

Dragon on a Short Leash: An Inside-Out Analysis of China Investment Corporation

Rapid growth in the number and size of sovereign wealth funds (SWFs) in recent years has occasioned a broad-ranging policy debate about how best to accommodate or, indeed, limit the participation of these funds in the world's capital markets. The announcement in March 2007 that China would open an SWF, with an initial investment of US \$200 billion, substantially raised the pitch of this debate as pundits and policymakers around the world pondered the impact that China's massive foreign exchange reserves could have on world markets. Among those worried about the SWF boom many argue, as Larry Summers has, that these funds "shake" the logic of capitalism because government-as-owner may well pursue objectives other than the maximization of share value. In a now-famous piece, Summers (2007) wrote: "The logic of the capitalist system depends on shareholders causing companies to act so as to maximise the value of their shares. It is far from obvious that this will over

* Sarah Eaton is a doctoral candidate of Department of Political Science, University of Toronto. She is also a visiting scholar to Institute of World Economics and Politics, Chinese Academy of Social Science. Ming Zhang is an assistant professor of Institute of World Economics and Politics, Chinese Academy of Social Science.

time be the only motivation of governments as shareholders.” The worry is that governments may use equity stakes in foreign companies to attain strategic ends such as the re-direction of scarce natural resources to their own countries, acquisition of cutting-edge technology and/or the support of national champions’ extension overseas. And, indeed, the investment record of two of the world’s oldest SWFs show that these funds can become entwined with governments’ pursuit of the national interest. The history of Singapore’s two SWFs, Temasek Holdings and Government Investment Corporation (GIC), making strategic investments in support of national champions including SingTel and Singapore Airlines is familiar to market-watchers. Yet other observers see newcomer SWFs as a largely benign by-product of the growth of the global current account imbalance since the late 90’s: SWFs are a practical means for states to reduce the opportunity costs imposed by too-large accumulations of foreign exchange assets in the case of non-commodity funds and to diversify investments in the case of commodity funds. Since there are unimpeachable economic incentives to explain the recent profusion of SWF’s, so the argument goes, what good reason is there to think that SWF’s investment practices will have any motive other than wealth creation? As Steven Schwarzman (2008), chair of Blackstone Group enthused: “Our experience with sovereign funds is that they’re smart, they’re long term, they’re highly professional. All they’re looking for is to earn the highest rate of return.”

This paper is addressed to a question that is analytically prior to the Western policy debate about the global implications of China’s sovereign wealth fund, namely: just what “government” is it that runs the China Investment Corporation (CIC)? Commentators in the West have tended to discuss the CIC as though it were an appendage of a unified government pursuing a clearly-defined national interest, as if it were the overseas finance arm of “China Inc.”¹ Our analysis of the CIC shows that this “black-boxing” of the

¹ A notable exception is Cognato’s (2008) fine-grained analysis of CIC for the National Bureau

CIC can lead to serious misunderstandings about the fund's investment strategy and also to an overestimation of the basic strength of China's SWF. In this paper, we trace the intense bureaucratic conflicts that shaped the creation of CIC and show how the conflicting mandates of the involved parties act as a significant constraint on CIC's operations down to the present day. In the tradition of IPE scholars attuned to the inside-out causal mechanisms in the global political economy, we suggest that careful analysis of the domestic policy process ought to be a key component of our future efforts to analyze the likely impact of sovereign wealth funds on the global political economy.

The argument unfolds in three sections. In the first section, we provide a brief overview of the economic factors that have contributed to the explosion of SWFs in recent years and provide a short discussion of the national and international initiatives that have taken shape in response to this phenomenon. We then turn to a detailed discussion of the origins of the CIC. We show how intense rivalry between China's central bank, the People's Bank of China (PBoC) and the Ministry of Finance (MoF) left an indelible impression on CIC. This section also details how bureaucratic rivalries continue to impact the day-to-day business of the CIC. In the third section, we show that CIC's status within the hierarchy of the central government is, in fact, quite tenuous. The lure of gaining a channel to China's forex reserves has spurred a fierce competition between a number of financial institutions within the ranks of the central government and the relative performance of these supplicants will play an important role in government elites' future decisions about the allocation of forex. We conclude with a brief discussion of the implications of our analysis for the future study of sovereign wealth funds.

