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Political and Economic Analysis on SWFs of Saudi Arabia

YANG Li & ZHANG Jin[①]

（College of International Finance & Commerce, Shanghai International Studies University）

Abstract: *Sovereign Wealth Funds established by Middle Eastern countries occupy an important position in world capital markets in terms of size or activity. However, regarding the establishment and operation of the funds, Saudi Arabia pursues a conservative investment strategy as a regional power, which is quite different from other Gulf countries. It is found that the economic conditions in Saudi Arabia, such as money supply, foreign exchange reserves, external debt and domestic economic development, which are generally considered to be the determining factors for the establishment of SWFs, were not favorable compared with those in the other GCC states in the last decades. However, even when those conditions have been improved since the beginning of this century, the performance of SWFs in Saudi Arabia still lags behind compared with other Gulf countries. As the economic indicators of the country will be studied, so will a political analysis be conducted in three specific perspectives: the significance of US dollar reserve for Saudi-US diplomatic relations, the deterioration of political environment of FDI in western countries after 9/11 and a mix of public and private ownership systems brought by the royal family. In the end, one can conclude that*

[①] Dr. YANG Li, Vice president and professor of Shanghai International Studies University. Dr. ZHANG Jin, associate professor of College of International Finance & Commerce, Shanghai International Studies University. This research is the product of Key Research program of SHISU "Study on the Financial Risk Manegement of China and Foreign Countries" (KX161022022).

Saudi Arabia is a conservative investor on SWFs.

Key Words: *Saudi Arabia; Sovereign Wealth Funds; Foreign Exchange Reserves; Political Environment*

From this century, sovereign wealth funds (hereinafter referred to SWFs) have had a profound impact and influence in the field of international political economy (Sornarajah, 2011: June 14: 267-288).[①]Capital flows from the Gulf States, China, Brazil and Russia to the markets of Europe and North America have left the developed Western capital recipient countries balancing between national security and market economy. Therefore, the power of capital in international economic relations needs to be re-discussed. The SWFs of the GCC member states occupy an important position in the world from both their scale and level of activity. But a more interesting phenomenon is that a big country in the GCC, Saudi Arabia has been rather conservative towards SWFs.[②]The development of Saudi SWFs greatly differs from other GCC member states, especially from the UAE, Qatar, Kuwait and other countries. Starting from the establishment conditions of SWFs, through the analysis of Saudi Arabia's unique political, economic and social environment, the reason of Saudi Arabia being more conservative in the establishment of SWFs will be explained in this article, in order to interpret the diplomatic material regarding this issue in Saudi Arabia.

I. The General Conditions for the Establishment of A

[①] There is no uniform definition of sovereign wealth funds. SWFs in this article meet the following three criteria: (1) established and owned by the state government; (2) funding comes mainly from the fiscal surplus, foreign exchange earnings and export of natural resources revenue surplus and is run by specialized agencies; (3) the fund is mainly constituted of financial assets, such as bonds, stocks, real estate or other financial tools made up of foreign exchange assets and investments conducted on a global scale.

[②] The first dedicated SWF in Saudi Arabia was established in 2008, worth $ 5.3 billion. Its investment objectives are mainly value-added technological and petrochemical projects.

Sovereign Wealth Fund

With the active performance of SWFs in the financial crisis of this century, academics began to attach importance to the study of the conditions and the reasons for the establishment of SWFs[①]. Previous studies have shown that generally the countries that establish and operate SWFs have as the main objectives the inter-generational transfer of wealth and diversified investment strategy, and also they have the corresponding objective economic conditions, which depend mainly on three major aspects: the foreign exchange reserves, the domestic economic stability and the strategic goals of the economy. Of course, these conditions need to be integrated when considering the economic feasibility of establishing the SWF.

1. A prerequisite for the construction of a sovereign wealth fund is sufficient foreign exchange reserves。

The first condition to establish SWFs is surplus in foreign exchange reserves[②] (FOREX). ''Only when a country has sufficient foreign exchange reserves, can it be possible for it to consider what investment tools to choose in order to maximize the profits of the foreign exchange it holds.'' (Reed, 2009: 110-112; Rose, 2008: 104). To

[①] Studies regarding this aspect include: Simon Johnson, ''The Rise of Sovereign Wealth Funds,'' *Finance & Development* ,Vol.44, No.3 , September 2007; Edwin Truman, *Sovereign Wealth Funds: The Need for Greater Transparency and Accountability*, Peterson Institute for International Economics, August 2007; And more recent empirical studies such as: B.J. Reed, ''Sovereign Wealth Funds: The New Barbarians at the Gate? An Analysis of the Legal and Business Implications of Their Ascendancy,'' *Virginia Law & Business Review*, No.4, 2009, pp.110–112; Julien Chaisse, Debashis Chakraborty, Jaydeep Mukherjee, ''Emerging Sovereign Wealth Funds in the Making: Assessing the Economic Feasibility and Regulatory Strategies,'' *Journal of World Trade*, Vol.45, No.4, 2011, pp.837-875; D. Park, G. Estrada, ''Developing Asia's Sovereign Wealth Funds and Outward Foreign Direct Investment,'' *Asian Development Review*, Vol.26, No. 2, 2009, pp.57–85; Dai Liyan, 'The Macroeconomic Factors in the Establishment of Sovereign Wealth Funds,'' *Social Science Journal*, January 2012.

[②] Refers to the foreign exchange holdings in the international reserves assets held by a country's government, namely, foreign currency-denominated assets, including cash, bank deposits abroad, and foreign marketable securities.

choose SWFs enables the countries that have established the funds to benefit from the growth of the global economy and prevent the risk of holding too much of a single foreign currency, such as the US dollar. Of course, a country's foreign exchange reserves should be considered in conjunction with other macroeconomic conditions in order to determine whether it is sufficient (Chaisse, 2011: 837-875). Usually the international balance of payments[①], GDP, external debt and money supply situation need to be taken into consideration.

