

Does the rise of sovereign wealth funds (SWFs), government owned investment vehicles, as relevant financial and political vehicles have any relevance for the analysis of energy security? “An issue ignored is a crisis invited”, Henry Kissinger once pointedly remarked. For the past decades, the industrialized economies of the West and the oil producers of the Gulf region have been linked by an uneasy, yet robust energy supply and demand relationship, determining respective political agendas and interests. It now might be profoundly challenged as both parties seek to distance themselves from what they perceive as an unhealthy dependence on oil.

For Western oil consumers, concerns about carbon dioxide emissions and the impact of the increasingly tense geopolitics of the region, as the Obama administration has repeatedly stressed, has made it imperative for the West to think about its energy security beyond oil from the Gulf. On the supply side, the strong hydrocarbon sector and relatively prudent government spending have enabled governments from the Gulf to transform their mineral assets into a viable financial asset base, stored mainly in SWFs. The revenues realized by SWFs already contribute a significant share to the public finance of Gulf States, reduces the volatilities of their GDPs and their dependence on oil prices respectively.

The emergence of SWFs is not merely a freak event resulting from global financial imbalances and discontinuities in global energy markets such as the oil price spike of the most recent past. SWFs from the Gulf and their peers from Norway, China and Singapore have become a new systemically relevant actor group on the international tableau. Since finance and its various agents, institutions and markets have become incontrovertible forces in the global economy, the current size and expected growth trajectory of SWFs from emerging economies fundamentally alters the geoeconomic balance of power and adds to the forces undercutting Western global power.

The world's SWFs collectively control over \$3 trillion of assets under management. Though this is far less than other established investor classes, such as pension funds (\$25 trillion), mutual funds (\$18.8 trillion), and insurance assets (\$16.2 trillion), they are the biggest amongst emerging investor classes, i.e. hedge funds (\$1.4 trillion) and private equity (\$0.9 trillion). Most SWFs' assets are concentrated in the hands of a few, very large ones: Norway's Government Pension Fund – Global (\$400 billion), the China Investment Corporation (\$300 billion), Singapore's Government Investment Corporation (\$250 billion) and Temasek (\$130 billion) also from Singapore.

SWFs from the Arab world are amongst the biggest ones. The Institute of International Finance (IIF) expects the net foreign assets of the members of the Gulf Cooperation Council (GCC) to rise by roughly 30% from an expected \$1,049 billion at end of 2009 to \$1,340 billion at the end of 2011, equivalent to 122% of the region's GDP. Though there is still considerable uncertainty about the real asset value of many Gulf-based SWFs, the IIF forecasts the external assets of the Emirate of Abu Dhabi stored in the Abu Dhabi Investment Authority (ADIA) to grow from a trough of \$310 billion in 2008 to \$390 billion by the end of 2010. An expert consensus has emerged that values the Kuwait Investment Authority's (KIA) assets at \$300 billion and those of

the Qatar Investment Authority (QIA) at \$70 billion. Saudi Arabia too has moved from a net debtor to a net creditor position. The Saudi Arabian Monetary Agency (SAMA) commands assets of around \$500 billion, earmarked for monetary policy purposes. Add to that the smaller dedicated funds such as the International Petroleum Investment Company (IPIC) and its subsidiary Aabar Investments from Abu Dhabi, and the Gulf oil producers feature a veritable group of sovereign financial institutions that can be used to foster the economic and fiscal policy interests of their governments. Collectively, SWFs from the Gulf have turned into important players in the redesign of the global economy and powerful symbols for the future strategic relevance of the region. Most importantly, they have become systemically significant for a profound transformation of the region's economic geography, as the petro-monarchies move from oil to finance.

The strategic imperative ensuring the lasting competitiveness of Arab countries has been to diversify away from one single, dominant and risky source of income: oil. Oil from the Gulf is a finite resource located geographically in one of the politically most volatile parts of the world; still in the ground it is highly illiquid; its financial value is very much exposed to only a few factors that drive international prices. In other words, oil in Arabian sands is subject to considerable risk. Consider an internationally oriented investment portfolio built on financial assets: it generates a constant stream of revenues; access to global financial markets allows its owner to diversify away from the idiosyncratic risks of the inherently unstable Middle East, away from unstable demand and the strategic calculus competitors, and away from the political considerations that might impede the physical delivery of oil to its customers. On top, it enables countries to balance current consumption with long-term investment, spreading the benefits of their resource endowment across multiple generations.

