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Managing Arab Sovereign Wealth in Turbulent Times—and Beyond

Sven Behrendt and
Bassma Kodmani, Editors

The custodians of Arab sovereign wealth have found themselves in a precarious situation, having to respond, first, to an external audience when it appeared that their influence in the world of finance had substantially increased; and, later, to a domestic audience when it appeared that they might have overplayed their hands.

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CHAPTER 7

Sovereign Wealth Funds: An Instrument Marked by Its Birth Conditions?

Samir Aita

As in old feudal societies, everyone is marked by his or her birth conditions in the financial markets of capitalism. And thus this is the case for sovereign wealth funds (SWFs). No one can choose how they were born.

Considering SWFs first involves the question of the "nature" of public money in hard currencies—"public," in the sense that SWFs' resources come from the surpluses of central banks, which are state institutions, from a country's foreign trade and transfers. This money thus belongs to the citizens of this country, and it is managed by a state-owned institution that should be accountable first and above all to them. However, because this money was born in "foreign" currencies—say, dollars—it cannot be used directly in the country, unless the country is "dollarized"—that is, it internally uses two currencies, its local one and the dollar. This is rarely the case, as it is, for example, in Lebanon. So the SWFs were born from the start marked by a dilemma: How to use public money outside the country, in assets more beneficial for the country's current and future generations than U.S. (or other highly indebted developed countries') Treasury bills? And, as we are talking of surpluses: How could this public money be placed in the long term for the benefit of a country's citizens?

The question of birth is also that of the country of origin, because most SWFs were born in developing countries—Arab, Asian, or others. The Norwegian SWF had grown for decades and was allowed its place "under the sun" of the financial markets, without polemics. It is only when these "strangers" came to play on the ground that the furors about "invasion"[1] and "worrisomeness"[2] with regard to national securities were raised in the media and by political players in developed countries. And at this level also, the birth was marked by other dilemmas—why SWF investments from developing countries should be dormant and nonstrategic, only available to save companies and financial institutions facing bankruptcy in the developed world, while the developing countries should open their companies and utilities, strategic even if less technologically advanced, freely to foreign capital and multinationals. Or is it, as in international politics, "two weights, two measures"? The issue here is clearly the legitimacy of SWFs playing a role in their countries' industrial policies in a globalized world—why their investments should not follow any logic, contrary to a classical multinational.

SWFs as Institutional Investors

SWFs (presently managing \$2.5–4.0 trillion[3]) are not the most important institutional investors acting in the world's financial markets. Pension funds and mutual funds, as well as insurance companies, have already been and will continue to be the major global players (each accounting for managing \$18 trillion to \$22 trillion). The extent to which their investments are transparent and free from their respective government's interventions, or that of national-champion multinationals, is a real question in political-economy terms. Some of them were even created and grew as public entities, like the SWFs—namely, the public pension reserve funds (PRFs).[4] These PRFs account for \$4 trillion to \$4.5 trillion, the biggest being those of the United States (around \$2 trillion) and Japan (\$1.2 trillion)—much bigger than SWFs. The difference, as the Organisation for Economic Co-operation and Development (OECD) states it,

> brings to light the geopolitics of SWFs: most SWFs are located in non-OECD countries and are dependent on global trade and exchange rates; all PRFs are based within the OECD and are dependent on demographic change and ageing societies…. SWF pools…are expected to grow rapidly in the coming years, [whereas] PRF pools (as well as other private pension funds) should begin to cash out between 2010 and 2025…. The requirements of accountability, suitability and transparency are broadly met by these reserve funds. However, some specific details of the funds' governance and investment management could be improved in a few countries, such as enhancing the expertise in the funds' governing boards and constraining discretionary interventions by government.[5]

These governance concerns, mildly stated by the OECD, have now evolved with the perspective of the current world crisis, as some governments, like France, have created their own state-financed strategic investment funds, which are dedicated to reinforcing and stabilizing the capital of French companies.[6] The question of governance and the accountability of public funds to their owner-citizens, and that of national interest, are intricate, and are becoming even more intricate with the global crisis.

