CHAPTER 4

# Sovereign Wealth Funds and the Politics of Boom and Bust

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Sovereign wealth funds (SWFs) burst upon the global scene, seemingly out of nowhere, in late 2007 when they acquired in just a few months more than $60 billion worth of shares in major global financial institutions. In the fad-driven world of finance, SWFs were the new stars. Latecomers such as Russia and Saudi Arabia rushed to create their own SWFs—in essence redirecting part of their foreign exchange reserves into a private equity arm that would seek high returns on the international equity markets.

Much of the debate has focused on the concerns, the fears, and the hopes of recipient countries: What do SWFs *really* want, and what is their impact on the host countries? As will be discussed below, the concept of governance, vague as it is, has been useful to placate critics and justify needed policies of openness or protectionism, but it does not explain much. To unlock the mysteries of SWFs, one needs to look at the changing political-economic context of the SWF-holding countries. Rather than having an unchanging essence, SWFs change with the ups and downs of oil prices.

The argument developed here is that in times of rapid rises in the price of oil, such as the periods 1973–1981 and 2003–2008, "technocrats" (experts in charge of making investment decisions) enjoy some autonomy, whereas in periods of stagnation and decline, such as the years between 1981 and 2003, and likely the post-2008 era, politics trumps technocracy. In the boom years, a financial logic prevails. Yet as soon as boom turns to bust, technocrats come under attack for their bad investments, and the politicians have to respond to myriad domestic and international demands.

As I have discussed elsewhere, there is a great deal of diversity among SWFs in general.[1] Those belonging to the states in the Gulf region do, however, have a few things in common: Their wealth depends directly or indirectly on oil and other sources of energy, and they evolve in an environment sharing political, religious, cultural, and geostrategic characteristics. A dynamic approach is essential, because the very peculiar circumstances of late 2007 and early 2008 have led to beliefs and generalizations that have taken on a life of their own, despite the fact that they are no longer warranted or relevant.

## Governance: A Red Herring

There are striking parallels between the oil price shocks of the 1970s and the 2003–2008 rise in oil prices.[2] In both cases, the sudden rise of "Arab money" stoked fears while whetting appetites. In the 1970s, business magazines were wondering how long it would take before Arab money would be able to buy all of Wall Street. In recent months, analysts have engaged in similarly wild extrapolations. Morgan Stanley analysts have predicted that SWFs will increase from $3 trillion in 2008 to $12 trillion in 2015. This guesstimate has been endlessly repeated, leading some to speculate that by 2015, SWFs "could be bigger than the U.S. economy."[3]

In the 1970s, Hans Morgenthau, then the best-known international relations specialist, expressed his outrage: "The control of oil, the lifeblood of an advanced industrial state, by potentates who have no other instrument of power and who are accountable to nobody, morally, politically, or legally, is in itself a perversity. It is a perversity in the sense that it defies all rational principles by which the affairs of state and the affairs of humanity ought to be regulated to put into a few irresponsible hands power over life and death of a whole civilization."[4] At the time, to avoid a protectionist backlash, managers of Arab wealth had to show that they were "responsible" in the "recycling of the petrodollars." The outcry was mitigated by economic recession in the West and the fact that, in addition to a few high-profile investments, much of the newfound wealth was placed in large international banks or was used to purchase U.S. Treasury bills.

In the years preceding the recent banking crisis, a system of "gated finance" based on de facto exclusion had come into existence. As in those gated residential communities where a small number of privileged people are protected from the surrounding often-chaotic environment, the major financial institutions enjoyed a great deal of freedom added to the privileges of self-regulation; but this came at the price of greater vigilance toward the outside world.[5] Despite the rhetoric of free enterprise and open capital flows, the system's flagships were not to be sold to outsiders. In 2005 the attempt by the China National Offshore Oil Corporation to acquire the oil company Unocal was foiled. The following year the prospect that Dubai Ports World could gain control of six American ports met with a great deal of resistance in the U.S. Congress and the media. Then came the current financial and economic crisis, and with it new attitudes toward certain foreign investors.

In 2008, as investors from China and the Gulf region started buying bank stocks, Jim Cramer, the star analyst of the CNBC financial news cable television network asked, "Do we want the communists to own the banks or the terrorists?" before answering "I'll take any of it, I guess, because we're so desperate."[6] The new attitude was, in the words of Kristin Halvorsen, the minister of finance of Norway, which is home to the second-largest SWF: "They don't like us, but they want our money."

