Modernity, institutional innovation, and the adoption of sovereign wealth funds in the Gulf States.

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Abstract. Whereas debate about sovereign wealth funds (SWFs) often focuses upon the global significance of their investment strategies, these institutions are also emblematic of the new global order of financial capitalism. SWFs are a mechanism for states to advance their interests through global financial markets and are a switch point for the translation of resource assets into financial assets in global markets. Yet, realising the promise of SWFs is not easy. The form and functions of these institutions are typically conceived in Western terms, which means the necessary infrastructure for their effective performance may not exist in non-Western jurisdictions. Nonetheless, these funds have grown increasingly popular throughout the world. As such, this paper examines the process of SWF adoption in non-Western jurisdictions, and, in particular, SWFs' recent rise in popularity amongst the Gulf States. These countries are particularly interesting as they face a variety of challenges due to institutional contradictions between the norms of Western finance and the inherited traditions of the Gulf. While Gulf SWFs may be limited in their effectiveness, these funds still serve as an important symbol for the region, representing a formal gesture towards 'modernity' in the context of nation-states' inherited traditions.

Keywords. Sovereign wealth funds, Gulf States, modernity, finance, form, function

JEL codes. G18, Q32, O16, O53

Acknowledgements. This paper was supported by the Leverhulme Trust (UK). It draws upon our SWF research programme and those that have commented upon the project through the medium of www.oxfordswfproject.com. We have been fortunate to be able to speak with those employed by Gulf States' sovereign wealth funds, industry and service providers, and academics who also follow this project. Given the sensitivity of this particular topic and its region, our respondents remain anonymous. More generally, we would like to thank Nancy Webman and her colleagues at Pensions & Investments for their co-sponsorship of an online survey of those involved in sovereign wealth fund investment management. As well, we would like to thank Diane Stone and Sarah McGill for their help on relevant sources. Finally, we would like to thank Olga Thönissen for her research assistance. None of the above should be held responsible for the opinions expressed herein.

Introduction

There have been two remarkable episodes of oil price speculation since the 1970s. The first occurred in the mid to late 1970s and created havoc in Western economies, prompting a burst of inflation alongside stagnating economic growth rates and rising unemployment. At the time, the Organization of the Petroleum Exporting Countries (OPEC) was pilloried in the media and attacked by Western governments as holding advanced economies hostage to Middle Eastern sources of crude oil.[1] Whatever the interpretation of events, Gulf States reaped considerable windfall revenues stemming from the spike in oil prices. However, the benefits of this sudden rush of wealth were ephemeral, as the revenue was largely lost through a combination of corruption and ineptitude. Most oil-rich economies were ill-equipped to secure, manage, and govern the sudden rush of income offered in exchange for their natural resources. Simply put, inherited financial structures and institutions were primitive.

Thirty years later, a second spike in oil prices associated with the global financial bubble matched the levels (in real annual prices) of the first spike. However, this episode was different as it was accompanied by a burst of institution building. As prices rose, there was, at hand, a tried-and-true institution that could secure the flow of revenue and manage the assets in ways that could add to the long-term welfare of the sponsoring states: the sovereign wealth fund (SWF). These special purpose vehicles exist to invest government assets in global financial markets in accordance with the interests and objectives of the sovereign sponsor (see Monk 2009).[2] From Alaska and New Mexico to Norway and Kuwait, governments have used these funds as a tool for converting physical assets into financial assets for the purpose of macroeconomic stability, inter-generational savings, economic diversification and more.

SWFs are emblematic of the new global financial order that is dominated by the finance industry and its various institutions and agents. While these funds provide useful services to the sponsoring governments, they are also a symbol of a state's "modernity." In large part, this is due to the fact that the SWF is an institution conceived in Western terms. And yet, while adopting such institutions in non-Western jurisdictions may have reputational benefits, the functionality of these institutions may be compromised by the institutional contradictions embedded within the SWF and the sponsoring society. Indeed, non-Western countries that have established SWFs have struggled to achieve Western levels of efficiency and performance with their funds. This stems from the mix of ingredients required to make funds work. Put another way, the idealized Western form of a SWF may not be a recipe for effective performance in non-Western jurisdictions.

Notwithstanding these challenges, the Gulf States have turned to these funds to help manage resource revenues. Through the region, governments can boast more than ten funds that fit the definition of a SWF. And yet, academic theory suggests that the transposition of institutions conceived and developed in certain "macro–regulatory environments" may be quite ineffective by virtue of the very different norms and traditions that characterise adopting jurisdictions (Gertler 2001). As such, the dissemination of the institution throughout

[1]/. In the context of continuing Cold War hostilities with Russia and (to a lesser extent) the People's Republic of China, the OPEC cartel was seen as a geopolitical intervention as much as an attempt by resource-rich economies to claim their share of global growth prospects. See Yergin (1992).

