi Arabia with huge infrastructure capacity needs is simple: invest the surpluses back home as even the IMF added that this was an important stabilisation role in the current global financial crises.

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