The Rise of the Middle East Sovereign Wealth Funds: Causes, Consequences and Policies

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Abstract: The basic purpose of sovereign wealth fund is pursuing a stable and sustainable economic development. The Middle East is the first region to set up sovereign wealth funds in the world. It is a resource-based sovereign wealth fund aiming to eliminate the potential impact of oil price fluctuations on the domestic fiscal and monetary policies, and balance the foreign exchange earnings. The sovereign wealth funds in the Middle East have developed rapidly in recent years and have exerted impact on regional economic development and macroeconomic policy. But the sovereign wealth funds in the Middle East are not able to cooperate with the domestic fiscal policy and balance the domestic economic fluctuations. Therefore, in order to play a more important role, the sovereign wealth funds in the Middle East need an improvement in investment, rules and target.

Key Words: Sovereign Wealth Funds; Middle East Finance; Operation of Sovereign Wealth Funds

Sovereign Wealth Funds (SWF) is a hot keyword among international investment banks in 2005, but in fact it is not a new thing. Back in 1953, the Kuwaiti government established world’s first

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sovereign wealth fund. With development in half a century, the SWFs have become an emerging pattern of Middle East countries used to manage public wealth. The initial objectives of SWFs in the Middle East are to eliminate the potential impact of oil price fluctuations on the domestic fiscal and monetary policy, to smooth country’s foreign exchange revenues, and to achieve a balance between intergenerational welfare via export earnings from resource commodities, accumulating wealth for the development of future generations as well as improving national sustainable development. In recent years, sharp fluctuations in oil prices and geopolitical turmoil in the Middle East have had impact on the domestic economy, thus the establishment of SWFs in Middle East countries is of certain significance. This paper examines the impact of SWFs on a country’s fiscal policy, monetary policy, balance of payments and other aspects. It also analyzes whether the operation of SWFs is consistent with macro-fiscal policy in the country, whether it smooths fluctuations in export revenues from resources commodities, whether it functions as an economic stabilizer, and whether it offers policy recommendations for the region’s development.

I. The Current Situation of the SWFs in the Middle East

Since the 1950s, the SWFs has been dedicated to reducing high dependence on oil exports and dealing with effectively the large foreign exchange surplus in Middle Eastern countries for the purpose of being a professional institutional investment agency. Especially in the 1990s, the Gulf countries, with oil export revenues surplus funds, established SWFs which was active in global financial markets. Since then, these sovereign states with plenty of the current account surplus followed this trend, expanding the camps of SWFs. In the 21st century, with the rise of global oil and gas prices, the overall aggravation of the world’s economic imbalances and emerging economies, the rapid
development of the world’s sovereign wealth funds, especially in East Asia and the Middle East, has become the major event in the international economic and financial fields.

According to the Sovereign Wealth Funds Institute (SWFI), among the 75 SWFs in the world, there are up to 48 newly established SWFs since 2000, among which there are 20 established since 2008. As of the end of September 2014, the global scale of SWFs has reached $6.73 trillion, which has doubled the amount at the end of 2007 (SWFI, 2015: May). SWFs have been the world’s most important non-traditional investment and management assets, with nearly 2.5 times of the size of the global hedge fund and nearly 2.3 times of the size of private equity fund. More surprisingly, SWFs in the Middle East and Asia dominion together accounted for 75% of the total scale of the world’s SWFs. Especially in the Middle East, as of the end of September 2014, 12 countries out of 22 countries in the Middle East had set up 20 SWFs, and reached the size of $2.65 trillion, accounting for one third of the world’s total scale (Kenyon, H., 2013).

