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Arab Sovereign Wealth Funds in the Global Public Policy Discourse

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Summary

In recent years, Arab and other emerging economies' sovereign wealth funds (SWFs)—government-controlled pools of assets designed to engage primarily in foreign investments—have grown into a relevant class of investors in global financial markets. Their past and projected growth has triggered an intense debate about their impact on the structure and architecture of the global financial system.

This paper argues that, rather than the absolute size of these funds, it is their rapid shift from the periphery to the center of global financial markets and the speed by which they have joined the ranks of other significant investor classes that have moved them into the global public space. Arab sovereign wealth fund managers have become increasingly sophisticated as global investors, managing complex international portfolios. Some of them make strategic investments in industries that their governments perceive to be particularly relevant for the development and diversification of their national economies.

The rise of SWFs has been accompanied by a heated public debate regarding the threats that such funds could pose to Western economic, corporate, and eventually political interests. However, these debates, which began in late spring 2007, have failed to develop substantial concepts to suggest how SWFs could constructively be integrated into the global financial architecture.

In response to public pressure, regulators on the international and national levels began to develop policies to provide new frameworks in which foreign investors, such as SWFs, could operate. The most important international initiative in this regard has been the International Working Group of Sovereign Wealth Funds convened by the International Monetary Fund (IMF), which sought to develop a voluntary code of conduct. However, this initiative has not prevented national regulators from developing their own policies with regard to foreign, sovereign investment. Rather, its results will compete with the outcomes of policy processes pursued on national and other supranational levels.

This complex political situation is posing new challenges for Arab investment managers. Given the SWFs' rapid transition from peripheral to central global investors, strategies that served them well in the past will have to be adjusted in light of their new position and exposure. They need to develop the capacity to manage more effectively the political challenges that are bound to confront them in the future.

Their newfound central position also needs to translate into taking broader responsibilities for the stability of global financial markets. For the time being, Arab investors have largely benefited from Western markets that are open and

fairly transparent. They made a financial contribution to maintain some degree of market stability in late 2007 and early 2008. Now, they need to go a step further by making an active contribution to the development of the norms and principles that will provide long-term stability to global financial markets. They need to play a key role in the construction of an institutional framework that will provide overall guidance to market participants.

Indeed, they have a profound stake in contributing to a new global framework that is robust enough to outbalance national legislation. Policies that would result in the fragmentation of the global investment space for SWFs are not in their interest.

The West, broadly speaking, will have to come to the realization that the global economic power equation is shifting. SWFs are not a passing phenomenon but a new, powerful, and lasting feature of international financial relations. Learning how to navigate a new investor landscape and how to negotiate with new investor classes eye to eye will become essential for Western economic diplomacy in its quest to secure access to capital from the Arab world and other emerging economies now and in the future.

Rather than focusing on defending Western assets from foreign investors, the West should acknowledge the foreign investors' new role and reach out to Arab SWFs in a constructive manner. The West should also consider the geopolitical consequences of tighter financial relations with the Arab world. Financial interdependence might help stabilize political ties between Western recipient economies and Arab investors. Arab strategic investments in Western assets can help diversify Arab economies and support the economic and social development agenda, thereby contributing to overall political stability in the broader Middle East. Finally, the West needs to prevent a populist agenda based on fear of foreign domination from determining its future policies with regard to Arab SWFs and those of other emerging economies.

There is room for speculation over whether the efforts of the International Working Group of Sovereign Wealth Funds, facilitated by the IMF, will acquire the necessary degree of legitimacy to shield financial markets from political intervention by national regulators. If, as financial analysts suggest, SWF assets increase from the current $3 trillion to $12 trillion in the coming years, financial markets and the explicit and implicit norms and principles that govern them will be under even greater strain than today.

International regulators need to take into account these profound transformations in global financial markets. A code of conduct that is tactically designed to help avoid controversy and to maintain business as usual will be insufficient. Any agreement between investing and recipient economies needs to be based on an understanding that fragmentation of the global financial markets is in nobody's interest. Investing and recipient economies therefore need to work toward an agreement that proves to be resilient in the long run.

Beyond tactical considerations, it would be useful for the key parties and stakeholders to engage in a sustained and inclusive dialogue to address the broader strategic context that will shape the global investment landscape in the years to come. This dialogue could help establish the basis for a new arrangement—one that enjoys the high degree of legitimacy necessary to provide long-term stability, as well as predictability, in global financial markets.

Background

In recent years, Arab and other emerging economies' sovereign wealth funds (SWFs)—government-controlled pools of assets designed to engage primarily in foreign investments—have grown into a relevant investor class in global financial markets. Their projected growth has triggered an intense debate about the future role that they would play in the world of global finance.

Sovereign wealth funds are not a new phenomenon, but until relatively recently they had been fairly peripheral players in the global financial theater. The transition from the periphery to the center was quick and consequential, driven by a massive inflow of capital from the West that went into commodity-exporting economies, principally oil-producing states but also other emerging economies. These incomes have provided an ever-broadening capital base for SWFs, catapulting them from the periphery to the center of global financial markets and turning them into the relevant players that they are today.

The increased prominence of SWFs has been accompanied by an intense debate about the consequences of their rise for the structure of global financial markets, their architecture, and the global economic system at large. That debate was instigated largely by a short report published by Morgan Stanley, suggesting that the total size of the SWFs could reach $12 trillion by 2015.[1] The most obvious concerns voiced by Western actors in 2007 and 2008 in turn include the compliance of SWFs with the principles of good governance and transparency; their impact on market developments; the strategic vulnerability of the United States; the potential strategic nature of SWF investments; geopolitical ambitions that their investments could help their owners to pursue; and direct threats to the national security of recipient economies.[2]

As a result of the debate over these concerns, Arab investors as well as Western recipient economies have begun to redefine their interests and to weigh their policy options. Arab investors have had to cope with a far-from-hospitable reception by a number of Western leaders and their publics, and they have had to weigh the emerging political risks against the attractiveness of Western assets and the availability of alternative options. Meanwhile, the West—the United States in particular—has had to weigh its needs to attract fresh capital to stabilize its economies against its interests in preventing foreign investors from extending their influence on the domestic asset base.