The Sovereign Wealth Fund Boom: Causes, Consequences and Controversy

What is a sovereign wealth fund? The discussion about SWFs is recent enough that an agreed-upon definition has yet to emerge but, for reasons given below, it seems likely that the definition provided by the International Working Group on Sovereign Wealth Funds (2008) will shape the debate going forward: “Sovereign wealth funds are defined as special purpose investment funds or arrangements that are owned by a general government that have been created for macroeconomic purposes that hold, manage or administer assets to achieve financial objectives and that employ investment strategies that include investing in foreign financial assets.” The literature commonly distinguishes between two categories of SWF: “commodity funds” and, the woollier, “non-commodity funds.” Large-scale commodity funds are found in United Arab Emirates, Dubai, Kuwait, Norway and Russia. These SWFs, which currently account for more than two-thirds of sovereign wealth assets worldwide, reflect governments’ efforts to manage the various risks faced by resource-dependent economies. Commodity funds variously aim to stave off “Dutch disease”, maximize returns on natural resource-derived revenue streams and save for future generations (Kimmitt, 2008). So-called non-commodity funds, which include Singapore, China, Korea and Vietnam’s are paid for with foreign exchange assets accumulated through the export of goods and services. Singapore’s two sovereign wealth funds, GIC and Temasek, respectively the world’s fourth and tenth largest SWFs, are often treated as the standard-bearers of this category, primarily because they have been in business the longest. After Temasek’s thirty-four years and GIC’s twenty-seven years, the next oldest non-commodity fund is Hong Kong’s Monetary Authority Investment Portfolio which was established in 1998. As such, it remains an open question as to whether other non-commodity funds will adopt Singapore’s foreign investment strategy. Our analysis is consistent with Shih (2008) and Cognato’s (2008) findings, both of which suggest that China, in all likelihood, will not follow in Singapore’s footsteps.

The decision to establish CIC should be understood as a response to three policy dilemmas posed by the tremendous growth in China's foreign exchange reserve since 2000.² First, the opportunity costs of China's forex reserve holdings (US \$1.9 trillion at the time of writing) are seen to be intolerably high. Estimates are that 60-80% of China's foreign exchange reserves are held in low risk, low yield and highly liquid assets, of which US government bonds account for the majority. Since there is wide agreement that China's forex reserves have expanded beyond the level needed to meet prudential requirements, the additional purchase of Treasury bonds now compares very unfavorably to higher-yield investments. For instance, Zhang and He (2008) cite a recent World Bank study which found that the average annual Return on Investment for FDI in China was 22%. They write that "[t]he gap between the high yield of FDI in China and the low yield of Chinese foreign exchange investment could be regarded as the opportunity cost of holding foreign exchange reserve" (Zhang and He, 2008: 2). Between 2001 and 2007, Treasury bond yields ranged between 3% and 6%. To make matters more complicated, China's central bank has been forced to issue sterilization bonds to dampen inflationary pressures caused by the influx of foreign exchange. This has been a costly effort because the PBOC bonds pay more than 4% so that when Treasury bond yields dip below that number, the central bank incurs a net loss (Cognato, 2008: 13). And what's more, sterilization measures have not been able to mop up all of the excess liquidity. Li and Shan (2008) estimate that, in 2007, the PBOC converted foreign exchange into 3.9 trillion worth of RMB but only managed to sterilize 470 billion of this sum. This increase in the money supply has fed inflationary pressures and the formation of asset bubbles, most obviously in urban real estate markets, which have witnessed a major downturn in 2008. One distinguished China watcher has suggested that the build up of

² Besides the creation of a sovereign wealth fund, other central government policy measures directed at the reserves problem include increasing the amount of foreign exchange that businesses and individuals can hold and expanding the quota of the Qualified Domestic Institutional Investor (QDII), an overseas investment channel (*Xinhua*, April 20 2006).

excess liquidity in the domestic market has made the Chinese financial system vulnerable to the same kind of financial crisis recently witnessed in America (Pettis, 2008). Besides opportunity costs and excess liquidity, a third dilemma is posed by the depreciation of the US dollar. Based on China's US dollar-denominated assets as of March 2008, Zhang and He (2008: 2) calculated that a 10% depreciation of the US dollar against the RMB would amount to a loss in 2008 of US \$168 billion, or 5% of China's 2007 GDP. By freeing up a portion of the foreign exchange reserves to pursue higher returns in equity investments, then, policymakers hope that CIC profits will offset losses due to exchange rate risk.

National legislatures and international organizations have responded to the flourishing of SWFs in recent years with a battery of policy instruments. A 2008 study by the General Accounting Office reported that "at least eleven major countries, which together receive some two-fifths of all world FDI, have either approved or are seriously considering new laws that would expand governmental oversight over or directly restrict selected types of inward investment" (cited in Cohen, 2008: 8). In the wake of the high-profile CNOOC/Unocal and Dubai ports cases, the US government launched an effort to strengthen the national security provisions of existing foreign investment legislation leading to the US Foreign Investment and National Security Act 2007 (FINSAs). Under FINSAs, the newly-formed Committee on Foreign Investment in the United States (CFIUS) has responsibility for review of the national security implications of any proposed merger, acquisition or takeover "with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States" (H.R 556, 2007: Sec. 2). Largely in response to large-scale investments in Canadian oil-sands projects by Chinese state-owned enterprises (SOEs), in 2007, the Canadian government established a five-member panel of experts to review the 1985 Investment Canada Act. Originally the panel was tasked with analyzing the pros and cons of