[2]/. Among SWFs, there is a significant group whose assets are based upon their sovereigns' resource or mineral wealth. There are, of course, SWFs whose assets are not owed to resource wealth but to government budget surpluses, windfalls, and export income. In this paper, we leave these reserve investment corporations and pension reserve funds to the side and, instead, focus on the rising importance of commodity funds in Gulf States.

the region raises some important questions: How has the adoption of this Western institution in the heart of the Middle East been realised in practice? What problems have these governments faced in adopting the institution? How are these problems being dealt with? And what is needed for these countries to realise the promise of SWFs?

In order to answer these questions, this paper first looks at the problems associated with managing resource riches, referencing the academic literature that coined the phrase "Dutch disease" (resource wealth may be lost by virtue of institutional incapacity and the adverse effects of unmanaged income flows through the domestic economy). We then turn to the issue of institutional innovation, noting that while a couple of Middle Eastern countries were "early adopters" of the sovereign wealth fund institution, the establishment of such funds was driven in large part by Western interests in the region. Only later, when the flow-of-funds came to dominate Gulf States' macroeconomic planning and development, did the rash of SWF adoption take place. As such, the SWF is inherently Western. Our case studies in the Gulf support Gertler's (2001) argument. Nonetheless, the Gulf States appear committed to Western economic norms and institutions (if not Western conceptions of liberal democracy).

Resource Dependency

There is compelling logic for Gulf States to save current resource revenues for the future. First, oil reserves are, in some sense, finite resources. Given the rate of exploitation and estimates of the available oil stocks, forecasts abound about the likely exhaustion of those stocks (Hubbart 1956). In this context, current revenue expenditures that lock in long-term obligations need to be balanced against the unvoiced claims of future citizens who may not be as privileged by virtue of the exploitation of a scarce resource. Second, the small size of many oil-rich Gulf States and their distinctive cultural and economic heritages may conspire to limit the translation of abundant current income into long-term export-led economic development (in the manner of East Asian developmental states; see Woo-Cumings 1999). Third, resource-dependence can affect the evolving path of whole economies (Corden 1984 and Corden and Neary 1982): lack of local backward and forward linkages, the limited employment effects of resource development, and low returns on education can effectively bifurcate the host economy and isolate inherited non-resource physical and human assets from the global economy (Auty and Kiiski 2001).

As Karl (1997) has observed, burgeoning resource wealth can also affect the structure and shape of the relationships between government, corporations, and civil society. Countries at the mercy of volatile global resource prices are particularly vulnerable, as windfalls in one year are too often followed by years of depressed resource prices which can leave resource-dependent states in a (economic and political) precarious position. Year-to-year price volatility has been common over the past few decades. In Figure 1, the path and volatility of crude oil prices are depicted from 1861 through to the end of 2009. As shown, the past 40 years have witnessed two remarkable peaks in oil prices quite unlike the past 100 years (comparing the period 1880 through to 1970).[3] Not only has volatility been an issue; it would appear that there was a step-change in the underlying "floor" of oil prices through the period 1970 to 2010.

[3]/. This figure is taken from http://www.bp.com/popupimage.do?img_path+liveassets/bp_internet/globalbp and is best seen as a characterisation of the path and volatility of global oil prices expressed in US dollars against the 2009 reference date. See also Dvir and Rogoff (2010) who use the same data base to give a broader characterisation of oil prices over the past 150 years. There are more sophisticated and perhaps more complete series although few have the global scope and temporal reach as this Figure. See also the International Energy Agency website.

[INSERT FIGURE 1 ABOUT HERE]

In episodes of rapidly increasing resource prices with the attendant flow-on effects for government revenue, there has been considerable political conflict over how best to manage those assets and in whose interests and over what period those assets should be put to use. In some cases, resource riches have been subverted by privileged elites whose claim on the instruments and institutions of power has translated into a disproportionate share of national income due to the exploitation of resources. Some governments claim legitimacy and the loyalty of citizens by distributing income beyond the reach of their core constituencies. But in doing so, governments have become hostage to the volatility of oil prices, particularly when price spikes or bubbles have been dramatically deflated, returning the flow of resource income to "normal". In these situations, the volatility of government expenditure may mimic prices, which, in turn, may amplify economic cycles.[4] In this context, countries with weak institutions have seen resource riches lead to resource dependency, rentierism, and what has come to be known as the 'resource curse'.

Conversely, countries with strong institutional foundations have fared well. With the discovery of large fields of oil and gas in the North Sea during the late 1960s, a number of countries stood to receive large 'unearned' windfalls beginning in the early 1970s and lasting through to at least 2030. In Norway, for example, from 1971 to 1972, the annual real rate of growth in government revenue jumped from 12% to 72%. As a result, in 1973 real expenditure rose 61%. And yet, in the years following this spike in revenue, Norway managed to integrate its new resource riches into its economy without too much disruption to inherited norms. Then and now, these windfalls were absorbed into an established nation-state characterised by deeply-held democratic traditions, a well-defined and accepted social contract, and a relatively conservative administrative system (Clark and Monk 2010a). In large part, it was Norway's institutional sophistication, and specifically the governance of its SWF, that allowed for effective management of resource revenues.