The objective of this paper is to review the rise of Arab SWFs as central players in global financial markets and to assess the rationale of their investments. It will evaluate the political reactions that Arab sovereign investors have faced in the West and the strategies they have employed in response. It will conclude with an outlook regarding the effectiveness of political arrangements to provide an institutional framework that is robust and yet reflects the changing nature of the structure of the global financial system that increasingly includes Arab SWFs and those of other economies.

Arab Sovereign Wealth Funds

The Arab countries of the Gulf are at the heart of a profound transformation of global financial markets, driven by the rapid ascendance of sovereign wealth funds.[3] The Arab world is home to some of the biggest SWFs and is aggressively creating new ones. The Abu Dhabi Investment Authority is by far the largest global SWF; its assets are estimated at anywhere between \$500 billion and \$875 billion. The Saudi Arabian Monetary Agency is assumed to manage \$330 billion, followed by the Kuwait Investment Authority at more than \$200 billion, the Investment Corporation of Dubai at more than \$80 billion, the Qatar Investment Authority at more than \$60 billion, and an ever-increasing number of smaller funds whose assets are around \$10 billion apiece. (See Table 1.)

Overall, the sovereign wealth funds of the Arab Gulf states are estimated to manage well over \$1 trillion. Including the assets managed by central banks, which approximate an additional \$460 billion, the combined portfolio might reach above \$1.5 trillion. Adding the assets of funds from Russia, Asia, Latin America, and Western economies, the current value of all SWFs combined is estimated at around \$3 trillion. Although it must be noted that this value is modest compared to that of other prominent investor classes (mature market institutional investors such as pension funds manage more than \$15 trillion, insurance companies \$16 trillion, and investment companies about \$21 trillion), it is big enough to consider the rise of SWFs as significant for global financial markets and to consider SWFs themselves as a new class of investors.

It would be misleading to conclude that the absolute size of SWFs would sufficiently explain why they have received so much public interest of late. Their global attention is due more to the pace at which they moved their position in global financial markets and to the continuing speed of their growth.

Table 1. Select Arab Sovereign Wealth Funds

Country	Name	Created	Est. size (billions)
Kuwait	Kuwait Investment Authority* (KIA)	1953	$213
Qatar	Qatar Investment Authority (QIA)	2003	$60
Saudi Arabia	Saudi Arabian Monetary Agency (SAMA)	1952	$330
UAE (Abu Dhabi)	Abu Dhabi Investment Authority (ADIA)	1976	$500 to $875
UAE (Abu Dhabi)	International Petroleum Investment Company (IPIC)	1984	$12
UAE (Abu Dhabi)	Mubadala Development Company	2002	$10
UAE (Dubai)	Istithmar World	2003	$12
UAE (Dubai)	Dubai International Capital	2004	$13
UAE (Dubai)	Investment Corporation of Dubai	2006	$82

Source: Edwin M. Truman, "A Blueprint for Sovereign Wealth Fund Best Practices," Policy Brief 08-3, (Washington, D.C.: Peterson Institute for International Economics, April 2008), own assessments.

* A portion of the holdings is in domestic assets.

Morgan Stanley projected in May 2007 that the total size of the SWFs could reach $12 trillion by 2015. According to Global Insight, SWFs have grown 24 percent annually in the past five years—a remarkable trajectory. This growth has enabled them to build a financially attractive asset base, diversified by taking broader interests in the global economy.

The following overview suggests that in parallel with their rapid growth, individual Arab SWFs have turned into sophisticated portfolio investors, spreading their risk across asset classes, industries, and geographies. Some actively contribute to the diversification and development of the national economies of their governments in the form of strategic investments. All face the challenges of how to position themselves as new, relevant actors in global financial markets and how to navigate the political space that they are embedded in.

Kuwait Investment Authority

The mandate of the Kuwait Investment Authority (KIA) is to achieve long-term returns on Kuwait's surplus oil revenue and to provide an alternative source of government income for when the country's oil resources are depleted.[4]

As an autonomous government body, the KIA is responsible for the management and administration of the Future Generations Fund (FGF) and the General Reserve Fund (GRF), as well as any other funds entrusted to it by Kuwait's minister of finance. In July 2007, the KIA revealed that its total holdings amount was $213 billion: $174 billion in the FGF and $39 billion in the GRF. The GRF holds all government assets and receives all government revenue, through which the state's budgetary expenses are paid. The FGF receives 10 percent of all state revenue annually and reinvests all investment income. All of the FGF's assets are held outside of Kuwait. The KIA's asset allocation is based on the global distribution of world GDP. However, a strategic review in 2004 recommended that the KIA diversify away from bonds and equities into other asset classes, such as private equity, real estate, and into emerging markets.

Some of the KIA's most prominent assets include a 7.1 percent stake in Daimler AG—making the KIA the single largest shareholder of the German car manufacturer—that dates back to an investment made in 1969; and a 3.3 percent stake in BP, which makes the KIA one of the most relevant shareholders of the global energy group. The latest sizable investments include a $720 million investment in the Industrial and Commercial Bank of China in 2006 that made the KIA its largest investor; a $3 billion investment in Citigroup and a $2 billion investment in Merrill Lynch during late 2007 and early 2008; and a $1 billion investment to finance Dow Chemical's acquisition of Rohm and Haas, a specialty materials company, in summer 2008. That same summer, the KIA announced its intention to allocate up to $50 billion, or 20 percent of its assets in Japan, apparently to rebalance its portfolio.

The KIA continues to be a quiet and loyal shareholder in its holdings around the world, a role best illustrated by the way in which it has managed its holdings in Daimler and BP.

Daimler-Benz AG acquired Chrysler in 1998 as part of its vision to become a globally integrated automotive company. Nine years later, however, after the Daimler management had failed to integrate its company with the U.S. car manufacturer, Chrysler was sold off. While there may have been reasons to divest from DaimlerChrysler, the KIA kept its stake and abstained from interfering.