First, from the perspective of the international balance of payments, the countries that have established the funds tend to have surplus. According to the statistics of SWFI[②], the countries that have established the SWFs all have current account surplus of a considerable scale. Even though trade deficit may exist in some countries, it is often because there is a large deficit in service trade. In fact, the merchandise trade surplus still stands, just not enough to make up for the deficit of trade in services (Chaisse, 2011: 837-875).

Secondly, foreign exchange reserves of the countries that have the SWFs have a relatively high ratio in GDP, as well as a growing trend (Yang, Z., 2008: 158-180)**.** According to the statistics of SWFI[③], these countries, whether developed or emerging countries, almost all have considerable foreign exchange earnings, which is necessary for these countries to build their own SWFs; plus, foreign exchange reserves have to have an increasing trend in GDP at the time of the establishment of SWFs. Another research into the correlation between foreign exchange reserves and the establishment of SWFs in 241 countries shows that the higher percentage foreign exchange reserves take up in GDP, and the higher the percentage of energy exports account for in the total exports of goods, the more likely is a country to

[①] Refers to a country's balance of international payments, i.e. the difference between the net exports and net capital outflow is zero. A country's balance of international payments depends largely on the country's import and export as well as the trade and capital inflow and outflow.

[②] www.swfinstitute.org.

[③] www.swfinstitute.org.

establish a sovereign wealth fund (Dai, 2012: January).

In addition, the foreign exchange reserves should be weighed in conjunction with the foreign debt and the money supply to be decided whether it is sufficient. The study of Park and Estrada shows that the ratio of the foreign exchange reserves to the short-term external debt in those countries tend to establish SWFs should be higher than 1 (Park & Estrada, 2009: 57-85).[①] If this ratio is lower, then the macroeconomic conditions are not suitable for the establishment of SWFs. The logic behind this view is that a country should have enough foreign exchange reserves to cope with the large number of short-term foreign capital withdrawal within a certain time. On the other hand, the country's money supply should be analyzed as well when considering the adequacy of foreign exchange reserves. According to monetary theory, the broad sense of money supply regulates the consumption and asset prices in a country’s economy, as well as impacts on investment. The proportion of foreign exchange reserves and M3[②], according to empirical studies of some scholars, is about 5%-20% in the countries that have the SWFs (Yang, Z., 2008: 158-180). The higher the proportion, the stronger the confidence index of the public for the currency, and the smaller the risk of capital outflows.

2. Stable domestic economy

In addition to sufficient foreign exchange reserves, a stable domestic economic situation is also the necessary condition for the establishment of the SWFs (Dai, 2012: January).

It is generally believed that countries with higher total savings tend to establish their sovereign wealth funds to make foreign

① In 2008, they designed Green-span-Guidotti formula which measures whether a country has enough foreign exchange reserves to set up SWFs.

② M3 is the money supply indicator, a key indicator to measure the money supply, which includes banknotes, coins, demand deposits and four-year time deposits. The European Central Bank measures the inflation pressure through the growth of the money supply by observing the impacts of currency in different levels on the economy.

investments because the gap between the large amount of savings and domestic investments provides money for sovereign wealth funds. Countries can take advantage of this to realize the optimal allocation of funds worldwide and to break the imbalance in the financing cycle between the developing and developed countries. However, in addition to the high savings, domestic government borrowing should also be considered. Domestic macroeconomic stability is vital for establishing and maintaining SWFs. According to macroeconomic theory, increased government borrowing in the domestic market will reduce the amount of savings that can be provided to the private economy. In this sense, government spending will correspondingly reduce private investment spending, producing the so-called ′′crowding-out′′ effect. Then, the economic expansion capacity will be significantly less than the government′s target. Moreover, the growth in interest rates usually need to be maintained during continued government borrowing, which in turn will lead to the inflow of foreign capital and the appreciation of the local currency, resulting in a decline in the export competitiveness and exacerbated trade deficits, affecting the international balance of payments. Therefore, the scale of government borrowing is also a key factor in the establishment of the SWFs.

If saving equals investment in the private economy, then reflected by the government′s budget deficit is the trade deficit. If all the savings of the country cannot support all of the domestic investments, then the country needs to borrow from abroad. This will result in a net income decline and increased foreign debt. This way, the increase in the fiscal deficit (unless there are savings in private economy) will lead to a reduction in domestic private investments.

If domestic investment is less than domestic savings, which means a large fiscal deficit in the country, the need for external capital inflows or foreign exchange reserves to make up the deficit will appear. In other words, surplus under the current account is an important safeguard. If there is no surplus or deficit, then the official reserves net increase in the foreign currency reserve assets can only be seen as capital inflows, turning into foreign borrowing. This shows that the government borrowing will offset the foreign exchange reserves and total domestic savings, and that the budget deficit will detract from the possibility of the establishment of SWFs (Griffith-Jones & Ocampo, 2008).

3 Strategic goals

Of course, the establishment of SWFs, besides the aforementioned objective economic conditions, depends also on the strategic objectives of a country's economic development (Slawotsky, 2009: 1239). Generally the strategic goals to establish the SWFs can be divided into the following five categories: first, the protection and stability of a country's finances and economy, to avoid the risk caused by the change in exports or foreign exchange earnings; second, the establishment of a diversified fund for a non-renewable resource export earnings; third, greater benefits than the foreign exchange reserves; fourth, reservation of wealth for future generations; and, fifth, accumulation of funds for social and economic development.

In summary, adequate foreign exchange reserves are a prerequisite for the establishment of the SWFs. Economic conditions symbolizing stability of domestic economy, including international balance of payments, the percentage of foreign exchange reserves in GDP, external debt, money supply, as well as the budget deficit, and the strategic objectives of a country's use of foreign exchange are all very important factors. One country needs comprehensive consideration of the economic conditions when making the decision of establishing SWFs.