II. Analysis on the Reasons of the Rapid Development of the Middle East Sovereign Wealth Funds

SWFs all over the world have different specific goals. The IMF divided them into five categories based on different policy objectives of SWFs in 2008:

(1) Stabilization fund, whose main goal is to ensure that fiscal budget and the entire national economy are free from the impact of some commodity prices, such as fluctuations in oil prices;

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Financial institutes of City of London divide the global investment management into two categories: traditional and non-traditional. Traditional management includes pension funds, mutual funds and insurance funds; non-traditional categories include SWFs, private equity funds, hedge funds, ETF and private wealth, etc., http://www.thecityuk.com/research/our-work/reports-list/uk- fund-management-2014/.
(2) Savings Fund, whose main objective is to reserve for future generations by transferring the non-renewable assets into a diversified portfolio;

(3) Reserve investment fund, whose assets are still considered as reserve assets; its purpose is to improve the rate of return on reserves;

(4) Development Fund, whose main goal is to provide funds for socio-economic projects, or to improve their potential output of industrial policy services;

(5) Pension Reserve Fund, whose goal is to provide funding for the uncertain pension liabilities on balance sheet of the government.

Chinese researchers have divided SWFs into two categories: First, it is the stable sovereign wealth fund. The main purpose is to smooth national income inter-temporally, in order to reduce the impact of unexpected earnings and volatility on economic and financial budget; the second is the offsetting sovereign wealth funds. The purpose is to help the central bank carry out foreign exchange reserves diversion, intervene in foreign exchange markets, and offset the market excess liquidity. The third is the saving sovereign wealth funds, and the main purpose is to smooth the national inter-generational wealth, accumulating wealth for future generations; the fourth is the preventive SWFs. The main purpose is to prevent the national socio-economic crisis and promote steady economic and social development; the Fifth is the strategic SWFs. The main purpose is to support national development strategies and optimize the allocation of resources on a global scale, nurturing world-class enterprises and better reflecting national interests on international economic activities (Xie, P. & Chen, C., 2009).

Previous studies show that the basic goal of the vast majority of SWFs is to pursue the stable and sustainable economic development, including strategic goals in increasing the value of assets and industrial policies. Initially, due to the accumulation of long-term current account surplus, some countries’ foreign exchange reserves
have exceeded the emergency needs in which case the government hopes to set up a sovereign wealth fund to earn a high return on investment. Thus, the government hopes to utilize institutional investors such as SWFs to invest overseas to diversify the country’s wealth and achieve risk-return optimization. These financial benefits urge SWFs to promote their commitment to more financial functions.

Being associated with the globalization national survival issues such as the “resource curse”, “Dutch disease” as well as monetary and financial crisis in an era of globalization, and integration with some basic principles to maintain safety of the nation from invaders in a complex international relations environment, the sovereign state will gradually set up SWFs with national policy orientation and strategic planning; their subjective motives are more complex and diverse, giving SWFs more policy objectives.

The Middle East is the first region in the world to set up sovereign wealth funds. Those SWFs are typical of resource-based sovereign wealth fund, whose goals are to eliminate the potential impact of oil price fluctuations on the domestic fiscal and monetary policy, and to smooth foreign exchange earnings. In recent years, due to the international economic situation and political instability, oil price has suffered from substantial fluctuations (see Figure 1). In 2008, international oil prices fell from $147 per barrel in July to below $40 per barrel by the end of that year, plunged by 70%. In 2014, Brent oil price fell from $115.06 per barrel in June to $57.33 a barrel at the end of the year, a decrease of 50.2% (Liu, X., 2015: January 3). Thanks to SWFs as reservoirs, frequent fluctuations in oil prices contributed to the expansion of the size of sovereign wealth funds in the Middle East. The scale of sovereign wealth fund assets in the Middle East has increased by nearly 50% in 2014, compared with the amount by the end of 2010, reaching $2.7 trillion.

