

Political Economy of Sovereign Wealth Funds: The Case of China

by

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ABSTRACT

The dissertation investigates the development and evolution of the investment patterns of the two Chinese Sovereign Wealth Fund (SWF), China Investment Corporation (CIC) and State Administration of Foreign Exchange Investment Company (SIC). As the dissertation demonstrates, the IPE literature on SWF is deeply divided between a realist-mercantilist approach that views SWFs as political and strategic instruments in the hand of (in many cases) authoritarian regimes, as opposed to financial economic theories that view SWF as economic instruments that are aimed at resolving specific macroeconomic disturbances suffered by excess reserves of foreign exchange. The latter tends to argue that SWF are driven, on the whole, by commercial as opposed to political or strategic interests.

Through extensive use of interviews with state officials, private sector actors as well as academic experts, as well as consultation of primary and secondary research material in Chinese and English, I advance three related set of propositions.

First, that the specific way by which the two sovereign wealth funds were established in China proved to be a crucial factor determining their subsequent development and function within the Chinese economy. Specifically I argue that because China opted to develop two SWFs, each with its own distinct institutional and operational background, one drawing on Central bank reserves (SIC), the other evolved as a swap arrangement that draw on the Ministry of Finance's holding of foreign currency reserve and debts instruments (CIC), the two funds saw each other as competitors.

Second, the dissertation could not verify that each and every investment decision that was undertaken by the two funds was driven by commercial interests only, but it shows that as each fund sought to demonstrate its superiority over the other, it sought to do so by demonstrating higher rate of growth and crucially, higher rate of return. Competition over rate of return ensured that the funds would prioritize commercial interests over the political goals to the Chinese state.

Third, and irrespective of the above, the funds had to work under certain preconditions and controls set by the Chinese state. I show that paradoxically, political and economic controls proved useful for the Chinese state in a number of respects. For instance, since one-third of the funds' assets were designed to inject additional funds to the Chinese state banking industry, these banks were able to support china's fledgling SOEs and SOCBs sustain fast economic growth. With regard to CIC's global operations, the State Council cleverly used the fund's connection and capital capacity to access wider range of international business opportunities, gain management knowhow, technology transfers as well as the access to new markets and secured the needed for raw materials and energy resources.

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LIST OF ABBREVIATIONS

ABC	Agricultural Bank of China
ADIA	Abu Dhabi Investment Authority
AMC	Asset Management Commission
AMD	Advanced Micro Devices
ASEAN	Association of East Asian Nations
BIS	Bank for International Settlements
BOC	Bank of China
BOCOM	Bank of Communications
CCOB	China Construction Bank
CCP	Chinese Communist Party
CCTV	China Central Television
CDB	China Development Bank
CDC	Caisse des Dépôts et Consignations
CIC	China Investment Corporation
CICC	China Investment Capital Corporation
CISF	China Insurance Security Fund Co. Ltd
CLGRSS	Central Leading Group on Reforming the Shareholding of SOCBs
CTGC	China Three Gorges Corporation
EIA	US Energy Information Administration
EIBC	Export-Import Bank of China
ECB	European Central Bank
EMEs	Emerging Economies
EU	European Union
FGF	Future Generation Fund
FOREX	Foreign Exchange market
FYP	Five Year Plan
GAPP	Generally Accepted Principles and Practices
GCC	the Gulf Cooperation Council countries
GIC	Government of Singapore Investment Corporation
GLC	Government-Linked Company
GLF	Great Leap Forward
GPF-G	Norwegian Government Pension Fund-Global
GRF	General Reserve Fund
ICBC	Industrial and Commercial Bank of China
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
KIA	Kuwait Investment Authority
KIB	Kuwait Investment Board
KIO	Kuwait Investment Office
LBO	Leveraged Buy Out
MOF	Ministry of Finance
NBIM	Norges Bank Investment Management
NDFI	National Development Fund of Iran
NDRC	National Development and Reform Commission

NPL	Non Performing Loan
PBOC	People's Bank of China
POEs	private-owned enterprises
PRC	People's Republic of China
RCC	Rural Credit Cooperative
RERF	Reserve Equalization of Reserve Fund
RMB	Ren Min Bi
SAFE	State Administration of Foreign Exchange
SASAC	State-Owned Assets Supervision and Administration Commission
SDBs	State Development Banks
SEC	US Securities and Exchange Commission
SEZ	Special Economic Zone SGD Singapore Dollar
SFRF	Stabilisation Fund of Russian Federation
SHSE	Shanghai Stock Exchange SOE State-Owned Enterprise
SIC	State Administration of Foreign Exchange Investment Company
SOCBs	State-owned Commercial Banks
SOEs	State-owned Enterprises
SRR	Statutory Reserve Requirement Ratio
SWF	Sovereign Wealth Fund
SZSE	Shen Zhen Stock Exchange
S&P	Standard & Poor's
TSR	Total shareholder return
UCC	Urban Credit Cooperative US United States of America
WTO	World Trade Organization

Introduction

(1) Problem Statement

China's relatively weak currency and its rapid increase of trade surpluses since joining the WTO in 2001 have led to a massive accumulation of foreign exchange reserves. By September 2007, these reserves were estimated to stand at US\$1.433 trillion, on top of its 19.29 million ounces of gold reserves (People's Bank of China–PBOC, 2008, accessed June 2012). However, China's decision to lift its pegged exchange rate at ¥8.28 per one US dollar in July 2005 to ease pressure and criticism from the international community, especially from the US, presented Beijing with a new challenging problem—the appreciation of its currency, RMB (人民币 Ren Min Bi or ¥ Yuan), against the US dollar (British Broadcasting Corporation–BBC News, 2005, accessed June 2012; Thomas and Chen, 2011, pp.471–2). Since the pegged rate was lifted in July 2005, Chinese Yuan has steadily gained strength, reaching a 10% increase of value relative to the US dollar in September 2007 when it was traded at ¥7.45 per one US dollar (MSN money, 2011, accessed May 2011). Consequently, this dramatic appreciation of its currency has forced China to find alternative ways for managing its foreign reserves, as the opportunity costs and negative returns continued to rise. The previous modus operandi of investing only in the US Treasury Bonds was no longer a viable option.

China was not alone in the search for solution of excess reserves, and there are many examples of how various nation-states have been trying to find a better way to manage excess reserves and national surplus. An Asian precedent can be seen in 1981,

when the Singaporean Government set up the Government of Singapore Investment Corporation (GIC¹) with a starting fund estimated at between US\$3 - \$US4 billion to manage 'the surplus funds generated by the government and excess reserves' (Elson, 2008, pp.76-8). However, the forefather of the sovereign fund are arguably the funds that derived their capital from the profits of the sale of natural resources. These funds have been in existence for almost six decades. A good example of this type of fund is the Kuwait Investment Authority (KIA), previously known as the Kuwait Investment Board (KIB). This fund was established in 1953 to invest oil revenue to reduce 'the volatility of government revenues and counter the boom-bust cycles of oil price' (Hassan, 2009, p.31). By 2005, more than 50 sovereign funds were created and their impact has started to be felt in the financial world (Hassan, 2009; Curzio and Miceli, 2010). As a result, they received increased attention from financial analysts, who coined the term 'Sovereign Wealth Funds (SWFs)' to define their function (Rozanov, 2005).

The Chinese government was well conscious of these precedents and examples when they decided to follow suit and establish its own SWF to tackle the problem of growing reserves. Thus, the China Investment Cooperation (CIC) was established on 27 September 2007, with a start-up capital of some US\$200 billion. While the establishment of CIC raised general awareness in regard to SWF among the general public, it also sparked off speculation as to the possible impact and consequences of this new SWF among academics and regulators. Furthermore, this development has placed CIC in the spotlight as a subject of much close scrutiny, especially since there were concerns that CIC was created to assist the Chinese government in the quest for achieving political goals. This concern is partly due to the perception towards the potential of China's growing

1. The Government of Singapore Investment Corporation has changed its legal name to GIC Private Limited in July 2013 (The Straits Times, 2013, accessed August 2014).

reserves and China's increasing role in global geopolitics and economy. However, to fully comprehend the impact of CIC, it is vital to gain an understanding of the political economy of the CIC itself, especially the internal politics within Chinese monetary system.

The State Council's decision to establish CIC emerged as the consensus decision from consultations and negotiations between key authorities involved in monetary management that all sought to have their say in managing China's growing excess reserves. The structure of the CIC's relationship with the government also speaks of the complicated arrangement to manage internal politics within monetary agencies. CIC is an independent investment arm, neither a subsidiary of Ministry of Finance (MOF) nor People's Bank of China (PBOC). In addition, CIC's status is only one level down from the State Council, which means it is accountable only to the State Council.

The competition to manage the CIC was essentially between two contenders: the Ministry of Finance (MOF) and the People's Bank of China (PBOC) (Shih, 2009, p.336). This fact should not be surprising. After all, PBOC's subsidiary, the State Administration of Foreign Exchange (SAFE), has been the only agency responsible for managing China reserve thus far. On the other hand, MOF have been trying to expand its influence by making the case with State Council that there are other countries where the Ministry of Finance is in charge of managing reserves, such as Japan (Eaton and Zhang, 2008, p.10). So when it came to setting up SWF for managing China's excess reserves, SAFE had to defend its turf, while MOF had to try to increase its influence.

Superficially, the MOF seemed to have won the competition. The appointed members of the CIC's Board of Directors, as well as the occupants of all key positions are mostly former MOF officials or their political allies. From the perspective of the general public, it seems that this was a clean victory for MOF over PBOC. However, what many

are unaware of is the fact that PBOC have, for a long time, invested its portion of the reserves through a secretive subsidiary of SAFE that was set up in Hong Kong in 1997. This subsidiary operates under the name SAFE Investment Company (SIC). PBOC think that it has every right to do so. Therefore, the competition between PBOC and MOF to manage excess reserves is far from over – it has merely continued in the form of CIC’s and SIC’s attempts to outperform each other.

It is in the context of the above political and economic situation that this dissertation seeks to study and explain the political economy of the Chinese SWFs. The dissertation will discuss the historical development of SWFs in general, the history of Chinese foreign reserves, the establishment of CIC, its competition with SIC, and how the Chinese government have, notwithstanding the competitive nature between the two funds, made use of them.

(2) Proposition of the study

This dissertation seeks to advance our understanding of the nature of the Chinese SWFs. Much has been written about the Chinese SWFs. Unfortunately, much of the material is speculative and draws on specific anecdotes and instances. A further complication is the existence of divergent views of SWFs. Some scholars of realist bent believe that SWFs are tools of state and power, and must be viewed as such by host states. On the other hand, financial economists treat SWFs as practical solutions to macroeconomic problems that arise out of excess reserves. Others still, especially those of neoliberal bent, are naturally suspicious of any form of publically owned or publically-run economic entities.

The dissertation is founded on the premise that the best way of adjudicating among these conflicting claims is to conduct a thorough and systematic historical study based on available information. For that purpose, I have conducted a series of interviews with Chinese state officials, private sector actors, as well as academic experts. An extensive variety of primary sources in Chinese, as well as secondary sources in Chinese and English were also consulted. I discovered that CIC officials and organisation as a whole were more open and willing to engage with the media, the recipient countries, and other interested parties. In contrast, SIC came across as a more secretive body². Nonetheless, I have gathered sufficient direct and indirect evidence to support the three core claims that will be advanced in this dissertation.

The first claim is that the way the two SWFs were established in China proved to be a crucial factor that determined their subsequent development and functions within the Chinese economy. Specifically, I argue that because China opted to develop two SWFs, each with its own distinct institutional and operational background, one drawing on Central bank reserves (SIC), the other evolved as a swap arrangement that drew on the Ministry of Finance's holdings of foreign currency reserves and debts instruments (CIC), the two funds saw each other as competitors.

Second, the dissertation could not verify that each and every investment decision that was undertaken by the two funds were driven by commercial interests only, but it can illustrate that as each fund sought to demonstrate its superiority over the other, it sought to do so by demonstrating a higher rate of growth and crucially, higher rate of returns.

2. Anderlini (2009, accessed May 2012) argues that SAFE's management is very secretive and that only two of the top senior officials (PBOC governor and head of SAFE) know the complete portfolio of China's reserve holdings.

Competition over the rate of returns ensured that the funds would prioritize commercial interests over the political goals of the Chinese state.

Third, and irrespective of the above, the funds had to work under certain preconditions and controls set by the Chinese state. I show that paradoxically, political and economic controls proved useful for the Chinese state in a number of respects. For instance, since one-third of the funds' assets were designed to inject additional funds to the Chinese state banking industry, these banks were able to support China's fledgling state-owned enterprises (SOEs) and state-owned commercial banks (SOCBs), thereby helping to sustain fast economic growth. With regard to CIC's global operations, the State Council shrewdly used the fund's connection and capital capacity to access a wider range of international business opportunities, gain management know-how, technology transfers, access to new markets, as well as securing sources for the raw materials and energy resources that were required to maintain growth in the Chinese economy.

(3) Structure of the dissertation

The dissertation is divided into five chapters, starting from this introductory chapter, which gives an overview of the dissertation. It does this by introducing the problem, proposition and structure of the dissertation.

Chapter One discusses the definition of SWF, and the historical development of SWFs. The study of SWFs' investment behaviour is the key to understanding their political economy and to realise their goals and objectives. The chapter offers three crucial insights. Firstly, SWFs are going to gain greater importance and influence in terms of global finance and politics due to their increasing size and number. The second insight is that SWF is seen by nation-states as an alternative strategic tool for maximizing or preserving wealth,

which has led to countries and international organisations dedicating greater attention to SWFs, especially in terms of assessing and formulating guidelines and regulations in regard to its emergence. Lastly, the chapter gave us the overall idea of scope and limits of what to be discussed or questioned within IPE.

Chapter Two presents a review from the perspectives of different theoretical lenses through which the SWF phenomenon has been approached. The chapter starts with a discussion of the financial economic literature as the first approach to the study of SWF. It will then discuss political science literature, including realism, Neo-liberal and other Political Economy approaches. The chapter concludes that much of the literature tends to be speculative, in terms of the possible behavioural traits of SWFs. At the same time, in the context of domestic politics in China, this chapter will show that the Chinese SWFs were essentially competitive bureaucratic enterprises concerned primarily with demonstrating their value vis-à-vis each other to the Chinese leadership, while seeking to draw on increasing resources under their disposal.

Chapter Three is designed to provide an important foundation for improving the understanding of the CIC and its peer, SIC. The chapter will do so in three parts. It will start with a discussion of the historical development of China's foreign exchange reserves. This section will be followed by a discussion and analysis of the more recent problems that have emerged, stemming from a surfeit of reserves. Finally, the chapter will cover the key role of political struggles behind the decisions of how the reserves should be managed.

Chapter Four aims to explain that the creation of CIC allowed State Council to solve political problems and also turned bureaucratic competition between CIC and SIC for the benefit of achieving high-rate of returns. In addition, the chapter explains how CIC helped to fix issues within the financial sector by strengthening the banking and insurance

sector and the rest of credit providers, through helping them to dilute the NPLs ratio. It also discusses how CIC equipped them with the management know-how and partnerships with world leading financial institutions in order to ready the banks for the competition with global peers.

Chapter Five aims to prove the third proposition. It discusses of how the State Council has mobilised the CIC, SIC, SOCBs, and State Development Banks (SDBs) to assist SOEs through the 'Go-global Strategy' that the Chinese government announced in 2001. The chapter will first discusses the problems of SOEs, before explain policies that Chinese leaders has been imposed to deal with above issues. More importantly, the chapter discusses how CIC, along with SAFE (SIC), SOCBs and SDBs could fit into the grand picture of conducting a coordinated investment strategy in order to assist SOEs to be competitive as well as securing prized assets and vital resources abroad.

Chapter One:

SWFs—Definition and Historical Development

In 2005, the term 'Sovereign Wealth Fund (SWF)' was coined for the first time by Andrew Rozanov, an analyst working for the State Street Corporation, to describe a new breed of government investment vehicle as he expressed his concern over its rapid growth (Rozanov, 2005, p.1). When Rozanov wrote his article, there were already a few dozen of SWFs; the amount of money invested by them had already surpassed the one trillion US dollars mark³ (Truman, 2010, p.1), in which five largest funds held about 75% of the overall assets (Rozanov, 2005, p.1).