II . Characteristics of the Saudi Sovereign Wealth Funds

In the empirical studies of the establishment and operation of SWFs, the GCC's SWFs are often cited as a model. True, oil and gas exports in the Gulf countries have accumulated massive foreign exchange reserves, so countries are keen to establish such a fund to achieve intergenerational wealth transfer, investment diversification and maximized revenue. Every time the oil price rises, it brings about new wealth for Gulf countries to set up SWFs (Zhang, J., 2010: January). However, through careful comparison of the SWFs in six GCC countries, one finds that the SWFs in Saudi Arabia are vastly different from those in the other five countries in terms of the time of establishment, size of funds and investment strategies. Compared with the other five countries, Saudi Arabia is relatively conservative in the development of SWFs.

In addition to Bahrain, all SWFs funds of Gulf countries are derived from oil revenues. Every high period of oil has witnessed the establishment of SWFs in GCC countries. In the 1950s, Kuwait established the world's first SWF. From the late 1970s to the mid-1980s, the United Arab Emirates and Oman followed. Qatar and Bahrain joined the group in the late 1990s and the early 2000s. In 2008, Saudi Arabia became the last GCC country to set up its SWF, Sanabil-al-saudia. The purpose of establishing the fund is to change the status of decentralized investment, aimed at the formation of a unified public investment institution. This strategy is in line with the overall vision of King Abdullah's Economic reform. However, it is not like the general aim of the establishment of SWFs. The establishment of Sanabil-al saudia is an attempt to improve the Saudi foreign investment management level, and an initiative of the reform of the financial system.[①]

The nature and investment strategies of SWFs of the GCC countries vary. For instance, the stable fund of Oman is a typical investment fund, whereas the United Arab Emirates' and Kuwait's tend to create multiple small funds, and invest in equity trading of listed and private companies. QIA, DIC, Istithar, Mubalaba and other funds in Qatar traditionally implement a more conservative strategy

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[①] http://www.ft.com/cms/s/0/15285a98-5299-11dd-9ba7-000077b07658.html#axzz1z5YlgBLf.

in conjunction with the central banks of their respective countries. But in this century, some new SWFs have begun to participate more actively in the equity transactions in capital markets. Thus, 15% -20% of the fund capital is used for fixed-income investments, 50% -60% for corporate equity investment, and 15% -20% invested in private corporate equity and hedge funds (Ziemba, 2008: June).

During this financial crisis, financing difficulties caused many SMEs to struggle. However, the impact on the Gulf region's SWFs is very limited, and the GCC countries have been able to display their strengths on the world's capital markets before the world economy has fully recovered (*Challenging Times for Gulf*). In 2007-2009, the SWFs of the Gulf countries were involved in many important equity transactions. And the SWFs of the UAE and Qatar were active in worldwide equity transactions. Nonetheless, despite the fact that Saudi Arabia has the most foreign exchange reserves, only SAMA was involved in the UBS equity transaction, lagging far behind the two countries in terms of participation in the number of holding companies, holding proportion and scale of investment (Asutay, 335), with its activeness even less than the small country Oman.

Saudi SWFs are fairly different. Before 2008, Saudi Arabia's foreign exchange management agency SAMA managed the non-reserve foreign capital, but it was also in charge of the investment of public capital along with other public investment agencies (PIF, GIOC, etc.). According to the generalized standards, SAMA can be regarded as a sovereign wealth fund, and the Saudi SWFs asset size is huge, second only the UAE (see Table 1).

Table 1: SWFs with Top Ten Scale of the Domestic Assets in GCC Countries (unit: USD million)

SWF	Country	Amount of capital in domestic markets	Proportion (%)

Government of Saudi Arabia	Saudi Arabia	132,005	45.1
Ministry of Industry and Finance	UAE	23,447	8.0
Dubai Investment Company	UAE	20,643	7.1
KIA	Kuwait	16,385	5.6
Qatar Petroleum	Qatar	15,692	5.4
ADIC	UAE	13,535	4.6
GOSC	Saudi Arabia	11,761	4.0
QIA	Qatar	10,085	3.4
SBIC	Saudi Arabia	8,957	3.1
PIF	Saudi Arabia	8,533	2.9
Total		261,074	

Source: Brad Setser, Rachel Ziemba, WORKING PAPER：GCC Sovereign Funds January 2009
http://www.cfr.org/economics/gcc-sovereign-funds-reversal-fortune/p18017

However, according to the IMF, World Bank, GAAP's definition of SWFs[①], SAMA is not in line with the narrow definition of SWFs. Its investments are not in overseas markets. As the central bank, the investment strategy of SAMA is quite conservative and direction of investment is mainly focused on the domestic market. The Saudi government's SWFs accounted for 45% of its market capital, while the number in other countries is not more than 10%. If SAMA, PIF and other generalized SWFs are taken into account, then Saudi Arabia has 5 SWFs in total that control 27 AG. The investment of these SWFs in the domestic market amounted to 166.7135 trillion Yuan, while their investment worldwide only $US101 billion. In addition, their investment area is mostly concentrated in the GCC capital markets, accounting for 57%. In contrast, for the other five countries, the

[①] Generally Accepted Principles and Practices for SWFs.

investment centers are not in the region, but in North America and Europe. The proportion of their investments by SWFs in the GCC region is generally below 10%, except for the UAE which amounts to 27%. (Table 2)

Table 2: The Holdings in Domestic Markets of the GCC Countries SWFs

Country	SWFs Amount	Number of holding companies	Worldwide investment ($ billions)	Domestic investment ($ billions)	Proportion in GCC capital market
Saudi Arabia	5	27	101	166,713	57
UAE	7	27	102	61,002	21
Qatar	6	9	40	28,744	10
Kuwait	5	33	180	25,054	9
Oman	9	21	128	5,998	2
Bahrain	4	14	43	5,045	2
Total	36	131	594	292,557	100

Source: Brad Setser, Rachel Ziemba, *WORKING PAPER：GCC Sovereign Funds* January 2009, http://www.cfr.org/economics/gcc-sovereign-funds-reversal-fortune/p18017.