Figure 1: the annual volatility of international crude oil price from
From the perspective of the historical background of the establishment, the rise of SWFs in the Middle East is a result of the surge of the global commodity prices, especially the petroleum resource prices and “resource curse” of these countries. As a conventional oil-exporting region, the Middle East SWFs are mostly oil price stabilization fund. Their funds are derived from the export revenues of oil and other resource commodities as well as tax paid for export resources. They were originally established for the purpose of eliminating potential impact of oil price fluctuations on a country’s fiscal and monetary policy, smoothing foreign exchange earnings and resource commodity export earnings to achieve intergenerational welfare balance, accumulating wealth for the development of future generations and improving sustainable competitive capability of countries. The 1970s oil crisis resulted in surge of oil prices, which brought huge additional revenues to the Middle East and other oil-exporting region; but it also led to a significant expansion of public spending in the region. Some countries have implemented very expansionary policies on public consumption and expenditure, and there was a substantial increase in consumer goods imports.

In the 1980s, oil production of non-OPEC member countries has increased. The Iraq war led to increased demand for funds in the

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1 According to IMF database.
Middle East and expansion of oil exports. As a result, international oil prices fell by 61.4% during the year of 1980 and 1986. Coupled with the continued expansion of the size of government spending as well as decline in oil revenues, in the 1990s, the oil-exporting countries which has abundant resources in general suffered from fiscal deficit and decline of the economic growth rate, and fell into the “resource curse.”

Many economists have explained this economic phenomenon in the Middle East and resource-exporting countries. Their views can be summarized as follows (Xie, P. & Chen, C., 2009). First, the “Dutch disease”. Increase in export prices of natural resource led to flow of labor and capital from manufacturing sectors to resource export sectors. Moreover, the increased foreign exchange earnings led to currency appreciation, and further weaken the competitiveness of the manufacturing sector, which eventually led to the decline of the manufacturing sector. Second, it is the heavy reliance on exports of natural resources. As the export of natural resources can generate a lot of income in a short time, national priorities and resources tend to accumulate in export-related industries, leading to stagnant pace of industrial diversification, and increasing imbalance in the industrial system. Third, energy price is very volatile. When the natural resource prices fluctuate, countries dependent on resource exports faces risks of their income, and may even erase revenue growth in the period of prices surge.

To avoid falling into the “resource curse”, resource-exporting countries in the Middle East began to reflect on irrational consumption due to the increase in oil revenues and the expenditure expansion, according to Canadian scholar Park (2007)’s empirical studies, it has been found that natural resource-rich country’s economic growth is likely to lag behind than resource-poor countries. During 1960-1992, in the sample states, portion of national resources export revenue in GDP and the country’s GDP growth rate are negatively correlated. Saudi Arabia’s per capita GDP fell by an average of 3% per year from 1965 to 1997, and Iran’s per capita GDP over the same period decreased by 2% per year.
Rethinking how to avoid impact of price fluctuations of resource commodities such as oil on the domestic fiscal balance of payments and budget. They also start thinking that, once oil and other non-renewable resources deplete, how the government can maintain a stable source of income to smooth national income during inter-temporal period. To make a more equitable resource distribution of wealth inter-generationally, the Middle East countries have set up sovereign wealth funds, diversified investments, and extended asset investment period to improve the level of long-term investment returns. Iran’s oil stabilization fund and foreign exchange reserves fund were established in 1999. Qatar established the Qatar Investment Authority in 2000. In recent years, the Middle East SWFs are playing increasingly important role in stabilizing the domestic economic policies. Kuwaiti gained independence again and rebuilt their homes at the end of the Iraqi war, which largely is owed to funding support from the Sovereign Wealth Funds set up and managed by the Kuwait Investment Authority in the economic recovery.

III. Analysis on the Role of Sovereign Wealth Funds in Regional Economic Development in the Middle East

The Middle East countries which set up national SWFs are in various stages of economic development, and their social and political conditions are different, but they all choose to establish one or more SWFs. Such fund management has become a new model of public wealth for many countries in the region. Although the Middle East has experienced economic turmoil and geopolitical troubles, they still made great progress in economic development. The IMF “Economic Outlook” estimates that the GDP of these Middle Eastern countries reached $2.64 trillion in 2014, which means that for the first time in the Middle East the total size of SWFs is expected to exceed their overall national GDP, becoming the new engine of economic development in
the Middle East. Among the 20 SWFs, 18 are based on oil and gas. The underlying funds accounted for 99.7% of the total size, marking the SWFs essential financial supporting tools of oil economy in the Middle East.