Six years on, SWFs are high on the agenda. Still, there is no universally accepted definition of a SWF. Moreover, over the years, the focus on SWFs was concentrated on their perceived threats and impacts rather than on their histories, reasons of existence, and their changing behaviour. Thus, the important historical and analytical accounts of SWFs which could offer us a fuller explanation or a more complete understanding of today's affairs of these state-owned funds were largely ignored by the scholars of this relatively young field.

To answer to the above shortcomings, this chapter's main objective is to explain that the study of SWFs investment behaviour is the key to understanding their political economy and to realise their designated true objectives. In order to achieve this, the

3. In 2005, Truman estimated that the overall asset under SWFs' management was US\$1.5 trillion (Truman, 2010, p.1) On a rather conservative estimate, Rozanov believed that the assets of SWFs in 2005 was only near a trillion US dollar mark, however, this seems to be an underestimated figure considering his own collected overall size of commodity-funds alone was already worth at least US\$895 million, without accounting for any of non-commodity funds (Rozanov, 2005, p.1) .

chapter firstly discusses the definition of the SWF, which is built upon the analysis of the characteristics of SWFs. Secondly, the chapter examines the development of the SWF in general, which can be chronologically divided by their changing behavior since 1953 to the present day.

1.1 Definition

Andrew Rozanov, who coined the term SWF, described them in the following terms:

“Typically, sovereign wealth funds are a by-product of national budget surpluses, accumulated over the years due to favourable macroeconomic, trade and fiscal positions, coupled with long-term budget planning and spending restraint.” (Rozanov, 2005, p.2).

Five years later, Rozanov accepted that the above definition was 'too vague to be applied' and we do need a much clearer framework in determining 'key features and distinct characteristic of the funds in question' (Rozanov, 2010, p.5). His concern was later addressed by the International Working Group of Sovereign Wealth Funds (IWG) in 2008.

After the SWF had been highlighted in the International Monetary and Financial Committee (IMFC) in October 2007, the IWG was established in 2008 to identify best practices for SWFs as a response to worried investors and recipients of SWF's investment (IWG, 2008, p.1). Consisting of 26 IMF members who own SWFs, IWG arranged three meetings in Washington D.C., Singapore and Santiago of Chile (IWG, 2008, p.1). One of the most important works the IWG had was a consensus in definition as follows:

“SWFs are defined as special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies, which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports” (IWG, 2008, p.27).

In order to help in identifying the SWF, the IWG also provides “specifications” of three must-have attributes; (1) ownership; (2) investments; (3) objectives; before any fund being considered as a SWF as presented in Table 1.

Table 1.1: IWG's three key elements that define a SWF

Ownerships	SWFs are owned by the general government, which includes both government and sub-national governments.
Investments	The investment strategies include investment in foreign financial assets, so it excludes those funds that solely invest in domestic assets.
Objectives	Established by the general government for macroeconomic purposes, SWFs are created to investment government funds to achieve financial objectives, and (may) have liabilities that are broadly defined, thus allowing SWFs to employ and wide range of investment strategies with medium-to long-term timescales; SWFs are created to serve a different objective than, for example, reserve portfolios held only for traditional balance of payment purposes. While SWFs may include reserve assets, the intention is not to regard all reserve assets as SWF.

Source: IWG (2008, p.27)

In addition, IWG had another approach in determining what fund should be regarded as SWF, by making a long list of market participants, which should not be classified as a SWF described below:

“This definition excludes, inter alia, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, operations of state-owned enterprises in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals” (IWG, 2008, p.27).

Despite that the IWG had captured the ambiguity over the definition of SWFs by providing extensive lists and specification, it also had left out four types of sovereign funds, even though in many cases it seemed illogical not to include them when you compare their portfolios or attributes against IWG's typical SWFs (Rozanov, 2010, p.9-10). The first group as sovereign funds were once investing exclusively in domestic markets. Recently, many of these funds had already shifted towards foreign markets and were likely to increase the ratio of their international portfolios (Rozanov, 2010, p.9-10). The second group are central banks that had an excess part of their assets invested in non-traditional financial products (Rozanov, 2010, p.9). Examples of this group given by Rozanov (2010) are central banks and monetary authorities in China, Republic of Korea, Singapore, Saudi Arabia and Hong Kong, which had parts of their operations behaving similarly like a SWF. The third group are funds owned by sovereign rulers, mostly concentrated in funds from the oil rich Middle East countries (Rozanov, 2010, p.9). They have a long history of investing abroad. The fourth group that SPFs should have not been excluded from the IMF definition are sovereign pension funds (SPFs). Truman (2010) commented that SPFs portfolio's assets could pose the same problems as SWFs (Truman, 2010).

In regard to the above opinions to IWG definition, Rozanov (2010, p.9-16) had recommended that the IWG should extend the scope of its definition to include domestic sovereign funds that had started investing abroad. For the groups of central banks funds and funds belonging to sovereign rulers, Rozanov argued that it would be in their best interest if we can encourage them to 'participate in the work of the Forum as affiliated members' (Rozanov, 2010, p.10). In the case of sovereign pension funds, Truman (2010) insisted that they should be included under the umbrella term of SWF due to capability to

invest in the same manner as a SWF. In addition, many type of assets of SPFs and SWFs are overlapping (Jen, 2007).

It is important to note that this dissertation uses the IWG definition, in addition, the author views that in the case of China, the subsidiary of State Administration of Foreign Exchange (SAFE), or SAFE Investment Company (SIC) is also should considered as a SWF in accord to IWG definition since it is a separate identity from the central bank and SAFE.

1.2 Historical development of SWFs

In this section I adopt Curzio and Miceli's (2010) 'four phases' typology of the development of the SWFs industry from 1953 to date. They describe the four phases as follows: (1) Sleeping Beauty—'from 1953 to mid-1990s'; (2) Awaking Giants—'from late 1990s to 2004'; (3) The High Rollers—'from 2005 to mid-2008'; (4) Rethinking and Maturing—'from mid-2008 to Present' (Curzio and Miceli, 2010, pp.5–24). The four phases are presented in four subsections all aiming to describe the transformation and development of SWFs' investments, as well as explain key factors, which encouraged or, in some cases, forced SWFs to change their behavior.

1.2.1 Sleeping Beauty—'from 1953 to mid-1990s'

Most scholars agree that the first SWF⁴ was established in 1953 when the independent sheikdom under British protectorate, or today's Kuwait, established the Kuwait Investment Board (KIB) to invest surplus oil revenues (Hassan, 2009, p.31).

4. Xu and Bahgat (2010) argue that the first SWF was the Caisse des Dépôts et Consignations (CDC) which was established in 1816 by the French government to manage overseas tax-exempt surpluses collected by its saving bank and post offices (Xu and Bahgat, 2010, p.1). However, his argument was not taken much notice in the SWF studies since most of the literature stated that the first SWF is Kuwait Investment Board (KIB), which are now known as KIA.

Kuwait's SWF has gone through many transitions in governance and structure, from the KIB to Kuwait Investment Authority (KIA). Firstly, in 1965, twelve years after its inception, KIB was abolished and replaced by Kuwait Investment Office (KIO), which was located in London (KIA, 2012, accessed May 2012). Secondly, in 1982, the Public Investment Authority or Kuwait Investment Authority (KIA) was established to supersede the KIO—leaving the relegated KIO to remain only as KIA's core office (KIA, 2012b, accessed May 2012). KIA's principal objective was to reduce Kuwait's dependence on 'exhaustible fossil and lessen the effects of price oscillation' (Curzio and Miceli, 2010, p.4). It also had responsibility to manage and oversee the General Reserve Fund (GRF)⁵ and the Future Generations Fund (FGF)⁶, which were established in 1960 and 1976 respectively (KIA, 2012b, accessed May 2012). By late 2009, KIA had approximately US\$203 billion⁷ worth of portfolio under its management, all invested in foreign countries (Truman, 2010, p.12).

The second SWF was the Revenue Equalisation Reserve Fund (RERF) of Gilbert Islands in Micronesia, or today's Republic of Kiribati, which was created by the British colonial administration in 1956 to collect and manage revenue generated from export levy of phosphate⁸ (Hassan, 2009, p.31). The RERF has since been playing a vital part in 'wealth creation and money management' for the next generations, despite the phosphate having been long depleted (Buhi, 2009, p.201). In 2009, RERF had reached the size of US\$570.5 million, almost four times larger than Kiribati's GDP in 2010, which stood only

5. GRF was set up to perform as Kuwait's 'main treasurer' and hold all government's assets (KIA, 2012a, accessed May 2012).

6. Since its inception, FGF was set to as a main country's reserve. FGF started its portfolio with half of GRF's asset, and, moreover, entitled to ten per cent of state's general revenue, which distributed annually (KIA, 2012a, accessed May 2012).

7. The amount of the projected portfolio varies within the range from US\$169 to 228 billion; See Curzio and Miceli (2010, p.4) for more details on the estimate.

8. Bird manure, it is used as a key ingredient in making a fertiliser

at US\$146.7 million (IMF, 2011, p.23). Nevertheless, RERF's size in 2012 was projected by the IMF to be contracted to US\$518 million due to its obligation to participate in large public investments as a part of Kiribati's long-term structural reform, aiming to achieve fiscal sustainability by strengthening the private sector with better infrastructures and needed stimulus measures (IMF, 2011, pp.1–2, 15, 23).

It was not until the 1970s to 1980s, however, that additional SWFs were added to the list. Rising oil revenues were the main impetus for the increase in the numbers of SWFs (Curzio and Miceli, 2010, p.5). The year 1976 proved particularly important since the oil price has increased from an average of US\$13 during 1970-1973 to US\$40 in 1976, which many government has a much higher revenue generated from the sales of oil production (Kesicki, 2010, p.1597). As a result, a number of major SWFs were created during in this year, such as the Abu Dhabi Investment Authority (ADIA), Future Generations Fund of Kuwait, the Alaska Permanent Fund Corporation of the US and Alberta's Heritage Fund of Canada (Hassan, 2009, p.32; Curzio and Miceli, 2010, p.5).

A different type of SWF (non-commodity based) had also emerged during this period led by Singapore's Temasek Holdings as world's first non-commodity fund and Government of Singapore Investment Corporation (GIC), which was considered as the first SWF to directly manage foreign reserves surpluses.

Temasek Holdings was established in 1974 to assist its sole owner, the Ministry of Finance (MOF), in managing and maximising returns out of S\$354 million (Singapore Dollar) worth of MOF's initial portfolio, which included strategic government-linked

companies⁹ (GLCs) (Temasek, 2004, p.3, 2012). By 2011, its portfolio had grown at the impressive total shareholder return (TSR) rate of 17% annually since its inception, making it one of the largest and most profitable SWFs on earth, at the size of S\$193 billion or approximately US\$120 billion (Temasek, 2011, pp.8–9). In 1981, another prominent fund of Singapore, GIC, was established with its designated task to earn 'reasonable returns within acceptable risk limits over the long term' out of the city-state's foreign reserves acquired from the government (GIC, 2008, p.6). Anthony Elson, an AGIP Professor of International Economics at the Johns Hopkins School of Advanced International Studies in Italy and a former senior staff member at the IMF, had estimated that the starting capital of GIC in 1981 was in the range of US\$3–4 billion. By the 1990s it had ballooned to around US\$100 billion and had reached an estimated level of US\$350 billion since 2006 (Elson, 2008, p.78). Due to its opaque nature of not reporting detailed portfolios to the public, the total assets of GIC can only be estimated. Truman (2010) estimated the latest figure in 2010 at US\$248 billion (Truman, 2010, p.12). Nevertheless, by 2012, Singapore's two SWFs were managing combined assets worth of no less than US\$400 billion¹⁰.

Most SWFs established during this period (1953–mid 1990s) were to serve as 'counter-cyclical tools' which meant to 'absorb temporary current account surpluses and/or booming commodity prices', in response to the highly volatile oil prices, especially from the 1980s onwards (Curzio and Miceli, 2010, pp.3, 6–7). This practical use of SWF was best demonstrated by commodity funds as they were set up to avoid the occurrence of the

9. According to its official website, Temasek Holding's S\$354 million starting capital was a combination of shares and assets in 'companies, start-ups and joint ventures previously held by Singaporean government', which included the likes of 'ship repair business, a start-up airline and an iron and steel mill' (Temasek, 2012). Anthony Elson revealed that Neptune Orient Shipping and Singapore Airlines were one of the companies GLCs Temasek acquired during its inception (Elson, 2008).

10. Truman (2010) estimated that the assets under control of Temasek Holdings and GIC are worth around US\$120 billion and US\$248 billion, which equals to US\$368 billion (Truman, 2010, p.12). During 2008, Adnan Hassan, a former senior advisor at the World Bank Group and currently a CEO of Mecasa Advisor, believed that the portfolio of Temasek Holdings and GIC is worth around US\$330 billion and US\$159 billion respectively, resulting the total assets of the two SWFs at US\$489 billion (Hassan, 2009, pp. 36–7).

'Dutch disease'¹¹, the tendency for large resource revenues to appreciate the real exchange rate, which then damages the non-resource tradable sector (Xu and Bahgat, 2010, pp.5–6). Similarly, Curzio and Miceli label this approach as a 'wealth-substitution strategy', aimed to transform national resources into financial assets (Curzio and Miceli, 2010, pp.6, 90). The best example is the Norwegian Government Pension Fund Global (GPF-G), world's second largest SWF, which its size in 2012 tallied at 3,496 billion kroner or approximately US\$582.7 billion (Norges Bank Investment Management–NBIM, 2012, p.2).

To conclude, from the early 1950s to 1995, sixteen SWFs were created. During this period, they maintained a relatively low profile and hence their existence had almost gone unnoticed. They tended to implement a rather conservative approach and strategy by concentrating their investments in US treasury bonds.

1.2.2 Awaking Giants—'late 1990s to 2005'

Asian's 1997 crisis had taught emerging countries' bankers an important lesson: never run a current account deficit again or otherwise surrender your microeconomic control and accept your fate in the hands of the IMF. Hard-hit emerging economies in Asia, such as South Korea, Thailand and Malaysia, have raised their foreign exchange reserves' ratios to the level suggested by Guidotti and Greenspan¹² in order to cover all short-term external liabilities with the maturity within 12 months, or in other words, the central bank should have enough reserves to pay all short-term debts that are due within a year (Park and Estrada, 2009, p.9).

11. Holland has suffered a rapid decline in the competitiveness of the non-booming tradable sector—resulting from overly strong currency due to excessive revenues generated from natural gas in the North Sea during the 1960s (Xu and Bahgat, 2010, p.23). See also Truman (2010, p.21) for more explanation of the Dutch disease and the applications of SWF.

12. Guidotti and Greenspan suggested that reserves and short-term liabilities should be equal. See also Park and Estrada (2009) for the study on excessive foreign reserves in Asian countries.

The pressure from government and the political system also played a part in encouraging the central bankers to opt for 'self-insurance' measures against future crises, which in turn, has led to a rapid rate of reserve accumulation like we have never seen before (Anderson, 2009, p.3). By 2001, ASEAN-5¹³ economies and Russia have all recovered the reserves lost during the 1997's economic crisis (European Central Bank—ECB, 2006, p.9). Within three years from 2002 to 2005, we witnessed a staggering 91% increase for the world's total reserves, having China, Japan and Taiwan as the top three accumulators (ECB, 2006, p.9).

In many cases, the hoarding of foreign exchange reserves exceeded Guidotti and Greenspan's recommended rule, in which some countries such as Japan, Singapore and India were able cover all short-term external liabilities up to 10 months or longer (Anderson, 2009, p.3, Park and Estrada, 2009, p.9). Excessive capital presented central bankers and administrations with a new set of problem. They had to ask themselves: Which direction should they go after possessing massive foreign exchange reserves?; What are the opportunity-costs of sitting on a large sum of low-yield US Treasury bonds?; How should they wisely manage this cost and perhaps generate higher incomes to beat the inflation?; What sorts of tools are available to accommodate these requirements? The answer is straightforward enough for countries with loaded reserves; to establish their own SWFs.