In a bid to replicate Norway's success, vulnerable countries, particularly those in the Gulf, have adopted the type of institution that worked for Norway and other 'modern' states. As Norway illustrated, SWFs are key institutions for managing resource revenues for the long-term interest of the state, maintaining a balance between current expectations and long-term commitments. Equally, SWFs contribute to macroeconomic stability while acting as a switch point for assets flowing into the nation-state and then flowing out to global financial markets. Finally, SWFs can also serve as a strategic investor underwriting the long-term transformation of the domestic economy in relation to the global economy. In these ways, SWFs are capable of dampening or managing the negative consequences of resource wealth (Monk 2009).

Institutional Adoption

It is arguable that the weakness of Gulf States' political and economic institutions prompted the search for new institutional forms capable of assuming responsibility for long-term income stabilisation as well as development. Moreover, there is evidence to suggest that Middle Eastern states were actually "early adopters" of the SWF institution, such as in Kuwait in 1953. In Table 1, these states are identified with the dates of formation and current assets under management (AUM). This suggests that SWFs are organic to the Middle East and inherently non-Western. However, we do not ascribe to this interpretation of history.

[4]/. See Landon and Smith (2010) on the causes and consequences of pro-cyclical government spending in Alberta, Canada.

Instead, we give initial credit for the SWF institution to the United Kingdom (UK) and the United States (USA).

[INSERT TABLE 1 ABOUT HERE]

It is often suggested that the first SWF was the idea of the forward-thinking ruler of Kuwait in the early 1950s: Sheikh Abdullah Al-Salem Al-Sabah. In his wisdom, Sheikh Abdullah apparently decided that the state's money should be set aside for the long-term welfare of the people of Kuwait. We do not doubt this logic. However, we note that this SWF, which was originally known as the Kuwait Investment Board, was established eight years before the country attained independence from the UK and was actually established in London. Here, we can assume British influence over the fund's establishment and design. The second country to establish a SWF, in 1956, was Kiribati. In this case, the fund was set-up to help manage phosphate mining revenue. At the time, Kiribati was under British rule (until 1971); the British administration was behind the levy on phosphate exports that ultimately led to the Kirabati Revenue Equalisation Reserve Fund. In short, the UK played a crucial role in conceptualizing and designing SWFs in these early years.[5] These funds were based on pre-funded pensions (that offered income smoothing and precautionary saving), which had become popular in Canada, the United Kingdom, and the United States.[6]

As history suggests, SWF adoption reflects the influence of global policy networks that have championed the virtues of Western institutions around the world. Indeed, the policy transfer process may be thought to reflect the proliferation of "policy entrepreneurs" in the context of what Stone (2008a, 19) has called the "global Agora" – the various and growing "transnational policy spaces where global public policies occur." As evidence, there are various actors and entities involved in promoting policy innovation and the diffusion of institutional templates and ideal forms. Those involved may include multilateral institutions like the IMF, international organisations like the OECD, NGOs, consultants, and private agents that set norms and standards well beyond the interests and expectations of their sponsoring nation-states (see Chwieroth 2009 on the role and significance of the IMF over the post-war era). It has also been noted that the diffusion and adoption of policies and institutions may be prompted by coercion, competition, and emulation through to shared-learning.

Amongst public policy specialists, it has been observed that nation-states have become increasingly open to the diffusion of policies and institutions whose origins lie outside immediate domestic concerns and, more often than not, are to be found in a variety of international institutions and policy networks (Stone 2004, 2008b). In part, the policy transfer process may be thought to reflect more general imperatives associated with globalisation and the increasingly contingent effectiveness of national economic policies (Meseguer and Gilardi 2009). We have noted elsewhere that the Asian financial crisis of the late 1990s prompted a number of affected countries to establish SWFs because intervention by the IMF in the case of another financial crisis would have been accompanied by national 'shame' and significant domestic political conflict (Clark and Monk 2010b). As well, we noted that a number of smaller Asian countries, recognising their vulnerability to regional

[5]/. It's also true that the Abu Dhabi Investment Authority was established in 1976, but, there again, it's probably reasonable to suggest the British had some influence in that decision, as the UAE had a 'special treaty' with the UK until 1971.

[6]/. Interestingly, the third country to set up a SWF, in 1958, was the United States via the US state of New Mexico. Next was the US state of Wyoming in 1974, which was in turn followed by Alaska and the Canadian Province of Alberta in 1976. The genesis of SWFs makes the current view in the west that SWFs are "foreign" and "non-Western" ironic.

geopolitical "power plays", sought ways of sustaining their independence through the adoption of an institutional form that owed its origins to the international financial community rather than domestic interests. In this respect, the adoption of a SWF may reflect competition between nation-states for regional and global power and influence (see Dixon and Monk 2011), if not dominance (as suggested in our case study of the China Investment Corporation; see Clark and Monk 2011).