With the changes in the international financial markets, SWFs has become an important force for economic development in the Middle East. So far, with the establishment of SWFs in the Middle East countries, their population accounted for 33.54% of total population in the region; their GDP accounted for 72.11% of that in the entire Middle East; per capita GDP is nearly five times of that in countries where SWFs have not been set up. However, the distribution of SWFs in the Middle East is not yet balanced. The size of SWFs in the top five countries accounted for up to 92.77% of the total area. The first tier is constituted by the United Arab Emirates and Saudi Arabia. Their SWFs scale is hovering at one trillion US dollars, and each accounted for more than 30% in the Middle East, totaling up to 72.6%. At the same time, the GDP of the two countries accounted for only 46.72% in the region, and their population accounted for less than 20% of the total population; their capital and wealth are extremely outstanding. UAE stands out in the Middle East with a total of seven funds nearly three times the size of the country’s GDP. The funds accounted for up to 40.54% of the region while its population accounted for only less than 5% of the total population in the region. The second tier is Kuwait and Qatar, whose fund sizes are at the level of one hundred billion US dollars, ranking ahead among the top ten countries owning SWFs in the world. The third tier is made up of Algeria, Libya, and Iran, whose fund sizes are below one hundred billion US dollars, accounting for 2%-3% of the region, but they are still in the middle and upper level in the world. The fourth tier includes Iraq, Oman, Bahrain, Palestine and other countries, whose proportions of the fund size are less than 1% in the area. (See Figure 2)
Although SWFs in different countries have different level of development, at present, SWFs are indispensable for economic development in the Middle East. First, this is a state apparatus to manage oil export revenues. Middle Eastern oil exporters accumulate revenues, and the governments need to rely on SWFs for effective management on the huge foreign exchange reserves and safeguarding national security asset. For example, SAMA (Saudi Arabian monetary authorities) and the foreign currency-dominated companies adhere to the principle of prioritizing central bank’s policy demands, abiding to low volatility and high credit fixed income securities portfolio in a long term. Second, SWFs is a stabilizer to maintain the level of social welfare. Middle East oil-producing countries rely on oil revenue to expand fiscal spending, and promote the development of social welfare, which has greatly improved the welfare of the people and provided political stability and economic security. In the context of the

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**Footnote:** Data Source: SWFI, sovereign wealth fund rankings, as of end of September 2014; IMF, World Economic Outlook, April 2014.
international oil price reversal, investment income generated by global asset allocation of SWFs can compensate for loss reduction in the oil exports, smoothing fluctuations in fiscal revenue. Kuwait is a typical example. It has been using the oil revenues mainly for the development of high welfare society. Again, it is also a booster for industrial diversification and economic transformation. At present, the Middle East countries are committed to reducing the economy’s dependence on oil. SWFs oil revenues will be transformed into diversified industrial capital, and by foreign direct investment, the lack of manufacturing will be addressed by transplanting factors of production from international community to domestic society. Abu Dhabi Investment Authority has been following economic diversification strategy as an orientation for investment in long-term, and makes significant progress in the development of financial services, tourism and entertainment industries. Qatar Investment Authority is more progressive. They recently launched direct investment projects towards a number of top luxury brands in Europe and America. Finally, SWFs is a vessel balancing the overall development of the region. Uneven distribution of oil resources in the Middle East has resulted in unbalanced regional development. Better-off countries can invest in their neighboring areas via SWFs investments; thus they can play a role as a link of capital, and the Middle East can create an environment of mutual benefit and all-round development.