As a result, a number of SWFs were established with the source of capital either being directed or leveraged from the excess of the foreign exchange reserves during this period. For instance, China's SAFE Investment Company (SIC) and Hong Kong Monetary Authority Investment Portfolio were established in 1997 and 1998 respectively, and in

13. ASEAN stands for Association of East Asian Nations. In addition, ASEAN-5 is used when referring to five original members of ASEAN—Indonesia, Malaysia, Philippines, Singapore, and Thailand.

2005, the Korea Investment Corporation (KIC) had joined the SWF club with other fast-growing economies (Curzio and Miceli, 2010, p.8).

Another contributory factor to the rising number of SWFs during this period was inflated energy prices. Kesicki (2010) explained that there are numerous factors that are considered as oil price influencing factors; demand, supply, refining, geopolitics and speculation on dollar exchange rate and inflation. In regard to the demand side, emerging economies such as China and India and countries in the Middle East have been the main driving force for the demands for oil and natural gas since 2000 (Kesicki, 2010, pp.1597–8). The price for oil rose from below US\$20 per barrel in late 1990s to almost US\$40 in 2001 and broke the price barrier in 2005 with a steep increase to US\$50 per barrel (US Energy Information Administration–EIA, 2012, accessed June 2012). The Oil Stabilization Fund of Iran and Abu Dhabi's Mubadala Development Company were set up in 1999 and 2004 respectively by two oil exporting countries in the wish to diversify their surpluses away from traditional foreign reserves (Curzio and Miceli, 2010, p.9).

The Oil Stabilization Fund of Iran was replaced by the National Development Fund of Iran (NDFI) in 2011. NDFI's main objective was to turn Iran's revenue from energy resources into 'durable wealth, productivity, economic incentive and capital' (NDFI, 2012a, accessed May 2012). According to the National Development Fund of Iran (NDFI)'s official website, the overall size of the fund was estimated at US\$22.8 billion (NDFI, 2012b, accessed May 2012). On a much larger scale, Abu Dhabi's Mubadala was at the time managing assets estimated at US\$177.1 billion (Mubadala, 2009, p.19), an impressive growth since its inception in 2004 with starting capital of US\$721 million (Mubadala, 2009, p.8).

To summarise, in seven years from 1998 to 2004 alone, an additional 15 SWFs were created (Curzio and Miceli, 2010, p.9). Furthermore, the overall size of the sovereign wealth funds industry grew rapidly to reach an estimate of US\$1.5 trillion with an extremely high concentration of capital within the top five SWFs.

1.2.3 The High Rollers—'2005 to mid-2008'

Curzio and Miceli (2010), Truman (2010), Anderson (2009), and Hassan (2009) all argue that the year 2005 marks a watershed in the development of the SWF industry. I have systematically summarised them into four main analytical reasons. The first reason is the growing assets of SWFs. Commodity-based SWFs benefited from the healthy rise of oil prices, from less than US\$50 in March 2005 to more than US\$130 in July 2008 (EIA, 2012, accessed June 2012). When the oil price reached US\$140 from 2007, the Gulf Cooperation Council countries (GCC) could save up to US\$100 per barrel (Hassan, 2009, p.33). This has contributed to SWFs assets accumulation (Hassan, 2009, p.33). The overall size of non-commodity SWFs was tallied by the introduction of new members such as CIC and KIC. Moreover, Singaporean SWFs have enjoyed an impressive rate of growth during this period as well, GIC and Temasek Holdings were generating solid year-on-year profits at the rate 20.1% and 15% respectively (Curzio and Miceli, 2010, p.10). During this period, many emerging economies also had pursued policies that led to a high level of accumulation in foreign reserves, which then had been transferred to existing or establishing SWFs (Truman, 2010, p.2). This then led to a systematic cycle of growth in numbers of SWFs.

The second reason is an increased number of SWFs. Within three years from 2005 to 2008, 19 additional SWFs were established bringing the overall number to 53 SWFs,

contributing overall 35%, or in other words representing a staggering 55% increase from year 2004 (Curzio and Miceli, 2010, p.10). The third reason is that SWFs outward looking investment. SWFs have tended to invest abroad rather than in their own domestic markets, and have reversed the inflow of capital from emerging economies to developed countries. Hassan (2009) saw this phenomenon as a significant indicator showing a gradual shift of geo-political and economic power from West to East. Curzio and Miceli have summed up that between 1994 to 2004, SWFs invested only US\$1 billion in the European Union (EU), the US and the rest of the world while the majority of their portfolio was invested in Asia at US\$15 billion (Curzio and Miceli, 2010, p.11). From 2008 the trend reversed itself, within 10 months in 2008, SWFs had invested a staggering US\$41 billion in EU and US while allocating only US\$3.5 billion for Asian markets (Curzio and Miceli, 2010, p.11).

Lastly, the fourth reason is due to the concentration of investments in banking and financial sectors. High concentration of SWF investments in the Western banking and financial sector, seen as one of the most influential and effective capital-recycling machines, had accounted for 96% for all investments in the first three months of 2008 worth US\$58 billion (Curzio and Miceli, 2010, p.12).

In addition, Curzio and Miceli (2010, pp.11–3) also spotted three perceptible trends during this period in the attitudes towards SWF. Firstly, SWF was regarded as a negative force that might be in breach of national securities. The second trend saw SWF as a hero who can save the economic crisis by providing the needed liquidity to the market. And lastly, SWF was seen as a shady fund that needed better international framework to govern their conduct.

Negative attitude towards SWFs began in early 2006 until mid–2008, when SWFs such as Temasek Holdings, Istithmar World, ADIA, GIC and KIA started to diversify their

portfolios away from domestic and concentrated more on various well-known US and EU's financial institutions (Curzio and Miceli, 2010, pp.12–3). Truman (2010) argued that the negative attitude towards the foreign funds became materialised in 2006 by Saudi-owned Dubai World and Russian state owned Gazprom (Truman 2010, p.2). The former was seen as a threat to national security from its attempt to purchase US ports, while the latter's expansion in Europe as it had entered the UK and Denmark after it had successfully penetrated Italian and French markets was seen as a peril to Europe's energy security (Truman, 2010, p.2; Gazprom, 2007, p.9). Although Gazprom is not a SWF, but actually is regarded as a state-owned enterprise (SOE) (Truman, 2010, p.2), the investment recipient countries did pass on their unwelcoming attitudes towards the SWFs as they started shopping for Western financial institutions.

By the second quarter of 2008, there was evidence that many governments had begun to change their attitude towards the SWFs. At the height of the sub-prime crisis, SWFs were seen almost as 'lenders of the last resort' (Curzio and Miceli, 2010, p.13). This view was harmonious with Truman (2010), Anderson (2009) on the idea of saving a crisis by tapping the money from SWFs and other central banks around the world. Hassan (2009) explained that the SWFs could actually help stabilise the financial market.

lastly, the third trend was the reactions of the international institutions and the EU in 2008 in response to the growing impacts and concerns of the SWFs, which were the European Commission's guidelines for SWFs and the Santiago Principles initiated by the IMF (Curzio and Miceli, 2010, p.13).

To conclude, within the short period of four years from 2004 to 2008 the numbers of the SWFs increased from just 34 to 53, with the portfolios under their managements

from nearly US\$900 billion in 2004 to between US\$3.3 and US\$4 trillion at the end of the year 2008 (Curzio and Miceli, 2010, p.13).

1.2.4 Rethinking and maturing—‘mid 2008 to present’

From the second quarter of 2008, assets under the management of SWFs decreased dramatically in value, and in some cases were almost totally wiped out. For example Norway’s Government Pension Fund-Global (GPF-G) experienced a loss of 23% in the year 2008, Singapore’s GIC reported a loss more than 20% of overall portfolio ending the March 2009, while ADIA had suffered a negative return of 25% (Truman, 2010, p.19).

CIC had also suffered substantial loss over its initial investments in Blackstone and Morgan Stanley of 74% and 58% by the end of 2008, but fortunately for its board, the overall portfolio could still realise profit due to the low level of exposure and small size of its international portfolio (Financial Times, 2012a, 2012b, accessed May 2013).

Such huge losses were mostly due to SWFs unprecedented interests in the financial sector, which had continued to fall till the end of 2009, and some needed a further capitalisation and diluted the shareholders ownership percentage. This had caused a change in investment strategies all across the board. Many SWFs saw this as a wakeup call to go back to basics and diversify their portfolio in a much more conservative way.

Many SWFs had started to invest in commodities and stayed away from the equity markets, especially those in Western markets. Truman (2010) pointed out that many central banks gradually began to shift their holdings from the US Treasury to gold¹⁴, which could see the SWFs follow the same route of lowering their bonds and equities ratio. Anderson (2009, p.84) on the other hand, argued that the SWFs had already started to feel that losses

14. Weiner (2010) confirmed that central banks and SWF have diversified their assets towards gold reserve instead of conservative investment such as US treasury bonds.

in 2008 did look like an opportunity, but there were hundreds of opportunities elsewhere that could generate much more lucrative profits with a more favourable level of risk.

Anderson (2009) argues that that SWFs had turned into a group of exclusive clients and partnerships with hedge fund and private equity, and that some SWFs had adapted this strategy even before the credit crunch crisis (Anderson, 2009, pp.76–7). Examples include the US\$4 billion stake in JC Flowers by CIC and the capital injection into TPG Capital by GIC (Anderson, 2009, p.77). Weiner (2010) describes this as a business activity of 'shadow markets' in which the business-savvy hedge funds partner with cash-rich SWFs to take over leveraged buy out businesses (LBOs) in private equity or troubled firms, leaving the equity market behind, since it was much more lucrative and much more controllable due to the lack of regulations from authorities (Weiner, 2010, pp.36–7).

Many commodity-based SWFs of Middle Eastern origins diverted some of their portfolios to rescue domestic markets and state-owned projects. This was also in-line with their government's interest to turn the attention back to domestic matters. The best example was the rescue of Dubai World and Nakheel's Sukuk in 2009 by the Dubai Financial Support Fund, which the latter belonged to the Government of Abu Dhabi, worth US\$20 billion (Department of Finance of the Government of Dubai, 2010, accessed August 2011; Gulf news.com, 2009, accessed June 2012).

Since the economy began to pick up in 2010, capitalising on a more welcoming attitude towards them, many SWFs began again to acquire equities in Western markets, as well as seats on the boards of those firms. In his report to the US Congress in September 2010, Michael F. Martin wrote that in 2007 SWFs such as CIC chose to give up its seats on the boards of directors of Blackstone and Morgan Stanley (Martin, 2010, p.9). This, however, changed as CIC had reversed that decision and had 'retained the option to appoint

someone to boards of some of its more recent investments' such as the GCL-Poly Energy Holdings Limited and South Gobi Energy Resources Limited (Martin, 2010, p.9). This had seen some mixed and confused attitudes by the authorities and the regulatory framework that had been initiated earlier, such as the Santiago Principles, in which they had tried to construct a proper guidance for SWFs and their investments, while also keeping the trend of protectionism away from the market.

Nevertheless, the uncertainty in the markets from 2010 until the time of writing made policy makers and leaders reluctant to pursue tougher measures against SWFs. For example, the US policy makers were warned that the regulatory constraint could 'precipitate a period of global financial protectionism' (Martin, 2010, p.11). There were also ideas to mitigate the fear of SWF while also protecting more of United States interests such as eliminating the tax-exemption for SWFs while at the same time making sure that US financial institution can also enjoy the same freedom and access to countries of SWF owners (Martin, 2010, p.11). The year 2011 saw some SWFs move into a new territory of investment. Being more mature with a much more balanced portfolio—lessons learned during the credit crunch crisis, they allied themselves with Western leading financial institutions to provide the liquidity to markets in the form of capital injections, corporate bonds or even short-term loans.

To conclude, after July 2008, many SWFs had suffered huge losses, especially on their investments in Western financial institutions, which saw their future-projected size decrease substantially. Losses came with the valuable lessons for SWFs to adapt their portfolio and investments strategies, that saw many of them move away from the equity market into commodities, real estate and LBOs. On the other hand, some funds chose to divert the capital back home to cope with the consequences of the sub-prime. Losses

during the sub-prime crisis also had changed attitude towards SWFs in general—from predators to market stabilisers. Despite the welcoming atmosphere from recipient countries, the overall economic environment had made the road towards recovery a rather difficult and tricky one—for instance, uncertainty within the financial markets, unprecedented level of national debts of the Western economies, tensions in the Middle East and African countries, US unfinished business in Libya, Afghanistan and Iraq and the recent run of commodities such as gold, from around US\$1400 to US\$1800 had confirmed that SWFs' changed strategies to diversify were likely to be a winning formula at least for the time being.

Conclusion

The chapter offered us three crucial insights. Firstly, SWFs are not new, they have been with us since the 1950s, and they are going to be very important both in the area of global finance and politics due to their increasing sizes and numbers. The second insight is that SWF is seen by nation-state as an alternative strategy for maximizing or preserving wealth, especially for a country that has large amount of foreign reserves or entitles to a steady income from either taxing or selling natural resources. More importantly, many investment recipient countries and international organizations have already started to assess and formulate the guideline and regulation to cope with the state-owned-funds. Lastly, the chapter gave us the overall idea of scope and limits of what to be discussed or questioned within IPE. This will also serve an important foundation of knowledge before the dissertation start discussing and analyzing Chinese SWFs. Chapter Two now examines literature that explains SWF from different perspective, starting from the financial and

macro-economist approach to realist interpretation of SWF. Neo-liberal approach also will be examined, before discussing literature of SWF and the case of China.

Chapter Two:

Economic and political theories of SWFs

Sovereign Wealth Funds have been known for more than half a century, if mostly by other names. They were known, for instance, as stabilisation funds, wealth transferred funds, government investment vehicles or even as government-linked-companies (Hassan, 2009; Curzio and Miceli, 2010). A specialised literature on the SWFs evolved only since 2005, when Rozanov coined the term. Since 2005, the number of contributions from financial analysts, economists, think-tanks and political scientists has grown rapidly. The vast majority of this literature is concerned with EMEs, especially China and the oil-rich countries. Naturally, considerable portion of the research tends to be descriptive adding new data and information on diverse SWFs, especially the Chinese SWFs which are among the larger and least known. Theoretical contributions to the debate are more limited. The result is a fragmented debate, mirroring partly the great diversity of SWFs.

This chapter presents a review of the different theoretical lenses through which the SWF phenomenon has been approached. The vast majority of SWFs research draws on broad theoretical traditions to discuss specific policy or historical questions: Why do states create SWF? What is the impact on these funds on relations between states and/or on the markets; how states should react to these funds. There is a clear distinction to be made among those who take a macro-political or economic approach to the topic, and who seek to treat the SWF as a phenomenon, and the more varied and details studies of specific SWFs. The latter often argue that a one-theory-to-fit-all is inapplicable in this case.

Nevertheless, the nuanced, country-by-country approaches do fall ultimately into one of the grouping suggested in this chapter.

I begin this chapter with a discussion of the financial economic literature. I then discuss political science literature, including realism, Neo-liberal and other Political Economy approaches. My conclusion that much of the literature tends to be speculative; it concerns with possible behavioural traits of SWFs. In reality, as will show in this thesis, the Chinese SWFs were competitive bureaucratic enterprises concerned primarily with demonstrating their value vis-à-vis each other to the Chinese leadership, while seeking to draw on increasing resources under their disposal. This type of discussion about the bureaucratic nature of these SWFs is still to be had in the literature.

2.1 Financial and macro-economic approaches

Early literature on SWF had been written primarily by financial analysts and business journalists. Some of this literature is exploratory and descriptive, discussing issues such as sources of funds, investment portfolio and performance. Other literature is more analytical in perspective, analysing the impact of these funds are having on financial markets and business environments. The latter analysis tends to centre on questions of asset allocations (Gintschel and Scherer, 2009), performance (Bortolotti et al. 2010), type of asset class (Jen, 2007a; Jen, 2007b), risks and costs of excess reserves (Zhang He, 2009; Cognato and Altbach, 2008), the rationale for setting set up SWF (Rozanov, 2005; Allen and Caruana, 2008) as well as rates of returns of SWFs compared with private funds.

