# The Role of Sovereign Wealth Funds in Economic Diplomacy

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## *The Case of the UAE*

By

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# INTRODUCTION

# OVERVIEW OF ECONOMIC DIPLOMACY

## Defining economic diplomacy

*Economic diplomacy* involves the utilization of government diplomatic tools and strategies to promote a country's economic interests through various means such as enhancing trade relations, promoting investments, and collaborating on both bilateral and multilateral grounds. According to Fels and (Menz, 2017), the most cited definition of economic diplomacy is provided by Mattoo and Subramanian, (2012), who defined the term as "the art of leveraging a country's commercial, financial, and economic resources to advance its foreign policy objectives." It also involves branding a country's economy in a certain way to advance its foreign policy goals. This can be manifested in various ways, whether by providing foreign aid, investing heavily in host countries, or even imposing economic sanctions in some cases, which are the most widely recognized tactics.

Economic diplomacy draws on multiple disciplines, including economics, international relations, international political economy, and diplomacy studies, and should not be confined to either the economic or diplomatic realm (Okano-Heijmans, 2011). It is a dynamic process aimed at maximizing comparative advantages and addressing external challenges. Nations engage with the global community to optimize national interests across various domains like trade, investment, and mutually beneficial exchanges. Economic diplomacy operates across regional, bilateral, and multilateral levels (Rana, 2007).

Economic diplomacy, far from being a mere adjunct to traditional political diplomacy, has become integral to a nation's strategic toolkit in the globalized world. It operates at the intersection of politics and economics, leveraging a state's influence to pursue its commercial objectives in the international arena. This encompasses securing access to foreign markets for exports and investments, as well as fostering an environment conducive to international business (Morillas, 2000). The complex web of negotiations, agreements, and initiatives that shape cross-border economic activity falls squarely within the domain of economic diplomacy (Pireva, 2014).

Beyond trade and investment facilitation, economic diplomacy extends to the strategic use of economic instruments to further foreign policy goals. This may involve offering incentives or imposing sanctions to influence the behavior of other states, showcasing the intricate interplay between economic and political power (Berridge & James, 2001). While traditionally associated with state actors, the contemporary landscape recognizes the growing influence of non-state actors, such as multinational corporations and NGOs, in shaping economic diplomacy.

Effective economic diplomacy necessitates meticulous information gathering and analysis. Trade and economic missions are tasked with discerning a country's interests, assessing investment potential, and identifying opportunities for mutually beneficial exchanges, even if they require concessions (Baltezarevic, 2024). When executed skillfully, economic diplomacy can significantly enhance bilateral trade, contributing to national prosperity (Lysak, 2005).

Beyond economic gains, economic diplomacy serves a broader purpose. It strengthens political ties, safeguards national security through international cooperation, and cultivates a positive national image on the global stage (Rymarczyk, 2010). In the digital age, this image-building extends to the online realm. Diplomats leverage social media and internet technologies to engage with diverse audiences, manage crises, and shape perceptions, underscoring the importance of digital diplomacy in modern statecraft (Baltezarević, 2021).

A positive national reputation serves as a magnet for foreign investment, further highlighting the interconnectedness of economic and political objectives in today's world. In essence, economic diplomacy is a multifaceted endeavor that requires strategic thinking, nuanced communication, and a deep understanding of both domestic and international dynamics. Its impact reverberates across a wide spectrum of national interests, from economic growth to political influence and global standing.

## The rise of sovereign wealth funds

The Sovereign Wealth Fund Institute defines a sovereign wealth fund (SWF) as “a state-owned investment fund or entity that is commonly established from balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, governmental transfer payments, fiscal surpluses, and/or receipts resulting from resource exports.” They invest worldwide, in various asset classes (stocks, Treasury bonds, etc.) and sectors (financial, real estate and infrastructure, power generation, sports, commodities, airlines, manufacturing, etc.). SWFs have been around for more than 50 years, but they only came under close scrutiny about a decade and a half ago, when the Global Financial Crisis (GFC) highlighted their aggressive acquisition sprees and roles as liquidity providers to failing financial and non-financial firms. At the heart of these funds is that they are owned by governments on behalf of their citizens. The bailout programs that came from the GFC also underlined the phenomenon of “state capitalism” (Boubakri et al., 2023).

In the past two decades, Sovereign Wealth Funds emerged as powerful players in the international financial arena, evolving beyond their initial role as custodians of surplus national wealth (Truman, 2010). Fast forward to 2024, the Global SWF reported a spike in their assets under management that reached a striking $11.3 trillion for the year before, showcasing their expanding influence in global markets (Global SWF, 2024).

Even amidst economic fluctuations in 2022[1], SWFs displayed robust investment activity, deploying a record $257.5 billion, underlining their resilience and strategic intent (Global SF, 2023). This significant capital deployment included numerous high-value deals, reflecting a growing appetite for strategic investments (Suranovic, 2023). Particularly notable is the ascendance of Gulf-based SWFs, which have emerged as some of the

[1] The fluctuations referred to here are the spillovers of the COVID-19 pandemic and the Russian-Ukrainian war.

most active and influential players in the global investment landscape (Alnahedh & Alhashel, 2024).