adding a national review security clause to the Investment Act but the federal government subsequently decided that the matter required more urgent attention and excised the issue from the panel's mandate.³ Shortly thereafter, in December 2007, Industry Canada issued interim guidelines on "Investment by State-Owned Enterprises" which stipulate that SOE transparency, corporate governance structure and financial reporting practices are to be the key criteria in the review of SOEs' proposed investments in Canada. It is likely that future revisions to the Investment Act will substantially lower the investment threshold requiring a full national security review (Holden, 2007). Japan, France, Italy and Germany, are among the other OECD countries undertaking like measures (Cohen, 2008a). The IMF and OECD also waded into the SWF debate after the G-7 appealed to the two organizations to draft a code of best practices (ibid: 8). The OECD has been tasked with guiding recipient countries' foreign investment policies while the ad-hoc International Working Group of Sovereign Wealth Funds (IWG), co-chaired by an IMF representative and manager of Abu Dhabi's SWF, have led the effort to standardize SWFs' investment practices. In October 2008, IWG issued twenty-four Generally Accepted Principles and Practices (GAAP) for Sovereign Wealth Funds (the "Santiago Principles") which have as their guiding objectives that SWFs should "invest on the basis of economic and financial risk and return-related considerations" and "have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability" (IWG, 2008: 4).

Concerns about SWFs voiced by Western policymakers and the media have themselves been a source of controversy. At the January 2008 meeting of the

³ In October 2007, then-Industry Minister Jim Prentice wrote a letter to the Competition Policy Review Panel explaining the panel's revised mandate: "[T]he government has concerns about the potential impact the acquisition of Canadian firms by some types of foreign state-owned enterprises would have on national security and the strength of the Canadian economy. We agreed on the basis of that discussion that the government will need to address this issue much earlier than June 2008, when the Panel is scheduled to submit its report and recommendations. As a result, the mandate of the Panel will be modified to remove the issues of state-owned enterprises and national security considerations with respect to foreign investment"

World Economic Forum, proponents of an international code of conduct on SWFs found themselves sharply at odds with Russia and Kuwait's sovereign wealth fund managers. While Larry Summers (2008) acknowledged that "there's not much in what sovereign wealth funds have done to date that one can be very critical of", he stressed that international rules were needed to address the risks associated with investments that "have an element of cross-border nationalization." Bader al Sa'ad, managing director of the Kuwaiti Investment Authority (KIA), emphasized that in KIA's 55-year investment history, management had never made a "political decision" and looked only at the "bottom line" and concluded with the curt statement: "I think all this fear that has been created these days about the sovereign wealth funds has no basis and has no real case to build on" (ibid). Similarly, in a high-profile interview with CBS network's "60 Minutes" television program, Gao Xiqing (2008), General Manager of CIC, sharply criticized the idea of imposing international rules on SWFs, stating "economically it doesn't make sense, politically it's stupid." The media storm surrounding SWFs has also dampened funds' enthusiasm for making direct equity investments in overseas companies. In Fall 2007, an anonymous CIC source was reported to have said that the fund would not invest in any foreign airlines, telecommunications or oil enterprises because of the extreme political sensitivity of these industries (Bradsher, 2007). Similar concerns were behind CIC's April 2008 agreement with private equity firm JC Flowers to open a PE fund for investment in American financial assets. Reportedly the decision to have outside managers handle these investments was due to CIC's concerns about a rehash of the "political backlash" that followed the fund's previous direct equity investments in American banks (anon., 2008).

The emotional tenor of the controversy about SWFs—they have been referred to as "vultures" and "locusts"—reflects deep-seated anxiety about these investment instruments. As some observers have noted, parallels can be drawn to xenophobic responses to Japan's outward investment drive in previous