Another incident that might still resonate within the KIA's institutional culture occurred in the late 1980s. Responding to opportunities opened by the ambitious privatization policy of then-prime minister Margaret Thatcher, the KIA built a stake of up to 22 percent in British Petroleum. Becoming its largest shareholder, however, prompted concern. A subsequent inquiry by the British Monopolies and Mergers Commission called upon the KIA to divest below 9.9 percent by October 1989. Although it had communicated to the British government that it did not aim to take an active role in the management of BP, the KIA responded to the political and regulatory pressure by considerably lowering its interests in BP.

As an investor, then, the KIA had to learn to live with intense political risks, in the case of BP, and as one that also maintained considerable loyalty throughout difficult periods, in the case of Daimler.

However, the KIA's quiet, wittingly nonpolitical approach was tested with the events that took place in late 2007 and early 2008. Its investments in Citigroup and Merrill Lynch pulled the KIA into the global public debate about the potential threats that these and other SWF investments could pose to the

Western banking sector, forcing it to explain the motives behind its investments. the KIA's leadership became among the first among SWFs to confront Western allegations.

There is room for speculation on what impact the public debate over the KIA's investments in Citigroup and Merrill Lynch has on its global investment strategy and how the KIA and other Arab SWFs are going to factor in the political risks they appear to be facing in the West.

In general, and since its establishment, the KIA has maintained its position as a sophisticated portfolio investor, spreading its risks across asset classes, industries, and geographies. It does not appear that the KIA has made any strategic investments that would substantially help Kuwait's economy diversify into other economic sectors beyond energy. Its engagements with BP and Daimler suggest that it has considerable experience to weather political risks and to minimize its public exposure. However, its sheer size as one of the world's largest SWFs will present a challenge to its strategy of maintaining a low profile.

The SWFs of Abu Dhabi

The emirate of Abu Dhabi controls three relevant SWFs: the Abu Dhabi Investment Authority (ADIA), the smaller, but more aggressive, Mubadala Development Company and the International Petroleum Investment Company (IPIC). Over the course of several decades, all three of these investment funds have been established to manage the emirate's oil and gas income, strengthen its position in the regional and global oil markets, and eventually help diversify Abu Dhabi's economy away from the risks posed by volatile oil markets.

The ADIA was established in 1976—the second relevant SWF in the Arab Gulf region and among the first worldwide—in response to the worldwide oil price spike in the 1970s. Its mission has been to secure and maintain the prosperity of Abu Dhabi through the prudent management of the emirate's financial assets.

Over the years, the ADIA has grown into the world's biggest SWF. However, it has continued to maintain a very low public profile. Little is made public about its governance, investment strategy, and assets. International financial experts speculated in 2007 and 2008 that its assets amounted to anywhere from $500 billion to $875 billion. This spread is a strong indication of the opacity that has characterized the fund. Adding to the difficulty in obtaining information about the ADIA is its policy of holding small equity stakes that remain below disclosure requirements. Another complication in assessing the ADIA's real worth is that it outsources 80 percent of its funds to outside firms.

Only in late 2007 and early 2008, driven by the turbulence in financial markets, did the ADIA move into the spotlight of the global public. Its acquisition of a 4.9 percent stake in Citigroup was perhaps the single most important event during that period, propelling the debate about sovereign wealth funds from a small circle of experts onto the radar screen of the international community.

And, similar to the the KIA, the ADIA responded to the pressures of the international public by providing more information about its policies.

It disclosed, for example, that in its asset allocation, the ADIA invested 45 to 55 percent in stocks of developed markets; 8 to 12 percent in stocks in emerging markets; 12 to 18 percent in government bonds; 4 to 8 percent in corporate and other bonds; 5 to 10 percent in alternative investments, and 5 to 10 percent in real estate; the remainder being its investments in private equity, small-cap stocks, infrastructure, and cash.[5] Its currency composition was estimated to be fairly balanced with 45 percent in the U.S. dollar; 40 percent in the euro; 5 percent in the yen; and 10 percent in the currencies of emerging markets.

While the ADIA seeks to maintain a balanced global portfolio of assets, the much smaller Mubadala (which means "exchange" in Arabic) plays a far more activist role in the economic diversification of Abu Dhabi. Mubadala was created in 2002 and, over the past few years, has developed an impressive network of international and domestic partnerships in numerous sectors, including energy, aerospace, real estate, health care, technology, and infrastructure and services.

Some of its most prominent international investments include a 7.5 percent stake in Carlyle, a private equity firm, which it bought in September 2007 for $1.35 billion; an 8.1 percent stake in the computer chip maker Advanced Micro Devices (AMD) for $622 million; a 25 percent stake in the Netherlands-based LeasePlan Corporation, a network of international companies engaged in fleet and vehicle management; a 5 percent stake in sports car maker Ferrari; and a 35 percent stake in the aerospace manufacturer Piaggio Aero.

What is interesting about these investments is that some of them provide an indication about how international partnerships based on a solid investment can benefit the economic development of the emirate. A joint venture with LeasePlan, called LeasePlan Emirates, offers fleet management and vehicle-leasing solutions. The investment in Ferrari provides the backdrop for the first Formula One Grand Prix to be held in the United Arab Emirates in 2009.

These appear to be modest examples, but Mubadala has also been keen to push forward with some more ambitious projects. The most recent illustration is its engagement with General Electric. In July 2008, Mubadala announced that it would seek to become one of GE's top ten shareholders, which, at that time, suggested an investment of well above $3 billion. Further, GE and Mubadala agreed to create an $8 billion global partnership that would include joint investments in commercial finance; clean energy research; and development, aviation, industry, and executive education.

To pursue its ambition to become a serious player in the global aluminum industry, Mubadala engaged in a joint venture with Dubai Aluminium Company (DUBAL) and established Emirates Aluminium (EMAL). In early 2008, it announced that it would study the possibility of building an aluminum smelter complex in Saudi Arabia. Apparently to supply the facility with bauxite (the raw material needed for the production of aluminum), Mubadala has also invested in the extraction and refining capacity of Guinea, the country with the world's largest bauxite reserves. Through EMAL, Mubadala is also conducting a feasibility study to build a smelter in Algeria to better serve European and U.S. markets.

Another way Mubadala is attempting to help diversify the emirate's economy is its plan to expand its nascent aerospace industry by developing ties with Boeing and the European Aviation Defence and Space Company (EADS).