In 2005, in a seminal contribution Rozanov (2005) pointed out an important shift in the treatment of financial assets by a number of countries that accumulated large trade surpluses. He notes that some countries have opted to shift reserve from their central banks

to newly created specialised investment funds. He called this new type of funds, sovereign wealth funds (Ronanov, 2005, p.1). He noted, in addition, that not only were these publically owned and managed, but they have tended to shift national reserves from risk-averse liquid assets, such as government bonds, into a more diversified if typically risk-tolerant portfolios with various classes of financial assets (Ronanov, 2005, p.2). following in Rozanov's footsteps, other such state-sponsored funds were identified. Indeed, as we saw in the previous, current literature dates the origins of such funds in the early 1950s (Bahgat, 2008, p.1; Hassan, 2009, p.31).

The question that Rozanov and others have asked is why certain countries' have opted to experiment with publically held management companies (as opposed to say, appointing privately companies to manage their surpluses). A number of important macro-economic studies have argued that these funds were created as solutions to macroeconomic problems experienced by surplus countries including: inflationary pressures due to surplus of foreign currency reserves, over-investment in domestic markets, the cost opportunities of holding to low-yield assets such as U.S. Treasury bonds and over-reliance on natural extracts revenues. Specifically, excess of reserves generated their own class of into risks and costs. These included:

(1) Complicating Central Bank's management of monetary policy. Excess reserves have undermined the effectiveness of Central Bank's measures in controlling money markets, disrupted exchange rate and transferred inflationary pressures onto the domestic economy. The most vivid examples were failed attempt at sterilisation's of domestic money supply due to massive capital inflows on the anticipation of making profits of high-yield bonds (from the sterilisation instruments) along with the likely appreciation of exchange rates of domestic currency. As a result, in many cases, sterilisation policies did

not decrease domestic money supply as planned and forced, as a result, central banks to attempt deeper rounds of sterilisation combined with active intervention in the exchange regime (Zhang He, 2009; Cognato and Altbach 2008; ECB, 2006, p.16-7).

(2) failed sterilisations incurred further costs as well as the amount of yields paid on sterilisation instruments exceeded those on foreign assets (Allen and Caruana, 2008, p.10; ECB, 2006, p.16). At the same time, the yield rate on US Treasury Bonds were deemed relatively low. In addition, excess reserves have led to appreciation of domestic currencies further reducing the yields of foreign currency denominated central banks assets.

A literature emerged (Anderson 2009; Curzio and Miceli, 2010; Park and Estrada 2009), arguing that specialised funds were created precisely to combat the adverse effects described above. SWF were tasked therefore with the following: (1) Wealth management for later generations (mostly established by countries with rich natural resources as an insurance policy against resource depletion); (2) Counter-cyclical financial instruments. In other words, they were tasked with absorbing temporary current account surpluses during booming commodity prices and were used in addition as a form of hedge against the fluctuation of the prices; (3) Serve as specialised risk management tools for the countries with excess reserves seeking higher returns on their investment (e.g., emerging economies, particularly Asian economies accumulating excess reserves following the Asian economic crisis in 1997).

A separate literature examined the funds' performance and utility over the long-run. With its tools in measuring and calculating, the approach excels in testing out how SWF perform against other mainstreams investors in the market which will also give us the ideas of the impacts to the funds activities. Analysis by Stephen Jen of Morgan Stanley

shows that SWF stand out as investors in financial market for the following reasons—(1) sovereign; (2) high foreign currency exposure; (3) no explicit liabilities; (4) high risk tolerance and (5) long term investment horizons (Jen, 2007a, p.1). Yet, he argues, there are great similarities between SWFs and other mainstream financial investors such as pension funds and hedge funds, considering from the attribute of nature of their portfolios. A view supported by Bortolotti et al. (2010, p.3) who see similarities between SWF and the likes of hedge funds and pension funds.

Jen (2007b) pointed out, in addition, the impact of SWF on global financial flows from emerging markets. He estimated that SWF's investment is likely to cause a rise of 35 bp in long bond yields in the US and lift the global P/E ratio by up to 10% (Jen, 2007b, p.6). More importantly, he argued that the changes of identity from 'creditors to owners' could lead to financial protectionism in near future as recipient countries look to protect their valuable assets and that issues of transparency and accountability will be vital to the development of SWFs (Jen 2007b, p.7).

Gintschel and Scherer (2009) studied asset allocation commodity-based SWFs, predict that SWFs from oil exporting countries will continue to create significant impact to the global financial markets, considering that there are still an estimated of US\$40 trillion worth of oil wealth left underground waiting to be added to today's US\$50 trillion dollars value in global equity markets (Gintschel and Scherer, 2009, p.216). More importantly, they argued that SWF proved to be a useful instrument for oil-rich countries in hedging their financial assets against the volatility oil price and able to keep higher rate of return on overall assets.

Goldeng et al. (2008, p.1266) argued that state-owned enterprises (SOEs) perform less well than private-owned enterprises (POEs) under similar market conditions,

moreover, SOEs and their managers were less willing to learn from POEs. They employ agency theory to argue that management incentives are the main reasons for the inferior performance in SOEs (Goldeng et al., 2008, p.1245). In addition, as performance of SWF or any institutional investors relies heavily on the human capital which formed their institutional capacity, the question then becomes whether state-owned investment arms such as SWFs may be unable to acquire and hold to top talents with first-class credentials and the necessary experiences. Park (2008, p.15), for instance, expresses doubts about the ability of SWFs' in-house investment staff to perform at the level of specialised investment vehicles.¹⁵ Park also believes that SWFs are plagued by the moral hazards syndrome as managers believe they will be 'bailed out' even if the investments occurred huge losses (Park, 2008, p.15). This further could retard SWF's performance.

Other Financial literature emerged aimed to test the hypothesis whether SWF are driven primarily by commercial or political objectives. Caner and Greenes (2010) study of the Norwegian SWF, Norges Bank Investment Management (NBIM) found that NBIM acted like 'a commercial investment fund dominated by profit motives, rather than political motives' (Caner and Grennes 2010, p.611). In their assessment, NBIM performed well compared with private funds even during difficult period when fixed income assets outperformed equities and, more importantly, NBIM showed no indication of being a destabilising force in the financial market (Caner and Grennes, 2010, p.611-2).

The impact of SWF on market prices and the companies they invested in is another area of research. Dewenter et al. (2010) found that the announcements of SWF's investments (divestments) carry positive (and equally negative) returns to the value of

15. Abdelal (2009, p.324) also worried about SWF's lack of institutional capacity which would make them rather inefficient investors. He argued that investing in strategic sectors such as heavy industry and high-tech firms requires long learning curves and lessons can be very costly, as with the case of ADIA (Abdelal 2009, p.324).

firms they invested in and that the reactions of market was ‘non-monotonic function of transaction size’ (Dewenter et al. 2010, p.277-8). Bortolotti et al. (2010) demonstrate that recipients of SWF investment have tended to yield positively abnormal stock price returns for the first three-day following the announcement of SWF investment. Interestingly, their analysis reveals that most of the firm that SWF invested would face a negative mean abnormal returns of up to -6.25% over two-years holding period, moreover, there is a correlation between the amount of stake SWF hold in the firms and the deterioration of the stock performances (Bortolotti et al, 2010, p.5). They used the 'Constrained Foreign Investor Hypothesis' to explain the poor performance of the foreign firms that SWFs invested abroad due to the funds' attempt to avoid the political consequence and backlash from regulators, and therefore, unable to properly monitor and pressure the firms to perform (Bortolotti et al, 2010, p.7). The thesis received further support from Wang and Yung (2011, p.800) who argue that state ownership has negative impact on market valuation of the firms invested —judging from their samples within the Chinese stock markets. This rather small sample of data, however, shows that the investors trust private companies more than those held or part-held by governments. Bortolotti et al. (2010) analysis reveal that out of SWF only acquired seats in 53 firms out of a possible 355 from their investments or only about 14.9% overall (Bortolotti et al. ,2010, p.5).

To recap, financial-economic analysis suggests that SWF may serve as a useful tool in stabilising trade-excess countries. Nevertheless, despite of all contributions above, an inadequate discussion on political dimension of SWFs and its inability to explain SWFs political motivation to establish the fund are the limitation of financial economic approach. Therefore financial economists has a rather limited space to operate when trying to explain

the bigger picture of SWFs, and therefore, it is best to be used in combination of other approaches in the analysis of SWFs, especially ones that carried 'political elements'.

2.2 Realist approach to SWF

The typical macro-economic approach alludes to, but avoid overtly political questions. Not surprisingly, the emergence of the SWFs phenomenon has attracted growing interest also among the policy making community and think-tank arena. An important strand of research, including some of the writers cited above, view SWFs as potential danger and disruption to the existing order. As Truman observes (2010, p.41) 'governments own SWFs, governments are political organisations, and it is naïve to pretend that they are not.' Truman's words are noted in particular by realists.

On the face of it, SWF appears consistent with the realist perspective in international relations. Realist theory is state centric; it views states as utility maxising actors operating under constraints imposed by the international system. As self-serving sovereign entities, states are likely to seek to deploy any means at their disposal, including military, political, diplomatic, but also economic and financial, to advance their interests in the international arena. The idea that large, and potentially power financial resource available to surplus-states such as a portfolio of foreign currency reserves, will remain in the hands of central banks to be used purely for monetary purposes appeared incoherent. They viewed the creation of such funds as a logical development of the realist logic of statecraft. Following this line of argumentations, realists tend to underplay the distinction between states and SWFs and view the latter as agent's of their states.

Since realists regard SWF as an extension of the state, they argue that these funds are tasked, first and foremost, in advancing state foreign policy goals, whereas commercial

interests are secondary. Alternatively, SWFs use company type of behaviour to maximize a country's return (Gilson and Milhaupt 2008).

Jonathan Kirshner (2009) argues that SWF can be used for three power politics policy goals. Yet, he concludes that despite some 'theoretical connections between SWFs and high politics', they are unlikely to become a major issue of national security (2009, p.301). Kirshner names the three policy actions as:

(1) Protective manipulation

Countries may use SWFs as a method of protective manipulation during time of crisis or 'those in distress in exchange for some political concessions.' For instance, it was reported during 2009 in the media that EU officials have tried to persuade the Chinese SWF to buy distressed EU sovereign debt. It was not clear what China would get in return, but a certain political gain would have been assumed. It is interesting to note in this context that China refused the EU's invitation.

(2) Strategic disruption

Strategic disruption is the act in which states using the assets of SWFs to achieve political goals to shake the system, and in effect, 'threaten to bring it down in order to extort concessions from other (states).'

(3) Subversive disruption.

An act of destroying the whole financial system in the eve of radical events.

Kirshner (2009, p.309) notes that any act of protective manipulation is likely to be followed with a counter measure. Strategic and subversive disruption are exceptional cases as in most scenarios the costs to the SWF country may be considerable.

Helleiner (2009) supports Kirshner's prognosis arguing that perception of SWFs' impact on geo-political order are overblown. Yet, he acknowledges that perception of SWFs potential damage to host country may play an important role in and by itself. Specifically, Helleiner argues Japan's foreign exchange reserves and China's State Administration of Foreign Exchange (SAFE) are much larger than most of SWFs. And yet, they have caused to date no disruption. Other significant SWFs such as Singapore, Kuwait, Abu Dhabi are 'close allies' of the US and are unlikely to use their financial might to destabilise the world economy. The same he argues is true for non-allied countries such as China. Indeed, the Chinese SWF provided a much needed liquidity during the time of credit crisis in US equity market which, for some extend, can be seen as a supportive role to the US economy and market prospect (Helleiner, p.302).

Hemphill (2009, p.555) list a widely held perception among recipient countries of how foreign SWFs might be pursuing political interests in their respective sovereigns. These include:

- (1) key strategic industries¹⁶ considered as a fundamental of national security are being transferred into foreign government controls;
- (2) those SWFs investments are not about profit maximisation but to achieve a strategic and political goals; and
- (3) the perceived threats of investments coming from SWFs of non-democratic countries.

Many scholars argue that lack of transparency is the real problem, because it leave out space for SWFs to operate in a strategic manners. CIC's purchase of 10% of blackstone

16. According to Hemphill, strategic industries are 'financial, energy, information technology, telecommunications, and transportation' (Hemphill, 2009, p.555).

in 2007, one of the world's largest private equity, is seen as a strategic investment (Sorkin, 2008, accessed July 2014). Temasek Holdings investments in Standard Chartered in 2006 and 2008, GIC's purchase in CITIC group in 2008 also viewed as a possible strategic buy for the two Singaporean SWFs. Abu Dhabi's Mubala 8.1% investment in Advanced Micro Devices (AMD), one of the world's leading Chip maker with defense department contracts, at US\$622 million in 2007, which later they increased the ownership in 2009 to 19.4% with another US\$314 million can also be interpreted as strategic investments by the Middle East's SWF (Epstein and Rose, 2009, p.116; Mubadala, 2009, p.18).

Considering that many of the funds are owned by authoritarian regimes (China, Middle East), the question of transparency is crucial. Lyons (2007) and Luft (2008) argue that SWFs could be used to acquire sensitive strategic assets (telecommunication, financial institutions, knowledge of sensitive industry, natural resources). Similarly, Jory et. Al argue that governments may use SWFs to 'acquire proprietary knowledge, patented technology, or trade secrets' (Jory et al., 2010, p.594, see also Teslik, 2008 and Markhiem, 2008) for discussion.

In the realm of business world today, we win and lose by the speed and accuracy of the information we have, therefore, the consequences of the lack of good governance has far reaching effects. SWFs fund managers who sit on top of valuable insider information, both domestically, as well as through targeted investment, internationally, are in very powerful position which, if they choose to, can trade those secrets into hundreds of millions of dollars in trading profits. As state employees, they are also likely to be protected from insider-trading laws. Moreover, issues of governance of the concern to the management of such large fund, especially when SWF can have such close connection with financial institutions. To give an example, Libyan Investment Authority (LIA) which

was established in 2006 and has been channelling its funds through world's top financial institutions such as Goldman Sachs and Societe Generale. It was reported that Goldman Sachs lost 98% of the LIA's \$1.3 billion investment, while Societe Generale has lost half of the \$1.8 billion of LIA's investment (Fontevicchai, 2014, accessed July 2014). To ensure further LIA funds, Goldman Sachs was reported to have offered US\$50 million in bribery to repair relationships with the LIA's top management (Palazzolo, 2011, accessed June 2012). The bribe was to be transferred to a third party investment firm called Palladyne International Asset Management BV, which was at the time run by the son-in-law of the head of the LIA (Rappaport and Legorano, 2013, accessed July 2014). In June 2011, UK prosecutors and US Securities and Exchange Commission (SEC) were conducting the US\$50 million bribery probe between Goldman Sachs and Libyan Investment Authority (LIA) (Palazzolo, 2011, accessed June 2012). After the fall of the Gaddafi regime, the new management team took over LIA and sued Goldman Sachs on the ground of mismanagement of LIA's funds helping the US Securities and Exchange Commission (SEC) with its bribery probe. At the moment of writing, it is believed that Goldman Sachs might once again decide to make a settlement rather than going to court (Rappaport and Legorano, 2013, accessed July 2014).

Felix G. Rohatyn, a former US Ambassador to France, made a comment in January 2008 that the state-sponsored funds might not exactly be seeking commercial gains but to gradually gain influence and he believed that there were political objectives 'over and above' the rate of returns (Sorkin, 2008, accessed July 2014). Senator Charles E. Schumer also expressed concerns that SWFs are susceptible to noneconomic interests, and that we should be concerned when the funds came closer to exercising control and influence (Sorkin, 2008, accessed July 2014).