As for the structure of its investment, 55% of Saudi SWFs investment is constituted of fixed-income investment and 3% of hedge funds. Cash deposits in SAMA's assets take up 20%, equity assets 25% and fixed income assets 55%. The ratio of Saudi investment in low-income to high-risk high-yield investment is 3:1, very different from other countries in the ratio of 2:8. Plus, the external asset management company is responsible for the SAMA portfolio investment (Diwan, 2009: 345-359). Therefore, SAMA is neither involved in direct investment, nor much involved in the emerging markets.

All in all, the situation in Saudi Arabia seems to be very different from the other five GCC countries. Even during the third wave of SWFs, the establishment and operation of the Saudi SWFs remained quite conservative. The dedicated SWF, established in 2008, also had a very small scale and level of activity in the capital market that is far less than SWFs in other Gulf countries. This seems to be disproportionate to the position of Saudi Arabia as a large Gulf country and the huge foreign exchange reserves it has. To explore the reason, the analysis should be conducted from both its economic conditions and political factors.

III. The Economic Conditions of Saudi Establishment of SWFs

Saudi Arabia boasts a regional power with abundant energies and unique geographic and religious position in the Gulf area and Middle East (Ramady, 2010: 7). It is useful to understand the unique Saudi's SWFs by analyzing its macroeconomic conditions, especially the specific foreign exchange conditions and domestic economic environment from 2000 to 2009.

Saudi Arabia has a huge amount of foreign exchange reserves for energy exports. Saudi Arabia's proven oil reserves are about 2.6 million barrels, accounting for 25% of the world's reserves. In recent years, its oil exports accounted for 1/4 in the OPEC production and 1/10 of the world production. Saudi Arabia is also the largest oil exporter with the world's fourth-largest natural gas reserves (Ramady, 2004: 23-24). The profits from energy exports surpass other Gulf countries', generating huge foreign exchange reserves for the country. In September 2011, according to the statistics of the Saudi central bank, its foreign exchange reserves amounted to 2 trillion riyals (SAR), approximately US$ 520 billion (*Riyadh Daily*, 2011: November 1). According to the IMF report, Saudi Arabia's foreign exchange reserves reached US $456.2 billion by the end of 2010, ranking behind China, Japan and Russia as the fourth largest in the world (CIA, 2010:

December 31). As a member of the GCC countries, Saudi has accumulated a large amount of foreign exchange reserves and sovereign wealth from its energy exports. Its sovereign wealth is mainly managed by SAMA, PIF and other institutions.

Saudi Arabia is a strong but not the most powerful Gulf country in terms of the GCC economic development indicators. Saudi' nominal GDP ranked first in the GCC countries with US$468.8 billion at the end of 2008; its net foreign exchange assets were up to US$ 308.8 billion, much higher than the subsequent United Arab Emirates ($ 272 billion) and Kuwait ($ 100 billion). But in terms of per capita GDP, which reflects the macroeconomic situation, Saudi Arabia ranks last in the six countries, with only US$18,700 per capita, far less than the US$65,060 per capita in Qatar, even lower than Bahrain. In addition, in terms of the sovereign rating which affects financing costs, Saudi is AA- while the United Arab Emirates is AA. So it cannot be considered powerful enough in the Gulf region. Table 3 shows Saudi Arabia's overall economic strength.

Table 3 Economic Indicators in GCC Countries[①]

	Bahrain	*Kuwait*	*Oman*	*Qatar*	*Saudi Arabia*	*UAE*
Nominal GDP (US $ billion)	*18.5*	*148.8*	*53.1*	*104.6*	*468.8*	*239.5*
Real GDP growth (%)	*6.1*	*6.3*	*6.2*	*16.4*	*4.4*	*7.4*
Per capita GDP ($)	*18810*	*35930*	*19480*	*65060*	*18700*	*43350*
Inflation rate (%)	*7.0*	*10.8*	*12.5*	*15.1*	*9.9*	*14.0*
Imports (US $	*14.6*	*26.1*	*16.7*	*21.2*	*100.6*	*116.6*

[①] According to the statistics of the central banks of GCC countries, World Bank and IMF.

billion)						
Exports (US $ billion)	*16.9*	*88.8*	*33.3*	*53.2*	*313.3*	*180.9*
Gvt.Expenditure to GDP ratio (%)	*2.7*	*30.8*	*4.2*	*9.6*	*33.6*	*12.2*
Oil and gas revenues (billions boe)	*1.6*	*112.7*	*11.8*	*174.7*	*308.8*	*135.9*
Oil revenues to nominal GDP (%)	*33*	*55.8*	*47.2*	*62.1*	*56*	*34.4*
Net foreign exchange assets	*3*	*295*	*23*	*100*	*403*	*272*
External debt to GDP (%)	*157*	*25*	*16*	*87*	*23*	*76*
Standard & Poor's rating	*A*	*AA –*	*A*	*AA –*	*AA –*	*AA*

Apart from the status of an unqualified regional power, Saudi had also been a debtor nation for a long time in history. For instance, it had experienced a decade-long "oil boom" with soaring prices of oil in the 1970s. When Kuwait and the United Arab Emirates started to establish SWFs, Saudi Arabia was still in the transition of oil economy (Mallakh, 1982: 427). The fiscal spending had increased every year in the first four "five-year plans", and Saudi Arabia's domestic economy boomed on the implementation of Rosenstein–Rodin's "big push" strategy, which characterized the development of the domestic economy as a sudden leap (Mallakh, 1982: 427). The huge amounts of petro-dollars were invested in domestic infrastructure, industry, agriculture, education, healthcare and career development. From 1975 to 1978, the construction investment growth rose from 5.5% to 14.3%, and government services sector investment grew from 3.6% to 6.8%, transportation warehousing industry also increased from 1.7% to 4.5% (SAMA, 1977: 146-149; 165-168). In addition, the Saudi government had a high expenditure due to its population structure and social system of high welfare.