These examples illustrate how aggressively Mubadala supports the emirate's diversification strategy through its ability to develop networks within and across different industry sectors.

The third relevant SWF from Abu Dhabi, the International Petroleum Investment Company, focuses on the emirate's investments in oil-related projects. Its investments include OMV, Austria's largest company and one of the world's leading oil and natural gas groups, and also a number of refineries and petrochemical corporations.

Recently, IPIC announced that it would become more active in Central Asia. In July 2008, IPIC and Kazakhstan agreed to launch a $1 billion fund to invest in energy and other sectors. It is also evaluating business opportunities in Uzbekistan and Turkmenistan. Eventually, its investment portfolio should reach $20 billion.

A fourth investment fund needs to be mentioned. When the Abu Dhabi Investment Council was established in 2006, it was assumed that it would take over the ADIA's domestic portfolio and control Abu Dhabi's investments in its Arab neighborhood. However, close to no information about the Council is publicly available, which has led to confusion about its role in Abu Dhabi's family of investment vehicles. In summer 2008, the Council attracted much public attention for its acquisition of a 90 percent stake of the Chrysler Building for as much as $800 million. The deal involving the New York landmark runs counter to the Council's alleged regional focus and adds to the general confusion about the role and mandate of individual sovereign wealth funds.

Overall, Abu Dhabi's SWF landscape seems to be structured by a division of labor among the different funds. Because of its size and the diversity of its international investments, the ADIA is a central player among global SWFs. It aims to play the role of a sophisticated portfolio investor tasked with gradually translating the emirate's oil wealth into well-managed financial assets. The ADIA's tight disclosure regime, which allows little information to make its way into the public domain, has made it a target of widespread speculation about its size and influence in global financial markets. Any arrangement designed to integrate SWFs more productively into the global financial architecture will therefore need a commitment on the part of the ADIA's leadership.

Mubadala, meanwhile, has taken on the challenge of contributing to diversify Abu Dhabi's economy. It aggressively builds up new international networks, partnering with global companies and engaging them in ventures that broaden the emirate's economic base. This approach is complemented by IPIC in the energy sector. And while there might be good reasons to direct one SWF, in this case the Abu Dhabi Investment Council, to oversee Abu Dhabi's regional portfolio, there does not appear to be any clear-cut division of labor between the Council and Abu Dhabi's other SWFs.

Most importantly, Abu Dhabi's political leadership has begun to respond to the public policy debates that unfolded in summer 2007 and that will be described in more detail below. It co-chairs the International Working Group of Sovereign Wealth Funds, developing a voluntary code of conduct for SWFs, and it reached an agreement with the U.S. Treasury and Singapore in March 2008 on a set of principles on SWFs' transparency and non-politization as well as avoidance of protectionism. That indicates that Abu Dhabi's leadership, far from being a passive observer, seeks to actively involve itself in the public and political debate about the future of the global financial architecture.

The SWFs of Dubai

While Kuwait and Abu Dhabi have managed their foreign investments through SWFs for some decades, Dubai has only recently developed its portfolio of SWFs in an effort to benefit from global investment opportunities. As such, Dubai does not have an extensive track record of managing the government's external assets through dedicated funds. Dubai's investment landscape is fairly fragmented, and private ownership in Dubai appears to be much more dominant than in other countries.

The main international investment vehicle of the government of Dubai is Istithmar World. ("Istithmar" means "investment" in Arabic.) Established in 2003 and capitalized with estimated $12 billion, Istithmar World has positioned itself on global financial markets with more than $3 billion of equity including a portfolio of more than 50 companies with assets in the financial services, consumer, industrial, and real estate sectors. Among its most prominent investments are a 2.7 percent stake in Standard Chartered that it bought in fall 2006 for $1 billion; a 3 percent stake in London-based GLG, the largest independent alternative asset manager in Europe with assets exceeding $20 billion; and an investment of around $170 million in the UK-based Pension Insurance Corporation Holdings, a leader in the provision of pension insurance to UK defined benefit pension funds and annuity providers. But although Istithmar World features an impressive portfolio of investments, it does not appear that its strategic priorities include making a major contribution to diversifying Dubai's economy. Its acquisition, with the Dubai real estate developer Nakheel, of a 20 percent stake in Cirque du Soleil, the Quebec-based live entertainment company, in summer 2008 and their plans to develop a permanent show on Palm Jumeirah, seem to be an exceptional strategic investment rather than the norm.

The mandate of Dubai International Capital (DIC), which was established in 2004 and capitalized with $13 billion, is to build an international portfolio of diverse business assets across a broad range of industries in North America, Europe, Asia-Pacific, and the Middle East and North Africa region. Its international ambitions and objective to acquire strategic holdings in Global Fortune 500 companies are reflected in its $2 million Global Strategic Equities Fund (GSEF), which has substantial investments in such companies as Sony, HSBC Holdings Plc., EADS, and ICICI, an Indian financial services firm. Within the next couple of years, GSEF plans to have up to $10 billion in assets under management. DIC is also active in private equity investments with acquisitions of Tussauds Group, the British engineering company Doncasters, the budget hotel chain Travelodge, and the German industrial packaging firm Mauser.

In summer 2008, DIC announced that it will get more involved in investing in emerging markets, particularly India and China. To advance its position in China, DIC and First Eastern Investment Group, a leading Chinese private equity firm, launched China Dubai Capital in April 2008 to target opportunities in China's growing economy. Already in 2006, First Eastern became the first Chinese investment bank to be registered at the Dubai International Financial Centre (DIFC).

There is, however, some public confusion about DIC's status. Some qualify DIC as a sovereign wealth fund, but DIC is wholly owned by Dubai Holding, which in turn is owned by the ruler of Dubai, Sheikh Mohammed bin Rashid Al Maktoum. That begs the question of whether funds owned by royalty do or do not meet the criteria of SWFs.

Istithmar World's ownership structure confirms the complex nature of ownership patterns in Dubai. Only through a layer of several holdings is Istithmar owned by the government. The first of these layers is Dubai World, a holding company that owns Istithmar. Dubai World, in turn, is owned by the Investment Corporation of Dubai (ICD), which is owned by the government of Dubai. ICD was created in 2006 with the transfer of the government's investment portfolio from the Department of Finance's Investment Division. It is this type of convoluted ownership structure that raises international concern about the transparency of SWFs.