This increased activity signifies a strategic shift in the mandate of SWFs. Traditionally, their primary mandate was to generate financial returns by investing excess reserves in international markets (Borisova et al., 2015). However, recent trends suggest a broader role, with SWFs actively participating in shaping national economic agendas (Lopez, 2023). This evolution is driven by a confluence of factors, including slowing globalization, the pandemic, geopolitical tensions, and supply chain disruptions, which have compelled governments to re-evaluate their economic and social priorities.

One prominent mandate or model gaining traction is the "strategic development sovereign wealth fund," which focuses on contributing directly to domestic economic transformation plans (Botlhale, 2024). Through investments in critical infrastructure and strategic industries, these funds aim to foster national capacity building, economic diversification, and employment generation (Makhoul et al., 2020).

The rise of strategic development SWFs exemplifies the evolving relationship between sovereign wealth and national economic development. It highlights the increasing recognition of SWFs as potent instruments for catalyzing economic transformation and realizing broader societal goals.

In the current global landscape, SWFs have transcended their traditional role as passive investors, becoming active participants in shaping economic and geopolitical outcomes (Clark et al., 2013). Their influence in international finance is undeniable, necessitating a careful balance between financial objectives, national interests, and global responsibilities. As their role continues to evolve, the impact of SWFs on the international financial system will undoubtedly remain a topic of significant interest and debate.

Boubakri et al. (2023) traces the presence of SWFs in academic literature and reports on the findings of Megginson and Fotak (2015, 2017, respectively). She identifies how the latter offer comprehensive overviews of the early academic research on Sovereign Wealth Funds, highlighting a tendency in this research to treat them as a homogenous group to draw generalizable conclusions. However, such an approach overlooks the inherent complexities of these state owned institutions. Boubakri et al. (2023) conforms how SWFs operate with diverse mandates, often characterized by a degree of opacity and occasionally conflicting objectives. Moreover, these SWFs originate from countries with varying cultures and institutional frameworks, further contributing to their heterogeneity. Consequently, attempts to draw universal lessons from this diverse group have often led to inconsistent and contradictory findings.

Recognizing these limitations, recent research has adopted a more nuanced approach, emphasizing the heterogeneity of SWFs. This approach acknowledges the significant influence of factors such as the country of origin, sources of funding, and specific mandates on the operations and investment strategies of SWFs. By taking these factors into account, researchers can gain a more accurate understanding of the complexities and dynamics of SWFs within the broader international financial landscape.

Nevertheless, the focus of SWFs' role in the international financial landscape comes in many shapes and forms. First and foremost, SWFs exercise their influence through their investment strategies, capital allocation, and the economic stability or not, they can provide. For example, these state-owned institutions tend to possess long term investment horizons motivating them to invest in a diverse range of global assets, including equities, bonds, real estate, and infrastructure. This long-term approach can stabilize financial markets during periods of volatility. With assets often exceeding hundreds of billions of dollars, SWFs can significantly impact the markets they enter. Their large-scale investments can lead to increased liquidity in the financial markets, influencing asset prices and market dynamics. Additionally, they often seek to diversify their investments across different asset classes and geographies to mitigate risks. This diversification can lead to more stable returns, which in turn can affect global investment patterns.

Raymond (2008) demonstrates how when SWFs announce investments in publicly traded companies, there is often a positive reaction in the stock prices of those companies. Research indicates that such announcements can lead to a transitory increase in share prices, reflecting market confidence in the SWF's backing. However, these effects may not be long-lasting, particularly if the market perceives the SWFs as unable to restore the financial health of distressed firms. At times of financial crises, SWFs have been known to step in and invest in struggling companies or banks, providing much-needed capital. For example, during the 2008 financial crisis, several SWFs invested heavily in distressed financial institutions, which helped stabilize the markets at that time (Černohorský & Tesnerová, 2021). Some of the notable examples in this regard emerge from the Gulf Region, and particularly the United Arab Emirates – the focal point of this study. The examples include[2]:

### *Financial Institutions*

- **Citigroup**: The financial crisis of 2008 was triggered in large part by the collapse of the subprime mortgage market, and Citigroup was heavily exposed to these toxic assets. In late 2007 and early 2008, Citigroup faced severe financial distress due to exposure to subprime mortgages. The Abu Dhabi Investment Authority (ADIA) and the Government of Singapore Investment Corporation (GIC) made substantial investments in Citigroup, totaling approximately $6 billion[3]. This injection of capital helped stabilize the bank and restore investor confidence[4] (Thomas, 2007).
- **UBS**: The Government of Singapore Investment Corporation (GIC) invested $11 billion in UBS in 2007, providing much-needed capital to the Swiss bank as it struggled with subprime mortgage losses.