The data presented in Table 1 shows that most Gulf SWFs were established in a short space of time, effectively from 2002 through to 2008 (leaving aside the Kuwait Investment Authority and Abu Dhabi Investment Authority). For instance, the UAE's Mubudala was established in 2002, followed by the RAK Investment Authority in 2004, Qatar Investment Authority in 2005, Bahrain's Mumtalakat and the Oman Investment Fund in 2006, the Abu Dhabi Investment Council and Emirates Investment Authority in 2007 and, finally, the Saudi Arabian Public Investment Fund in 2008. Simply invoking the functional value of a SWF in the context of burgeoning earnings from exporting oil resources may not be a complete explanation of both the timing and the pattern of adoption (country by country) within the region. This point has been made by Chwieroth (2010), who suggests that the adoption of the SWF institution should also be considered as a process of emulation through policy transfer. Based upon an analysis of 140 countries through the period 1984 to 2007, he concluded that there is a 'neighbourhood effect' in the rate of adoption, just as the source of national wealth creates a club-like effect. He demonstrates that these effects were most apparent amongst oil and gas exporters.

For Chwieroth (2010), emulation is related to peer-based "standards of behaviour as well as the desire to maintain or enhance esteem, pride, prestige, and status." In a region where competition between elites for international recognition and acceptance extends to the purchase of Western "trophy assets" and the cultivation of formal and informal cultural, educational, and military alliances, it should not be surprising that the adoption of SWFs may be part of the "fads" and "fashions" that characterise status-seeking behaviour. If entirely believable, this explanation discounts the significance of the SWF as an institution that is symbolic of countries' modernity. While we accept that emulation is a form of status-seeking behaviour, we would also suggest that in this particular case the SWF institution represents a form of organisation that is believed by domestic elites to signal to local stakeholders, neighbouring countries, and to the rest of the world that their country has attained a level of maturity consistent with the leading edge of global innovation. The adoption of SWFs can be construed as a symbol of the global 'centrality' of the adopting country.

Symbol and Form

The SWF institution has distinctive attributes and constituent features (form) that mark it as different from conventional banks and related institutions. By "form" we mean that it is a "purposive systematic arrangement" with explicit and implicit institutional boundaries that distinguish it from other related organisations and thereby provide it with a mandate to do certain tasks and functions using recognised instruments (Summers 2006, 5). Certain forms may be more effective in realising certain functions. In the case of the SWF, its form is both symbolic of the development of modern financial management and can be shown to be more effective than treasury agencies in realising certain functions. As such, form and function are related even if form is not uniquely determined by function.[7]

[7]/. For Merton and Bodie (2005), there is an intimate, even unique relationship between form and function such that the design of an institution (form) is conceived in relation to a priori defined functions. Indeed, by their account, the logic or imperatives involved in realising certain functions provides the rationale for the design of the institution itself. In this respect, their argument represents a larger commitment to understanding financial systems by virtue of their functions rather

For instance, national treasury agencies that undertake similar functions as SWFs appear to be quite different organisations. Treasury agencies are typically staffed by their national government civil service, have no independent powers from their ministries, and are subject to instruction by the responsible minister—they do not have the formal powers and responsibilities as well as the organisational structures of SWFs. Indeed, reading the Santiago Principles, also known as the Generally Accepted Principles and Practices of SWFs, highlights the significance of claims for the independence and autonomy of decision-making embedded in formal conceptions of the SWF institution.

As such, the form of the SWF represents an opportunity for governments to remake the past in relation to the country's blueprint for the future, one that is not compromised by inherited traditions. From our field research, it would appear that the Gulf States assumed that breaking with the past by adopting the SWF institution was preferable to remaking their inherited institutions. By this logic, the SWF is symbolic of a commitment among the Gulf states to adopt the instruments of advanced financial management to facilitate the modernisation of what were otherwise semi-feudal states. The SWF is more than just a tool for managing resource wealth; it is a step towards modernity and economic development.

If emulation of modern financial management has a hollow ring in the aftermath of the global financial crisis, it should be acknowledged that from the mid-1980s onwards the financial growth and development of Anglo-American economies represented, for many, a mode of capitalism that was to sweep away vestiges of the past. So, for example, this point has been made with respect to the transformation of UK and US corporate capitalism, re-engineered in the name of shareholder value and accountability (Jensen 1993, 2000). Equally, it has been widely observed that financial interests fuelled wave upon wave of mergers and acquisitions. The global hegemony of financial capitalism has been widely discussed, particularly with reference to the discounting of other 'varieties' of corporate capitalism apparent in Germany and Japan (Dore 2000; Dixon 2010). In short, finance-led capitalism has been attributed unparalleled significance in the global economy over the past few decades.

Through the global financial crisis of the first decade of the 21st century, the pervasive influence of finance on individuals, corporations and even governments is all too apparent. We should not be surprised by this fact-of-life: the size of the financial economy was estimated to be nearly three times larger than the "real economy" in 2007 (Lee et al. 2009). Moreover, the significance of institutional investors in global financial markets is well-documented (see Hawley and Williams 2005). It is appropriate, then, that twenty-first century capitalism is portrayed as the era of "financial capitalism"; which is another way of explaining why production and trade, often described as the core attributes of the "real economy", are no longer the dominant forces in the global economy. This is not to say that the real economy has lost its importance for understanding the global economy; but its relevance as the catalyst for policy formation has fallen in favor of finance. As Dore (2007) puts it, the global economy has moved away from "industrial relations" towards "investor relations". In our view, SWFs represent the 'high-water mark' of financialization and are the next installment of capitalist development following in the wake of Clark's (2000) "pension fund capitalism".