The SWFs of Dubai and those that are assumed to be sovereign funds, such as DIC, have developed into sophisticated portfolio investors within a fairly short period of time. However, it is not easy to discern any strategically coordinated role they play in the development of Dubai's economy or what strategic directions their investments collectively follow. It is noteworthy that although Dubai seeks to become a hub for the financial services industry, neither Istithmar nor DIC seems to have a specific mandate to support this ambition. Although DIFC Investments, the investment arm of Dubai International Finance Centre has placed strategic investments in the banking sector, such as the acquisition of a 2.2 percent stake in Deutsche Bank in summer 2007, Dubai's investment vehicles appear not to have developed a consolidated strategy on how to benefit from the volatilities in this sector in 2007 and 2008.

The reason for the lack of an obvious strategy might be the complex ownership structure of the SWFs, which makes it difficult to effectively govern them. It also makes Dubai vulnerable to outside allegations on the transparency and governance of its sovereign funds, although individually they might be more transparent than some others in the Arab world.

Saudi Arabia

The position of Saudi Arabia as the world's largest oil producer would make it a prime candidate for operating a large sovereign wealth fund. However, for a long time the leadership of Saudi Arabia has been hesitant to use sovereign funds as its vehicle for engagement in global financial markets. The kingdom's economic geography and the size of its population require a considerable degree of financial liquidity and suggest a lower appetite for risk, providing the backdrop for an external investment policy that is considerably different from those of the smaller emirates in the Arab Gulf region. It was only in April 2008 that Saudi Arabia announced the establishment of an SWF; until then, its foreign reserves were managed by the Saudi Arabian Monetary Agency (SAMA), the kingdom's central bank.

SAMA's non-reserve foreign holdings were estimated to exceed $300 billion by 2008. Its reserves are valued at $30 billion. In addition to these funds, SAMA manages nearly $60 billion, including Saudi pension funds, on behalf of other government agencies. Its assets are mostly invested in liquid, low-risk bonds, but it also includes equities and higher-risk bonds, making SAMA a conservative investor. McKinsey & Company estimates that 20 percent of SAMA's total foreign assets are cash/deposits; 55 to 60 percent fixed income; and 20 to 25 percent equity. SAMA's dollar share of up to 85 percent is high. SAMA is assumed to outsource all of its equity allocation and probably also some of its fixed income management, indicating that Saudi private investors are active in placing investments.

Saudi Arabia's Public Investment Fund (PIF), governed by the Ministry of Finance, announced in late April 2008 the launch of the kingdom's first SWF, which was approved by the Saudi Cabinet in July. The new vehicle, Sanabil al-Saudia, will start with $5.3 billion and will be managed by a dedicated investment company wholly owned by PIF and intended to diversify the kingdom's financial asset base and improve its investment risk management. It also aims to diversify Saudi Arabia's economy by developing its financial services sector and building the asset management skills of Saudi nationals.[6]

It is too early to tell exactly what role Sanabil al-Saudia will play in international financial markets or in Saudi Arabia's national economy. Some commentators have speculated that any fund to be set up by Saudi Arabia would be much larger than $5.3 billion, given the drastic increase in Saudi Arabia's official foreign assets. Yet, the smaller, actual size of the newly established fund is deemed to be a reaction to the global public debate about SWFs and the political backlash they have encountered. The small capitalization suggests that the new fund might pursue a very cautious approach when building up its international assets.

The Qatar Investment Authority

The prime objective of the Qatar Investment Authority (QIA), which was established in 2003, is to help Qatar diversify its financial assets into new asset classes and to strengthen the country's economy. Consequently, the fund predominantly invests in international markets; within Qatar, it invests outside the energy sector. It is capitalized with an estimated $60 billion and is backed by surplus funds originating from the sale of Qatar's natural resources.

According to information disclosed in 2007, its holdings are composed of 40 percent in the U.S. dollar; 40 percent in the euro; and 20 percent in other currencies, including the British pound.

Some of the most interesting holdings include UK-based Four Seasons Health Care, which QIA obtained in September 2007 from Allianz Capital Partners for 2.08 billion euros; a 14.9 percent stake in the London Stock Exchange; and a 5.1 percent stake in the French group Lagardère. In February 2008, QIA acquired a 1 to 2 percent stake in Credit Suisse. Later, in July, it raised its stake in J Sainsbury, the UK's third-largest supermarket group, to 26 percent. That same month, it became the largest shareholder of Barclays.

Beyond these investments, it appears that QIA is very active in forging new alliances in the Arab world and in other emerging economies. Together with DIC, it acquired a 3.12 percent stake in EADS. In March 2008, the QIA and the Kuwaiti IPIC launched a $2 billion investment fund aimed at sectors other than oil and gas. Through its Diar Real Estate Investment Company, it plans to develop two real estate projects in Syria, including a $250 million mixed-use development in the coastal town of Latakia. It also has invested $350 million in the Rawabi project, which provides housing to more than 40,000 residents in the West Bank.

QIA's joint venture activities and investments in emerging markets reach well beyond the Arab world. It set up the $400 million PME Infrastructure Management Limited Fund to invest in African transportation, communication, and energy sectors. The QIA and Vietnam's State Capital Investment Corporation agreed in April 2008 to set up an investment fund valued at $1 billion to invest in Vietnamese oil, port, infrastructure, and property projects. It also assesses joint ventures with the government of Indonesia.

The QIA has become a fast-moving, active, strategic global investor with a focus on assets in Europe and realizing growth opportunities in emerging economies such as those in Asia and Africa. It has also spun a wide network across different industries, including financial services, health care, construction, and real estate.

Arab SWFs: The Challenge of Rising to a Global Role

The Arab sovereign wealth fund landscape is in the process of a profound transformation. Arab SWFs are fueled by a massive influx of capital driven by the high prices of natural resources. This has, as a matter of course, led them to explore investment opportunities outside their traditional investment patterns and to spread their funds' risk across asset classes, industry sectors, and geographies. In recent years, they have also become more active as strategic investors, by attempting to diversify their national economies away from oil and natural gas as their main source of income.