On the other hand, Saudi Arabia experienced frequent periods of inflation in the 1970s. According to IMF statistics, its inflation rate was up to 35.4% and 41.3% respectively, in 1975 and 1976. Saudi Arabia lacked an effective financial and monetary system which led to transaction disorders and monetary chaos. Although the Saudis established the Ministry of Finance and Monetary Agency in the 1930s and 1950s, in the 1970s, the foreign exchange parity was 3.75:1 of Rial to US dollars, which caused the recession in which imports increased and financial income could only maintain high domestic welfare system in the early 1980s (Vassiliev, 2000: 403). Thus, the Saudi government did not establish petrodollars intergenerational transfer or strategic objectives of diversified investment by SWFs at that time.

In the 1990s, especially after the first Gulf War, Saudi Arabia moved from a creditor nation to a debtor nation. When King Abdullah took office, Saudi encountered the 1998 oil crash and experienced financial hardship, whose debt was 100% of GDP and even had difficulty paying the employees' wages. They went through the crisis by borrowing money from Abu Dhabi's King Sheikh Zayed and eventually came out from the fiscal deficit only in 2003 when a new round of rising oil prices occurred (Asutay, 335). This explains why Saudi Arabia had few SWFs during the two SWF establishing trends in the last century.

In recent years, the Saudi government has been strictly carrying out the development strategy of debt priority. Especially with the recent round of oil prices soaring, Saudi's debt decreased by 9% and 29% in 2004 and 2005 (Ziemba, 2008: March 20). National energy export revenues took a large share of debt repayment. In 2006, the Saudi government achieved a foreign exchange balance, and the conditions of its foreign exchange reserves have been improved to a greater extent.

In 2000-2009 Saudi foreign exchange reserves accumulated, and the conditions for the establishment of a sovereign wealth fund was more and more mature. If we select Saudi Arabia's foreign exchange reserves, GDP, external debt and M3 data in the decade of 2000-2009, according to the indicator-study approach of foreign exchange conditions, we could find out whether Saudi had the necessary economic conditions to establish the SWFs in this period of time by analyzing the ratio of foreign exchange reserves to GDP, the relationship of foreign exchange reserves and foreign debt and M3 data.

Figure 1 shows the changes of Saudi FOREX to GDP ratio. The ratio is lower than 20% and basically did not rise from 2000 to 2003, but a rapid rise began from 2004 onward. The indicator of Saudi Arabia is far more than that of the United Arab Emirates, which means Saudi began to have better conditions to establish SWFs after 2004.

Figure 1： Ratio of FOREX to GDP

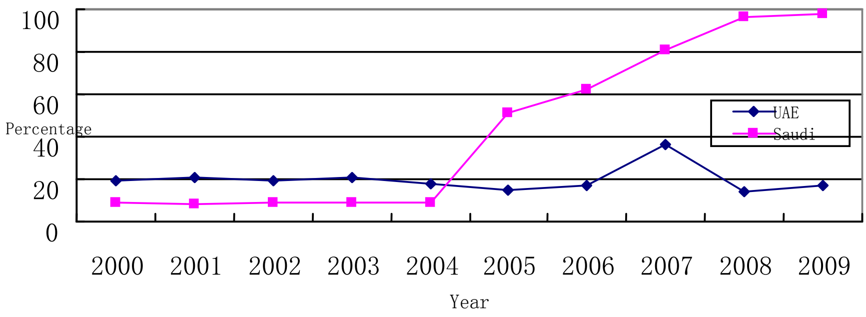


Figure 2 illustrates the ratio of foreign exchange reserves and foreign debt in the same period of time. Before 2004, the ratio of Saudi Arabia was under the index value of 1, which means Saudi debt was not suitable to establish SWFs. After 2005, this ratio was much improved to over 1. Although there were fluctuations caused by the financial crisis in 2007, the ratio was over 5 by 2008, which is far better than the conditions of the United Arab Emirates.

Figure 2: Ratio of FOREX to Foreign Debt

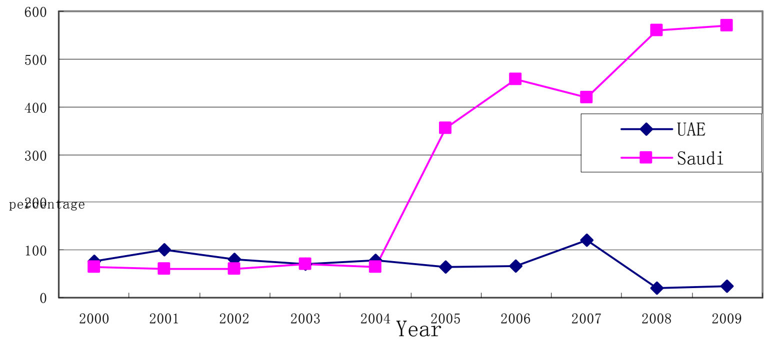
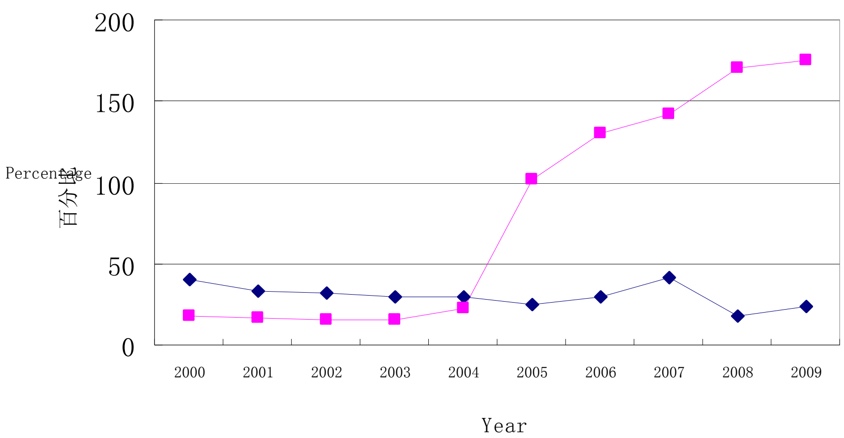


Figure 3 is the ratio of the FOREX and M3. The ratio was about 10% -20% from 2000 to 2003, basically inclining to the critical point. While after 2004 this indicator exceeded 100%, showing good establishment conditions. Therefore, Saudi's foreign exchange reserves, external debt, and the M3 indicators were fully fit to establish SWFs after 2004 based on existing studies on the establishment of SWFs theory.