In recent years, the Middle East SWFs’ role in promoting domestic economic development is increasingly apparent. In theory, the sovereign wealth fund has usually been regarded as a stabilizing mechanism for the economy. However, learning from the sovereign wealth fund investment practices in the Middle East countries, the operational part of the Fund does not always play an effective role in the domestic economy or regional stability. In recent years, some countries experienced a larger volatility in their GDPs in the region
and larger budget deficits, which to a certain extent has undermined the sustainability of the economic development of these countries.

IV The Impact of the Middle East Sovereign Wealth Funds on Macroeconomic Policy

Examining the impact of SWFs investment on monetary policy, balance of payments, fiscal policy, and income distribution policies will help analyze whether operation of sovereign wealth funds is consistent with the macro-fiscal policy in the country, whether they smoothen fluctuations in of the country’s revenue from resource export, and ultimately whether SWFs have reached their targets.

(A) Fiscal policy

The Middle East countries bear the tasks of adjustment of economic structure and fiscal policy as well as reducing the vulnerability of macroeconomic policy to achieve financial independence and stability of government spending (Engel, E. & Valdes, R., 2000: January 27). In Most countries, in the beginning of the establishment of a sovereign wealth fund, it is endowed with the function of providing support for its own fiscal policy. In fact, the internal mechanism of the sovereign wealth funds themselves can play a role in hedging the financial gap for economic shocks.

First, as capital buffer pools, the SWFs themselves can play a role in smoothing fluctuations in fiscal revenue and expenditure. When the national revenue surplus is abundant, there will be more money to be put into SWFs. At this time, The SWFs will play the role of savings funds. Iranian government deposited all of its oil revenue into Iran’s sovereign wealth fund. The size of the fund’s assets in 2013 reached more than $104 billion; it is the typical savings fund. Once the country’s fiscal accounts experience any financing gap, sovereign wealth funds will provide financing for economic development in a timely manner. In this case, sovereign wealth funds play the role of
pooling funds to effectively hedging the impact of fluctuations in financial expenses of their economies. Saudi Arabian sovereign wealth fund is about to fill the majority of funding of government spending. It pays for welfare spending and high military spending for their inhabitants. In 2011, the country’s military spending accounted for up to 10% of GDP. In the economic downturn, the demand for the private sector to absorb the decline in the ability of the public sector is relatively strong, the SWFs can make up for some of the funds fall in domestic output revenue, and inject these funds into the economy a boost economy effect.

Second, the SWFs may hedge financial impact on a country’s national economy from fluctuation of export prices by investment in assets that are negatively correlated to the country’s exporting resources. In countries such as Saudi Arabia, Kuwait and other Middle Eastern countries which are dependent on resource exports, the fiscal gap is mainly composed of two parts: one is resources revenues such as oil export revenues. This part of the revenue is of the typical pro-cyclical economic features; the other part is composed by the tax and fiscal income. This part of the government revenue also has economic pro-cyclical features. The Middle East SWFs reveal the potential impact of oil price fluctuations on the financial situation of the country through investment in assets that are negatively related with the region exports (mainly oil), in order to smoothen the country’s foreign exchange earnings, effective hedging economic impact for its own fiscal gap.

Meanwhile, the real GDPs of the countries in the region have experienced a larger volatility as well as slow growth, accompanied by a large budget deficit, which undermines the sustainability of fiscal policy in these countries. We take a country’s fiscal revenue/GDP standard deviation and coefficient of variation to measure the volatility of revenue and expenditure. According to the statistical data, the recent volatility in international oil prices has a greater impact on
revenue volatility of the Middle East countries. (See Figure 3)

Figure 3: The Middle East GDP growth rate fluctuations from 1991 to 2003 (%) (International Monetary Fund, 2014: October)

![Changes in GDP Growth in the Region of the Middle East 1991-2003 (%)](image)