The implications of such zero-sum perspective of the international political arena was that recipient states, many of which are be OECD countries, where realists are located, are well advised to treat SWF with caution if not suspicion. Besides the issue of transparency and accountability (to which I return below). On that basis Hemphill (2009, p.560-2) suggests that host states must protect themselves. He suggests they do the following:

- (1) Encourage transparency, accountability and good governance of the funds through the international working group (Santiago Principles);
- (2) Host investment countries should adapt its legal framework and monitoring agency to assess SWF investment and FDIs;
- (3) Use multilateral policies that welcomes SWF or FDI on equal terms (fair, if not fully free principles), and use bilateral agreement to negotiate reciprocal treatment from host investment countries and fund owner countries.

Jory, Perry and Hemphill (2010) add that it is vital for SWFs home countries to improve their disclosure in their investment objectives, portfolios, and performance reports in order to lower the resistance (Jory et al., 2010, p.601). More importantly, host investment country need to assess not only if the incoming investments might pose any geopolitical risk, but also with the same treatment for all and not discriminatory (Jory et al., 2010, p.602).

Realist-inclined theorists have tended to view SWF as a tool of foreign policy and a potential threat to the international order. While their ideas are widely discussed, to date there is no detailed study that shows that either all or some SWF were used clearly to advance strategic political interests as opposed to commercial and macro-economic

interests of states. Nevertheless, and fearing the worst, the Italian government has introduced measures preventing SWFs from owning more than 5% of equity in Italian companies (Bennhold, 2008, accessed June 2012). In Germany, SWF are allowed to own no more than 25% voting equity ownership in firms having 'strategic relevance' to the 'public order' or 'national security' (Biberovic, 2008). The German government is actively redrafting an update to its investment law that will establish a formal review process allowing the nation's executive branch to block SWFs or other large, state-sponsored investment agency company acquisitions deemed of 'strategic relevance' (Biberovic, 2008, accessed June 2012; Walker, 2008, accessed June 2012). Similarly, in North America, the Canadian government launched a review of its Investment Canada Act, and in December 2007, it issued guidelines clarifying the Investment Canada Act as it pertains to foreign state-owned enterprises (DLA Piper, 2008, accessed July 2009).

In October 2007, the G-7 finance ministers and central bank governors recommended (after pressure was applied by the United States and France) that the International Monetary Fund, the World Bank, and the Organisation for Economic Co-operation and Development (OECD) identify 'best practices' for SWFs in the areas of institutional structure, risk management, regulatory transparency, and accountability of the implementing authorities. The efforts were later taken up by the IMF to establish the International Working Group of Sovereign Wealth Funds (IWG) in 2008. The IWG has set out Generally Accepted Principles and Practices (GAPP) or the 'Santiago Principles' in which all major SWFs have agreed and joined in the drafting process (Koch-Weser and Haacke, 2013, p.34). However, GAPP is to be implemented only on a voluntary basis, and it will only be subject to provisions of intergovernmental agreements, and legal and

regulatory requirements, and subject to applicable home country law, if a SWF owner choose to implement the GAPP (International Working Group–IWG, 2008).

Many among the US and European policy makers and politicians are receptive to the Realist explanations for the rise and function of SWFs. They tend to view these SWFs in terms of a challenge posed by emerging economies (China, Middle Eastern, groups of countries such as BRIC). To give an exmaple, Senator Bayh, a US Senator from the state of Indiana, argued that his hometown firm, Magnaquench, a company which used to produce 80% of rare earth magnets for US laser guided smart bombs was bought by a Chinese firm that belongs to the son-in-law of Deng Xiaoping (US-China Economic and Security Review Commission–USCC, 2008, p.6). More importantly and crucially for Senator Bayh, this company closed its operation in the US in 2003 and moved all production to China, depriving therefore the US of a strategic asset (USCC, 2008, p.6).

State capitalism

A separate but related literature placed the development of SWF within a broader contest of the development of authoritarian regimes committed to capitalism or state capitalism. According to this perspective, the traditional Lockean model (Van Der Pijl, 1998) of state that is associated with OECD countries and hence with advance capitalism is supplement with either single-party states (China, Vietnam) or authoriatian regimes (Saudi Arabia, the gulf states) and/or quasi democratic states (Russia), still committed to capitalism. For those regarded SWF as a representation of state capitalism (lyons, 2007; Anderson, 2009; Aizenman and Lee, 2007), they see the transforming nature of state-nations in trying to perform as a key actor in the economy in allocating resources through SWF. The theory is that whether the traditional model of advanced capitalist state

decentralized key decisions of resource allocation to the private sector, in state capitalist societies not only does the state act as regulator but also as an important market player. SWF are viewed as important instrument in this scenario.

Indeed, SWF offer many advantages when viewed from such perspective. As state capitalist economies still maintain a private economy, SWF may be preferable tool of state intervention because they have a competitive edge over private sector actors, including very large ones, considering that the state is regulator and owner of large financial means. SWF can also benefit from investing abroad (whereas domestic private investor may sometimes be barred from doing so) as it can choose to invest in the country that practices liberal principles under market economy. More importantly, in the last three decades the world has gone through a major period of financial deregulation, and the preaching of neo-liberalism which encourage free trade, privatisation, opening of markets and enhancing the role of private sector. This also mean the tariffs and various protectionist policy that has been discouraged under neo-liberal regime provides a cash-rich SWF a unique opportunity and a fertile environment to grow. The latest figure from Sovereign Wealth Fund Institute, global SWFs are now worth more than US\$6.7 trillion (Sovereign Wealth Fund Institute-SWFI, 2014). As a result, more and more countries establish SWF or at least discuss the possibility of setting up one, from a few in 1960s to more than 70s in 2014 (Curzio and Valeria, 2010; SWFI, 2014).

With many functions SWF can perform as we discussed earlier, combined with the ability to accumulate wealth, SWF can be seen as an important tool in the hands of state seeking to raise their profile in the international pecking order. Gerald Lyons, chief economist in Standard Chartered, is one of the first to point out the rise of SWF as practice of State Capitalism (Lyons, 2007). He argued that the SWF have focused investments into

five strategic sectors: telecommunications, energy, media, financial sector, intellectual property related and are all to be used to boost or strengthen SWF owners' strategic agenda (Lyon, 2007, p.14). Lyons maintains that there is evidence for the use of some SWF investment as a way to open access to market, with example of how China was able to regain access in various African Countries (Lyon, 2007, p.16). Anderson (2009, p.17) argued that SWF are exercising 'soft power', and may challenge eventually US's dominance in the global economy. Within this perspective, scholars such as Aizenma and Lee (2008) has also dragged SWF into the discussion of a new tool in mercantilist policy in order to promoting trades and limiting imports, especially for the large and power countries like China.

2.3 The Neo-liberal approach

A separate literature that may be described as neo-liberal in orientation is less concerned with state power and more with potential market distortive mechanism that state actor in the guise of SWF may induce (Beck and Fidora 2008; Park 2008). Neoliberals are also concerned with the potential mismanagement of funds subject to extraneous political interests, lack of transparency, accountability and good governance (Park 2008; Ang 2010; Balin 2009; Truman 2010).

Beck and Fidora (2008) examined the impact of capital flow from US treasury bonds and Eurobonds to riskier assets with higher returns. They argue, however, that the flow of funds from low-yield government bonds into high risk assets in developing countries perpetrated by SWFs has been a positive development since it gradually removes

the favouritism¹⁷ or seignorage of ‘major reserve currencies’ (Beck and Fidora 2008, p.353). This continued trend should result, they argue, in a more competitive and rational pricing of assets and currencies in the global financial market. They show that while the US has suffered some a degree of net capital outflows from bonds class assets, it received massive inflow of equity capital due to the size of the US equity market which is the equivalent of 45% of the global market capitalisation (Beck and Fidora 2008, p.353). They show that SWF’s were responsible for the EU suffering a net capital outflow as well. Japan and emerging countries are likely to benefit from the diversification of capital through SWFs (Beck and Fidora 2008, p.353).

Beck and Fidora (2008) argue that SWFs investment strategy differs considerably from that of central banks, as the state-sponsored-funds aimed at much higher rate of returns through sophisticated portfolio management, which includes a much wider range of financial products in comparison to central bank's assets which has to focus on liquidity and the stability of the assets. Like realists, they believe that SWFs investments decisions may not be driven only by commercial interests, and hence may lead to price asset distortions (Beck and Fidora 2008, p.358). Interestingly, the argument remains largely theoretical with no evidence brought to bear that SWFs have created such negative outcomes.

Nevertheless, other scholars went even further and claimed that SWFs could even pose a systematic risks to the market they invested in, and in extreme extent, to the global financial system. Park (2008, p.15) argued that governments may be tempted to use their

17. What Beck and Fidora (2008) refer to 'favouritism' of the major reserve currencies were the practice of central bankers around the world, especially those with excess reserves. The central bankers traditionally invest in highly liquidated assets with low-risks, those assets are usually US treasury bonds and Eurobonds. Therefore, despite the future economic prospect of the US or European countries might not be in a positive trajectory, might possibly have a lower-than-expected growth, or unlikely to have stronger currency, the central bankers, due to their practice, still purchase US and Eurobonds. This of course give US and EU artificial demand for their bonds, and hence they can even offer less than competitive rate of interest, and still able to find buyers from countries with trade surpluses.

SWFs to buffer the economy during time of crisis. This could result in dramatic losses to the SWFs. turmoil. A mistaken decision by one domestic SWF not only could pose systematic risks to its own financial markets, but also send the wrong signals to the whole SWF industry, triggering panic and shock to the system. To give an example, during 2007-2009, global SWFs had lost the fifth of their assets with an estimated of US\$600 billion (TheCityUK, 2012, p.8), Weiss argues that had the losses been concentrated in particular industry or sector, the aftermath could lead to the destabilisation of the recipient's market Weiss (2008, p.14).

The idea that public funds are more likely to be mismanaged than private one is accepted by others as well. Ang (2010). Ang claimed that SWFs might be tempted to invest for political reasons excessively in their domestic economy. Excessive domestic investment by SWFs capital in domestic market could lead to damaging a country's international credit position, capacity and prospects of other 'non-export oriented sectors' and more importantly, it would result 'consequent inflationary pressures'. In one extreme case of Timor-Leste's Petroleum Fund, which has an asset size portfolio eight times greater than the country's GDP (US\$4.1 billion vs US\$0.5 billion) (Ang, 2010, p.9). If such fund would devote considerable resources to the domestic economy, it would lead to 'severe economic distortions, endemic corruption and rampant embezzlement' (Ang, 2010, p.9). Balin (2009, p.10) argue that commodity-based SWF have tended to confuse wealth management with domestic fiscal policy. On the other hand, non-commodity based SWF would need to generate very high rate of returns due to cost of sterilisation, and therefore, would be likely to invest in high-return risky assets (Balin, 2009, p.10). Truman (2010, p.39) argue that domestic political forces 'led to the dissolution of the funds', as was the case of the failed Ecuadorean Stabilisation Fund and Nigeria's Petroleum fund.

Transparency and accountability plays an important role in the Neo-liberal argument. It is generally assumed that opaque SWFs are more prone to political pressures while funds managed like private fund will be focused on profit maximising (Goldeng et al., 2008, p.1250). Weiss (2008, p.13) argue that the problems with transparency also made the work of assessment very difficult for policy makers or interest parties to identify any mismanagement or corruption (Weiss, 2008, p.14).

SWFs are more prone, argues Truman, to conflicts of interests (Truman, 2010, p.54–5) particularly when SWFs' wishes are incompatible with an invested firm's actions. He used the example of disputes between ADIA and Citigroup. In this case, ADIA disagreed with Citigroup's decision to sell shares in order to raise cash, as it would automatically dilute ADIA' holding (Truman, 2010, p.55). As a result, ADIA made a case against Citigroup—accusing it for 'fraudulent misrepresentation' (Truman, 2010, p.55). Truman (2010, p.55) regarded this incident as typical of the conflict that may occur between foreign government investors and US regulated financial institution, therefore, call for the development of US framework and regulation to prevent such incident.

Neoliberal thinkers agree that some of the problems associated with the potential market distorting impact of SWF may be resolved through greater transparency. Beck and Fidora (2008) maintain that in order to achieve good governance and minimise the potentials of market distortions, SWFs need to disclose their asset allocations and being transparent about investment motives. Mason (2008) studied the way to increase SWFs' investment performance while in the meantime also decrease the political elements the funds might carried. He made the case that the funds are prone to 'political influence' from their respective governments, and called for two conditions that if me were to improve SWF performance. Firstly, he argued that when SWFs do invest abroad they are free from

domestic obligation and certain degree of political pressure such as keeping jobs on loss-making companies (Mason, 2008, p.1322). Secondly, SWFs should concentrate on portfolio style when investing abroad due to limitation and regulation of host countries they invested in, hence minimise the risk and increase efficiency (Mason, 2008, p.1322).

2.4 The Chinese SWF

Realist assumption about the establishments of the Chinese SWFs are not without reason. The team of advisers that proposed the idea to the Chinese leadership had to phrase their proposals in the language of power politics that is understood by politicians—which dutifully they did. But not all leaders and interested parties would limit themselves only to the realist approach of the utility of SWF. The Chinese leadership had to be convinced of the economic rationale for A SWF as well (Shih, 2009, p.336). Specifically, the set of questions they raised were how can a SWF help China resolve problems associated with China’s growing foreign reserves and how could they help to deal with problems of investment, economic bubbles and so on. Chinese economists raised, in other words, precisely the sort of macroeconomic problems that were discussed above (Interview: C1, 2010).

In reality it was Singapore’s experience with SWFs that proved decisive. Singapore two SWFs are the Government of Singapore Investment Corporation (GIC) and Temasek Holdings¹⁸. Since its inception in 1974, Temasek Holdings was responsible to restructure key industries inherited from the colonial era as well as placing itself as a holding

18. Temasek Holdings was established in 1974 with the mandate of managing shareholding of Singapore’s government-linked companies (GLCs) in order to maximise value for shareholders with the long-term investment horizon (Curzio and Miceli, 2010, p.70). Singapore Ministry of Finance (MOF) is the sole owner of Temasek, and received dividends from its profitable operations (Hassan, 2009, p.58). The fund started with the US\$245 million endowment fund from the MOF in 1974, by the end of March 2011 the fund reported a value of overall portfolio of S\$193 billion or approximately US\$160 billion (Hassan, 2009, p.58, Temasek, 2011, p.8). In growth rate terms, Temasek has achieved a staggering 17% compounded annual return since its inception, and a solid 7% annually in the past five years despite volatility in financial markets since the Sub-prime crisis (Temasek, 2011, p.19).

company that oversaw all strategic firms acquired by the government. Meanwhile, Singaporean government has created strong foundation for the domestic firms to grow—stable politics, highly efficient and innovative administration, and investor friendly legal and business environment (Interview: S1, 2009). With the introduction of Asian Currency Unit (ACU) offshore market in 1968 (Palan, 2006, p.33–4), the city-state enjoyed an influx of excess capital from Western economies, especially the US who was also on the mission to exert political and economic influence in this South East Asia while the Singapore itself can gain better political stability by using the US as a deterrent of pressures and threats from Malaysia and Indonesia (Dent, 2003, p.255).

With sound and prudent fiscal management as well as pro-business and adaptive state-led policy, Singapore was successful in changing itself from low-valued manufacturer into a service provider and high-value added sector with the help of foreign direct investments (FDIs) and the growing capital and financial markets. The business partnerships of MNCs and SWFs¹⁹ allowed Singapore to undergo a rapid industrialisation and passed on the growing room for local business through subcontracts (Low, 2001, p.418). During this period, GIC was set up and to exploit the fortune Singapore has been accumulating through fiscal surpluses. It was incorporating with the task of maximising its portfolio as well as performing as caretakers of state's central provident funds. Moreover, government direct the use of GIC and Temasek Holdings in a highly positive way to the growth of domestic financial markets, it encourages the use of domestic bonds and the incentive the offshore market can provide (Interview: S1, 2009). Hence, before the world ever heard of the world sovereign wealth fund, Singapore was already a leading tiger for developmental state model with a pedigree of a strong domestic economy towards

19. Before the term SWF has come into use, both GIC and Temasek holdings were regarded as government-linked-companies (GLCs).