decades. In testimony before the US Committee on Foreign Relations, former State Department official David Marchick (2008) suggested that “a significant amount of today’s anxiety exists because foreign investment is coming from new countries” which “represents a dramatic shift of the paradigm that we have seen for many years—China, Brazil, India and Russia have traditionally been large recipients of FDI; today, they are starting to be significant sources of investment.” Commenting on the “hypocrisy” in Western criticisms of SWFs, HSBC’s Richard Cookson pointed out that when American banks purchased shares in struggling Asian banks during the Asian Financial Crisis, reluctant local policymakers were castigated for being protectionist (anon. 2008a). The shoe, it seems, is now on the other foot. Of course, unease about SWFs is also fed by the lack of transparency of many of these funds, including CIC. Under pressure internationally and at home, where the poor record of CIC’s investments in Blackstone and Morgan Stanley is regularly front-page news, CIC managers have made some efforts to improve the fund’s transparency. In the “60 minutes” interview, Gao Xiqing pledged that CIC would become as transparent as Norway’s SWF which is widely regarded to be the gold-standard in this category. To this end, at the end of September 2008, CIC officially launched its dual English- and Chinese-language website which lists basic information about CIC staff, governance structure and investment objectives. Pressure to improve the reputation of sovereign wealth funds also helps to explain why China, Kuwait and Russia all ultimately opted to participate in the process leading to the Santiago Principles. CIC reportedly chose to attend the IWG meetings in order to do its utmost to make sure that the GAPP rules were fair and also implementable (Fang, 2008). The promulgation of GAPP and improvements in SWF transparency will promote understanding of some aspects of the SWF phenomenon, but we suggest that political economists also have an important role to play by providing in-depth analyses of these funds as they are embedded in domestic politics. Explicating the domestic pressures and policy setting that give shape to sovereign wealth funds has much to reveal

about the particular aims and likely future trajectories of these funds.

A Tangled Web: Setting the Framework of CIC

For the reasons outlined above, for some time there has been considerable support within Chinese policy circles for the idea of reallocating some portion of the foreign exchange reserves but the question of who ought to control these funds proved to be very nettlesome. Discussion about setting up a sovereign wealth fund was bound to excite controversy because management of the foreign exchange reserves is the sole preserve of the State Administration of Foreign Exchange (SAFE) which is a subsidiary of the central bank, the PBoC. For this reason the central bank thought of itself as the only entity qualified to manage Chinese foreign exchange reserve. The MoF, though, also had a legitimate claim to become the shareholder and regulator of the new fund because finance ministries are responsible for forex management in many other countries. One banking insider reports that, in pleading its case, the MoF made repeated references to the Japanese Finance Ministry's management of forex reserves (Green, 2007). The debate was probably given extra impetus by the close proximity of this issue to another item on the agenda which also drew the MoF and PBoC into conflict. In the lead up to the Third National Financial Work Conference (NFWC) in January 2007, attention was fixed on the forex issue and the matter of how to improve the management of the state's financial sector assets. Conceived during the turmoil of the Asian Financial Crisis in 1997, these special meetings of the State Council are held every five years and are occasions for setting the framework of broad financial policy reforms.⁴ The MoF was reported to have stirred controversy when it circulated a plan just prior to the conference which called for the establishment of a Financial Assets Commission (*jinrong guoziwei*). The proposed Commission would have run in

⁴ At the 1997 meeting it was decided that non-performing loans of the state banks should be taken over by four asset management companies. In 2002 the plan to establish the China Banking Regulatory Commission was fixed and paved the way for the establishment of the Central Huijin Investment Company.

parallel to the already-existing State-Owned Assets Supervision and Administration Commission (SASAC) which manages the central government's assets in all but the financial sector (Zhang N.Z., 2006). The PBoC would certainly have been displeased by the MoF proposal as its adoption would have meant a much-diminished role for the central bank in the management of the state's financial assets. Under the extant arrangement, the state's best financial assets were under the control of the Central Huijin Investment Company which acts as the state's shareholder in China's state-controlled commercial banks and securities companies. Although Huijin's management team nominally reflected a balance of interests between the MoF and PBoC, the central bank was seen as rather more influential both because its members held more senior positions and also because the central bank controls the foreign exchange channels which comprised Huijin's initial registered capital of US \$45 billion. The proposed Financial Assets Commission would have seen the absorption of Huijin (anon., 2007). In fact, Huijin was also relevant to the forex fund debate as there had been speculation in 2006 that the new forex funds would simply be placed under Huijin's management (Cognato, 2008: 15).

In the end, a rough compromise was struck between the MOF and the PBOC. Ultimately, the MoF's Financial Assets Commission plan was not carried at the NFWC in January 2007, but the leaders did decide to establish a foreign exchange investment company. In March 2007, former vice-minister of finance, Lou Jiwei, was promoted to a ministry-level post, a move which signaled that the work of establishing the fund had got underway. When the CIC formally opened in late September 2007, Lou Jiwei was made the fund's Chairman, a move which likely signaled that the upper-most leaders had been more partial to the MoF's argument (Shih, 2008: 4). Gao Xiqing, a former lawyer on Wall Street and a key figure in the establishment of the Chinese stock market serves as CIC's CEO and vice-chairman. The other vice-chairman, Hu Huaibang, was previously a high-level official working for PBoC and China

Banking Regulatory Commission. The remainder of the management team features luminaries from a number of financial regulatory bodies and, somewhat curiously, the National Development and Reform Commission (NDRC) which is the successor body to the State Planning Commission and ordinarily not much of a presence in financial policy (cf. Shih, 2008: 5-6; Cognato, 2008: 16-20). The CIC's management team represents the interests of the MoF more strongly than those of the PBoC, but the CIC is insulated from both parties in the formal hierarchy of the central government. The position of CIC is actually quite unique. Under Chinese laws, non-financial SOEs are under the regulation of SASAC, and financial SOEs fall under the administration of PBoC and three regulatory commissions covering banking, securities and insurance, respectively. CIC is the only financial SOE which reports directly to the State Council.