[2] While SWF investments played a role in stabilizing certain companies and markets during the 2008 financial crisis, it's important to note that the overall impact of these investments on the broader economy is still a subject of debate among economists and policymakers.
[3] The $6 billion figure is in the ballpark. While the exact amounts may vary slightly depending on the source, it's widely reported that the combined investment was around this figure
[4] The investment did help stabilize Citigroup by providing much-needed capital and boosting investor confidence. However, it's important to note that Citigroup also received substantial government assistance during the crisis.

- **Merrill Lynch**: The Korea Investment Corporation (KIC) invested $2 billion in Merrill Lynch in 2008, supporting the bank during the crisis. Merrill Lynch was later acquired by Bank of America.

### *Automotive Industry*

- **General Motors**: In 2009, the United Auto Workers Retiree Medical Benefits Trust received a stake in General Motors as part of the automaker's restructuring. This stake was partially funded by the Kuwait Investment Authority, helping GM emerge from bankruptcy.

### *Real Estate Market*

- **Commercial Real Estate**: The Government Pension Fund of Norway, one of the world's largest sovereign wealth funds, increased its investments in commercial real estate during the crisis. This helped stabilize the market and provided liquidity when other investors were pulling out.

### *Stock Market*

- **Stock Market Stabilization**: Several SWFs, such as the China Investment Corporation (CIC) and the Qatar Investment Authority (QIA), invested in stocks during the crisis to support their domestic markets. These investments helped mitigate volatility and provided a stabilizing presence in the face of global economic uncertainty. Furthermore, QIA made strategic investments in several European banks to help stabilize the financial system. In 2008, QIA invested £2 billion in Barclays, becoming one of the bank's largest shareholders. This investment helped Barclays avoid a government bailout and maintain its independence (Drezner, 2008). QIA has been actively diversifying its portfolio into alternative assets, such as real estate and infrastructure. In 2015, QIA acquired a 44% stake in the company that owns London's Canary Wharf business district for £2.6 billion. This investment highlighted QIA's focus on long-term, income-generating assets (Abougabal, 2015).

The financial crisis along with other market tensions that followed brought the global financial system to the brink of collapse, and amidst widespread panic and uncertainty, Sovereign Wealth Funds emerged as unlikely heroes. Although often criticized for their opacity and perceived political motivations, they demonstrated their potential to act as stabilizing forces during times of extreme market stress.

Being armed with vast reserves accumulated from oil revenues or trade surpluses, they strategically deployed their capital to shore up struggling financial institutions. Their investments weren't merely about providing a lifeline to individual companies; they served a broader purpose. By injecting much-needed liquidity into the system, SWFs helped to stem the tide of panic selling and restore a semblance of confidence among investors.

This stabilizing effect was particularly evident in the case of Citigroup, Morgan Stanley, and AIG, which teetered on the edge of bankruptcy. SWF investments provided a crucial buffer, allowing these firms to weather the storm and avoid a catastrophic collapse that could have triggered a domino effect throughout the global financial system.

Beyond direct investments, SWFs also played a role in stabilizing broader markets. Their presence as large, long-term investors signaled a vote of confidence in the eventual recovery of the financial system. This helped to calm jittery markets and encouraged other investors to return, contributing to the gradual thawing of credit markets and the eventual resumption of economic growth.

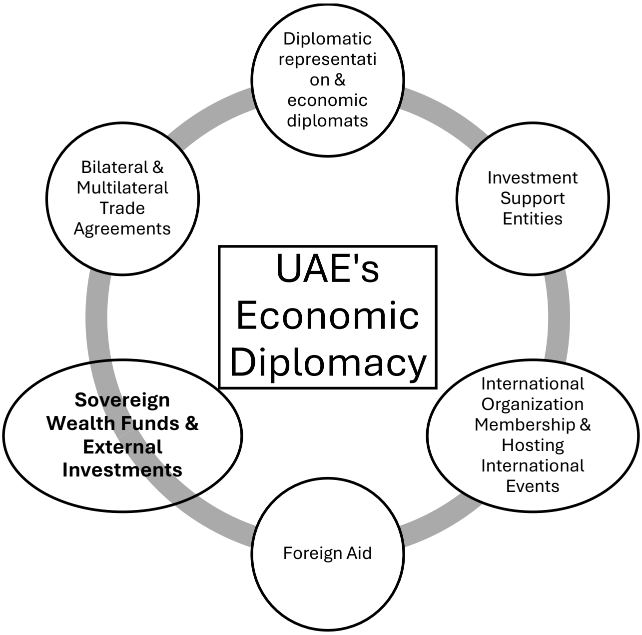
The financial crisis underscored the evolving role of SWFs in the global economy. No longer simply passive investors seeking returns, they demonstrated their ability to act as responsible stewards of capital, deploying their resources to promote financial stability and avert systemic risks. This newfound prominence highlights the growing importance of SWFs in shaping the future of global finance.

# CHAPTER 1

# THEORETICAL FRAMEWORK

## Conceptualizing SWFs and economic diplomacy

**Figure 1: the Pillars of the UAE's Economic Diplomacy**




Source: UAE Economic Diplomacy report 2023, AGDA, 2023.