Governments have sought to "plug in" and reap the benefits of financial capitalism through their SWFs assuming these funds have a form that is fit-for-purpose in relation to the

than concentrating on institutional forms, thereby emphasising the commonalities between financial systems rather than their apparent formal differences.

imperatives driving global financial markets. However, Gertler (2001, 15-16) argues that idealised institutional forms cannot be easily transferred between jurisdictions. He suggests that adoption of ‘external’ institutions depends upon the larger "macro–regulatory environment and institutions" that frame society. He also suggests that transposing "a distinctive set of practices from one national space to another … where the institutional environment is not as conducive or supportive of such practices will be limited at best." The successful transfer of policies and institutional forms between "home" and "host" jurisdictions thus depends upon shared cultures and traditions or what Gertler refers to as "institutional thickness". This implies that SWF adopters in non-Western jurisdictions face a variety of challenges that may constrain the effectiveness of their ‘new’ institutions.

The Challenges of Adoption

Even in the West, establishing an effective financial institution is challenging. It requires a mix of rare inputs and complex design features that, in combination, produce the foundation for effective institutional behavior. In particular, three characteristics stand out as being important for the success of SWFs (and financial institutions in general) (Clark and Urwin 2008a). We refer to these as the Three Ps:

- **People:** SWFs must be able to attract, motivate, and retain talented individuals with the necessary skills and competencies for managing modern financial institutions operating in the global economy. As public organizations tasked with investing in private markets, they must find ways to fill public sector jobs with individuals that can compete in and with the private sector. This can be quite challenging, as fund sponsors are loathe to pay employees private sector rates of compensation. However, talent or human capital is paramount for success in financial markets and arguably in modern economies (see Teece 2000).

- **Process:** Financial institutions also require highly developed decision-making frameworks and risk mitigation capabilities in order to manage the complexities of investing. Successful investment management within institutional investors is a function of how decision-making is framed, routinized, and implemented.[8] Scholars have recognised the importance of governance for institutional performance for many years (see North 1990; Williamson 1996). Research has also unequivocally demonstrated a correlation between ‘good’ investment governance and positive financial returns (see Hsin and Mitchell 1997; Mitchell and Hsin 1997; Iglesias and Palacios 2000; and Ammann and Zingg 2010). Innovation in governance is particularly important in overcoming inherited institutional and organizational features so as to ensure functional performance (Clark and Urwin 2010).

- **Politics:** One of the obvious factors that may constrain a sovereign fund is the role that politics can play in the investment decision-making process. To suggest that these funds can be entirely apolitical is, in our view, naïve notwithstanding the objective of the Santiago Principles. Every government fund is the product of a political decision. However, close ties with policymakers can be damaging to returns if close relationships distort the investment decision-making of skilled professionals. Indeed, research in a rather different domain shows that political influence can have negative impacts on the financial returns of government pension funds (see Romano 1993).

[8]/. Governance refers to the inputs and the frameworks for making investment decisions within a financial institution (see, for example, Ambachtsheer et al., 2008).

If these three Ps can be realised through sound investment governance and organizational design, funds can operate in financial markets effectively. As such, this raises the question of how the Gulf States have responded to these imperatives in SWF design and implementation. There are two distinct views on how this process has unfolded: the official view and the view of current and former employees at the Gulf SWFs.

According to official literature and formal communications, the process of SWF adoption appears to be going extremely well. On the surface, these funds are operating like any other globally-oriented financial institution. SWFs have investments across a range of asset classes on a global scale, some outsourced to asset managers and some done by in-house teams. They have sophisticated and talented staff. They have dedicated investment departments, risk committees, investment committees, due diligence teams, and even share a variety of formal decision-hierarchies that reinforce the impression of "best practice" investors operating in the region. Finally, respondents note the clear separation of funds from political leadership. At this level of analysis, Gulf States would appear to have met the Three Ps.

Upon deeper examination, interviews with current and former financial market-oriented employees at Gulf States' SWFs have identified a variety of problems with these official characterizations. While funds' communications teams have grasped the importance of the Three Ps in their outward-focused statements, funds' departments and operations managers are constrained in a number of ways.

- **People:** It appears that attracting high-quality talent to work at these funds is a serious problem. The small pool of local talent available in the region is particularly problematic. Moreover, those employed within these funds from the Gulf often have work norms that are not aligned with the norms typical of Western financial institutions. In order to overcome this problem, Gulf SWFs' human resource strategies rely almost entirely on expatriate labour: funds recruit overseas for the talent needed to sustain the SWFs' functions. However, this arrangement generates a variety of internal tensions and agency issues.