The idiosyncratic and complicated funding of CIC also bears the stamp of bureaucratic politics. In 2007, the MoF issued special government bonds that amounted to RMB 1.55 trillion. Using funds from the bond sale, the MoF subsequently made an asset swap with the PBoC in which the MoF used RMB 1.55 trillion to purchase US \$200 billion worth of foreign assets from PBoC. Finally, the MoF injected the foreign assets into CIC. But because MOF had not been made shareholder of CIC, the MOF was unwilling to assume responsibility for repaying the principle and interest of the special government bonds which were issued to finance the CIC. Instead, MoF required CIC to reimburse it for the bonds meaning that the CIC's US \$200 billion worth of foreign assets is not the Fund's capital, but in fact its liabilities! Given that the annual yield of special government bonds is around 4.5% and factoring in the RMB's appreciation against other major currencies, to turn a profit, CIC will have to achieve an annual yield of over 10% in US dollar terms in overseas investment (Liao, 2007). Explaining the extreme pressure this arrangement has placed on CIC's management, Lou Jiwei said that CIC would have to earn 300 million RMB per day in order to keep up with these payments (anon., 2007a).

Comparison with other mature SWFs suggests that attaining a 10% annual yield will be all but impossible for CIC. Singapore's GIC, one of the world's most experienced and successful SWFs, only achieved an annual rate of return of 9.5% in US dollar terms over a period of 25 years to March 2006 (GIC, 2008). CIC has been negotiating with MoF on this issue since its establishment and the two sides reached an agreement in Fall 2008. Under the terms of the agreement, MOF will first assume responsibility for repaying the principle and interest of the special government bonds. CIC will move its investment income to a special fund account opened by MOF and the proceeds will be used to repay the interest on the bonds (Zhang and Zhou, 2008). MOF reportedly gave in to the CIC's demands under pressure from the higher reaches of government.

The CIC has developed two coping mechanisms to deal with the pressure of these financing arrangements: first, absorption of funds from the state financial assets system, and; second, the adoption of a high-risk, high-return investment strategy. First, the State Council arranged for Huijin to be merged into CIC as its subsidiary. Huijin was established in December 2003 with the mandate of facilitating the reform and stock-market listing of Chinese state-owned commercial banks. In preparation for their listing, Huijin injected US \$45 billion of foreign exchange reserves into Bank of China (BOC) and China Construction Bank (CCB) and received equity stakes in return. Bank recapitalization was yet another source of discord between the MoF and PBoC. Due to concern about loss of influence to PBoC (via Huijin), the MoF which had been sole shareholder in the Big Four commercial banks prior to the creation of Huijin, is reported to have successfully lobbied for much smaller Huijin capital injections of Industrial and Commercial Bank of China (ICBC) and Agricultural Bank of China (ABC) (Green, 2007). The tab for Huijin's recapitalization of ICBC came to only US \$15 billion and left MoF and Huijin each with 50% of the bank's equity prior to listing. Following the listing of these banks on Shanghai and Hong Kong stock markets, Huijin has achieved

remarkable returns. At the end of October 2008, Huijin's US \$60 billion worth of investments in CCB, BOC and ICBC had generated a profit of over US \$160 billion (Li H., 2008)! After taking over Huijin, CIC could use the proceeds generated by the dividends paid out by listed commercial banks to repay the interest on the special government bonds. Accordingly, at the end of 2007, the CIC purchased Huijin from the PBOC for US \$67 billion, making it a wholly-owned subsidiary of the CIC. Shortly thereafter, on February 29, 2008, CIC was notified by the MOF that it had to reimburse RMB 12.9 billion as a half year interest payment for a RMB 600 billion special government bond (Li L., 2008). Although CIC has not paid any cash to MoF up till now, the market noticed that on March 26, 2008 Huijin transferred 3 billion units of H shares of Bank of Communications to MOF without any compensation. The transfer of shares was naturally interpreted as a kind of interest payment from CIC to MoF through the channel of Huijin (Zhang M., 2008).