It appears that the next step for Arab SWFs—to become truly exposed players in globalized financial markets—is to spread their interests across developed and emerging economies and to forge new partnerships in the emerging markets of East Asia, Africa, and Latin America. The industrialized world has long been the preferred destination of Arab investments. The historical relationship with the West has enabled Arab investors to build a deep knowledge base about the functionalities of mature financial markets. Turning now to emerging economies, they need to build a corresponding knowledge base in order to succeed.

The tremendous growth of SWFs and the diversification of their portfolios have propelled them into a central position in global financial markets. Even if they wanted to play the role of quiet investors, their newfound visibility would prevent them from doing so. Their increasingly diverse mandate and the sophistication of their investment strategies have exposed them to a global and ever more politicized audience. This exposure has added another layer of complexity to their overall investment strategy.

Managing Political Exposure

Eventually, the most fundamental and qualitative challenge for sovereign wealth funds, as they rise to global financial roles, has been how to deal with the politics that surround financial markets. The preceding section showed how Arab SWFs have grown in size, number, and sophistication. This section assesses how they have managed the political risks they have been exposed to as a result of their rise and what conclusions could be drawn from their performance, also providing some indication about how their policies will affect the future architecture of global financial markets.

Agenda Setting in the West

"One day someone woke up in the morning and considered this [SWFs] to be a threat, a danger," Bader Mohammed al-Saad, managing director of the Kuwait Investment Authority, noted in an interview given to a German weekly on May 19, 2008.[7] That day can be fairly well identified. It was May 3, 2007. Morgan Stanley had published its short report suggesting that "calculations show that the total size of the SWFs could reach $12 trillion by 2015."[8] The paper did not offer any conclusions with regard to potential threats that the growing size of SWFs could pose. Rarely, however, did a half-sentence in a briefing paper attract such immense international attention. Those few words acquired quasi-iconic status by triggering a worldwide public policy debate about the role of SWFs in the world of global financial markets.

Political analysts and economists were quick to comment on this figure, suggesting that sovereign funds would shake the logic of capitalism,[9] thereby setting the tone for a much deeper policy discussion that would unfold some months later. They highlighted the low governance standards and lack of transparency of SWFs, questioning whether the motives behind their investments were purely economic or perhaps political as well. Critics argued that governance of SWFs should be made transparent and politically independent, solely maximizing risk-adjusted expected returns, otherwise "cronyism and political shenanigans are sure to intrude, particularly worrying at the international level."[10] For months, commentators in the West enjoyed agenda-setting power in much of the global media; Arab investors, at that stage, barely responded to explain their positions.

Public concern over the role of SWFs in financial markets increased further with the subprime crisis of late 2007 and early 2008. Arab SWFs and other investors bailed out a number of Western global financial heavyweight banks, including Citigroup, UBS, Morgan Stanley, and Merrill Lynch. SWFs made direct investments totaling more than $40 billion in global financial firms, which proved essential to fending off a more serious meltdown of the U.S. financial system. If in summer 2007 the rise of SWFs was debated only by an exclusive circle of specialists, by winter the discussion of the role of SWFs in global financial markets had become a mainstream issue. But instead of acknowledging the productive role that sovereign wealth funds played in stabilizing the markets, public commentators in the West became increasingly critical, citing the funds' considerable lack of transparency and suggesting a hidden political agenda. It is interesting to note that there was little reference in the public debate to Dubai Ports World's plan in 2006 to take over the management of major U.S. ports. Rather, the debate was anchored in the generic public skepticism about the growing influence of emerging countries in the economies of the West. It would be a mistake, however, to identify the subprime crisis and the subsequent investments by SWFs as the primary cause for the disparaging reception the SWFs received. The tone of the discussions and the agenda was set months earlier.

The Public Policy Process in Motion

The dramatic growth of SWFs' assets, along with the public attention, focused on the funds over the second half of 2007, increased the pressure on political leaders and regulators in the West to respond.[11]

On the international level, the most prominent initiative to provide a loose governance framework for SWFs was put forward by the International Monetary Fund. In April 2008, the IMF, assuming the role of facilitator, established the International Working Group of Sovereign Wealth Funds, co-chaired by a senior representative of the ADIA and the director of the IMF's Money and Capital Markets Department. The panel aimed to find agreement on a common set of voluntary principles for SWFs in the form of "Generally Accepted Principles and Practices" to be presented by October 2008.[12]

While the IMF's efforts focused primarily on standards for investors, the Organization for Economic Cooperation and Development was instructed by the G7 finance ministers and the OECD's other member states to develop guidance by mid-2009 for the recipient countries' policies toward sovereign wealth funds. The OECD's approach has been to maintain OECD member states' commitment to open international investment policies, including SWFs, while also recognizing the need to protect essential security interests.[13]

Beyond those international efforts, the European Union (EU) and its member states, along with the United States, began to develop policies to respond to SWF investments on the national and supranational levels.[14]

In February 2008, the European Commission argued that EU members' common approach to the treatment of SWFs should reaffirm the EU's commitment to open markets for foreign capital and to an investor-friendly investment climate.[15] The Brussels European Council in March 2008 noted that the emergence of new players with limited transparency regarding their investment strategy and objective raised some concerns relating to potential noncommercial practices.[16] Based on this assessment, the EC called for the development of a common European approach by the end of 2008.[17]

It is important to note that direct foreign investment activities do not necessarily fall under the mandate of the EU to regulate. Rather, it is left to the member states to conduct investment agreements with third countries. Accordingly, in 2008, the member states have been reviewing their own national foreign investment policies.

As in Europe, the role of sovereign wealth funds emerged as a prominent item in the political discourse in the United States. Numerous congressional hearings were held, starting in November 2007, in an attempt to arrive at a greater understanding of the strategic implications of large-scale SWF investments in U.S. assets.[18] Two schools of thought emerged. Pragmatists contended that SWFs, as other foreign investors, would constitute a vital source of capital for the U.S. economy. They highlighted the stabilizing role that SWFs played in late 2007 and early 2008 in advocating that the U.S. economy be kept open for foreign investors. Populists asserted that foreign investors, lacking transparency, would pose a threat to U.S. strategic and economic interests by acquiring some of the most valuable U.S. assets and eventually threatening the welfare of U.S. citizens. In February 2008, two Virginia congressmen, Jim Moran, a

Democrat, and Tom Davis, a Republican, established a bipartisan task force to assess how SWFs could affect the geopolitical interests of the United States and the international economy.