- **Process:** Notwithstanding formal organisational charts, the decision-making frameworks within Gulf funds are, for the most part, idiosyncratic and unpredictable. The publicly available organizational maps simply do not do justice to the actual decision-making processes and protocols that dominate the funds examined. There is a common inclination (in practice) to forego formalisation and, instead, base decisions (both in terms of hiring and investments) on a variety of 'local' heuristics. In particular, it would appear that personal relationships and cultural symbols of trust often trump fundamental analysis. Rather than relying upon the domain-specific knowledge of financial experts inside and outside of the Gulf-state SWFs, there is a tendency to discount the evaluation of relevant knowledge in decision-making; that is, expertise is often subject to the play of 'interests' inside and outside of the funds. Knowledge and information about global market performance is not only "sticky" in the sense of being attached to expertise (von Hippel 2005), its status and efficacy easily degrade in the face of arbitrary decision-making.

- **Politics:** SWFs in the Gulf have an intimate relationship with political elites. The political leadership feels obliged to watch over the operations of these funds, either personally or through the nomination of close political allies who run departments or serve as funds' managing directors. Clearly, the close relationship between government and SWFs <u>can</u> (but need not) damage returns due to complications in the investment decision-making process. In fact, leaders appointed to run the various departments are there because of their personal relationships and political identities not their financial expertise. As a result, there is a mismatch between individuals with final authority over investment decisions and their expatriate employees. The complex and time-sensitive decisions typical of large global financial institutions are often caught-up in fundamental disagreement over investment principles and policies.

In sum, there is a contradiction between Gulf State norms and those of Western financial institutions and markets. In the parlance of Gertler (2001), the effectiveness of Gulf SWFs has been affected by the larger "macro–regulatory environment and institutions" that mark Anglo-American countries as different from the Gulf States.

Realising the Promise of Finance

It is tempting to suggest that Gulf SWFs are uniquely dysfunctional: Gulf funds will never be able to adapt to the norms of Western finance. We do not ascribe to this view; our findings are evidence that realizing the promise of finance, be it in the Gulf or elsewhere, is extremely challenging. While some jurisdictions, such as in the Gulf, may take decades to develop the necessary ingredients for 'best practice' SWFs, some Western funds have also struggled to overcome inherited institutional commitments. One of the lessons from our research program on the design and governance of pension and sovereign funds has been that effective financial management in financial markets is enormously demanding. Good investment governance, talented investment professionals, and competent leaders are in short supply.

For example, the representative inclinations within US public pension funds are a constraint on investment performance. The fireman or history teacher that serves as a trustee on multi-billion dollar pension boards is, in our experience, no better at making an investment decision than a sheikh from the Gulf. Both are there for <u>who</u> they are and not for <u>what</u> they can do or <u>what</u> they know. Similarly, there are a variety of Western jurisdictions that struggle with the talent issue. Attracting savvy financiers from core financial markets to help manage funds in peripheral locations has been challenging. For instance, the Norwegian SWF, which is often cited as a model for others, has also established investment teams around the world. In this and other cases, the 'geography of talent' is closely allied to the 'geography of finance': an inability or unwillingness to adapt to this imperative is, more than likely, a constraint on institutional effectiveness.

The institutional distance from the Gulf to Western markets amplifies these problems. To be sure, this has been recognised by Gulf States. The cultural and institutional starting point forty years ago was diametrically different from where it is today. Even if the tents and nomads have been replaced with skyscrapers and palatial hotels, inherited commitments are not so easily discounted (just as new institutions are not so easily constructed). It is challenging to the leadership of these countries, who come from the 'pre-oil period', to manage multi-billion financial institutions; just as it is too much of a burden to place on an American fireman or police officer. And yet, the investment committees that have final say over nearly all investments made within Gulf funds remain almost entirely local (with some rare exceptions). Gulf elites are unwilling to hand oversight and management of their funds to expatriates due to the obvious agency issues.

Significantly, the solution to the problems in the Gulf is the same as the solution to the problems facing Western funds: the management of scarce human capital. With talented employees and competent leaders, the design, governance, management and policy implementation will inevitably follow. Significantly, the Gulf funds recognize this and are working to develop domestic expertise through a variety of policies that seek to train a new generation of local financiers. Indeed, decisions have been made at the highest levels to forgo some financial returns in the short and medium term in order to provide valuable experience to locals. This is seen as an investment in human capital. Even so, in many cases appointment is an opportunity to engage in patronage, reciprocity, and gestures of tribal and ethnic loyalty.

Realising the promise of finance then, is a function of education and political development. Put another way, a country cannot hope to truly realise the benefits of their SWF without first attaining certain levels of competence and governance. In this regard, establishing and managing SWFs in the Gulf represents an important symbol of modernity. On the one hand, the adoption of a SWF demonstrates to the world that these regions have (or are developing) the capabilities to run these financial institutions and play their role in global financial markets. Access may be constrained by a variety of limitations in the short-term, much as they are for public pension funds in the United States, but the symbol remains important. The trillions of dollars sitting in financial institutions have undoubtedly raised the global status of the Gulf States.