Such contradictions would be resolved with talk of governance and codes of good behavior. The new consensus was that SWFs would be welcome, provided they were committed to good governance. The Organisation for Economic Co-operation and Development, the International Monetary Fund, the World

Bank, and other international organizations started devising codes stressing transparency, accountability, and responsible investing. SWFs would also commit to restraining from investing for strategic or political reasons.

Despite the fact that investments by SWFs have slowed considerably, the rush to adopt such codes has not. In October 2008, the Abu Dhabi Investment Authority, the world's largest SWF, took the lead in issuing a statement of investment principles stressing transparency, accountability, and good governance.[7] Many other unilateral and multilateral declarations of good governance have since followed.

All this is somewhat ironic—considering, first, that the guiding lights of global finance on Wall Street and elsewhere have not been, as recent developments have amply shown, paragons of good governance; and, second, that with the growing intervention by governments, the world of finance is being increasingly politicized. In this respect, it is revealing that one of the newest SWFs in the developed world, created by France, is primarily designed to protect national industries from foreign SWFs.[8]

It should be said that the concept of good governance, though heartily endorsed, is increasingly fuzzy. Indeed, a 2008 survey of corporate governance practices in the Middle East and North Africa found that while the vast majority of publicly listed banks and companies believed corporate governance to be vitally important, more than half—53 percent—of the participants did not know what the expression meant.[9]

## Between Technocracy and Politics

There are two main characteristics to the technocratic phase observed in the boom years. One is that a significant part of surpluses is invested overseas; the other is that wealth managers are likely to be professionals somewhat insulated from politics. The focus on foreign investment and the quest for high returns are based on the view that local Gulf markets are too small to absorb sudden financial windfalls, and that wealth should be husbanded for the benefit of future generations.

In both periods of rising oil prices, the investment technocracy, much courted and much feted, had its day in the limelight. In the 1970s, the extent of mismanagement of oil wealth was not immediately clear. Boom times often have a self-fulfilling element: Growth feeds upon itself, and short-term gains are often interpreted as proof of the talent of the managers and the justification for their relative autonomy. But as the saying goes, one should not confuse brains and a bull market. Inevitably, disappointment sets in. In 2007 and early 2008, the consensus was that the move by SWFs to buy financial stocks at the bottom of the market was clever—until it became clear that the market was far from hitting bottom.[10]

The technocratic logic becomes unsustainable when recession hits. Investment funds hunker down. Foreign investment and private equity deals become less significant, and new priorities appear. Policies that once seemed logical show their limits. In the early 1980s, as in late 2008, the oil-producing countries were hit with sudden global economic downturns, which affected them in multiple ways. In addition to the double whammies of sharp drops in oil revenues and losses from foreign investment, new demands appeared, first as a result of the recession at home, but also as a result of commitments made and expectations built up in the boom years.

In the context of the current recession, investments in shares of global financial institutions have quickly become an embarrassment.[11] SWFs are first and foremost funds for future generations, whose duty is to help fructify the national capital or at the very least preserve it. Because charity begins at home, the idea of rescuing foreign companies when national firms need rescuing musters little domestic support. Thus, as national economies have been hit by the recession, a number of SWFs have announced a reorientation of priorities toward the home (or at least the regional) market, in particular toward local infrastructure projects.[12] The Kuwait Investment Authority and the Qatar Investment Authority have been called upon to inject liquidity in collapsing stock markets, recapitalize banks, finance stimulus plans, and more generally make up for the decline in the value of oil exports.[13] In Dubai, the recession has caused a massive reorganization and scaling back of SWFs.[14] Two of Dubai's SWFs—Dubai International Capital and the Dubai Group—were merged, as Abu Dhabi came to the rescue of Dubai. In Kuwait, the question of mismanagement and the squandering of public money was behind the resignation of the cabinet, the dissolution of Parliament, and the subsequent paralysis of political institutions.

Given the opacity of Gulf politics, the multitude of politically driven deals will only start to be known when future historians look back at the contemporary period. It is nonetheless useful to consider three dimensions—domestic, regional, and international. At the domestic level, governments must respond to the demands of various constituencies, and dwindling resources must still somehow finance big projects launched in euphoric days—whether in development, educational, or media projects—not to mention stepped-up efforts at public diplomacy.[15] Such challenges are exacerbated by underlying tensions (succession battles, sectarian conflicts, restless and often jobless youth, yearnings for democracy, and so on). At the regional and international levels, there is the ubiquitous question of "checkbook diplomacy," justified by the wealth—real or perceived—of the Gulf nations. Against a backdrop of geostrategic threats (the Arab–Israeli conflict, Iran and Sunni/Shi'i tensions, nuclear issues, the "war on terror," and so on) and political and military dependence on the United States, these countries are called on to pay for war and peace, purchase weapons, and help pay for the maintenance of the international order.