These issues are continuously evolving, and they have reached a turning point with the current crisis. Before the crisis, who dared, in fact, to point a finger at the "bad children" of financial capitalism—the hedge funds? Their size was similar to that of the SWFs; they hid—and are still hiding—behind tax havens; and they were specializing in speculation, the aggressive acquisition and dismantling of industrial ventures, and glamorizing bad assets and distributing them in the world financial system, with some tricky games with rating agencies. These hedge funds were, however, well born—the legitimate children of major banks and insurance companies, and other institutional investors based in developed countries. And such birth conditions influenced even angry world leaders at the recent London meeting of the Group of Twenty (G20) to mildly agree that "it is necessary to extend regulation and oversight … for the first time, systematically on important hedge funds."[7] However, as after the Washington G20 meeting, these new recommendations were "music to the ears of many (hedge) fund managers."[8]

Arab SWFs: Governance, Transparency, and Industrial Policies

In the developed countries, the media turmoil over SWFs went along with the emergence of public concerns about the adverse consequences of globalization—the delocalization of jobs, protectionism,[9] and the national interest—despite the OECD's calls for freedom of investment and the fair treatment of SWFs.[10] The case of Dubai Ports World's tentative acquisition of P&O, including its operation of some U.S. ports, which was accepted by the Committee on Foreign Investment in the United States but blocked by the U.S. Congress,[11] had clearly shown that the issue goes far beyond "fair" protectionist measures. Things have changed only relatively with the current major global crisis, as the SWFs were called to save and to behave responsibly as part of the global financial system.[12]

In the Arab world, the major concerns were at another level. In fact, the media turmoil about Arab SWFs had first shed light on a long-standing concern of Arab citizens: the social distribution of oil revenues (and of revenues from other natural resources). In fact, it is worth noting that the first Arab SWF was created by Kuwait, a country with a relatively democratic public life, and that the second one was created by the Emirate of Abu Dhabi, whose leader was sincerely concerned about public policies, industrial as well as geopolitical. From the point of view of the citizens of Arab countries, the creation of Arab SWFs was then seen as a positive step: The countries' oil surpluses would go to a public institution and not be distributed among princes or other members of the "power system."[13] Public money in hard currencies would serve public policies and not private interests. And it should be noted that a major transparency and governance concern in many Arab countries with respect to the revenues of exported natural resources is still to have the share devoted to the "power system," and not in SWFs, under citizens' scrutiny.

With the development of Arab SWFs, a second issue arose concerning their institutional governance and accountability as state institutions. In those PRFs in OECD countries with the best governance practices, such as social security funds, the governing bodies typically include members nominated by the government and representatives of employers, as well as representatives of workers (generally trade unions). The same situation exists for the PRFs' investment committees, even if independent audits and public disclosure are sometimes not up to OECD guidelines.[14] Some PRFs are also directly accountable to national legislatures. Such practices only rarely exist for Arab SWFs, as with many other public institutions in the Arab countries, including social security and other funds operating in local currencies. For instance, the board of directors of the Abu Dhabi Investment Authority is recruited from—only—senior government officials. The Kuwaiti Investment Authority is accountable beforehand to the Council of Ministers. And Saudi Arabia's nontreasury-bill public investments are managed directly by the Saudi Arabian Monetary Agency, which avoids putting the issue of accountability on the table.

However, the major concern from an Arab citizen's perspective is with SWFs' investment policies and objectives. In fact, SWFs represent about twice the total gross domestic product of the Arab countries, for which remittances from foreign workers (roughly $50 billion yearly) constitute the major incoming capital flow to sustain non-oil-producing economies (and are their real social safety net) and are far more important than foreign direct investment.[15] A significant share of Arab SWFs' investments went to other Arab countries, but mostly in Arab stock markets, which bubbled up recently also to more than the size of the total gross domestic product of Arab countries, with only around a thousand companies in the market. Not only have Arab stock markets experienced two severe corrections—respectively, in 2006 and more recently and more severely with the global crisis in the autumn of 2008—but half these stock markets' capitalization has been made up of financial and real estate companies, a quarter of telecommunications firms, and the remaining quarter of all other service, agricultural, and industrial companies, oil industries included. With the current crisis, SWFs are assumed to have experienced severe losses, both in regional and international markets, amounting to $450 billion to $600 billion,[16] yet they are being called to intervene to save regional banks and real estate companies from bankruptcy.