The prevailing developments in economic diplomacy involve growing partnerships between government and non-government entities, investments from state owned institutions, endorsing free trade and preferential trade accords, preventing double taxation, and other similar topics. These developments are embedded through several tools some of which were identified in a conceptual framework proposed in the United Arab Emirates' first economic diplomacy report published in 2023, depicted above.

The framework encompasses the diplomatic economic tools, which are referred to as the foundational pillars of the UAE's economic diplomacy5.

In the contemporary era of globalization, economic diplomacy holds immense significance.

It serves as a pivotal instrument for shaping international economic relations, nurturing cooperation, and propelling economic growth and development across borders.

The evolving nature of economic diplomacy reflects the increasing importance of geoeconomics (Thirlwell, 2010). It is defined by its engagement with diverse economic issues and its close ties to global economic decision-making (Bayne & Woolcock, 2007). This concept represents a shift from traditional diplomacy, transcending stereotypes by emphasizing the links between political and economic spheres, domestic and international factors, and the growing influence of non-state actors, namely the private sector.

Economic diplomacy encompasses the UAE's capacity to engage in overseas investments through sovereign wealth funds (SWFs) and government-related enterprises (GREs). The UAE has several key SWFs that have been established in response to the significant surplus in the balance of payments (Young, 2020). These avenues enable the UAE to strategically allocate resources abroad and actively participate in global economic activities. The most prominent SWFs in the UAE with international orientation are:

[5] The six pillars that are presented in Figure1 collectively form the foundation of the UAE's economic diplomacy, reflecting the country's approach to interact with the international community and the growing soft power to carve out a prominent role on the global stage.

## Understanding the role of SWFs in international relations through their different mandates

According to El-Sholkamy & Habiburahman (2022), understanding the specific mandate of a SWF provides valuable insights into its strategic objectives, risk appetite, and investment behavior. This knowledge is essential for comprehending the diverse roles of SWFs in the global economy and their implications for international relations. The authors highlight that analyzing SWF mandates is a fundamental step in understanding their complex dynamics and influence on the global stage. The mandate of a Sovereign Wealth Fund (SWF) is pivotal in determining its strategic orientation and investment behavior. Traditional classifications categorize SWFs based on their primary objectives, each with distinct characteristics and implications for their role in the global economy:

1. Stabilization Funds: These funds function as fiscal buffers, designed to shield the budget and economy from the volatility inherent in commodity prices and other transient economic phenomena. They play a crucial role in maintaining macroeconomic stability, particularly in countries with less developed capital markets or fixed exchange rate regimes. By smoothing fiscal gaps and facilitating government payments and foreign exchange obligations, stabilization funds serve as a vital tool for economic resilience (Sharma, 2017). However, their investment strategies are often constrained by underlying liabilities tied to fiscal deficits (Kalter & Shena, 2013).
2. Savings Funds (for Future Generations): These funds embody a long-term perspective, aiming to transform non-renewable assets into diversified portfolios for the benefit of future generations. They capitalize on excess reserves, often arising from favorable commodity price cycles, to generate sustainable wealth for posterity. Operated by central banks, savings funds can adopt a higher risk appetite in pursuit of substantial long-term returns, supplementing traditional foreign exchange reserves.
3. Reserve Investment Corporations: Primarily established to optimize returns on reserves, these entities focus on mitigating the negative carry costs associated with holding reserves or maximizing returns

on abundant reserves, while preserving the underlying asset base (Al-Hassan et al., 2013). Countries like China, South Korea, and Singapore exemplify this model, emphasizing the efficient management of sovereign wealth for enhanced financial returns.

It is imperative to recognize that SWF mandates can evolve over time, reflecting changing economic landscapes and policy priorities. Furthermore, some SWFs may adopt a hybrid approach, blending elements from different models, thus blurring traditional classifications. Transparency and robust governance frameworks are crucial for ensuring SWF accountability and fostering public trust, regardless of their mandate.

4. Development funds typically help fund socio-economic projects or promote industrial policies that raise a country's potential output growth. They are directed towards national projects such as infrastructure and often aim to crowd in foreign institutional investor capital. Development funds have also been termed "strategic investment funds". These exist when typically, 50% or more of their investments are in national companies (i.e. defined as a private equity stake) (Hentov and Petrov, 2015). Development funds may involve earmarking excess revenues for specific domestic investments like transportation and water infrastructure projects, healthcare development assignments, and education schemes. Such earmarking can be an approach to preventing politically driven spending decisions from bypassing the natural budgeting process. Earmarking involves withdrawing money from a sovereign fund; usually a natural resource one; and requiring that it be spent on specific expenditure items through the budget process (Onifade, 2016).

With this assortment comes a variety of objectives and mandates that SWFs carry. These objectives include multiple macroeconomic and political standpoints such as protecting and stabilizing the budget and the economy from volatility shocks in revenues/exports; diversifying from non-renewable commodity exports; earning greater returns on foreign exchange reserves; assisting monetary authorities dissipate unwanted liquidity; funding social and economic development; and last but not least; shaping a country's political strategy.