In theory, the SWFs have usually been regarded as a stabilizing mechanism for the economy. However, learning from the sovereign wealth fund investment practices in the Middle East countries, the operational part of the Fund does not always play an effective role in lowering fluctuation of the domestic spending in this region. The variation in government spending is larger than the fluctuation of prices. In Bahrain, Iran, Saudi Arabia, the UAE and Yemen, volatility of government spending is greater than the volatility of revenue. However, in Kuwait, Oman, and Libya, the volatility of government expenditure is less than the volatility of revenue. Operations of sovereign wealth funds in the Middle East are not able to integrate with the domestic fiscal policy, and did not play a role in smoothing the country’s fiscal revenue. The regional governments allow the sovereign wealth funds to finance for non-oil industry, but in most countries in the Middle East, the SWFs did not play a significant role
in smoothing domestic budget. In recent years, for countries in the Middle East, the increased volatility of revenue and expenditure is partly due to the soaring international oil prices; and is also because the region’s sovereign wealth fund is in relatively small size, compared to the scale of economy of the country, which is insufficient to hedge fluctuations in export earnings. Therefore, those SWFs cannot play a role in smoothing the revenue and expenditure fluctuations radically. (See Table 1)

Table 1 volatility of national government revenue and expenditure in the Middle East (1999-2014) (International Monetary Fund, 2014: October)

<table>
<thead>
<tr>
<th>Government Revenue/GDP</th>
<th>Bahrain</th>
<th>Iran</th>
<th>Kuwait</th>
<th>Libya</th>
<th>Oman</th>
<th>Saudi Arabia</th>
<th>UAE</th>
<th>Yemen</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>27.107</td>
<td>20.524</td>
<td>38.678</td>
<td>45.014</td>
<td>39.059</td>
<td>34.830</td>
<td>42.097</td>
<td>33.625</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>2.814</td>
<td>3.275</td>
<td>5.302</td>
<td>15.683</td>
<td>4.099</td>
<td>3.569</td>
<td>5.381</td>
<td>4.024</td>
</tr>
<tr>
<td>Variation Coefficient</td>
<td>0.104</td>
<td>0.160</td>
<td>0.137</td>
<td>0.348</td>
<td>0.105</td>
<td>0.102</td>
<td>0.128</td>
<td>0.120</td>
</tr>
<tr>
<td>Number of Observation</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Government Spending /GDP</th>
<th>Bahrain</th>
<th>Iran</th>
<th>Kuwait</th>
<th>Libya</th>
<th>Oman</th>
<th>Saudi Arabia</th>
<th>UAE</th>
<th>Yemen</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>26.192</td>
<td>22.225</td>
<td>67.181</td>
<td>52.927</td>
<td>47.257</td>
<td>44.605</td>
<td>30.305</td>
<td>30.51</td>
</tr>
<tr>
<td>Variation Coefficient</td>
<td>0.105</td>
<td>0.215</td>
<td>0.098</td>
<td>0.247</td>
<td>0.079</td>
<td>0.172</td>
<td>0.182</td>
<td>0.161</td>
</tr>
<tr>
<td>Number of Observation</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>16</td>
</tr>
</tbody>
</table>
(B) Sovereign wealth fund investment on monetary policy

The SWFs’ investment strategy impacts on monetary policy of the country by influencing the domestic market liquidity. Fluctuations in a country’s fiscal revenues, especially export volatility in commodity prices, will pose challenges on monetary policy authorities, because fluctuations in the country’s fiscal revenue will lead to fluctuations in a country’s total demand. If a country’s export commodity prices keep going up, earnings from resource commodity export will increase, and government investment and domestic private sector lending will be more active. As a result, an additional increase in the domestic financial system liquidity will have a positive wealth effect on government spending through the channel, leading to the country’s serious inflation and bringing fluctuations in the real exchange rate. Thus, with the growing size of the SWFs, it should be ensured that the diversity of goals of sovereignty wealth funds and those targets match national economic policy; otherwise the country will experience more difficulty in control of monetary policy. Sovereign wealth funds, particularly stabilizing sovereign wealth funds that have the smoothing state revenue as the main objective, can reduce the impact of sovereign wealth fund investments on monetary policy by enacting strict rules in capital inflows and outflows, thus minimizing the impact of above mechanism on a country’s total demands.