Figure3: Ratio of FOREX to M3



Saudi Arabia has been one of the countries with the highest savings rates in the world.[①] According to statistics, the GNS of low-income and middle-income economies are up to 29% of GDP. Saudi Arabia's GNS/GDP was basically higher than this level in the years from 2003 to 2011, except for 2009 because of the effects of the financial crisis[②], as shown in Table 4.

Table 4: GNS/GDP of Saudi Arabia(2000-2009)[③]

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
GNS/ GDP	29%	26%	28%	34%	41%	48%	48%	46%	51%	-17 %	38%

However, Saudi Arabia's high savings rate coexists with the government's high fiscal deficit. The high savings rate does not bring about a relaxed environment for investment and financing. Saudi domestic financing has been tense due to the development strategy of the debt priority, and the debt repayment accounts for a large share of the national energy export revenues. Although Saudi's capital expenditure increased from 10% in 2000 to 32% in 2006 with domestic foreign exchange balances, these capital expenditures were mostly used on ambitious industrial projects. In the 1980s and 1990s, the Saudi government set a series of economic reform programs to adjust the structural defects of the oil economy, since its energy income could not meet the social needs of welfare and public services in the fastest population growing country. In recent years, Saudi Arabia has suffered from a high rate of unemployment which reached 15% or even higher. The per capita GDP declined rapidly. At the worst times, it was only 1/3 of the best period of the 1980s (Saeed, 2008: January 31).

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① http://intl.ce.cn/sjjj/qy/201203/27/t20120327_23193244.shtml.

② http: / /data,worldbank.org.cn /indicator.

③ http://data.worldbank.org/indicator/NY.GNS.ICTR.ZS.

Diversification of the economy and increasing employment requirements are two major tasks for the King to tackle, which require him to reform and take the New Deal, including encouraging the development of private capital, employing well-educated capital management personnel, expanding external market and opening up emerging sectors. Saudi Arabian General Investment Authority (SAGIA) is responsible for the implementation of investment policies (Seznec). One of its ambitious projects is to build six large industrial cities. SAGIA plans to invest about US$60 billion and to create employment opportunities in five different industries for the rising number of young people over the next 20 years. Saudi investment in domestic economic construction greatly reduced the scale of foreign exchanges accumulation (Asutay, 2008: 335), which significantly weakened the driving force to establish SWFs by such spillovers of squeezed investment.

From the above analysis, one can observe that the ratio of Saudi Arabia's foreign exchange reserves, external debt and M3 from 2000 to 2004 was around the lowest criteria of SWFs establishment, which is not a strong driving force for the government to establish SWFs. This also explains why Saudi Arabia did not set up specialized SWFs institutions in 2000-2003 and why SAMA was not active in overseas and diversified investments. However, the foreign exchange conditions have changed since 2004, regardless of the international payments and FOREX-GDP ratio, or the ratio of external debt and M3 which are showing strong Tendencies in the establishment of SWFs. Even though when compared with the UAE, Saudi Arabia's foreign exchange conditions to establish SWFs are more appropriate, in the light of stability of domestic economy, domestic investment projects have absorbed large foreign exchange capital, which weakened the conditions for the establishment of SWFs. Or it could be understood that the focus of the Saudi government on domestic economic construction has limited the country's SWFs development. Nevertheless, the transition of diversified oil economy is not exclusive to Saudi Arabia; in fact, the Gulf countries, such as the United Arab Emirates and Qatar also have a similar economic strategy. So it could be deduced that Saudi Arabia's conservative SWFs strategy is also related to its political environment at home and abroad.

IV. The Political Limitations of Saudi Arabia's SWFs

Firstly, the political environment of investing in SWFs in the Gulf countries has relatively deteriorated in recent years. Due to the fact that 15 out of the 19 hijackers involved in the 9/11 terrorist attacks were Saudis, the US government's financial war against terrorism set many restrictions on financial practitioners in the Middle East. Many Saudi American assets were frozen sometimes just because of the same names of individuals. The negative impact is that a large number of Saudi companies repatriate their overseas assets or seek other markets out of concern that their assets might be frozen (Diwan, 2009: 345-359). Also, the legal environment of SWFs' overseas investment has changed. For all the national governments and emerging economies that have SWFs in the Middle East and Asia, SWFs showed an active performance during the subprime mortgage crisis which triggered a strong concern of the United States, Germany, France and other countries that Middle East countries, Russia and China would use this investment tool to control energy, defense and strategic industries. So they modified foreign investment law in the name of safeguarding national security and changed the principle of open and non-discriminatory treatment that the Western developed countries used to adhere to. Now they have set strict restrictions on SWFs investment due to ''national security'' censorship in the newly revised Foreign Investment Law. Between 2005 and 2010, countries such as France, the United States, Australia, Canada and Germany had revised investment laws to authorize censor departments to deter foreign investors' ''threatening national security'' behaviors and SWFs investment censorship has become a trend which could have a negative impact on the SWFs foreign direct investments of Arabia and other countries (Zhang, J., 2010: January). Another obstacle in Saudi overseas investment is due to Americans' anti-Saudi and anti-high-oil-price sentiment. The Riyadh government has no intention of investing overseas and showing its foreign assets of oil exports. Dubai Port event was an example that the Dubai port company sold its shares of American company to avoid angering the American people (Alexander, 1981: July 13). Concerns about the use of SWFs for political purpose result in making Americans regard such funds as ''jihadists'' of the Middle East and China. To discuss whether to establish SWFs in the Saudi, clearly the government needs to take the political risk of investment such as "financial anti-terrorism'' and ''national security'' into account.