As previously stated, SWFs receive their funding either from transfers of oil/natural gas revenues earned by national energy companies or from transfers of excess foreign exchange reserves earned from exports and managed by the country's central bank or Treasury. For this reason, SWFs are often referred to as either "oil based" or "trade surplus based". Nevertheless, there are other important methods of categorizing SWFs, which help explain their investing behavior, operating philosophy, and how they are received by nations targeted for SWF investment— whether the funds are sponsored by democratic or nondemocratic nations and, closely related, whether the funds operate in a transparent or nontransparent manner (Bortolotti et al., 2023). The rationale, objectives and investment behavior of SWFs are identical to other funds like trust, hedge, or private-equity funds. However, as the assets of SWFs belong to a Sovereign nation, managed through an ad hoc fund, these funds are aptly christened SWFs. Although little is known about the nature and degree of government intervention in the operations of individual SWFs, most of them are largely semi-autonomous, self-directed entities, dedicated to professional portfolio management (Griffith-Jones & Ocampo, 2011).

The inception of most SWFs, however, is not – and should not be - linked to political motivations but the primary result of macroeconomic considerations: wealth funds might seem an excellent opportunity for nations with high variance in public revenues to ensure steady cash flow levels and provide resources for long-term investments. However, there is a challenging balance when excluding political decisions in managing SWFs, particularly in the emerging world.

As of 2024, the global landscape of Sovereign Wealth Funds largely featured the Middle East. Despite not ranking among the largest global State-Owned Investors (SOIs), the Middle East was home to nine of the top 20 SWFs worldwide. The largest in the region was The Abu Dhabi Investment Authority, managing approximately one trillion U.S. dollars at the time of conducting this research (Statista, 2024). Seven of the world's leading SWFs were domiciled in Asia, the largest of which was the China Investment Corporation (CIC). In general, most funds are located in Asia and the Arab world – in Hong Kong, China, Singapore as well as Saudi Arabia, Kuwait and the United Arab Emirates[6].

### *A quick look at global funds beyond the Middle East region*

The topic SFWs is directly linked to the unique Norwegian fund that was established in 1990. The "Government Pension Fund Global" was established after Norway discovered oil in the North Sea in 1969. It was set up to shield the economy from ups and downs in oil revenue. It also serves as a financial reserve and as a long-term savings plan so that both current and future generations of Norway get to benefit from its oil wealth. The first revenue-injection was deposited in the fund in 1996. As the name suggests, it was decided that the fund should only be invested abroad. While the fund receives revenue from oil and gas production, these contributions make up less than 50% of its total value. The majority of its worth stems from strategic investments in diverse assets, including equities, fixed income, real estate, and renewable energy infrastructure. There's widespread agreement on how to manage the fund: save more now to better weather future downturns. Budget surpluses go into the fund, deficits are covered by it. This allows for counter-cyclical spending – more in tough times, less in good. To benefit future generations, a fiscal rule limits spending to the fund's expected real return, about 3% annually. This ensures oil wealth enters the economy gradually, preserving the fund's capital while spending only its earnings. The Norwegian fund stands at an estimated 1.66 trillion U.S. dollars as of September 2024, with Equities taking the largest share of its investments, amounting to 1.2 trillion U.S. dollars (77% of total Assets under Management, AUM) spread out across 66 countries. The second largest industry attracting the Norwegian Fund is fixed income assets, calculated at 435 billion U.S. dollars (26.1% of investments) across 49 countries; followed by real estate (1.7% of all investments) and renewable energy infrastructure (0.1% of all investments)[7].

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[6] https://www.statista.com/chart/24060/the-worlds-biggest-sovereign-wealth-funds/
[7] Norges Bank Investment Management. Retrieved from https://www.nbim.no/en/the-fund/investments/#/

On the Asian front, Singapore stands out as a prominent SWF since its incorporation in 1981. The fund, (GIC for short) was established under the Singapore Companies Act and is entirely owned by the Government of Singapore to manage its excess reserves. The sources of funds include proceeds from the government's issuance of securities, budget surpluses and proceeds from the government's land sales. Under the Singaporean constitution, the government is granted up to 50% of expenditure and withdrawal from the fund's asset returns owned by the Monetary Authority of Singapore and Temasek Holdings, a separate investment company with a global portfolio that manages its investments based on commercial principles[8].

GIC invests only for financial returns. Its "client", the Singaporean Government, sets its risk tolerance that acts as the directive for the fund, and accordingly the latter constructs the appropriate investment portfolio to generate pleasing long-term returns. The GIC's core investment domains underpin its investment portfolio: Public Equity, Fixed Income, Private Equity & Infrastructure, and Real Estate. GIC is also very present in cross-asset investment opportunities which is a strategic approach where two or more SWFs from different countries co-invest in projects or assets, either in their own countries or in a third country. This can take various forms, such as joint ventures and bilateral agreements. The motivation behind cross investments addresses risk diversification, access to untapped markets, knowledge and technology transfer, and of course, strengthening diplomatic ties. Such co-investment initiatives improve risk-adjusted returns for all partners and enhance the expertise and capabilities of stakeholders. They also solidify international influence and endorse soft power (Klitzing et al., 2010).