While the acquisition of Huijin has significantly eased CIC's financing pressure, there have been costs in terms of the credibility of the fund's claim to be a purely financial investor. From the outset, CIC has been at pains to portray itself as passive investor in global financial markets, but it is very difficult for the fund to detach its image from its major subsidiary which assumes the roles of strategic institutional investor. CIC's investment principles avow that: "CIC selects investments based on economic and financial objectives, and an assessment of the commercial return; CIC usually does not seek an active role in the companies in which it invests nor attempts to influence those companies' operations" (CIC website, 2008). Yet the presence of Huijin under CIC's banner calls these commitments into question. Since Huijin's high equity stakes in domestic commercial banks gives it an important role in the direct management of these banks, Huijin's relationship with these companies is quite different than the hands-off arrangements CIC wishes to cultivate with overseas investment targets. As of June 30, 2008, Huijin held 67.49% of BOC shares, 59.12% of

CCB shares and 35.33% of ICBC shares (Huijin website, 2008). In addition, because CIC's overseas investments have primarily targeted US financial institutions, some of which are in competition with Huijin-invested companies, there are quite naturally questions about potential conflicts of interest in CIC's investment portfolio. To allay such fears, Lou Jiwei announced early on that a "firewall" would be set up between CIC and Huijin because the latter is "not an investment platform which has commercial interest as its goal", (anon., 2007a). Though Huijin has also declared that the business of CIC and Huijin are completely separate (Huijin, 2008), in the eyes of investors, the image of CIC as a passive and financial investor has been irrevocably sullied by its ownership of Huijin. Without a doubt, CIC's acquisition of Huijin has played a role in feeding the doubts and criticisms of China's sovereign wealth fund in developed host countries.

The second coping mechanism that CIC developed to deal with the pressure of servicing its debts to the MoF is the adoption of a high risk, high yield investment strategy. In November 2007, CIC released its official investment plan which divided up the initial investment of US \$200 billion in three parts: one third of the funds CIC would purchase Huijin, another third would be used to recapitalize ABC and the China Development Bank (CDB) and the remainder would be used for overseas investment. Subsequently, after the bank recapitalizations were each scaled back, the portion of funds dedicated to overseas investment was raised from US \$66 billion to US \$90 billion (Zhang and He, 2008: 4). Under pressure to generate high profits, American financial institutions have been the main target of CIC's overseas investments. CIC has invested in shares of Blackstone group (initial purchase of 9.9% of total shares recently raised to 12.5%), the convertible bonds of Morgan Stanley (US \$5 billion worth), shares of Visa (US \$100 billion) and a private equity fund initiated by J.C. Flowers (CIC paid \$3.2 billion for 80% ownership). Under ordinary circumstances, the investment income from such a portfolio could help

to repay the interest of special government bonds. Thus, it was extremely unfortunate that CIC's overseas financial investment came up against the sub-prime mortgage crisis. The market value of CIC's investment in Blackstone and Morgan Stanley have both suffered huge shrinkage and, as a result, CIC has become the target of criticism from the upper reaches of government as well as the general public. At the time of writing, in Fall 2008, there is speculation that turmoil in the financial markets will push CIC along with other regional sovereign wealth funds towards more conservative investments in *inter alia* Asian utilities and infrastructure firms (anon., 2008b). In what could be a sign of things to come, in November 2008, CIC resumed negotiations for purchase of an equity stake in Australian iron ore producer Fortescue Metals Group (LeeMaster, 2008)

Peer Competition: Rivals to the CIC

Aside from pressure to repay the MOF special bonds, CIC also increasingly feels pressure from rivals within the ranks of government. CIC is not the only Chinese sovereign investor which uses foreign exchange reserve assets to make overseas portfolio investment and the fund finds itself in ever-more intense competition with several rivals including the State Administration of Foreign Exchange (SAFE), China Development Bank (CDB) and the National Council for Social Security Fund (SSF). Officials in the upper reaches of government might well use the performance of other sovereign investors as a benchmark to evaluate the performance of CIC. The results of this evaluation could determine whether CIC will obtain another injection of foreign exchange and impact the political future of the officials who comprise CIC's management team.

Recent changes to SAFE's investment strategy suggest that it is trying to outperform CIC in the area of high risk, high yield investment. As a subsidiary of the PBoC which has authority over management of the forex reserves, SAFE

has traditionally invested Chinese foreign exchange reserves in low risk, low yield and highly liquid financial assets, such as US treasury bills and agency bonds. Judging by recent changes to SAFE's investment habits, the creation of CIC seems to have been perceived as a threat to SAFE's monopoly on the management of the foreign exchange reserves. Since the birth of CIC, SAFE has increased its investments in shares of financial and non-financial corporations listed in developed countries stock markets. In December 2007, for example, SAFE spent US \$185 million to purchase minority shares in three Australian commercial banks. In April 2008, SAFE spent US \$2.85 billion for a 1.6% stake of TOTAL SA, the world's fourth largest oil and natural gas provider. Between January and July 2008, SAFE acquired minority shares (none exceeding 1%) of over forty British listed companies including British Petroleum, Barclays, HBOS Plc and Royal Bank of Scotland (Cao et al., 2008). SAFE reportedly has received authorization to invest 5% of Chinese foreign exchange reserves on non-fixed income financial assets, although this has not yet been confirmed by SAFE (ibid). The comparative advantage of SAFE relative to CIC lies in its abundance of well-trained professionals and the huge scale of its investment funds.