(C) Sovereign wealth fund investment on exchange rate policy

If the SWFs set up a floating exchange rate regime, fluctuations in currency exchange rates against the dollar will fluctuate export commodity prices and form a negative impact. In face of export prices decline in the resource commodity, their export earnings will fall, and the domestic currency tends to depreciate. If the SWFs’ yields are denominated in local currency, the nominal fund yields will increase, shortening the gap between country’s fiscal revenue and expenditure.
account.

If the country’s SWF sets up a fixed exchange rate system, the buffering role of sovereign wealth funds is limited. If a country is highly dependent on commodity exports revenue, there is usually sufficient liquidity in the banking system in the country. Once there are sharp fluctuations in commodity prices, for example, when a country is facing pressure from a substantial increase of export commodity prices and great currency appreciation, the central bank needs to pay considerable cost to maintain the stability of domestic liquidity and the effectiveness of monetary policy. Once the export commodity prices decline, and there are signs of currency devaluation, in order to prevent a significant decline in the exchange rate, central bank will intervene and export earnings of the country’s resource commodities will decline. It will need some money from the SWFs to make up their own output revenue shortfall. This has posed a serious liquidity management problem for domestic policy authorities. It is worth mentioned that, if the government allows a resource export enterprises to pay tax with US dollars, it will avoid the impact of exchange rate fluctuations on export earnings. In particular, if the export resource commodity prices rise, the country’s national income will increase; this approach also avoids appreciation of real exchange rate of the currency.

V Recommendations on Management of the Middle East SWFs

The initiative goals of the Middle East SWFs are to eliminate the potential impact of oil price fluctuations on the domestic fiscal and monetary policy, and to smooth foreign exchange earnings. Empirical study has found that the operation of sovereign wealth funds in the Middle East cannot integrate with the domestic fiscal policy, and did not play a positive role in smoothing fluctuations in the domestic
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economy. Thus, we propose recommendations in management of the Middle East sovereign wealth fund investments.

First, the Middle East SWFs should invest in the assets that are negatively related to export price volatility of commodity of this country. Middle East economies and changes in financial income are highly correlated with oil prices, and their domestic economic structures are mainly in a form of a single economy dominated by the oil industry. The oil price and the domestic economy have a positive correlation; we gave some statistical analysis on effective exchange rate and oil prices and their correlation, and found that fluctuations in the dollar and oil prices have the greatest negative correlation. In this sense, for the oil-exporting countries in the Middle East, the optimal allocation of the sovereign wealth fund investment is to invest in dollar assets that are were negatively correlated with national commodity price volatility. In Saudi Arabia, the goal of establishing a sovereign wealth fund is to stabilize impact of income fluctuations in oil on the Saudi Arabian economy, therefore, the investment is mainly concentrated in the low-risk, low-income, high mobility and low entry US dollar assets.