The Bush administration was proactive in engaging with SWFs in an effort to identify ways that would preempt greater protectionist measures and keep the U.S. economy open to foreign investments. Secretary of the Treasury Henry Paulson toured the Gulf region in late spring 2008, partially in an attempt to defuse fears of a more protectionist stance on the part of the United States. And, in a move to preempt tighter legislation, the Treasury on March 30 reached agreement with Singapore and Abu Dhabi on principles for sovereign wealth fund investment.[19]

Arab Reactions

The Arab world was taken aback by the frosty reception it received in the West, particularly in late 2007 and early 2008. It had not responded to the concerns voiced in the Western media a few months earlier, in summer 2007, either because it had failed to monitor the public debate in the international media and therefore missed out on the “weak signals” that foreshadowed the much harsher public reaction to come, or because it had grossly underestimated the relevance of the early rumblings. As a result, Arab fund managers found themselves in a defensive position when they placed their investments in late 2007 and early 2008.

In late January 2008, they began to regain some of the ground they had lost in the preceding months. Any fear of SWFs, they argued, was unfounded and unjustified.[20] The leadership of Abu Dhabi launched an attempt to alleviate Western concerns by sending a letter to Western financial officials affirming that the emirate’s SWFs sought only to maximize risk-adjusted returns and were not using their investments as a foreign policy tool.[21] Others joined in the argument, reconfirming their commitment to national and international regulations in addition to their support for the international economy.[22]

At the same time, SWF leaders articulated their demands that the West become more transparent about its regulatory frameworks and its definition of strategic or critical sectors that needed to be protected from foreign investors.[23] They also began to place their investment decisions in a political context, emphasizing that emerging markets were more welcoming of investments than Europe or the United States. Additional regulations imposed by the EU and the United States to greatly restrict SWFs not only would make the investment environment less attractive for sovereign investors, but also would create adverse consequences for global capital flows.

Some Arab leaders also expressed opposition to the IMF’s efforts to develop a voluntary code of conduct for SWFs. The governor of the Central Bank for the UAE issued a statement on behalf of thirteen countries, which argued that the IMF did not have the requisite expertise to produce a set of best practices for SWFs.[24] Their stance on the matter changed, however, and the ADIA and other SWFs later supported the efforts of the IMF.

From Agenda Setting to Policy Making

The period from May 2007 to late summer 2008 provides an excellent case study of a global policy cycle in the making.

Until May 2007, SWFs were well at the periphery of global public attention. For decades, they existed far below the radar of policy makers and regulators. However, the May 2007 publication of Morgan Stanley's report changed that. Reactions in the West to this report can best be summarized as "too loud, too early" and in the Arab world as "too quiet, too late." Several Western commentators reacted in an openly antagonistic manner to the rise of SWFs without developing options of how the funds could be constructively integrated into the global financial system. Arab commentators were largely silent, allowing the Western commentators to set the agenda as well as the tone of the debate. Only in January 2008 did they begin to explain their positions to an international audience. But by then, Western public perceptions of non-Western SWFs and their emerging financial clout were already shaped.

The weakness of Western banks' balance sheets and the strength of Arab SWFs' cash positions in late 2007 and early 2008 provided the backdrop for another occasion to assess how relevant SWFs had become. The Arab reaction to the subprime credit crisis and the bailing out of Western financial institutions had a temporary stabilizing effect on the markets. If the discussions in summer and fall of 2007 were largely based on rather academic findings, the intense public discussions in the months that followed were inspired by watching the SWFs in action as they bailed out Western banks. This newfound role provided an opportunity for Arab fund managers to participate more actively in the public policy debate and to highlight the constructive role they were able to play during the crisis. It also had an impact on the Western positions, nurturing the emergence of the two schools of thought mentioned previously. The pragmatists highlighted the systemic relevance that SWFs had taken on and the need to identify ways for constructive cooperation, while standing firm on core demands of transparency and governance standards. The populists focused on the threat that SWFs would pose to national security and their influence over the economic well-being of the public.

By early 2008, the public policy discourse evolved into the formation of more concrete political positions. The IMF and the OECD were the most prominent international organizations to facilitate negotiations about the norms and principles that could provide a foundation for the future role of SWFs and pave the road toward better integrating them into international financial markets. Their efforts, however, did not prevent national regulators from developing their own policies vis-à-vis foreign investors in general and SWFs in particular. The Arab world, after initial hesitance, made some valuable contributions in the international policy process, best illustrated by the ADIA's co-chairmanship of the International Working Group.

Looking ahead, given the numerous policy processes under way on the national and international levels, intense competition can be expected among different policy approaches to the challenges that SWFs present. The outcome of the International Working Group's deliberations will be particularly important because most countries that have SWFs are involved in the process. Furthermore, it is vital that the group's work results in a robust framework that anticipates the tremendous growth of SWFs in the mid-term future, further straining any new financial markets regime.

Should the International Working Group fail to present a resilient framework for the global financial architecture, states will revert to national legislation in regard to regulating SWFs. The outcome of these policy processes will largely be a function of the domestic discourse between pragmatists and populists in the Western countries.

Moving Forward: When Money Should Talk

The rise of SWFs in the past years appears to have taken most, if not all, stakeholders in the global financial system by surprise. Western policy makers and the general public were surprised by the emergence of financial powerhouses from the Arab world, Russia, and China. Arab investors were surprised by the antagonistic reception they received in the United States and Europe. International regulators were surprised by the precariousness of the consensus on which the international financial architecture is based.

More than one year into the discussion about the new role of SWFs and the future of the international financial architecture, the principal actors have begun to weigh policy options. The analysis in this paper suggests a number of issues for them to keep in mind.