A striking illustration of the speed with which boom can turn to bust can be found in Kuwait at the beginning of the 1980s. With its vast oil production and small population, Kuwait looked immune to economic trouble and was poised for an era of great prosperity. It was also regarded as a pioneer of what were not yet known as SWFs. In the summer of 1981, after years of a seemingly unstoppable flow of oil revenues, another outlet for Kuwait's new oil wealth appeared—an informal financial market known as the Souk Al-Manakh, which listed fifty-four recently formed Gulf companies (mostly from Bahrain and the United Arab Emirates). Unlike the staid official market, the unregulated Souk Al-Manakh, with its skyrocketing values, looked like the place where instant fortunes could be made. At its peak, its market capitalization was said to be the third highest in the world, behind only the United States and Japan.

The incredible rise in the value of these fifty-four companies was fueled in large part by the common practice of postdated checks, as thousands of investors drew against funds they did not have. Investors would routinely write such checks for twice or three times the price of the stock. It took only a year for this seemingly unstoppable bull run—which had the entire country caught in a speculative fever—to end, when one of the postdated checks was presented to a bank and bounced. In August 1982, the Kuwaiti government ordered all such dubious checks to be turned in for clearance. According to the official investigation, the total of such checks was $94 billion.

Despite the burdens of this massive bailout, funding demands—domestic, regional, and international—did not abate. All things being relative, the outside world had a hard time believing that Kuwait was broke, or even that it was facing a liquidity crisis. One pressing financial demand that was impossible for Kuwait to turn down was that presented by Iraq, at war with Iran between 1980 and 1988, as the powerful neighbor argued that the war was also protecting Kuwait and indeed the entire Gulf region from Iranian-style fundamentalism. The Gulf War was also the occasion for embarrassing revelations about the Kuwait Investment Office (later to be known as the Kuwait Investment Authority), the first of those institutions that were not yet called SWFs, which was then highly regarded yet nonetheless was depleted by 60 to 80 percent from a prewar total of $100 billion, as a result of politically driven expenditures, mismanagement, and fraud.[16] It is a cautionary tale about the ease with which the coffers of an SWF can be emptied.

In the current global financial and economic crisis, the greatest demands are likely to be placed on Saudi Arabia, the world's largest exporter of oil. As of this writing, Saudi Arabia has embarked on a massive economic recovery program worth $400 billion, which the International Monetary Fund considers as the largest in the countries belonging to the Group of Twenty.[17] Like the other Gulf countries, Saudi Arabia is also expected to make significant contributions to the International Monetary Fund. It is too early to know about other handouts to regional and international causes, but if recent history is any indication, they are likely to be substantial. Much is known about the Saudi role in financing the Afghan jihad, and about the Saudi agreement (in 1980) to match American expenditures in Afghanistan dollar for dollar.[18] But Saudi checkbook diplomacy has extended much farther, all the way to places such as Angola or Nicaragua.[19] In the Saudi-bashing climate of the post–September 11, 2001, period, Prince Turki Al Faisal, the former Saudi chief of intelligence, reminded his Georgetown University audience in February 2002 of the role played by his country when the United States was hobbled by political and economic constraints:

> In 1976, after the Watergate matters took place here, your intelligence community was literally tied up by Congress. It could not do anything. It could not send spies, it could not write reports, and it could not pay money. In order to compensate for that, a group of countries got together in the hope of fighting communism and established what was called the Safari Club. The Safari Club included France, Egypt, Saudi Arabia, Morocco, and Iran …. The main concern of everybody was that the spread of communism was taking place while the main country that would oppose communism was tied up. Congress had literally paralyzed the work of not only the U.S. intelligence community, but of its foreign service as well. And so, the Kingdom, with these countries, helped in some way, I believe, to keep the world safe at the time when the United States was not able to do that.[20]

Charles Freeman, who was the American ambassador in Saudi Arabia between 1989 and 1992, also recalls the incessant financial requests he had to make—the largest one being the $65 billion Saudi contribution to the 1990–1991 Gulf war—as well as a running dispute with the Saudis about the true state of their finances. In his words, “There was simply disbelief [in Washington] that Saudi Arabia could be cash poor.”[21]