China has had a steady growth in its trade surpluses from export earnings. Progressively rising oil and gas prices on the other hand have increased the revenues of the Gulf Cooperation Council (GCC) and the Russian Federation and turned them into globally significant net investors. In this

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[8] While Temasek is largely considered as being a sovereign wealth fund, there are major differences as it invests mostly in equities, is the outright owner of many assets and companies, and pays taxes like other commercial investment firms.

sub-group of economies, China has been the largest global investor, with almost twice as much foreign investment as the next largest EME, the Russian Federation and three times as much as the Republic of Korea (herein after Korea), the third largest investing EME. Economies that are Asia's financial hub, namely, Hong Kong SAR, Singapore and Taiwan, have strengthened their bond with the EMEs of the region and they are expanding global investment rapidly (Das, 2009).

### *A closer look at SWFs' mandates: domestic development, stabilization and savings*

SWFs are meant to bring stability to government finances or provide long-term economic stimulus. They could act as a helping arm to traditional monetary and fiscal policy tools (macroeconomic policies) that administer taxes, government spending, money supply, interest rates, among other tools). Despite the multiple similarities present among SWFs, there are many striking differences when it comes to size, goals and levels of sophistication. Sovereign wealth funds typically have one of three goals: stability, savings for future generations or domestic development. These goals often vary based on the SWF's source(s) of capital and the needs of the entity controlling it (Ouni & Plaisent, 2020). Ultimately, in a lot of cases, SWFs have been established to manage natural resource-derived revenues yet in others, they may not be linked explicitly to the latter, and have been established to manage balance of payment (BoP) surpluses in countries with no natural resources. Literature broadly points to two important prerequisites for establishing a resource-based SWF, namely the expectation of large capital inflows and existing low public debt (Mulder Mulder et al., 2009). Importantly, if a country suffers high public debts, it is usually advisable to first pay them off to improve borrowing terms and international credit ratings, and only then consider establishing a fund.

Nevertheless, the core objective behind their creation resides in protecting and stabilizing the budget and economy especially at times when export earnings are excessively volatile due to price swings. Nevertheless, SWFs are meant to ensure long-term growth of capital and diversification of the local basket of exports (particularly non-renewable commodities).

SWFs are not sensitive only to risk-return considerations like other traditional (or market focused) institutional investors. One major distinctive feature is their long-term investment horizon as they have no short term liabilities; they maximize their risk adjusted returns and diversify their portfolios across asset classes, industries and geographies (Arouri et al., 2018).

The investment and development objectives are expected to have different portfolio allocation implications and a rich ongoing financial literature tests the validity of the two hypotheses (Grira, 2020). Previous work on the motives behind sovereign wealth funds deals was subject to empirical investigation and showed that, in some cases, politics do interfere (Murtinu & Scalera, 2016), but in most cases, sovereign wealth funds transactions are dealt with as rational institutional investors (Liu & Price, 2020). It has also been shown that, compared to other institutional investors, sovereign wealth funds are more likely to target firms operating in strategic sectors (Boubakri et al., 2016). According to the Organization of Economic Cooperation and Development (OECD), SWFs are welcomed as constructive contributions to recipient countries' economic development (Lorfing, 2021). To date they have been reliable, long-term, commercially-driven investors and a force for global financial stability. The international organization has also recognized that if SWF investments were motivated by political rather than commercial objectives, they could be a source of concern, and that legitimate national security concerns could arise. The latter also welcomed international discussions involving SWFs, their governments and recipient governments. These increase understanding, contribute to mutual trust and confidence, and help avoid protectionist responses that could undermine economic growth and development.

Going back to SWFs with stabilization mandates in resource-rich countries; it is worth noting that such lucrative revenues are often subject to price and supply volatility. Given the correlation between commodity prices and their supply, while small price swings may occur frequently, significant fluctuations hit more rarely but with longer periods of spillover effects. The discovery of natural factor endowments; as in the case of Ghana in 2007, can therefore have a de-stabilizing effect on a country's budget cycle, leading to disproportionate and inefficient spending during resource booms and budget shortfalls during busts (Dixon &Monk, 2011).