Secondly, the diplomatic significance of holding dollars is also a major factor affecting Saudi SWFs construction. As mentioned above, the main objective of the Gulf countries to establish SWFs is to reduce foreign exchange risk of holding US dollar reserves and diversify strategic investment. However, the Saudi government is very cautious in regard to the significance of Saudi-US diplomatic relations based on dollar reserves because Saudi Arabia is a loyal ally of the United States in the Middle East, whose investment strategy reflects its political and diplomatic posture, particularly towards the United States. There are ample reasons for the conservative SAMA to control foreign investment in order to guarantee the stability of the US-Saudi alliance. Many scholars believe that America's allies tend to hold US treasury bonds as a symbol of political support (Spiro, 1999; Helleiner, 2008: 92-121), and thus, it is not difficult to understand that 84% of Saudi foreign exchange capitals are dollars while the other Gulf countries diversify their oil revenues. According to IMF statistics, Saudi Arabia is the third largest holders of US treasuries following China and Japan. Riyadh implemented the monetary policy of pegging to the US dollar for a long time, which is the reason why SAMA has adopted the conservative investment strategy to hold US treasuries.

On the other hand, oil price is set in US dollar, and the Saudi government could not afford the possibility that the dollar loses its strong position as the currency of the world. However, the price that Saudi Arabia has paid for this policy is also high. According to the estimates of the relevant financial institutions, Saudi Arabia has used about 30% of its economic development results to maintain the dollar-denominated system, inflation and import price factor not taken into account (Diwan, 2009). In order to ensure a solid alliance with Washington, the dollar-denominated policies are not affected even if there is some strong anti-American sentiment in Saudi domestic politics.

Last but not least, the oil revenue allocation mechanism is also a factor because national and royal wealth allocation mechanism is an obstacle to the economic development of Saudi Arabia. In Saudi Arabia, members of the royal family receive the pensions before the national budget, and the remaining funds are allocated to each part of the government. Although SAMA is an official agency of foreign capital investment in the country, in fact there are over fifty domestic governmental agencies and even individuals involved in this type of investment with different shapes of investment shares. In this way, private capital and national capital are mixed together, which could inevitably lead to some malpractice without fully protecting the public interests.

This mixed ownership of public and private investment reflects the Saudi political characteristics which is the historical problem of the Kingdom of Saudi Arabia. Oil was the main fiscal source at the establishment of the administrative system in the 1950s, while ruling families struggled to share the cake of governmental departments on behalf of each others' interests, which resulted in today's Saudi Arabia's institutional fragmentations. The ruling families share their interests within the framework of the governmental management system, just as a new form of "Enclosure Movement" that petroleum revenues are the bureaucracy's trade resources. The fragmented political environment hinders the Saudi economic reform today. The institutional obstacles on this system lead to the dispersion of the nation's wealth and the failure to reach a unified investment strategy due to the fragmentation of the investment.

Another reason that explains why Saudi Arabia has little interest in SWFs is that members of the royal family can receive a high proportion of the national wealth. Saudi Arabia can also diversify foreign investment through the members of the royal family's private investment entity relying on the huge oil revenues without SWFs. To analyze Saudi foreign investment, one should consider the importance of the Saudi private foreign exchange capital (Institute of International Finance, 2008: January). McKinsey 2006 Investment Report on global petrodollars capital flows shows: 41% of Saudi Arabia petrodollars are privately owned while the corresponding proportion in the other five countries is about 33%. Before 2006, the corresponding proportion in Saudi Arabia was 62% (McKinsey Global Institute, 2007: 45).

Prince Walid bin Talal is the largest beneficiary of the oil revenues in Saudi Arabia. He controls share capitals worth US$ 50 billion in the world, including all kinds of domestic and foreign private and listed companies. Many people question how an individual could inherit such a huge amount of wealth, and some people believe he is just the representative of the Royal family. But in any case, there is no doubt that Saudi royal family controls a large number of foreign exchange capitals.

Therefore, the traditional US-Saudi alliance determines that Saudi Arabia will continue to maintain a large number of dollar capitals and the Saudi government will continue to hold dollar capital rather than use SWFs to diversify investment. This is not only to avoid causing the political worries of the Western countries about Saudi Arabia, but also to proclaim the importance of the Saudi-US alliance. On one hand, Saudi Arabia could clear up European and US's concerns and misgivings on its political and financial system this way. On another hand, the domestic distribution system also affects the Saudi government's decision-making---SAMA holds dollar assets while private enterprises diversify foreign investment. There could be fewer differences in SWFs investment between Saudi and other five countries if SAMA and the royal family investment are taken into consideration. This kind of arrangement not only presents to the United States its firm support to dollars, but also gives the country the advantages to take part in the portfolio in the international capital markets.

V. The Future Development of Saudi Sovereign Wealth Funds

Today, as the Gulf region is still one of the most volatile regions in the world, Saudi security is mainly dependent on the US. In the development of SWFs, Saudi Arabia must consider the impact of the strong US dollar currency. As an expression of the support for the ''Saudi-US alliance'', Saudi Arabia will not positively develop SWFs in a short period of time. However, there are huge differences in ideology, political institutions, fundamental interests and views on regional issues between Saudi Arabia and the US, and in the long run, the bilateral relation will face certain instability. In fact, in recent years, as an oil-importing country, the US has re-evaluated its oil policy, taking into account the security dimension of imported oil. The disparity of oil production and prices is a hindrance in the deep political and economic developments between Saudi Arabia and US. Saudi-US relations are not very solid (Fan, W., 2007).