Knowledge Based Economy (KBE) and two large investment funds to venture abroad to secure needed resources under the policy Singapore INC (Low, 2001, p.426). Singaporean SWFs have always been strategic; Temasek Holdings and its subsidiaries were responsible for nurturing and acquiring national champions²⁰ in various strategic sectors such as telecommunication²¹, banks and energy. GIC has been very active in buying top real estate globally, with its stronger weight in neighbour countries (GIC, 2011, p.11).

In addition, the two SWFs and their subsidiaries²² have made the good use of state-owned banks, domestic bonds and offshore financial markets to strengthen their financial positions (Interview: S1, 2009; Interview: S2). The subsidiaries of SWFs are also very important to help Singapore secured its prized assets, since they can be used to perform a coalition and buy any firms, which belonged to sensitive sectors²³ as a way to gain majority votes through multiple entities (Interview S1, 2009). At times, the sophisticated nominee model was used to get around the host-country's legal and restrictions. The best case to explain the use of nominee was the case that Temasek Holdings purchased Thai's Shin Corporation in 2006 (Lhaopadchan, 2010 p.16-7). In recent years, GIC and Temasek Holdings have been very active in acquiring assets in top financial institutions²⁴, especially during the subprime crisis. Despite their losses, the two SWFs have developed a new

20. Temasek Holdings' portfolio concentrates in many national champions, or in another word, firms that have the largest market share in their own sector, for instance, Singtel, DBS Bank, PSA international, SMRT Corporation, Singapore Power and Neptune Oriental Line (Hassan, 2009, p.59).

21. Temasek Holdings is also known of having an appetite in telecommunication sector from the infamous acquisition of Shin Corporation that has caused a political stir between Thailand and Singapore in 2006. It is one of the biggest investor in this sector in the Southeast Asia, besides Singtel, it holds a majority stake in Singtel, STASchippac, Thailand's Shin Corporation as well as being a sole owner of MediaCorp and Singapore Technologies Telemidia (Temasek, 2011, p.87).

22. Temasek Holdings also has indirect stakes in many foreign firms under its companies, which it called Temasek-Linked Companies (TLCs) such as Singtel's ownership of Optus as well as Singapore Airline's 49% share in Virgin Atlantic (Hassan, 2009, p.59).

23. If divide by sector Temasek's portfolio can be categorised as followed: Temasek invested 36% of overall assets in financial services; 23% in transportation and industries; 22 % in telecommunications, media and technology; 11% in life sciences, consumer and real estate; 3% in energy and resources and 5% in others (Temasek, 2011, p.17).

24. The biggest chunk of Temasek's portfolio or 36% of overall assets is concentrated in financial markets with its key investments such as PT Bank Danamon of Indonesia, NIB Bank of Pakistan, and Standard Chartered of Britain (Temasek, 2011, p.84).

relationship with those financial firms and form joint venture to invest in new developing markets or co-issue corporate bonds. The latest developments were the news of Temasek Holdings that it will turn itself into a private fund manager, which accepts investment from individuals (Interview: S1, 2009).

Singapore's grand strategy for the SWFs was interpreted in China to be as follows: (1) create and strengthen domestic national champions; (2) use the capital resources to nurture smaller subsidiaries; (3) working with government to create and expand domestic financial markets with incentive of offshore and tax breaks, while also exploit this rich resources of cheap loans to expand domestic subsidiaries (Interview: S1, 2009; Interview: S2, 2009; Interview: S4, 2009); (3) secure needed resources as well as other strategic assets which can give Singapore the economic security it needs (Interview: S2, 2010; Interview: S4, 2009). In the meantime, SWFs then could act as a leader to explore other new markets²⁵ and help Singaporean local firms to acquire new opportunities (Low, 2001, p.421; Interview; S4, 2009; Interview: T3, 2009); (4) renovate business strategy and move into high value-added service sector while also improving the domestic human resources; (5) Singapore then need to keep its edge on championing the status of its financial markets so it could enjoy more capital inflows, while try to manage for fiscal surplus (Interview: S1, 2009). The growing size of SWFs then can be further channelled to domestic economy when needed or help to fund infrastructure projects.

25. Geographically, Temasek's portfolio is diversified throughout the world. Asia is the main destination and accounted for 77% of overall portfolio, 20% is invested in North America, Europe, Australia and New Zealand; the last 3% is allocated in Latin America and other non-Asian growth regions (Temasek, 2011, p.8).

Conclusion

The literature on SWF is extensive and varied. The three principle schools of thoughts have dominated the discussion are financial economists, realist-mercantilists and neo-liberals. But despite the existence of large literature on the subject, and a related growing literature discussing the Chinese SWFs, much of the discussion has tended to raise issues of principles, whether or not the SWFs are driven by economic or political interests, whether they should be viewed as a potential threat to the current order or perhaps they are benign.

In the case of China, it is clear that all these considerations were discussed at inception. The Chinese leadership had to be convinced of the political value of SWF as well as their economic value (Interview: C5, 2009). But whether or not the Chinese SWF would become essentially a political instrument in the hands of an authoritarian government or would develop into commercial enterprises managed by cold calculating economic logic is an historical question that cannot be answered by theory.

Chapter Three now examines core foundation of the dissertation, namely, China's foreign reserves, its problem and political struggles prior to CIC. It will show the historical development of China's reserves, costs and risks of having excess reserves. More importantly, the chapter will also the bureaucratic competition within Chinese monetary system which leads to the establishment of CIC in September 2007.

Chapter Three:

China's foreign reserves, its problem and political struggles prior to CIC

"The rise in foreign reserves demonstrates the strength of China's economy. But the extraordinary growth has also had some negative impact and brought with it foreign exchange rate risk" (China Daily, 2006).

—Xiao Zhouji, Professor of Peking University

Since the 1990s, foreign reserves have become one of the most important sources which governments use to fund their prospective sovereign wealth funds (SWFs). In many cases it was the result of trade surplus, especially for funds in growing economies. China, with its double-digit growth in the 2000s, saw its reserves accumulate to the point where it had become a problem for the central bank to control domestic money supply. With its tight currency control and strictly managed capital account, issues of inflation and costs of sterilisation had forced the monetary authorities to think of other alternatives.

Setting up China Investment Corporation (CIC) in 2007 in the wish to solve this macro-economic problem had definitely drawn attention to focus on the fund instead of the source itself. However, considering the potential of CIC in getting more investment funds from the growing reserves, it is important to understand the historical development of the foreign reserves, monetary policies that influenced the wealth, and lastly the politics behind decisions of how the reserves should be managed in the first place. Understanding these issues will greatly enhance our insights on the political economy of CIC.

In order to achieve this understanding, this chapter is designed to discuss three main points; China's foreign exchange reserves itself, problems that emerged from possessing too great amount of it and the political struggle over the management of reserves. The chapter is then divided into three smaller sections, to further discuss each point introduced above.

3.1 Developments of foreign reserves and monetary policy

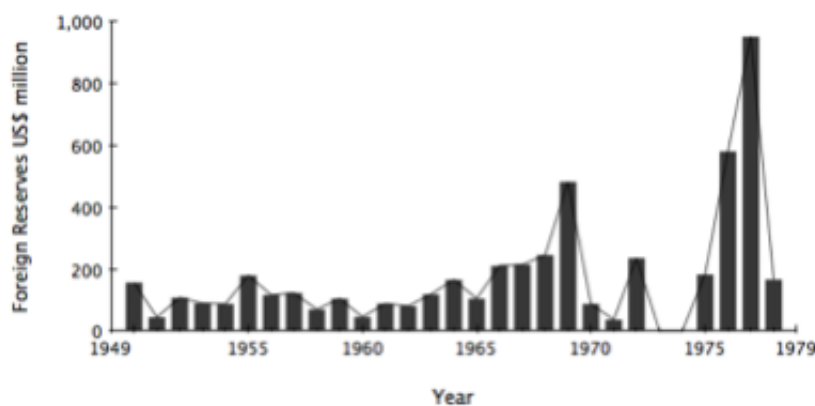
Despite its long history of trade and commerce with the world, China has only been enjoying a meaningful amount of foreign reserves in the past 20 years, especially the last decade. Since the establishment of the PRC in 1949, China has gone through various adversities and difficulties to develop its financial and monetary system. Despite some failures and drawbacks, Beijing's leaders have learned from their mistakes, and slowly accumulated their own style of monetary, trade and fiscal policies by having the ability to manipulate the value of domestic currency at its core.

This section aims to explain key moments and policies that were built around their experiences, which transformed China from one of the poorest nations into the second largest economy, with an approximate US\$3 trillion in foreign reserve. Moreover, it will also describe the growing concerns and issues attached to the accumulated wealth. The section contains four subsections that represent four historical periods. It starts from Chairman Mao's era in 1949 to 1978, then succeeded by Deng Xiao Ping, who laid a foundation for today's modern China. The third subsection then examines from 1993 towards the entry of the WTO in 2001. Finally, the last subsection will discuss of how the level of foreign reserves has become both a blessing and a curse for China's monetary policy since 2002.

3.1.1 Chairman Mao and central planning—'1949 to 1978'

During this long period, China could only manage to accumulate modest amounts of reserves, all in the range under US\$1 billion dollars (SAFE, 2011). This was mostly due to the centralised economy²⁶, based on Chairman Mao Tse-Tung's interpretation of marxian economy. Hall (2004) argued that the idea of central planning had a far-reaching effect on trade and financial modernisation, which then prevented China from effectively accumulating its foreign exchange reserves.

Figure 3.1: China's foreign reserves from 1950 to 1978



Source: State Administration of Foreign Exchange–SAFE (2011, accessed May 2013)

There are four main phenomena, which are considered as the effects of central planning. They had both direct and indirect impacts over China's accumulation of foreign reserves during this period, which can be summarised as follows:

(1) A stagnant trade

Under central planning, foreign trade, which accounted for the majority of China's international balance of payments, was limited only to those 'designated' SOEs (Hall, 2004, p.437). Lardy further explained on this point that although those SOEs were given

26. The success of central planning and the centralised economy also enabled the PRC to takeover 'private industry and commerce' by 1956, as well as to make the agricultural sector successfully 'collectivised' (Perkins, 1991, p.475). Its economy became an ideological marriage between the Soviet socialist model and China's own interpretation of Marxian economics.

export quotas, they had no interest to increase their exports since 'they would not share in any profits earned' (Lardy, 1992, p.17-9). To make the matter worse for foreign trade, China had joined with other developing countries in adopting the import substitution policy, which understated the importance of international trade. Exports, therefore, were used only to fund 'needed imports' for goods or capital goods that could not yet be produced domestically (Lardy, 1992, p.17-9).

(2) An overvalued domestic currency

The economic model of central planning during this period was built upon the idea of achieving equilibrium of the balance sheet, between values of export and import. With its monopoly over foreign currency and trade, the central government was able to balance the imports bills with export's foreign currency by intervening and manipulating the currency exchange rates (Hall, 2004, p.438).

(3) Famine and inadequate agricultural output

Early success achieved by the first Five Year Plan (FYP) had given the China Communist Party (CCP) a false hope that its country could actually grow at faster rate if they put their efforts into intensifying industrialisation. As a result, the Great Leap Forward (GLF) was introduced in 1958 that aimed at increasing the pace of growth towards industrialisation and communisation of the countryside (Lieberthal, 1987, p.294). To elaborate on this point, the policy was heavily influenced by Mao, who believed that the size of the agricultural sector was large enough for the China to exploit its surplus and could mobilise labour and other resources towards rapid industrialisation (Lardy, 1987, p.363). This misperception of agricultural output, miscalculations of demand-versus-supply sides, and setting unrealistic goals had led to a severe shortage in agricultural goods and one of the worst famines in human history, which cost China a staggering 16–27 million deaths (Lardy, 1987, p.370). The outcomes of GLF had a direct impact on exports in agricultural products, which translated into a disappointing number of foreign reserves.

(4) Fractions and fear within the CCP—the Cultural Revolution

The failures from the miscalculations of GLF united the leaders together for the recovery attempt in order to save the economy. The initiatives could successfully recover pre-GLF levels of outputs, however, at the same time, Mao²⁷ had become much more suspicious of many of his colleagues who tried to modernise the country in the way which he considered too similar to the practice of western capitalism. Therefore, to prevent this, Mao had launched an attack on 'the legitimacy of the CCP', while also providing the fire of rhetoric and 'political vocabulary for protest and dissent', or in other words, it was he himself that mobilised 'the social force that undermined his own government' (Harding, 1991, p.110-1). Schram (1991, p.95) described it as Mao's war against capitalist elements within his ideal socialist utopia to ensure 'the thoroughgoing and systematic realisation of Marxist ideals'.

Besides removing or stripping a number of influential leaders of their powers, the Cultural Revolution resulted in a lack of innovation and creativity within those who were in charge of the economy. In other words, no one dared to reform out-dated policies for fear of being regarded as being one of those who opposed Mao and his political ideology. The sharp drop in imports of machinery in 1968 and 1969 could in part have represented an attempt to please the 'left' in opposing 'foreign' technology (Perkins, 1991, p.490).

To conclude, under a central planning regime which was plagued with stagnant trade, out-dated economic policy, overvalued domestic currency, as well as political confrontations and famine, China could accumulate only a modest amount of foreign exchange reserves, with the peak in 1977 at US\$952 million, while the rest of the Asian Tigers were already beginning their growth miracles (SAFE, 2011, Thomas and Chen, 2011, p.470).

27. Mao's power play and his great ability to manipulate had given those who wanted to be promoted only two choices, either completely agree with Chairman Mao, or totally disagree with him and face the consequences, which to emphasise this point Deng Xiao-Ping was one of the few lucky ones to have survived from disagreement with the Chairman (Brown, 2009, p.82).

3.1.2 Deng and his opening policy—'1978 to 1993'

Under the leadership of Deng Xiao Ping, China adopted the policy of reform and opening, which consisted of ground-breaking reforms in both financial and economic spheres. This laid a solid foundation for the economic miracle and rapid growth in China's foreign exchange reserves. During this period, China turned its back against the centralised economy and improvised its own interpretation of a market-based economy. In regard to the reforms, there were four main initiatives that boosted the amount of foreign reserves, which can be recapped as follows:

(1) Economic reform—FDIs and capital injections

Since the 1980s, Special Economic Zones (SEZs) were set up to attract FDIs, acquire new technology and learn western business management practices. This reform was working in parallel with two micro-finance programs, Urban Credit Cooperatives (UCCs) and Rural Credit Cooperatives (RCCs), which were established to support local businesses and enterprises (Allen et al., 2009, p.7). Moreover, in the later years of this period, the State Council decided to further create platforms to attract FDIs that seek higher returns from new emerging markets by establishing two stock exchanges²⁸, namely, Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) in 1990 (Allen et al., 2009, p.4). The above policies provided the substantial amount of capital needed to stimulate the economy and increase the size of the domestic market.

(2) Banking and monetary reforms—PBOC and the Big Four

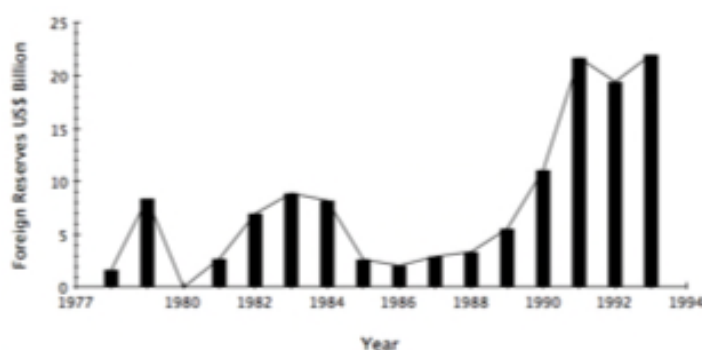
During the same period, there was also a major banking reform. From 1978 to 1984, China underwent a major transition in banking to establish a two-tier system, by assigning the People's Bank of China (PBOC) into the role of central bank and appointed the other four state-owned banks into commercial banks, each with designated roles (Allen et al., 2009, p.7).

28. Allen et al. also commented that the establishment of the stock exchange was also aimed at absorbing the growing domestic earnings within the economy (Allen et al., 2009, p.4).