Ideally, economic theory would argue that stabilization ought to be achieved via sound management of traditional macroeconomic policies[9] rather than resorting to withdrawals from a SWF. In the case of many emerging and developing countries, unimpressive macroeconomic performance indicators have caused withdrawal constraints which are usually heightened during commodity price falls. Other emerging economies with better macroeconomic performances, as in the case of some Arab Gulf States like the United Arab Emirates, prefer to resort to conventional budgetary measures to relieve their economy from a recession or provide anti-inflationary measures should it be racing through an expansion.[10]

Generally speaking, monetary policy tends to be less effective in developing countries if there is poor transmission of the latter to interest and exchange rates, stemming from underdeveloped domestic capital markets or export sectors. Hence, if a country is to wisely handle resource windfalls, it needs politically independent central banks with some degree of autonomy; otherwise, establishing a separate stabilization fund would be the alternative solution. On the other hand, fiscal stabilization funds seek to support countercyclical fiscal policies through "ring-fencing" resource revenues subject to fiscal rules. In other words, a straight-forward fiscal rule would tie any government withdrawals, and deposits, into a SWF to a resource "reference" price or benchmark. This link would allow for withdrawals should current market prices fall below this benchmark, and conversely, call for deposits if revenues were above the reference price. This way, stabilization funds can stock-pile extra earnings at times of revenue hikes

[9] Such as fiscal and monetary policies; which could be administered either pro-cyclically or counter-cyclically. General countercyclical fiscal policy can be carried out through automatic stabilizers, as well as by paying down debt in boom times and borrowing in times of recession (Markowitz, 2020). Meanwhile, pro-cyclical monetary policy instruments can alleviate the externalities of currency exchange fluctuations and demand shocks by adopting expansionary measures at times of economic booms and contractionary ones at times of recessions.

[10] The United Arab Emirates adheres to a pegged exchange rate system that somehow limits its authority over its own monetary policy.

and can be used to be drawn upon at times of revenue-plunges (Bauer & Mihalyi, 2018).

Unfortunately, there is no golden fiscal rule prescription that can be generalized. Yet, establishing an enforceable one with little room for loopholes is crucial for stabilization funds to operate effectively (Makowitz, 2020). If not, political pressure would find their way into SWF agendas and would highly influence their mandates. Lessons have proven that SWFs with market-orientations are more credible, as they driven by high-risk high-return investments. As stabilization funds tend to rely on the readiness of funds whenever necessary; as the name entails, they require some degree of liquidity. Hence, most if not all stabilization SWFs move towards short-term investment plans, incorporating more dilute financial instruments, as in the case of treasury bills. These funds function as an alternative to external borrowings at times of economic recessions. Finally, applying solid fiscal rules to stabilization funds renders itself fruitless if such solidity is not mirrored onto the general budget, especially if SWF revenues do not comprise a large percentage of the country's GDP (Wills, 2018).

With respect to SWFs that incorporate saving-mandates, it is difficult to refute the logic behind them which emphasizes the importance of extending resource-earnings to future generations and not only current ones. To mitigate the effect of over-consuming resource revenues by current generations, countries often resort to capital investments. By investing resource revenues in capital, which translates into permanent income and continues to grow even after resources have been depleted, this conundrum could be resolved. Stemming from this logic, savings funds seek to invest resource wealth in long-term assets (often abroad), in order to spread current wealth more evenly over time to benefit future generations (Carney et al., 2021). Ultimately, savings funds aim to share the wealth of a country across generations by investing in a portfolio of higher risk-return investments. The investment returns on these funds can then be used to finance government expenditures once oil or minerals are depleted. In summary, the retained earnings from commodity sales that are injected into savings funds are eventually converted into more sustainable and "longer-duration" financial assets.

For example, Singapore's Temasek and Malaysia's Khazanah SWFs were both established with funds raised via the sale of government owned companies (Carney, 2021). The advantage of possessing savings SWFs is that they encounter the smallest number of restrictions on their capacity to engage in strategic investments because they are not specifically targeted for any future-funding obligations. The longer investment horizon of savings funds allows them to benefit from the illiquidity premium[11] (Amihud et al., 2015). In summary, savings funds retain a big appetite for large-scale and long-term ownership stakes in both domestic and foreign firms, thereby yielding the highest potential for active interventions in invested firms among all SWF categories (Amihud et al., 2015).

[11] A liquidity premium is any form of additional compensation that is required to encourage investment in assets that cannot be easily and efficiently converted into cash at fair market value. For example, a long-term bond will carry a higher interest rate than a short-term bond because it is relatively illiquid.

# CHAPTER 2

# THE UAE'S SOVEREIGN WEALTH FUNDS: AN OVERVIEW

## UAE's economic landscape

The economic landscape of the UAE up to the first two quarters of 2024 was characterized by several key developments in both domestic and international trade that reflected its ongoing evolution and adaptation in the global market. However, uncertainties surrounding the global economy prevailed with divergent implications. Optimistic International Monetary Fund (IMF) upward revisions for the US were corrected, dropping from 2.7% to merely 1.8% growth of GDP, decelerated by China's economic shrinkage and overall drop in world demand. This put downward pressure in general on all other economies, particularly emerging ones such as the UAE, as they rely heavily on the dynamic economic activities of the more-advanced hemisphere. On the other hand, global inflation was projected to decline, with inflationary risks remaining from rising transportation costs and geopolitical tensions in the region.

Despite the global downturn, the UAE's non-oil foreign trade defied the global trend and soared to an unprecedented AED 2.4 trillion in 2023, fueled by new economic partnership agreements. This robust trade performance was projected to drive continued economic growth, with real GDP expected to reach 3.9% by the end of 2024 and 6.2% in 2025. While oil production decisions by OPEC+ remained a factor, the UAE's non-oil sectors are expected to remain strong, with consistent growth of around 5.4% forecast for both 2024 and 2025.