After the 9/11 incident, the Saudi-US alliance was negatively influenced. The US then promoted the so-called ''Greater Middle East Initiative'', which was conflicting with Saudi rule mode of political-religious alliances and clearly constituted a threat to the Saudi regime, such as its state system, political system and rulers' governing base and status. Western interference in Tunisia, Egypt, Libya, Yemen and other countries also caused distrust of the United States and Europe from the leaders of the Arab world, including Saudi Arabia. In May 2011, the GCC summit meeting in Riyadh announced the co-optation of Morocco and Jordan as new members. This indicates that the GCC has broken the geographical boundaries so as to expand its sphere of influence, and that it has become the backbone of the Arab world. The center of gravity of the Arab world has been shifting eastward apparently (Yao, K., 2012). In this context, Saudi Arabia is making significant adjustments to its foreign strategy, implementing a multi-diplomatic strategy to strengthen its relations with the European Union, Russia, China, India and Japan, and to reduce dependence on the United States. Thus, with a large amount of foreign exchange reserves, Saudi Arabia is likely to adopt a more flexible and diverse investment management of its petro-dollars in the future. The lessening of dependence on the United States will promote the effects of Saudi SWFs. Saudi SWFs' development will be more active under the Arab world's ''Look East'' background.

However, this will be slow, because both the degree of change of US dependence on Saudi energy is not dramatic. As for the recent drastic changes in West Asia and North Africa, the United States still relies heavily on Saudi Arabia because the GCC, headed by Saudi Arabia, is the forefront of anti-Iran coalition in the Middle East for the United States. Saudi Arabia is the most important part in the US Middle East strategy. Because of Saudi Arabia, Iraq and Iran's geopolitical relationship, Saudi Arabia will continue needing the security protects from the United States for a long time. In December 2011, US and Saudi Arabia signed a $ 30 billion arms deal which including the F-15 fighter jets, to strengthen mutual relations.[①] Therefore, positively developing SWFs, and transferring the petro-dollars from the US market to other markets should be Saudi future trend in dealing with the national wealth, but it will not be

[①] http://news.xinhuanet.com/world/2011-12/31/c_122516964_2.htm.

completed in a short term.

However, Saudi Arabia's diversified development strategy and the ''Look East'' trend will change the existing foreign exchange reserves' investment structure and region, and the Asian countries which still maintain good economic development during the financial crisis will be important target area of Saudi future external development. In Saudi ''Look East'' policy, relations with China are a top priority. Sino-Saudi cooperation's new opportunity will appear.

Saudi Arabia has a long history of friendly relations with China, and there are broad prospects for bilateral economic and trade cooperation (Liu, L., 2011: July). China has become the world's second-largest economy after three decades of ''reform and opening up'' policy, and its international status and influence is also rising. China's huge market, huge demand for energy, as well as the economic development mode are attracting Saudi Arabia. In August 2005, Abdullah became the new King of Saudi Arabia, and his diversified foreign policy is more obvious. Saudi Arabia takes the relations with China as a new strategic focus. King Abdullah made it clear that ''the future of Saudi Arabia is in China'' (Tang, Z., 2008: June 24).

In the economic realm, there are great complementarities and wider areas of cooperation. As mentioned above, the economic and industrial city constructions are the main projects of the Saudi 2010-2014 ''five-year plan''.[①]Chinese enterprises cooperate with their Saudi counterparts in infrastructure construction. At present, Chinese enterprises have participated in the Saudi energy, cement, aluminum and transport programs. Aluminum Corporation of China Ltd. invests $ 1.2 billion in the construction of electrolytic aluminum plant with annual production capacity of 1 million tons in Jazan. Saudi Arabia is China's major engineering contracting market in the Middle East. In 2007, China signed an MOU for an engineering project with

[①] http://intl.ce.cn/right/jcbzh/201104/19/t20110419_22372741.shtml.

Saudi Arabia, which put an end to the "subtractor-only" position of Chinese construction companies in Saudi Arabia. In 2008, the two sides signed documents on cooperation in the field of infrastructure construction, which played an important role in helping Chinese enterprises to enter the large-scale infrastructure construction market in Saudi Arabia. In January 2008, the Saudi Basic Industries Corporation and Sinopec signed a framework agreement and invested $1.7 billion to establish a large-scale petrochemical joint venture in Tianjin with 50% stake separately, and its estimated annual output is 0.6 million tons of polyethylene, 0.4 million tons of ethylene glycol. [①]

For China, Saudi Arabia is not only a big Gulf country, but is also an important strategic partner because Saudi Arabia is one of the world's largest oil producers. In addition, as a big country of the Gulf region and OPEC's member, Saudi's influence both in the region and on the international arena continues to expand. Especially, with its huge amount of petrodollars and sovereign wealth funds, Saudi position in the international financial sector keeps rising. King Abdullah took part in the world financial summit, which reflects Saudi Arabia's prominent financial power. In the G20 conference, on behalf of the 22 Arab countries, Saudi Arabia showed its role in the international financial field. The GCC countries' SWFs account for half of the global sovereign wealth funds, and China and Saudi Arabia both have huge foreign reserves and both have purchased a large amount of US Treasury bonds. China and Saudi Arabia have similar interest demands in dealing with the global financial and trade protectionism triggered by the subprime mortgage crisis, and reforming the international financial system. There is new opportunity for cooperation between China and Saudi Arabia in the fields of energy and finance.

[①] http://www.ce.cn/ztpd/xwzt/guonei/2009/hjtcf/fxpl/200902/09/t20090209_18153565.shtml.

VI. Conclusion

On the one hand, although owning a great amount of foreign exchange reserves to establish SWFs, due to internal and international political environments, Saudi Arabia will continue to maintain a large number of US dollars capitals and be cautious in the construction of SWFs. On the other hand, the Saudi royal family members' overseas investment has greatly reduced the differences between Saudi Arabia and the five other GCC countries in SWFs overseas investment. This arrangement not only implies to the United States for Saudi stable attitude in supporting the US dollar, but also helps the country acquire advantages of the portfolio investment in the international capital markets. Saudi Arabia is cautious about establishing SWFs, but this does not mean it refuses it. In 2008, Saudi Arabia established SWFs and started the operation of overseas investment, which matches the Arab world's political gravity eastward trend.

We have reason to believe that Saudi Arabia has been transferring foreign exchange risk though the use of SWFs, and its diversified investment will continue to go eastward. Based on good diplomatic relations and complementary economic advantages, Saudi Arabia and China can seize further opportunities in the energy and financial cooperation fields.

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