For oil-exporting countries in the Middle East, the objectives of sovereign wealth fund’s investment should be to offset fluctuations in capital gains rate due to fluctuations in oil prices to the maximum extent. The specific investment strategy should be to invest in assets that have a negative correlation with the price of oil or currency and asset has no correlation with oil price. Therefore, to avoid the adverse effects of the sovereign wealth fund investments in domestic economic policy, when investing in foreign assets, the best choice for the Middle East SWFs is to invest in assets of a counter-cyclical correlation with commodity price volatility, to offset the impact of commodity prices fall on revenue for the resource-exporting countries, and also to offset the impact of rising commodity prices on the country’s domestic liquidity and inflation.
Second, set up a flexible and effective rule for the operation of SWFs. Few countries in the Middle East have established a comprehensive, transparent investment strategy; usually resource SWFs will mainly invest in offshore foundations to prevent the excess liquidity due to domestic capital investment as well as the currency appreciation. Different countries of the Middle East has differences in management of SWFs, which are mainly showed in fund management, fund accounts auditing and disclosure rules. The SWFs in some countries provide the market with complete operational and financial information, while in some SWFs, transparency is very poor—only part of the operational information is provided for the market. In addition, many oil-exporting countries have established strict exit and entry rules of SWFs and set the proportion of injecting funds based on oil export revenues based on commodity prices. However, with time and resource fluctuations in commodity prices, it is difficult to design a scientific and flexible rule to adapt to changes in the external environment. Once these countries experience serious political and economic changes, the rules will change as well, and the proportion of oil export revenues will be adjusted. The fund itself may even be canceled, which will hinder the country’s capability in smooth earnings volatility. Second, the rules are too strict, thus fund management assets and liabilities management will be worsen, and some countries have to borrow in order to maintain the high cost of fund assets. Furthermore, the sovereign wealth fund’s investment strategy should be dynamically adjusted to the dynamic changes in national macroeconomic and financial market conditions and should have a corresponding change in investment strategy. In practice, the general specific investment strategy will be adjusted once a year, while the overall regulatory framework and investment will be adjusted once every three to five years. Finally, investment objectives and asset categories of sovereign wealth fund are closely related to each other. If the sovereign wealth fund has saving function, then
there should be clear asset yields and corresponding investment requirements; if the sovereign wealth fund’s investment objective is to minimize income volatility, it needs to meet the requirements of volatility.

Third, asset management of the Middle East sovereign wealth fund should match the objectives of the country’s macroeconomic policies. Affected by oil price fluctuations, revenue volatility of oil exporting countries in the Middle East is high; the key point is to avoid disproportionate impact on fiscal revenues from oil price fluctuations. In theory, the sovereign wealth fund is generally considered stabilizing mechanism, but actually it is not the case, the Fund’s operation did not play a significant role in lowering the fluctuations in expenses in the region.

Experience from operation of the Middle East SWFs indicates that resource SWFs have a limited impact on domestic fiscal policy of the state, if poorly designed, the SWFs would even undermine the financial management of the country. When the fund can generate income for the country, it will reduce the flexibility of government revenues and spending policies at the time of changing economic conditions. As a result, the government’s liquidity management becomes more complex, the government will face higher borrowing costs for other financing, which will affect the validity of government spending. If the SWFs and domestic fiscal policy framework achieve more robust integration, just as the fund and domestic public financial system, it is easy to achieve the goal of smoothing domestic fiscal policy. States in the Middle East should accommodate SWFs with domestic fiscal policy in a better way, strengthen expenditure control, cash management and fund reporting system, enhance domestic public financial system, and actively develop functional institutions including the timely preparation of reliable economic data for decision-making and fiscal plan.

First, states should set flexible rules in order to maintain the
stability of the fund, and to avoid paying a high cost of borrowing money when the fund is insufficient to sustain operations. Secondly, the Fund should not provide financial support for excessive government spending. Thirdly, states should enhance the fund’s management and transparency. In order to achieve long-term stability of fiscal policy, investment factors of the SWFs need to be considered in the development of the country’s fiscal policy. Sovereign wealth fund asset management should accommodate with country’s fiscal policy and macro policy on asset management. The investment of assets should maximize return on investment, and meanwhile be consistent with the objectives of domestic fiscal policy. If the country’s expense is heavily dependent on resource exports, SWFs should take a more cautious position in investment strategy to avoid the fluctuations in resource export earnings. Furthermore, to enhance the stabilizing effect of SWFs on fiscal policy, the government should build financial framework for the medium term upon the development of the macroeconomic policy, identify key financial risks and improve the stabilizing effect of SWFs on fiscal policy, and integrate the government’s annual spending into medium-term fiscal framework, and identify the long-term impact of existing policies.

Reference

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