(3) FOREX management reform—the establishment of SAFE²⁹

In order to facilitate the influx of FDI and support foreign currency earnings, China took a major step to modernise its monetary system by establishing the State Administration of Foreign Exchange (SAFE) in 1980 to regulate³⁰ and administer foreign exchange management, as well as to start decentralising FOREX control, which had been carried out throughout the 1980s (Hall, 2004, p.439).

Figure 3.2: China's foreign reserves from 1978 to 1993



Source: SAFE (2011, accessed May 2013)

(4) Currency control and FOREX markets—the devaluation of RMB

From 1985, China allowed domestic firms and foreign invested enterprises to trade their foreign reserves' earnings in two different markets, namely, the Foreign Exchange Adjustment Market and the Swap market (Hall, 2004, p.439-40). This had led to the existence of two different exchange prices, the official one and one traded in the swap market. China then capitalised the differences between these two markets to 'devalue its (currency) for trade transactions while retaining the purchasing power parity rate' as the official rate (Hall, 2004, p.442). Since then China devalued the RMB during the 1980s and the early 1990s, and the rate gradually deflated from ¥1.5 per US dollar in 1980 to around

29. The Bank of China (BOC) was responsible for 'transaction related to foreign trade and investment'; the People's Construction Bank of China (PBBC) was given a task to manage 'fixed investment' especially in manufacturing; the Agriculture Bank of China (ABC) was established to serve 'banking business in rural areas'; The Industrial and Commercial Bank of China (ICBC) was given a role to take over commercial transaction previously handled by the PBOC (Allen et al., 2009, p.7).

30. In order to fulfil this objective and accommodate SAFE, the government gave SAFE the authority to license commercial banks, and non-banking institutions the rights to handle foreign exchange business (Hall, 2004, p.439).

¥5.3 per US dollar in the early 1990s (Hall, 2004, p.442)³¹. The devaluation of the rates in the swap centre was even more dramatic, dropping from ¥6 per one US dollar in 1988 to around ¥9 per one US dollar in 1993 (Hall, 2004, p.442). This devaluation of the RMB played a major role in increasing the competitiveness of Chinese exports and also helped China to attract more FDI from those investors aiming to outsource their products and services. It is also important to note that the volume of transactions in foreign exchange swap centers increased from US\$4.7 billion in 1987 to US\$86 billion in 1989 (Lin and Schramm, 2003, p.256).

To conclude, during this 16 year span from 1978 to 1993, China's monetary and economic reforms that concentrated around conservative management of foreign reserves and tight currency control increased its foreign exchange reserves tenfold, from US\$2.072 billion in 1978 to US\$21.99 billion in 1993 (Hall, 2004, p.443; SAFE, 2011).

3.1.3 Major reforms, economic crisis and WTO entry—'1994 to 2002'

The decentralisation of FOREX management resulted in an unprecedented growth of reserves from the late 1980s to the early 1990s. However, by late 1993, the existence of the swap markets became a new source of problems for the monetary authority.

In regard to this issue, Hall (2004, p.443-4) argued that there were at least three main difficulties associated with the swap markets. Firstly, the ever-increasing number of transactions from the swap centres had made the job nearly impossible for the central bank to make sense of the FOREX's movements. Secondly, the dual exchange rate system embedded in the swap centres was also seen as 'a non-tariff barrier' and 'an obstacle to China's WTO accession' (Hall, 2004, p.444). Thirdly, insufficient amount and uncoordinated allocation of foreign currency were main shortcomings of the swap markets, thus, instead of facilitating international trades, the trading platforms had caused traders more concern.

31. ¥ = Chinese currency, 元 (Yuan) or used interchangeably with 人民币 (Ren Min Bi).

Other than the swap centres that were placed under scrutiny, the idea of FOREX's decentralisation itself was in question, as it had stripped the central authority too great of its control over FOREX management to local governments. To correct these problems, the government decided to act swiftly and initiated major reforms in 1994. Lin and Schramm (2004, p.247) and Hall (2004, p.444-6) argued that there were four main initiatives that have made an enormous impact to the management and the accumulation of China's foreign reserves that can be summarised as follows: (1) Unification of the official and swap market to 8.7 (2) Swap market participation by domestic entities and individuals no longer permitted. (2) Interbank market established as the CFETS based in Shanghai (April 4)

(1) The abolishment of swap markets³² and the retention system

On the 1st of January 1994, the State Council decided to abolish the swap markets and the system of retention rights and replaced them with '*the Bank of Foreign Exchange Settlement System*³³ and a policy that forced all Chinese entities to convert all earnings into RMB, as well as purchase the foreign currency at one of the designated FOREX banks.

(2) The establishment of a unified exchange rate

During this round of reform, China had also cleverly capitalised on a good opportunity to set the only official exchange rate for both official and swap market that pegged at ¥8.7³⁴ per US dollar, as it was the latest rate being traded at the swap market before the abolishment (Lin and Schramm, 2003, p.247).

(3) Simplified bureaucratic process for obtaining foreign currency

The pre-approval for foreign currency purchase from SAFE was no longer required, thus the process of acquiring such currency became much more simplified.

32. The swaps centers for the FIEs had continued to serve until 1998, however, they were incorporated into CFETC to guarantee the liquidity for FIEs (Hall, 2004, p.446).

33. 银行结售汇制度

34. Since then Chinese currency was 'pegged to US dollars in a managed exchange rate regime' until 2005 at around ¥8.3 (Morrison and Labonte, 2011, p.2; Thomas and Chen, 2011, p.471).

(4) The establishment of the Interbank FOREX trading market

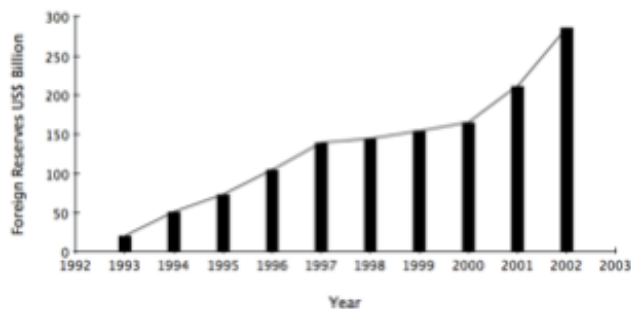
In April 1994, another milestone achievement of FOREX management was the inception of the interbank foreign exchange trading market—the China Foreign Exchange Trading Centre (CFETC)³⁵ that was opened in Shanghai to allow licensed foreign and domestic financial institutions to trade FOREX electronically (Hall 2004, p.445; Lin and Schramm, p.247). In 1994, the transaction in US dollars and HK dollars were permitted, Japanese Yen was also added in 1995 (Lin and Schramm, p.247).

Besides identifying key initiatives presented above, Hall (2004, p.445-6) also gave a detailed analytical explanation of the benefits from the reforms in 1994, which can be summarised into five accounts.

Firstly, the reforms allowed the central bank to efficiently control and easily manage FOREX transactions from those designated FOREX banks. Secondly, it improved access to foreign currency by eradicating the sluggish and outdated retention system, which was plagued with various bureaucratic processes. Thirdly, the reform gave banks the freedom to trade FOREX surpluses within themselves, thus eliminating the problem of liquidity or the difficult task of finding a match between buyers and sellers of foreign currency that existed in the swap markets. Fourthly, more control and much more accessible foreign currencies translated into a drastically improved environment for international trades and 'greater integration with international banking standards' (Hall, 2004, p.445). And finally, the single interbank market allowed PBOC or the central bank to firmly monitor and control the exchange rate through its regulation on FOREX markets, as well as having the privilege to intervene in the exchange rate when needed.

35. 中国外汇交易中心

Figure 3.3: China’s foreign reserves from 1993 to 2002



Source: SAFE (2011, accessed May 2013)

From 1996 onwards, China then entered the period of solidifying its monetary position while enjoying a stable influx of FDI, which guaranteed the healthy state of its foreign reserves. The next breakthrough in its FOREX management was their commitment to eliminate various restrictions of FOREX trading through its conformity with IMF Article VIII of section 2, 3 and 4 on the 1st of December 1996 on the attempt to transform its current account transaction into fully convertible (IMF, 1996)³⁶.

The IMF has summarised the goal of Article VIII into two purposes:

“(1)...to facilitate the expansion and balanced growth of international trade, and thereby to contribute to the promotion and maintenance of high levels of employment and real income; (2) to assist in the establishment of a multilateral system of payments in respect of current transactions between IMF members” (IMF, 1996).

Despite that China’s commitment in 1996 looked rather convincing and optimistic, the hopes of investors and the world to see a full conversion of China’s current account were shattered as the Asian economic crisis played out in 1997. The crisis dragged various Asian countries such as Thailand, Indonesia, and South Korea into current account deficit nightmares with more liabilities than foreign exchange reserves that could be used for payments. In other words, they did not have enough money to pay off their debts and had

36. IMF Article VIII’s section two focused on the avoidance of restriction on current payments; while section three indicated the obligations of members to avoid discriminatory currency practices; lastly Section four that China agreed upon in 1996 was on the issues of convertibility of foreign-held balances (IMF, 2012).

to accept the IMF rescue packages. Therefore, from late 1997 to early 1999, China decided that it had to tighten the transactions of its current account in the fear of rapid and massive capital flight, even though it would go against the chance of preparing itself for the WTO's entrance (Hall, 2004, p.448). In 1999, the IMF classified RMB exchange rate as a conventional peg to the US dollar (Lin and Schuramm, 2003, p.247).

There were many companies, which had been illegally depositing their foreign currency earnings abroad, that used a 'fraudulent import documentation' technique to deduct the foreign currency out of their accounts without actually buying any goods (Hall, 2004, p.449). Therefore, in the attempt to stop the illegal capital flight, China encouraged those companies to come clean under a grace period. Moreover, during 1998–early 1999 China basically became very strict on capital flight, opposite to its relaxed manner prior to the Asian crisis. It chose to tighten the leaks through enforcing previously existing regulations, letter by letter, and tried to avoid imposing new regulations (Hall, 2004, p.450).

Lin and Schuramm (2003) added that during 1999, three strict measure were imposed. The first is the introduction of a system for 'evaluating exporters' performance in meeting foreign exchange surrender requirement', and secondly, SAFE asked BOC to halt all RMB remittances from accounts deposited by foreign banks at the BOC. And lastly, SAFE asked BOC to 'close all offshore RMB accounts and therefore, offshore RMB could no longer be converted into foreign currencies or remitted to China' Lin and Schuramm (2003, p.262).

The attitude on the current account control changed again from the early 2000s, which can be explained two fold. Firstly, China's entry to WTO in 2001 had directly and indirectly dragged China towards achieving free-movement of capital and further

modernisation of its banking and financial industries. For instance, WTO's principle required China to eradicate laws and regulations that discriminate against foreign firms, as well as asking China to open its financial services sector to foreign competition within the five-year grace period of its WTO entry (Hall, 2004, p.450). Secondly, after the effects of the Asian crisis had faded away and with new business opportunities opened up by its WTO membership in 2001, China enjoyed great influx of FDIs and trades that smoothed the position of its balance of payments, as well as drastically strengthening the amount of foreign reserves required to protect the economy (Hall, 2004, p.451).

To summarise, the reform during this period successfully brought back the control for central bank's FOREX monitoring mechanism, solving liquidity problems of the FOREX market, making foreign currency much more accessible, and thus created an encouraging platform for international trade. Despite the Asian crisis starting in 1997, China was encouraged by an influx of FDI and trade and with its WTO entry in 2001 to slowly move towards making RMB a fully convertible currency. During these nine years, 1993-2002, China saw its foreign reserves increase from US\$21 billion to US\$212 billion, or almost ten fold (SAFE, 2011).

3.1.4 Accumulating and leapfrog—'2002 to CIC's creation in 2007'

Since China entered the WTO in December 2001, it had experienced a great influx of investment, as investors hoped to catch an early ride of one of the most rapid cases of economic development the world has ever seen. With great interest in China's potential growth, it was not a surprise that the optimism translated into unprecedented direct investments and trade with China. Nevertheless, it is possible to systematically identify

key factors that had great impacts on the development of China's FOREX during this period prior to the establishment of Chinese SWF, as elucidated in the following sections.

(1) A dramatic increase of portfolio after WTO's entry

As China opened its market to international standards and promised to modernise its banking and financial sectors, which would naturally expand the size of the credit market and purchasing power, it attracted investors from around the world. The most important factors were the emergence of portfolio investment on top of the FDIs, which grew rapidly from almost non-existent in 2002 to near US\$50 billion in 2007 (Jian et al., 2011, p.43).

(2) The emergence of speculative capital inflows

Even before its WTO entry in late 2001, China had always been accused for its manipulative currency policy which kept its RMB at a relative low in order to gain export competitiveness. With increasing investments and trade surpluses, together with a not-fully convertible capital account, China was facing the increase of domestic money supply. The inflation was due to jump, while at the same time China had limited ability to raise interest rates³⁷ (which would normally solve this problem in a market-based exchange regime), since it would attract even more capital inflows because of better earnings (Prasad et al., 2005, p.6). Therefore, with the financial and economic pressures, many investors speculated that sooner or later, China had to give up and let the RMB to appreciate. This was the explanation for unregistered capital inflows (non-FDI, non-portfolio investments)

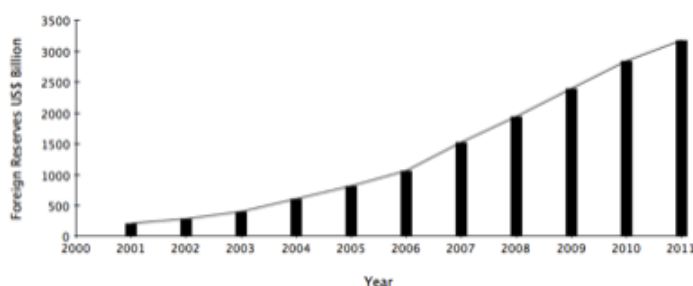
37. This would not be a problem for China, if it chose to operate under the market-based currency exchange regime, since raising the interest rate would eventually result an appreciation of the local currency, and thus offset the gains from the from the currency trader to gain from speculations and eliminate the need to worry about the over-supply of local monies.

that emerged in 2003 and intensified in late 2007, which accounted in the range of US\$40-50 billion (Jian et al., 2011, p.43).

(3) The lift of pegged-exchange rate

In July 2005 China decided to lift the pegged-exchange rate against dollars into the 'managed float' exchange regime. Since the WTO's entry to late 2007, the RMB had appreciated by as much as 11.8%, from ¥8.28 per US\$1 to ¥7.30 per US\$1 (PBOC, 2008). The managed float regime was a vital catalyst that attracted another round of speculative capital, which also contributed to the increasing size of China's foreign reserves during this period.

Figure 3.4: China's foreign reserves from 2001 to 2011



Source: PBOC (2011, accessed May 2013); SAFE (2011, accessed May 2013)

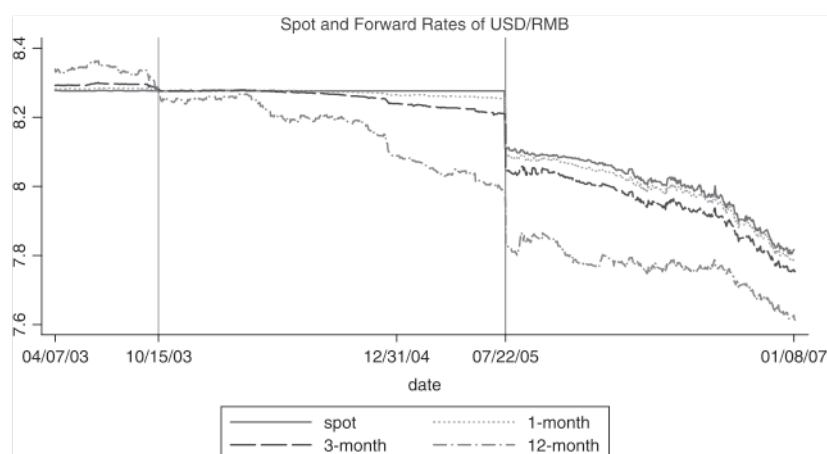
Having been able to dictate its currency regime firmly since the use of pegged-rate, the speculation of RMB and the lift of pegged exchange rate regime, however, are not coincidental—there are four reasons that led to the above phenomena:

(1) Pressure for RMB's appreciation from US Treasury

With its own economy being as integrated with the world as ever, the external factors and pressures made the job of managing the economy and finance much more difficult for Chinese policymakers and central bankers. Frankel and Wei (2007, p.579–80) argue that the abolishment of pegged-rate was an outcome of US political hardball initiated

by the US Treasury Department. This was proven by the attitude and unprecedented attention of the US Treasury whose Secretary, John Snow, travelled to lobby with Chinese leaders over this subject. Moreover, the Treasury’s semi-annual report also recommended ‘bilateral negotiations’ in regard to Chinese currency (Frankel and Wei, 2007, p.580). In addition, since October 2003, there was an important change of direction of RMB’s forward exchange rate in the Non-deliverable forwards market (NDF). As you can see from Figure 3.5, the market has been trying to push for stronger RMB in order to close the gap of RMB's perceived devalued margin.