On the other hand, the adoption of a SWF may be used to demonstrate to the local populace a commitment to a 'new' path for the nation: integration into the global economy and modernity. Through reference to these funds, local leaders may claim legitimacy if not common acceptance by all sections of community. In a manner of speaking, then, the SWFs in the Gulf are part of a long-term institutional transformation of the region. The purpose is to reshape domestic institutions for the looming challenges of modern financial capitalism if not liberal democracy. So, contra Gertler (2001), we take a long-term perspective on the issue of institutional convergence. It is apparent that these countries have made a commitment to finance and financial markets, which will require breaking with the past (in one form or another).

Conclusions

Over the past decade, more SWFs have been created than ever before and, in sum, more than the previous 40 years put together. Countries around the world look to these institutions as representatives of modern finance designed and managed so as to 'place' these countries in global financial markets. For some countries, SWFs are more than instruments adopted to solve problems: they represent to their own constituents and to the outside world a commitment to modernity emulating the form and functions of Western institutions. If the problems of resource wealth are pressing and of enormous importance for sponsoring governments, accepted institutional solutions to these problems carry a great deal of weight in the multilateral forums that join together the West with the East and the Middle East. As such, the adoption of SWFs by the Gulf States is a gesture aimed at facilitating their inclusion in the international community of nations.

While the accepted form of SWFs is well known, and based upon the principles and practices of modern financial theory, we have suggested in this paper that the establishment of SWFs can be quite problematic when considered in the light of the people, processes, and politics of institutional formation. The experience of the Gulf States suggests that no institution, however idealised in terms of its form, can be implemented such that form and function trumps inherited traditions and established cultural practices. This conclusion should not surprise social scientists aware of the challenges that face countries when establishing institutions that are modelled on some idealised form and function. Inevitably, for institutions to be effective, they must be embedded in their host societies (notwithstanding the costs and consequences that might come with being embedded). To think otherwise, to think that these institutions can 'float free' of the established order and its constituents, would seem to ignore the history and geography of institutional innovation (Gertler 2001).

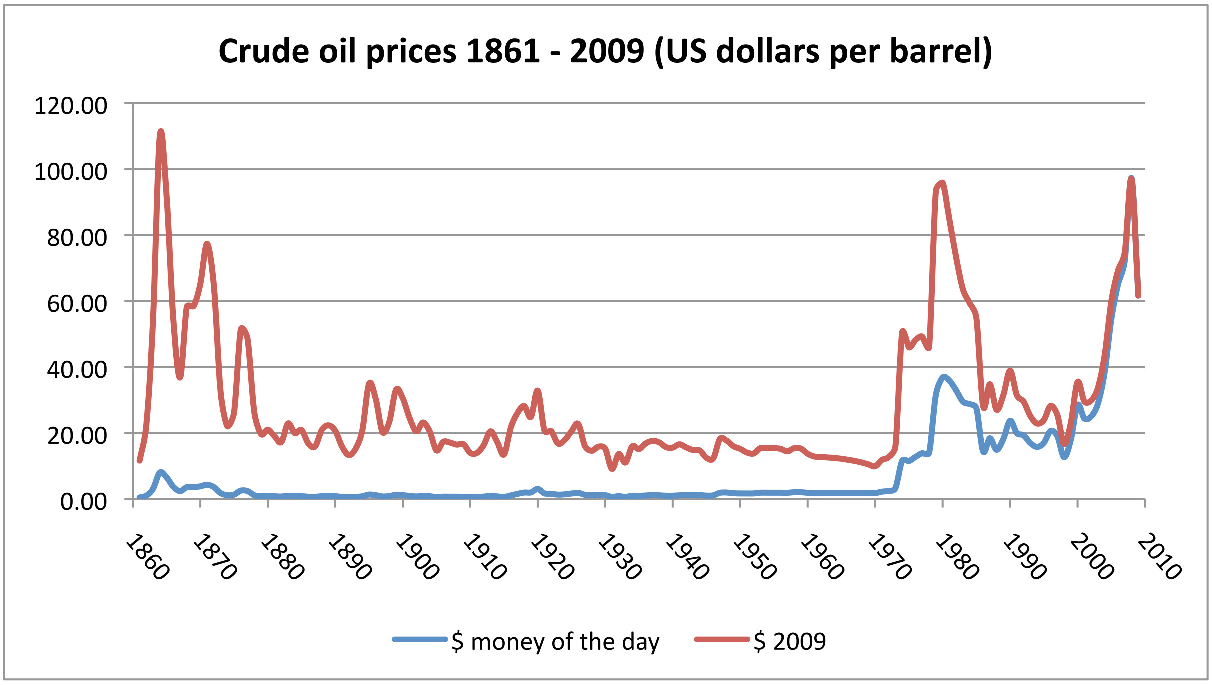
Our argument should not be interpreted as suggesting that Gulf States' SWFs must fail in the future. Whatever the form of the SWF institution, its functions remain crucial to the long-term development of the Gulf States in the context of the global economy. That is, whether or not SWFs succeed, the functions performed within its institutional domain are vital for the future of the Gulf States. Take, for example, the need to modernise and deepen the inherited financial systems of many of the Gulf States; the evidence suggests that many of these states' financial systems are relatively immature and unlikely to prosper at a level consistent with the long-term diversification of states' industry structures without government-led initiatives to promote financial development (Beck 2010). As such, to the extent that the SWF form is consistent with realising the functions needed for a modern economy to participate in global financial markets, this institution could play a significant role in promoting local financial expertise and capacity. The adoption of the SWF form is not only a gesture in favour of modernity, it is a commitment to economic development.