To be sure, oil and natural gas will maintain their role at the core of Gulf economies for the medium term future. But that role will be increasingly complemented as the region benefits from other sources of income derived from its investments in financial assets and from developing its own industrial asset base. In turn, three questions emerge: Who, in the long run, is exposed to the transformation in the Gulf region's economic landscape away from oil to finance, and does it affect the supply policy of traditional oil exporters? How robust is the transformation of Gulf economies away from an oil-based and towards a financial asset-based economic geography? Will regional players' political ambitions, having grown in parallel with wealth accumulation, in any form suggest that oil supply in the future will be subject to political considerations?

### **Increasing political options**

Growing financial clout does increase the options for Arab countries with SWFs to play a more active role in international affairs. It does not necessarily suggest, however, that the Arab world is heading down the avenue of a 1973-type confrontation with the West when it used oil as a weapon. As the economic fortunes of the West are still very much reflected in Arab financial balance sheets, and the bulk of the financial assets of SWFs are invested in Europe and the US, any attempt to use oil as a weapon against the West would certainly jeopardize growth, thereby depressing the value of assets.

But policy shifts will unfold gradually. A more balanced portfolio of economic activity leaves space for the governments from the Gulf to use their still strong position in energy markets to

support more extroverted foreign policy ambitions. This could put those economies in a fairly precarious situation that in the future will rely very much on stable supply to fuel their economic growth. As the West reduces its exposure to oil from the Gulf, oil dependent emerging economies are increasingly vulnerable. That shifts the spotlight to China. China's economic future (*ceteris paribus*) is increasingly exposed to a commodity that, first, its Arab producers are no longer pressed by economic necessity to supply, and, second, whose availability is no longer underwritten by the US—the long-standing guarantor of reliable access to oil supply from the Middle East.

The emergence of SWFs and their increasing contribution to Arab oil producers' incomes will require China to invest heavily in building political ties with the region. The age of Chinese passivity in the Middle East is over, as Beijing will play an increasingly proactive role in the region to secure its own energy supply security. Its diplomacy will have to transform from a reactive to a proactive one as it meets a more assertive Arab world, testing Beijing's capability to anticipate and prevent conflict, both within and beyond its immediate borders. With its economic activity diversified, the Gulf could turn into a strategic liability for East Asian consumers as a mere weak link of an envisaged pan-Asian grid that links the Gulf, Iran, Central Asia and Russia to the huge customer base of Asia. As Asian economies continue to demand oil, Gulf States might utilize a portion of their earned revenue to ensure against any security threat and yet enjoy the leverage in fixing prices, setting production quotas, influencing policy and negotiating from a position of strength.

### **Transition from oil to finance**

SWFs already contribute considerable cash flow to regional Gulf States governments' budgets. Conservative estimates by the IMF suggest that in the year 2007 some 20% of the overall budget of the United Arab Emirates was financed by the transfer of SWFs' earnings. This is a remarkably conservative estimate, however. According to ADIA's own records, the 20-year and 30-year annualized rates of return for its portfolio were 6.5% and 8.0% respectively, with an exposure mainly towards equities in mature and emerging economies. If one assumes ADIA's assets to reach \$310 in 2010 and to realize a 6.5% annual return, its return on investment is just above \$20 billion or 25% of the UAE government total revenue. The same calculation indicates that in KIA's estimated \$300 billion financial value and a 6.5% annual return translates into around \$20 billion in investment income or around 40% of the IMF projected total revenue of the Kuwaiti government. Qatar's financial asset-based revenues would be somewhat more modest at around 10%. Only some years ago, none of these countries featured any investment income at all. With government spending remaining on the moderate side, the portion of financial asset based cash flow in government finance will substantially increase.