Prior to that, the UAE economy showed strong growth in the fourth quarter of 2023, driven by both the non-oil sector (which comprises about 75% of the economy) and improved performance in the oil sector.

**Key Drivers:**

- **Strong non-oil sector:** Tourism, transportation, finance, insurance, real estate, and communications are all expected to contribute significantly to growth.
- **Rebounding oil production:** Oil and gas production is forecast to pick up significantly in 2025.

**Challenges:**

- **Global uncertainty:** Geopolitical tensions, high interest rates, and potential oil production cuts by OPEC+ could dampen growth.

**Opportunities:**

- **Favorable global conditions:** Lower interest rates in advanced economies could boost demand and attract investment to the UAE.

### *Economic Growth and Diversification*

- **Post-Pandemic Recovery**: The UAE's economy has shown resilience and growth following the pandemic, with a focus on diversifying its economic base beyond hydrocarbons. The financial sector has emerged as a leading non-hydrocarbon sector, contributing significantly to the overall economic landscape (Babenkova, 2024).
- **Sustainable Finance**: the UAE has been making bold moves in the domain of sustainable finance and has been resorting to it as a driver for its economic growth (Sameer et al., 2024). Research indicates that sustainable finance positively influences foreign direct investment (FDI) and economic development in the UAE, highlighting the importance of financial stability in maximizing these benefits. Some of the UAE-based examples include: investments in renewable energy and the issuance of green bonds by one its leading sovereign funds (Mubadala) that will be further explored in the proceeding chapters of this book. Climate-focused

investments also proliferated across numerous companies and projects, aligning with the country's energy-transition objective, including battery storage, electric vehicle charging infrastructure, and sustainable aviation fuel (Maaskri, 2024).

### *Financial System Development*

- **Innovative Financial Centers:** The establishment of international financial centers like the Dubai International Financial Center (DIFC) and Abu Dhabi Global Market (ADGM) has positioned the UAE as a leader in innovative financial systems within the MENA region. These centers aim to create a transparent and efficient financial environment, attracting global investments (Babenkova, 2024).
- **Islamic Finance**: The UAE's financial system is also characterized by a robust framework for Islamic finance, which operates under clear regulations and standards, enhancing its appeal to international investors.
- **Regulatory Frameworks**: The adoption of International Financial Reporting Standards (IFRS) is expected to enhance financial transparency and attract FDI, although challenges related to resistance from family-owned and state-owned enterprises persist (Morshed, 2024).

According to the World Investment Report for 2024 issued by the United Nations Conference on Trade and Development (UNCTAD, 2024), the value of foreign direct investment (FDI) inflows to the UAE in 2023 amounted to USD 30.688 billion compared to USD 22.737 billion in 2022, to rank 2nd globally in FDI inflows. On the other hand, the UAE's Ministry of Finance announced the country's Foreign Direct Investments to have reached a record high of $52.3 billion in 2024, registering a 33.2 percent increase compared to 2023. The surge in FDI volumes rectifies the nation's image and position as an attractive investment destination with substantial room for diversification. The UAE was recognized in that year as the second-largest economy in the Arab World accounting for 60% of the total

FDI inflows into the GCC bloc. The ministry of economy in 2024, confirmed the economic indicators for the year before as follows:

> *In 2023, the GDP stood at AED1.68 trillion at constant prices, marking a 3.6 percent increase from 2022. Furthermore, the non-oil GDP reached AED1.25 trillion, reflecting a 6.2 percent growth compared to 2022.*

## *UAE SWFs*

SWFs in the Middle East region have proved their influence on the international scene in general, whether financial or economical. One prominent role they played was that witnessed during the Global Financial Crisis of 2008. Their role was decisive in rescuing the international financial system at the time by injecting several billions of dollars into the vaults of financial institutions. Over the past decade, they have grown in power, gaining considerable weight to the point of becoming major players in the global economy and forming a new class of investors.

Some of the wealthiest and most powerful SWFs in the world, emerge from the Gulf Region. The United Arab Emirates by itself owns eight[12] SWFs from a total of twenty-eight originating from the Middle East region. In 2021, UAE SWFs witnessed exponential growth particularly from their lucrative investments in foreign equity markets as well as recovery in oil prices after a tough previous year due to the outbreak of the Covid-19 pandemic. According to Global SWF's 2022 annual report "State-Owned Investors 3.0," the UAE-based sovereign wealth funds' fortunes jumped from USD 1.374 trillion (AED 5.04 trillion) in 2020 to USD 1.624 trillion (AED 5.9 trillion) at the end of 2021.

The definition of sovereign wealth fund excludes, among other things, i) Foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes ii) State-owned enterprises (SOEs) in the traditional sense iii) Government-employee pension funds (funded by employee/employer contributions) iv) Assets managed for the benefit of individuals (El-Sholkamy, 2022). In

[12] This number was counted at the time of writing this book. It is subject to change depending on time.