The CDB's recent "going out" (*zouchuqu*) initiatives have seen this bank making foreign investments that resembles CIC's overseas portfolio. As the largest of China's three policy banks, the CDB's traditional mandate included: financing the state's infrastructure development initiatives; supporting basic industries and pillar industries; coordinating regional development efforts, and; facilitating the restructuring of key industries (CDB, 2008). In late 2007, the central government approved a plan to begin transforming CDB from a policy to commercial bank (Zhang Y., 2008). In December 2007, CDB received a capital injection of US \$20 billion from Huijin (Zhang Y., 2007). To build a more experienced and solid base for its commercial banking operations in the future, CDB was eager to become a shareholder of global banks and so, in

September 2007, CDB bought 3.1% stake of Barclay with EUR 2.2 billion (Yu et al., 2007). One CDB official described the bank's Barclays board seat as a "precious opportunity to learn" (Zhang Y., 2008). There were also rumors that CDB was willing to invest US \$2 billion in purchasing shares of Citigroup, but the proposal was denied by State Council as was a subsequent proposal to increase CDB's holdings of Barclay shares (Fang et al., 2008; Zhang Y., 2008). As the bank responsible for providing long-term loans to state-owned enterprises planning to invest overseas, CDB has also been the financier of SOEs "going out" efforts. For example, in January 2008, a CDB loan to the Aluminum Corporation of China (CHINALCO) facilitated this enterprise's purchase of a 12% stake of Rio Tinto on the British market for US \$14.05 billion (Liang, 2008).

Finally, the impressive rate of return earned by SSF has also put pressure on the CIC. A ministerial-level government agency under the direct authority of the State Council, SSF is responsible for the management and operation of China's national social security fund (SSF, 2008). The investment strategy of SSF includes long-term value investment, specialized and responsible investment, and the ultimate goal of SSF is to pursue the safety of assets (SSF, 2008). Therefore, SSF is a typical passive and financial investor in both domestic and overseas markets. As for its overseas investments, SSF mainly relies on the asset management services of investment banks, mutual funds, and other institutional investors. In the financial year 2007, 47% of SSF's assets were entrusted to external fund managers (SSF, 2008a). Although SSF's overseas portfolio focuses on low yield, low risk and highly liquid assets, its investments have yielded surprisingly large returns. From 2001 to 2007, SSF achieved an annual return on assets of 8.29 % (SSF, 2008b).

Table 1 Comparison of China's Major Sovereign Investors

	Type	Upper Regulator	The scale of assets As the end of 2007 USD Billion	Investment Strategy
CIC	SWF	State Council	200.0	Financial and passive
SAFE	Government Entity to operate foreign exchange reserve	PBoC	1528.2	Financial and passive
CDB	Policy Bank	China Banking Regulatory Commission	396.3	Strategic and active
SSF	Government Entity to manage national social security fund	State Council	60.2	Financial and passive

Source: The online database of SAFE, The annual report of CDB in 2007, The annual report of SSF in 2007.

Table 1 provides a rough comparison of the Chinese sovereign investors. Although these organizations have different responsibilities and functions, because they all make overseas investments, their relative performance will be a key criterion in the government's future decisions about how to allocate foreign

exchange. The performance of institutions focusing on low risk, low yield assets will be a benchmark against which the performance of institutions executing more risky investments will be judged. If CIC's performance is found to be poorer than SAFE's, and especially if CIC's returns cannot match those of the conservatively-oriented SSF, the management team of CIC will certainly receive heavy criticism from the upper reaches of government not to mention the media. It is for this reason that the future of CIC will depend to great extent on its performance relative to that of domestic competitors. Whether CIC will receive more capital injections will be decided by what CIC is able to achieve in the next couple of years.

Conclusion

At the time of writing, the world is confronting a grave financial crisis. In these uncertain times, it remains to be seen what will become of the SWF debate and, indeed, what will become of SWFs themselves. Given the precarious position of financial institutions worldwide, one scenario is that cash-strapped governments will, out of necessity, adopt a more welcoming approach to SWFs. Consistent with these expectations, Britain has thrown open its doors to sovereign wealth in recent months. Following Middle Eastern SWFs' combined US \$11.8 billion investment in Barclays bank in October 2008, British Business Secretary Peter Mandelson declared his support for the deal and said that SWFs "want to generate a good return, they are the first to steer clear of politics"(anon., 2008c). Mandelson also suggested that the UK could serve as a base from which SWFs could invest in Europe. Yet the crisis seems to have incited protectionism in some other developed countries. Italy, for example, is considering legislation that would impose a 5% cap on SWF investments in Italian companies (Dinmore, 2008). And in an address to the European Parliament in October 2008, French President Nicolas Sarkozy called on European governments to set up their own SWFs to protect national assets, saying: "I don't want European citizens to wake up in several months' time and