The growth trajectory of SWFs from the region appears to be relatively robust as oil prices are underwritten by growing demand from emerging economies and governments, preventing public spending spiraling out of control. Resulting favorable balance of payments positions allows them to further accumulate surplus wealth. Also, the financial performance of SWFs' portfolios has been fairly solid; though suffering from the global financial crisis, as did other market participants, some benefited by employing an active trading strategy focusing on the financial services industry. The bulk of SWFs' assets are invested outside the region. ADIA has diversified its portfolio quite extensively, spreading across industry sectors, geographies and

asset classes. QIA has adopted a much more aggressive private equity investor style, holding large concentrated stakes in the automotive, energy and retail industry. It is the largest source of global real estate capital in 2010. KIA provides only little information about its strategic asset allocation, but one can plausibly assume that its investment strategy is not unlike ADIA's. Given its monetary policy purpose, SAMA is mostly invested in liquid government bonds.

SWFs today appear to be more professionally run, making extensive use of external investment managers but also higher quality in-house management capacity. Perhaps the biggest risk for Arab SWFs is to follow politically motivated requests to expose portfolios towards the region, or similar politically motivated resentment against foreign state-backed investments in Europe and the US that would negatively impact on their balanced strategic asset allocation.

### **Financial wealth and political aspirations**

The buildup of financial wealth and overall economic growth in the region has already very much underwritten a more assertive foreign policy agenda and certainly bolstered the political ambitions of the Gulf countries in different global policy arenas. To be sure, it would be exaggerating to expect a revolutionary redesign of foreign policy objectives and willingness to use available instruments, including finance and/or oil, to pursue them. What we can ascertain, however, is a gradual evolution of a more proactive agenda. Abu Dhabi competed successfully to permanently host the International Renewable Energy Association (IRENA), and has subsequently been rallying international support for accession to IRENA. Qatar has turned into a Norwegian-type of international mediator to international and national conflict in the region and beyond. It has also used its growing financial wealth to build strong relations with leading European countries, taking highly concentrated stakes in some European flagship companies. In the process it is building a range of development funds in cooperation with emerging economies such as the Philippines and Indonesia. Saudi Arabia was invited into the G20, not least for its growing significance for the international financial system as a holder of US dollar denominated debt. All Gulf States play an ostensible, if not transformational, role in the realm of food security.

But financial wealth does not only support more pro-active foreign policies. It also represents also a very strong insurance against the political headwinds that the region might be exposed to in the coming years. The volatile security situation in the Gulf makes it almost imperative to store at least some national wealth outside the region. During the Iraqi occupation of Kuwait over 1990-91, the Kuwaiti government-in-exile depended upon its \$100 billion in overseas investments in order to help sustain its operations and pay for reconstruction. As the ambitions of the Iranian regime continue to focus on a nuclear program that is threatening the rest of the world, SWFs constitute an important financial buffer. Yousef al-Otaiba, Ambassador of the UAE, in early summer remarked that a nuclear-armed Iran would be a greater disaster than a military strike, and a strike would certainly have a devastating impact on the oil infrastructure and industry of the region. Financial wealth stored outside the region, shielded against the shock of dramatically escalating tensions, constitutes an important hedge.

### **Why transparency matters**

The wildcard that spreads across all of the dimensions discussed in this contribution is transparency of SWFs. Though figures presented by the IMF and some other financial

institutions provide a good overall perspective of the emerging relevance of SWFs as meaningful agents to substitute oil with financial asset-based rent, they do not tell the full story. SWFs from the Gulf region are still highly non-transparent about the true value of their assets, which has caused considerable confusion in Western policy making circles. If what we have argued here is a robust hypothesis, i.e. that the reliability of the Gulf region to supply the rest of the world with oil is very much determined by its efforts to establish alternative means of income, then more transparency about the value and performance of SWFs would add to overall predictability in energy markets. In a recent study, it was concluded that SWFs from the Gulf region are amongst the least transparent ones. It would be important for current and future consumers of oil to know the true size of Gulf SWFs in order to assess the reliability of oil supply from the region in the long run.

“An issue ignored is a crisis invited.” A crisis could very well manifest itself in many of the oil producers of the Gulf feeling somewhat less inclined to supply the rest of the world with the resource it needs for economic growth, while living off a substantial financial rent. King Abdullah of Saudi Arabia in late June already suggested stopping exploring for new oil fields to save them for the benefit of future generations. A position out of reach some years ago, this has become a feasible policy option as Gulf economies move “beyond petrol”.

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