Recommendations for Western Policy Makers

The West, broadly speaking, will have to understand that the global economic power equation is shifting and that the West is no longer the uncontested dominant player in global financial markets. The emergence of SWFs is not a passing phenomenon but a fixed feature of international financial relations. Securing access to capital from the Arab world and other emerging economies has become a substantial challenge for Western economic diplomacy. Without this capital, Western financial markets would have been in greater trouble in late 2007 and early 2008. The West also needs to realize that the new investors with whom it is dealing have become increasingly sophisticated in pursuing their investment objectives. Arab sovereign investors are in the process of building substantial capacity to manage ever more complex portfolios and to balance the political risks they might face in the future.

Developing the capacity to navigate a new investor landscape and to negotiate with a new class of investors eye to eye will become essential to securing access to capital now and in the future. In doing so, the West must acknowledge that the bargaining power of the Gulf countries has increased considerably, because of the sheer weight of their financial clout and the rise of interesting, alternative investment opportunities in emerging markets.

In summer 2007, the West reacted strongly to the emergence of Arab sovereign investors but generally failed to develop a coherent approach to constructive collaboration. The West has yet to accept the Arab economic institutions as partners in the development of an international financial markets architecture that reflects the structural transformations that the global financial system is undergoing.

In its deliberations, the West should also consider the geopolitical consequences of tighter financial relations. Financial interdependence will compel Western recipient economies and Arab investors to develop more stable political ties. And Arab strategic investments in assets that are designed to support the diversification of Arab economies have a positive impact on economic and social development in a region that the West perceives to be highly unstable.

Representatives of Western financial institutions who have tended to be pragmatists need to actively engage their domestic constituencies and prevent populist sentiments from dominating policy outcomes.

Recommendations for Arab SWFs

Arab SWFs have repeatedly argued that they are proven, stable, long-term investors without any particular agenda beyond securing adequate risk-adjusted returns. They have argued that the clearest indication of their future performance is their past investment behavior. But given the dizzying growth of these funds, it is unlikely that the past is a good predictor of their future policies.

Arab SWFs have grown in size and number and have become sophisticated investors. A strong argument can be made that their newfound role as some of the global economy's principal financiers will have a tremendous impact on their strategic outlook. It is plausible to assume, as they already have begun to do, that they will adjust their investments and policies to correspond with their newfound central position in financial markets. That shift will have substantial consequences for their governance and management. Even if they wanted to maintain their long-time status as quiet, low-scale investors, their central role in global financial markets will prevent that from happening.

The transformation of Arab investors from successful players into responsible leaders with a global vision will entail a number of elements: Their newfound central position needs to translate into taking broader responsibilities for the stability of global financial markets. For the time being, Arab investors have largely benefited from Western markets that are open and fairly transparent. They made a significant financial contribution to market stability in late 2007 and early 2008. They now need to go a step further and make a more studied and policy-based contribution to international market stability. And since SWFs have been at the core of a structural transformation of financial markets, the time has come for them to participate at the core of building the institutional framework that will provide overall guidance to market participants.

The Arab world has a profound interest in open and coherent global financial markets. Any fragmentation caused by national regulation and national political pressure will make it more difficult for Arab investors to make efficient investment decisions.

Arab investors should also develop a more differentiated understanding of the Western reactions to their investments. As described above, the public in the West is highly fragmented over the risks and benefits of SWF investments in its economies. The outcome of the debate between pragmatists and populists on how freely foreign investors will be able to acquire assets in Europe and the United States will determine the overall investment climate. It is in the interest of Arab SWFs to make concessions vis-à-vis Western demands for more transparency and higher governance standards, thereby strengthening the pragmatists' case to work cooperatively with the SWFs.

The public debate in the Arab world has hardly taken notice of the emergence and investment strategies of their countries' SWFs. It is both important and legitimate for Arab public opinion, media, and civil society to begin to take a more healthy interest in their countries' SWFs and to demand a more transparent accounting of how their nations' funds are being invested. In particular, the Arab public could legitimately ask what social and economic goals are being served by the investments and to what degree they are serving broader regional objectives.

Arab SWFs need to further develop their institutional capacity to manage the complexities of the politics that surround global financial markets. The period from early summer to winter 2007 provides a strong clue about how a lack of political awareness can affect the commercial interests of SWFs.

Recommendations for International Regulators

The rise of SWFs and the structural transformation of international financial markets have posed challenges to key principles and norms, including transparency and governance standards, which have long been important components of the international financial architecture. The key initiative to maintain these norms has been the International Working Group of Sovereign Wealth Funds, which aimed to produce a voluntary code of conduct for SWFs. But it is far from certain that this effort will acquire the necessary degree of legitimacy to shield global financial markets from political intervention by national regulators. If, as predicted, SWF assets increase from the current $3 trillion to $12 trillion in the coming years, financial markets and the explicit and implicit norms and principles that govern them will be under even greater strain than today. Given the immense interest that the public has taken in the issue, along with the political pressure that built up in 2007 and 2008, it is legitimate to question whether a voluntary code of conduct would provide a sufficiently legitimate and, thus, stable framework within which SWFs can operate. A code of conduct that is tactically designed to help avoid controversy and maintain business as usual would be insufficient and can serve only as a first attempt to provide some overarching structure and order during transitional periods in the global economy.

Any international agreement needs to take into account that the opponents of foreign sovereign investment base their case also on populist arguments. If international agreements fail to factor in those sentiments, there is less of a chance that any agreements will acquire the degree of legitimacy that can withstand tighter national legislation driven by cruder political arguments.

Prior debates have not sufficiently emphasized the common interests on which an agreement between investing and recipient economies can be based. Both sides, capital exporters and recipients alike, have argued their respective cases from defensive positions. Arab investors have warned against discrimination and made clear that tougher regulations in the West would have negative repercussions on their financial engagements. Western arguments have not been lucid about whether it is the "opacity" of Arab and other SWFs that they are concerned about or whether a general fear of undue financial power is affecting their policies. It would therefore be useful for the key stakeholders to engage in a sustained, inclusive, honest dialogue moving beyond tactical considerations to address the broader strategic context that will shape the global investment landscape in the years to come. Such a dialogue might succeed in establishing the basis for a new arrangement that enjoys the legitimacy, credibility, and robustness needed to provide long-term stability and predictability in global financial markets.

Notes

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