It is the comparison between the size of these investments, especially the losses, and the development investment needs of the Arab countries that shock Arab public opinion. Even in the countries belonging to the Gulf Cooperation Council, infrastructure and public services are much below capacities.[17] Also, the non-oil-producing Arab countries are experiencing the highest unemployment rate in the world and one of the highest poverty rates;[18] and all are moving toward deindustrialization—calling into question the efficiency of SWFs' investments for fostering development in their own countries. This disappointment comes along with that about the Madrid peace process, which instead of launching a major "Marshall Plan" for the Arab countries ended with controversial Euro-Mediterranean and other free trade (and free investment) agreements. And the meager $2 billion fund to promote small and medium-sized enterprises, put forth by the last Arab League Kuwait summit, will not alleviate disappointed Arab public opinion.

Perspectives

From a global perspective, the issue of SWFs is not really that of their behavior toward a responsible global financial system; it is mainly the regulation of such a financial system that the current crisis has shown to be going crazy at many levels (hedge funds, rating agencies, conflicts of interest, tax havens, and so on), with no real perspective that an agreement could be reached soon for sound and fair global regulation. Taxpayers and unemployed people in the OECD countries are currently paying the price for such deregulation. And there are also the issues of protectionism and national security, given the destructive results (for jobs and welfare, and, in the OECD countries, also for technology investments) of global financial capitalism. Can anyone expect these to decline with this crisis?

From the perspective of the Arab countries, the issues of SWFs are those of the social distribution of revenues, the transparency and accountability of state-owned institutions, and investment policies for economic development and industrialization, on the levels of both each country and Arab complementarities. In short, these issues are precisely those of state building, democracy, and development. As one says in Arabic, you have to care first about your parents to be able to be good with others.

Notes

1 "Invasion of the Sovereign-Wealth Funds," *Economist*, January 19, 2008.

2 See, for example, the debates of the Council on Foreign Relations at http://www.cfr.org/publication/15484/mckinsey_executive_roundtable_series_in_international_economics.html.

3 Morgan Stanley Research, "Currencies: How Big Could Sovereign Wealth Funds Be by 2015?" May 3, 2007.

4 See Juan Yermo, *Governance and Investment of Public Reserve Funds in Selected OECD Countries*, OECD Working Paper on Insurance and Private Pensions 15 (Paris: Organisation for Economic Co-operation and Development, 2008).

5 OECD Investment Committee, "Consultation on Sovereign Wealth Funds: Comments by TUAC," Organisation for Economic Co-operation and Development, December 13, 2007.

6 See http://www.caissedesdepots.fr/IMG/pdf_CP_FSI_CDC_201108.pdf.

7 The London Summit 2009, "Global plan for recovery and reform: the Communiqué from the London Summit," April 2, 2009, see http://www.londonsummit.gov.uk/en/summit-aims/summit-communique/.

8 "For Hedge Funds, Little News from G20 Is Good News, So Far," *Hedge Week*, November 17, 2008.

9 "Thinktank Calls for EU Laws to Curb Sovereign Wealth Funds," *Guardian*, November 10, 2008.

10 OECD Investment Committee, "Sovereign Wealth Funds and Recipient Countries' Policies," Organisation for Economic Co-operation and Development, April 4, 2008.

11 Like many similar entities in other OECD countries, such government entities as this OECD committee can block any foreign investment in the United States, if contrary to national interests and security; what the OECD answers is that "national security is a legitimate concern but should not be a cover for protectionist policies." OECD Investment Committee, "Sovereign Wealth Funds."

12 "Gordon Brown Asks Gulf Wealth Funds to Invest in U.K.," Bloomberg, November 2, 2008.

13 The term "power system" is preferred here to "regime," because it refers, in republican or royal regimes, to rulers who are not accountable to the public, that is, to state institutions and citizens. See Samir Aita, "Reforms, State and Politics in Syria," in *The Changing Role of the State*, ed. S. Radwan and M. Riesco (Cairo: Economic Research Forum, 2007).

14 See Yermo, *Governance and Investment*.

15 Samir Aita, *Towards Reinforcing the Role of Capital and Investment in Arab Social and Economic Integration* (in Arabic), background paper for the Arab Development Summit of Kuwait, January 2009 (Cairo: Economic Research Forum, 2008).

16 For different estimations, see www.sovereignwealthfundwatch.com.

17 See, for example, the debates in the Arab press on the "scandal" of the Jeddah sewage system.

18 See, for example, World Bank, *Unlocking the Employment Potential in the Middle East and North Africa: Towards a New Social Contract* (Washington, D.C.: World Bank, 2008).