However, we must take care not to idealise or in some sense 'fix' SWFs' form and functions. One lesson from the global financial crisis has been that institutional innovation has been a necessary response to the challenges supplied by the crisis—to imagine that institutions can or should remain fixed in terms of their form and functions given the changing global financial environment would be to consign these institutions to failure (over the long-term). More importantly, to hold constant institutional form and functions in the face of changing market imperatives may be to set in motion a crisis that would profoundly discount the realisation of the purposes or goals that animated the establishment of these institutions in the first instance. For the Gulf States, as for other resource rich but small economies, the adoption of the institution must also be accompanied by institutional innovation consistent with the leading edge of global markets. Otherwise, these countries will not be able to manage their resource wealth in a manner consistent with the interests of future generations.

Elsewhere, we have argued that one characteristic of global financial markets is their unceasing evolution. That is, endogenous changes in structure and performance that discount the effectiveness of inherited theories and practices are widespread (Clark and Urwin 2010). As the global financial crisis has demonstrated, holding to conventional policies and practices may come at a very heavy price. Equally, the global financial crisis has demonstrated that financial markets can penalise those institutions and their sponsors who would wish to hold constant inherited forms and conventional functions. Having adopted the SWF as a commitment to modernity, the Gulf States have also to make a commitment (if unacknowledged) to the pathways of global financial integration. Whether they are able to manage the people, processes of decision-making, and domestic politics in ways consistent with such innovation remains to be seen.

Here, then, is a significant implication from our discussion about the apparent challenges facing the Gulf States when establishing SWFs. Whereas, in the short term, establishing such institutions in the context of inherited traditions and commitments requires institutional innovation within the organisation, making good on the promise associated with SWFs also requires institutional innovation consistent with changes in the local operating environment. In other words, there are organizational workarounds in the short term, such as the importation of talent, but in the long term the local environment will need to evolve such that the inputs for a successful financial institution are readily available. As such, the challenges associated with the adoption of SWFs are nontrivial: at one level, building an institution consistent with the effective realisation of its desired functions, and, at the other level, building an institution that, once established, is able to adapt and develop its functional performance in ways consistent with the changing environment. It may turn out that this second imperative is more difficult to achieve than the first in that the compromises needed to make good on the first may inhibit institutional innovation in the long-term.

FIGURE 1. Trends and Volatility of Crude Oil Prices



Source: BP Statistical Review of World Energy June 2010[9]

1861-1944 US Average; 1945-1983 Arabian Light posted at Ras Tanura; 1984-2009 Brent dated. This line chart shows crude oil prices since 1861, in US dollars per barrel of oil. Data are available in both the money of the day (nominal terms) and in 2009 prices (real terms). Since 2001 prices (nominal and real) have risen year on year until 2008. In 2008 the nominal price was higher at $97.26 than the real price $96.91. The 2009 price is $61.67 per barrel.

[9]/. See: http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622 and http://www.bp.com/sectiongenericarticle.do?categoryId=9023773&contentId=7044469.

TABLE 1. Gulf States' Adoption of SWFs

Country	Sovereign Wealth Fund	Date of Creation	Origin	AUM US$ Billion	Investment Style	Entity/ Structure
Bahrain	Mumtalakat Holdings	2006	Oil	9.1	Portfolio	Corporate
Iran	Iran Oil Stabilisation Fund	1999	Oil	23		Corporation
Kuwait	Kuwait Investment Authority	1953	Oil	202.8	Mostly Portfolio	Fund
Oman	Oman Investment Fund	2006	Oil, Gas			Fund
Oman	Oman State General Reserve Fund	1980	Oil, Gas	8.2		Fund
Qatar	Qatar Investment Authority	2005	Oil	85		
Saudi Arabia	Public Investment Fund	2008	Oil	5.3		
Saudi Arabia	SAMA Foreign Holdings	N/A	Oil	415		Fund in Central Bank
United Arab Emirates	Emirates Investment Authority	2007	Oil			
UAE – Abu Dhabi	Abu Dhabi Investment Authority	1976	Oil	627	Mixed	Fund
UAE – Abu Dhabi	Abu Dhabi Investment Council	2007	Oil			
UAE - Abu Dhabi	International Petroleum Investment Company	1984	Oil	14	Portfolio	Corporate
UAE - Abu Dhabi	Mubadala	2002	Oil	13.3	Portfolio	Corporate
UAE – Dubai	Dubai World Holdings Ltd	2006	Oil		Portfolio	Corporate
UAE – Dubai	Investment Corporation of Dubai	2006	Oil	19.6	Portfolio	Corporate
UAE - Ras Al Khaimah	RAK Investment Authority	2004	Oil	1.2		

Source: SWF Institute

http://www.swfinstitute.org/

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