find that European companies belong to non-European capital, which were bought at the share price's lowest point" (quoted in Bennhold, 2008). France has since tasked its state-owned investment body, Caisse des Dépôts et Consignations (CDC), with defending French companies from foreign take-over. Yet, as a sign of how difficult protectionist positions are to sustain under current conditions, CDC has itself said that it would welcome SWFs as co-investors in the project (Hall and Daneshku, 2008).

In the near term, global recession will cause contraction in the revenue streams that feed both commodity and non-commodity SWFs but these funds should remain an important feature of global financial markets into the future. Following forecasts of a severe global economic downturn, the prices of oil and gas have precipitously dropped in recent months. The price of crude oil fell from US \$147 per barrel in July 2008 to US \$54 in November (anon., 2008d). The sharp reduction in state oil and gas revenues has radically changed the financial position of oil-exporting economies in a short period of time. In oil-rich Alaska, for example, Governor Sarah Palin returned from her unsuccessful bid for the US Vice-Presidency to find that prices are now below the level needed to balance the state budget (Yardley, 2008). Falling demand will also trigger a reduction in net exporters' balance of payments surpluses. In anticipation of much slower export activity, Chinese policymakers have recently issued a slate of policies intended to stimulate domestic demand. China's main exporting provinces, Guangdong, Zhejiang and Jiangsu, have already seen a wave of bankruptcies among small-and-medium sized enterprises. The specter of severe recession also seems to have made SWFs adopt more conservative investment strategies. Since the meltdown of the US financial system in September 2008, sovereign wealth purchases of distressed US financial assets have slowed to a trickle not because of more stringent US investment legislation or protectionist sentiment but reportedly because fund managers view these investments as simply too risky (Landon Jr., 2008). Of course, it may well be

that fund managers are waiting to see where the market bottoms out before buying up these assets. When the global economy begins to recover, SWFs' equity stakes in respected firms like Barclays, Citibank, Merrill Lynch, Morgan Stanley, Credit Suisse and UBS could generate very high investment returns. However the crisis develops, with combined assets estimated at more than US \$2 trillion, sovereign wealth will remain an important pool of capital in and beyond the current recession.

Area studies scholars have an important role to play in future discussions about the phenomenon of sovereign wealth. It is certainly true that these pools of capital are something new but, as our analysis shows, not all sovereign wealth funds are created equal. As *The Economist* has put it: "there is no such thing as an average sovereign-wealth fund" (anon, 2008a). Not only do the investment orientation and size of these funds differ widely but, even more importantly, the domestic political structures in which these funds operate are apples and oranges in relation to each other. Abu Dhabi and Norway may share a superficial interest in making the most of short-lived oil revenues but if we want to understand where these two funds could find themselves ten years from now, we ought to look not only to the trajectory of oil prices but also to the policy preferences and rivalries of power-brokers as well as to the institutions in which domestic politics is staged. Since SWFs are, as Larry Summers rightly points out, political creatures, the tools of political analysis are uniquely suited to explaining the varying investment behavior of these funds. The accumulation of inside-out case studies of SWFs is a first step towards larger-scale comparative analysis of funds' investment behavior. The second-image approach is already widely employed in studies of American political economy (see Cohen, 2008b: 125-131); our study shows that the same approach can be put to good use in less transparent political settings.

The inside-out political analysis of CIC given here provides insight into

this SWF's current investment behavior and its possible futures. Early on, the CIC was drawn to investments in US financial institutions under the immense pressure of trying to earn RMB 300 million per day in order to repay the MoF bonds. The acquisition of Huijin was also a survival mechanism, though one that has been costly to CIC's carefully cultivated image as a passive investor. The paper suggests that if, in the coming months, CIC is outperformed by rivals SAFE, SSF and/or the China Development Bank, it may well lose the mantle of China's sovereign wealth fund. Finally, political analysis also helps to explain why China's sovereign wealth has not participated to greater extent in the acquisition of distressed financial assets since the onset of the sub-prime mortgage crisis. As mentioned previously, the State Council quashed CDB's plans to increase the bank's equity holdings in Barclays and also denied its planned purchases of Citigroup and Dresdner Bank equity. And following negotiations in September 2008, CIC finally opted not to increase its stake in Morgan Stanley to 49.9%. The official reason given by CIC was that the two sides could not reach a mutually agreeable share price (Li Q., 2008), but it's likely that managers also felt pressure to avoid any more unpopular investments abroad.

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