This analysis has sought to show that the conventional wisdom on SWFs is flawed. It is based on a simple extrapolation of recent trends that disregards likely cycles of boom and bust; it is based on a private equity logic that leaves politics out; and it looks at governance and codes of good behavior as panaceas. The question of how the excess wealth of oil-producing countries is spent is a complex one. In times of boom, a private equity logic may be a good approximation of investment strategies. In times of bust, however, such a logic is trumped by political factors. The use of SWFs thus can only be understood in relation to the collision of countless claims on oil revenues made at the domestic, regional, and international levels—and how governments choose to adjudicate among these claims.

## Notes

1 Ibrahim Warde, "Sovereign Wealth Funds to the Rescue: Are They Saviours, Predators or Dupes?" *Le Monde diplomatique*, April 2008.

2 There were two distinct oil price shocks. The first, at the time of the October 1973 Arab-Israeli war, resulted in a quadrupling of the price of oil over a four-month period. The second, in 1978–1979, resulted in a doubling of the price of oil as a result of the Iranian upheavals that led to the Islamic Revolution.

3 Kathryn Hopkins, "Sovereign Wealth Funds 'Could Be Bigger Than US Economy by 2015,'" *Guardian*, April 28, 2008.

4 Quoted by Jack Anderson and James Boyd, *Fiasco: The Real Story Behind the Disastrous Worldwide Energy Crisis—Richard Nixon's "Oilgate"* (New York: Times Books, 1983), 256.

5 Ibrahim A. Warde, *The Price of Fear: The Truth behind the Financial War on Terror* (Berkeley, Calif.: University of California Press, 2007), 107–125.

6 Peter S. Goodman and Louise Story, "Foreigners Buy Stakes in the U.S. at a Record Pace," *New York Times*, January 20, 2008.

7 "A Bid for Trust," *Financial Times*, September 4, 2008.

8 Philippe Ricard, "La France propose des fonds souverains en Europe pour protéger le capital des entreprises," *Le Monde*, October 23, 2008.

9 "Time for Transparency: What Will It Take to Improve Corporate Governance in the Middle East?" Knowledge@Wharton, March 11, 2009, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2178.

10 Heather Connon, "Why Sovereign Wealth Funds Can't Get Enough Bank Shares," *Observer*, June 22, 2008.

11 Stanley Reed, "Sovereign Wealth Funds Taste Bitter Losses," *Business Week*, December 11, 2008.

12 Marc Roche, "Les fonds souverains du Moyen-Orient battent en retraite," *Le Monde*, November 30, 2008. Also see Simeon Kerr, "Istithmar Set to Launch Fresh Asset Sales," *Financial Times*, March 8, 2009.

13 Antoine Reverchon, "Des investisseurs financiers provisoirement affaiblis," *Le Monde*, November 11, 2008.

14 Simeon Kerr, "DIC Cuts Workforce in Rare Arab Redundancies," *Financial Times*, October 1, 2008.

15 One example is the efforts of the Qatari government to sponsor an agreement among feuding Lebanese factions.

16 Youssef M. Ibrahim, "Financial Scandal Is Shaking Kuwait," *New York Times*, January 10, 1993. See also Marc Roche, "L'éclipse du KIO: Victime de la guerre er des difficultés du Koweit le puissant bureau d'investissement de l'émirat n'est plus que l'ombre de lui-même, " *Le Monde*, May 26, 1992.

17 P. K. Abdul Ghafour, "Kingdom's Recovery Program Largest in G-20: Al-Assaf," *Arab News*, April 4, 2009.

18 Robert Gates, *From the Shadows: The Ultimate Insider's Story of Five Presidents and How They Won the Cold War* (New York: Simon & Schuster, 1996), 148–149.

19 George Crile, *Charlie Wilson's War: The Extraordinary Story of the Largest Covert Operation in History* (New York: Atlantic Monthly Press, 2003), 236.

20 Prince Turki Al Faisal, special address, Center for Contemporary Arab Studies, Georgetown University, February 3, 2002. See also John Cooley, *Unholy Wars: Afghanistan, America and International Terrorism* (London: Pluto Press, 2002), 15–18.

21 David B. Ottaway, *The King's Messenger: Prince Bandar Bin Sultan and America's Tangled Relationship with Saudi Arabia* (New York: Walker, 2008), 104–105.