Figure 3.5: Prices of USD/RMB NDFs from 2003–2007



Source: Frankel and Wei (2007, p.579)

(2) Exports could benefit from RMB’s appreciation

Although it might sound as if China would lose its competitive edge in exporting goods due to the appreciation of RMB, the effects for export-oriented goods, however, has been minimal. To clarify, over half of Chinese exports concentrated only on the final assembly of products that 'used intermediate input produced by other countries' (Prasad et al., 2005, p.6–7). Moreover, China’s value added to its exported goods to the world and the

most important partner, the US, only accounted for 30% and 20% respectively—meaning that the big portion of the process was either finished elsewhere or imported (Lau, 2003).

(3) More tools and flexibility for Chinese monetary authorities

With floating RMB, it was then possible for the PBOC to adjust the interest rate, or initiate other policy that related to the supply of domestic monies. Market forces would eventually correct the exchange price according to the supply and demand of its currency, despite the range of fluctuation that the PBOC allowed was considered relatively small.

(4) Hot inflows of money is unavoidable

There are scholars who argue that RMB was artificially undervalued (Mercurio and Leung, 2010). While others believed that has been slow in action to correct trade imbalance through currency reform (Castle, 2010, p.446). With its promising prospect of growing economy and business opportunities, China understood that despite its relatively closed capital account, it was only a matter of time when investors had consensus to speculate either long and short term on the potential appreciation of Chinese currency. Therefore, it was better to let the float exchange regime do its job, rather than sterilise more foreign currency into RMB, which could cause much more macro-economic damage, such as inflation or speculative bubbles.

To conclude, there were various influential factors, such as the growing of FDIs and speculative capital, that contributed to the phenomenal growth of foreign reserves during this period. By the time China decided to establish CIC, its foreign reserves had ballooned to US\$1.4 trillion. But why did it have to be 2007? And why was CIC's starting capital set at US\$200 billion? This thesis is designed to answer these questions in the next

section—the issue of whether China had been holding too much reserve and problems attached with it.

3.2 Problems from hoarding foreign reserves and the case of China

After getting a good grasp of the history of China's foreign reserves from the last section, we are now able to describe 'how' the reserves were accumulated. However, it is equally important that we also understand 'why' China decided to hoard its reserves in such fashion. In addition, the analysis of other fast growing economies' reserve accumulations will also give us a new insight towards China's rationales to keep hoarding reserves. More importantly, the analyses of whether China is holding too large foreign reserves, along with problems attached to it, is vital information to us in understanding China's motive in establishing its first SWF.

In order to do that, this section is then designed to explain the rationales behind reserves' accumulation, as well as determining whether China's foreign reserves should be regarded as 'excessive'. Moreover, it will also discuss the problems associated with hoarding excessive reserves and analyse the case of China, which will give us a better insight into what difficulties CIC was aiming to solve.

3.2.1 Trends and rationales of hoarding foreign reserves

Even before the Asian financial crisis, the rate of exposure to capital flight for emerging countries was gradually increasing as they grew to adapt the financial structure to fit the grand idea of free movement of capital (Li et al., 2009). It seemed logical for them to speed up the financial integration, after all the staggering amount of FDI had been

rewarding. While they enjoyed the bullish mood in stock, bond and real estate markets as financial deregulation progressed, they left themselves in a very vulnerable position of capital flight if foreign investors started to pull the money out. But that was not an issue, they thought they had it figured out with the use of the pegged rate currency regime.

The pegged rate system has proven to be one of the costliest policies the growing economies encountered, especially in the case of Asia during 1997-8. Nevertheless, the lesson educated their central bankers to push for an unprecedented and systematic increase in foreign reserves, especially in developing Asia and those crisis-hit countries, in which we are still witnessing today. The next subsection will explain three important trends of the foreign reserves' hoarding, as well as discuss the rationales behind reserves' accumulation.

(1) Systematic increase in Asia and developing countries since the 1990s

There was a systematic increase of international reserves since the 1990s, with a large proportion of growth belonging to developing countries in Asia (Aizenman, 2008, p.487). The growth of reserves within Asia and many other emerging economies (EMEs) were mostly due to the rapid financial integration in the early 1990s based on a macro-economic design that relied heavily on pegging with the world's most common reserve currency—the US dollar.

The pegged exchange regime was utilised especially to attract FDI, since it increased the willingness and confidence of prospective investors to put money there. In other words, it guaranteed investors a risk-free in financial cost and transaction so that they could invest, make profit, and know that their earnings would not be affected by the fluctuation of currency exchange as a result of a pegged rate. Hence, many Asian countries and EMEs were successful in turning themselves into export-led economies. In addition,

the power of a pegged currency was not only limited to attracting FDI, but it also boosted confidence of local financial institutions in borrowing from foreign markets, either in terms of loans or issuing corporate bonds, since it eliminates the risks of exchange rates and financial costs and between the local and denominated foreign currencies. As a result, from the early 1990s to the breakout of the Asian financial crisis in 1997, developing Asia's share of world reserves had increased from around 22.4% to 30%, from merely US\$200 billion to approximately US\$575 billion (Park and Estrada, 2009b, p.3–4).

(2) Rapid accumulation of reserves after the Asian economic crisis

The pegged-exchange regime that then was at the heart of the early 1990s' accumulation had started to turn out to be a two-edged sword for developing Asia as the economies started to burst their speculative bubbles. Since most of the growth was building upon Ponzi scheme-like bases, non-performing loans (NPLs) resulted from bad practice and poor governance in banking sectors, as well as over-investing in real estate, the economic bubbles started to pop and the Asian crisis began in 1997. Lacking in liquidity and confidence, the foreign investors rushed to pull their cash out of the Asian economies. Central banks, such as the Bank of Thailand, held on to their belief in the pegged system and defended the currency with their foreign exchange reserves until nothing was left in the vault. Within a short time, Thailand had to raise the white flag and float its currency. The growth accumulated in a decade was almost lost in the devaluation in currency alone. The worse was yet to come for those financial institutions and firms that had borrowed from abroad, most of which were US dollar-denominated loans.

The devaluation of local currency then proportionally increased the size of borrowers' debts. The outcome: Thailand and many countries had to be bailed out by the IMF and accept the harsh consequences. As a consequence from the crisis, the EMEs thus

had adjusted their financial architectures, many decided to use a floated or basket-weighted system for their currency exchange mechanisms. Having learned that only an adequate level of foreign reserves could sustain the liquidity within the market from aggressive capital outflows during moments of crisis, they started to hoard their foreign reserves. And, unsurprisingly, they were not the only ones. The rate of reserves' accumulation of crisis-hit countries was further exacerbated by various factors, such as; (1) influx of FDIs as a result of cheap currencies which were dramatically devalued and (2) net trade surpluses from exporting goods and services, exploiting the advantages that resulted from relatively cheap currencies (Park and Estrada, 2009, p.1). Therefore, from 1997 to 2008, developing Asia's share of international reserves increased from 30% to 48.1%, from only US\$575 billion to a staggering US\$3.371 trillion (Park and Estrada, 2009, p.3–4).

(3) China is a leader of the herd; developed countries are left behind

Within Asian countries, China stands out as a country which has the fastest rate of growth of foreign reserves. In addition, China is also a country which possess largest amount of reserves by value. One useful figure that can measure the magnitude and the direction of growth is the ratio of reserves to GDP. While the developed countries' ratios had been held almost constant at 4%, Asia had its ratio increase from 5% in 1980 to 37% in 2008, with the leader of the pack—China, which had its ratio grow from just 14% during 1997-2000 to a staggering 41% in 2006 (Aizenman, 2008, p.487–8). China's underdeveloped financial sector, inherited from the days of central planning, protected China from the risks and exposures of capital flight that most fast growing countries were facing during the Asian crisis (Fernald, 1999). However, China's growing reserves were influenced by different sentiments from investor's speculation—its growing prospects of

double digit growth and a strong economy, which would push the RMB to appreciate. Together with the WTO entry in 2001, China has been the runaway winner in the game of hoarding foreign reserves. From the year of Asian crisis, China's foreign reserves increased from US\$150 billion to almost US\$2 trillion in 2008 (SAFE, 2011).

In regard to the rationales behind the increase of international foreign reserves, Jie Li, Jing Chen and (Jie Li et al., 2009) (to be called as JLJ from now on), Park and Estrada (2009) and Aizenman (2008) have analytically explained that there are two hypotheses that can be used to describe the phenomenon of large foreign reserves, namely, active holdings and passive holdings.

For active holdings, the rationales behind it were (1) solving the constrained optimal public finance (Aizenman, 2008, p.491) and (2) 'Precautionary demand' to use reserves as self-insurance (Park and Estrada, 2009, p.1, 5) against currency attack and maintain the liquidity from potential capital flight during the time of crisis (Jie Li et al., 2009, p.359). On the other hand, for passive holdings, the reserves were regarded as 'a by-product of other policy targets' (Jie Li et al., 2009, p.359), mostly accounted for by 'a mercantilist export-led growth model', which relied on cheap currency to increase the competitive advantages in export (Park and Estrada, 2009, p.1).

In regard to the level accumulated by Asian countries, LJJ argued that it was 'so significant that even precautionary demand motive may not be sufficient to explain' (Jie Li et al., 2009, p.350). Aizenman (2008, p.495) credited the hoarding phenomenon as the emergence of new financial architecture and claimed that there was a possibility that the EMEs were entering a hoarding war due to their export-led strategy. Besides the active and passive holdings, Park and Estrada (2009, p.6) offered an alternative beneficiary of foreign

reserves usage, accumulation for 'exchange rate stability'. Jie Li et al. (2008) suggested that China's vast amount of foreign reserves could in fact be self-augmented.

In other words, existing reserves lead to more reserves and so on. To support this argument, they proved this with the economic model based on the assumption that China would channel its reserves by buying more US treasury bonds that lowered US interest rates and enabled US firms and consumers to buy more Chinese exports; they concluded that 'every one dollar of China's foreign reserve holdings can lead to 0.07 dollar more when the self-augmented process is completed' (Jie Li et al., 2009, p.359–60).

3.2.2 Why did China's foreign reserves are considered as 'excessive' ?

In addition to pointing out the rationale of foreign reserves hoarding, Jie Li et al. (2009) and Park and Estrada (2009) also argued that China's foreign reserves were excessive. They proved their arguments with the combination of five macro-economic measures presented below:

(1) Reserves-to-Import Ratio (RIR)

China's RIRs have long been exceeding the conventional requirement (three months of imports) at 12.4 months since 1998 and 19.2 months during 2007, the year that CIC was established (Jie Li et al., 2009, p.352).

(2) Reserves-to-Short-Term External Debt Ratio (STED)

It is also known as the Guidotti-Greenspan recommended rule, which is defined as 'a measure of all debt repayment to non-residents due within the coming year'. For this measure, China's STED ratio in 2007 was equal to 6.35, with the benchmark of adequate reserves equal to one (Jie Li et al., 2009, p.353). In other words, China had 6.35 times

more reserves than it needed to cover all STED within the year 2007. Park and Estrada (2009) also conducted the same measure and commented that China did show that it had a much higher reserves to STED ratio than the average of Asia's top ten reserves holders during 1990 to 2008 (Park and Estrada, 2009, p.7).

(3) Bank of Korea's benchmark

This benchmark requires the combination of three months imports, STED, and '30% foreigners' stock holdings'; against this bench-mark, China's reserves still show that what China had is more than adequate, with the peak from the sample in 2007 that the reserves reaches US\$1.5 trillion, while the amount required by this benchmark in the same year was only around US\$450 billion (Jie Li et al., 2009, pp.353–4).

(4) Reserves-to-M2 ratios

This is the benchmark that calculates against potential 'capital flight by domestic residents during a financial crisis', which sets the adequacy of reserves at 5% of the M2, shows that China's reserves level comfortably beat the benchmark since 1998 at 11.5% and 29.5% in 2007 (Jie Li et al., 2009, p.355). Park and Estrada (2009, p.7–8) also supported the verdict that China possessed reserves far beyond an adequate level when measured by the Reserves-to-M2 benchmark.

(5) Claremont measures of reserve adequacy

This was a new and innovative bench-mark proposed by Kim et al. (2005) that used the templates of capital flight from five 'crisis-hit' countries (Thailand, Philippines, Malaysia, Korea and Indonesia) to calculate against China's scaled 'M2, GDP and short-term external debt', as five scenarios of benchmarks according to the country being used as a template (Jie Li et al., 2009, p.356). The benchmarks showed that with the vast reserves

China had in 2007, it would still be able to sustain any scenario of crisis, with the exception of a Thailand-type crisis, which would be a close call by having US\$1.474 trillion fly out from the actual reserve of US\$1.528 trillion (Jie Li et al., 2009, p.356–8).

To conclude, the results of five different economic benchmarks and the analysis of rationale hypotheses for accumulating foreign reserves shows that the level of reserves China had been holding was way beyond the optimal adequacy scale. Especially in 2007, the year that CIC was established, the upward trend hinted that China could actually afford to move some of its vast reserves to more aggressive investments. But what are the reasons to diversify foreign reserves once it is proven that one has been hoarding too great a sum? We will find out in the next subsection.

3.2.3 Problems associated with China's excess reserves

The vast amount of reserves does have its merit in increasing the country's ability to repay external debts during times of aggressive capital flow, defending the currency from speculative attacks, and intervening in the exchange rate when needed for a more favourable position against other currencies. However, possessing a too great amount of reserves also creates problems for central bankers and monetary authorities. In 2005, the European Central Bank (ECB)'s International Relations Committee (IRC) conducted a systematic analysis of problems of excess reserves with help from a group of central banks experts within the European System of Central Banks (ESCB). They concluded that the problems of hoarding reserves could be presented in two groups, namely, risks and costs. Anderson (2009), Zhang and He (2009), Park and Estrada (2009), Prasad and Wei (2007), all agreed that there were costs attached to the appreciation of RMB against dollars, as

well as the sterilisation, which tried to keep inflation at an acceptable level. There are three main risks attached with possessing excess reserves:

(1) Exchange rate instability, inflation and economic bubbles

Disruption in exchange rate stability, inflation and economic bubbles—these are the possible outcomes from 'unsuccessful sterilisation', which could be the result of 'underdeveloped financial markets and snowball effects'³⁸ (ECB, 2006, p.16–7). These risks became real effects during 2002-2003, when signs of 'over-investments and bubbles' in real estate prices limited the ability of PBOC to implement their sterilisation measures (ECB, 2006, p.17).

(2) Market risks from fluctuation of currency and interest rate

Zhang and He (2009, p.103) explained that when the RMB appreciates by 10% against US dollar, its foreign reserves of US\$1.68 trillion would also lose its value by US\$168 billion, or in other words China will lose from its vast assets close to 5% of 2007's GDP. Cognato and Altbach (2008, p.12–3) added that China had also been facing a dilemma to maintain a large amount of dollar reserves, since moving out of dollars would 'immediately accelerate the loss in value of remaining dollars'. He Fan, a researcher of the China academy of social sciences, commented that China's reserves were in a difficult situation as if being held under a 'hostage situation'.

(3) Difficulties for the central banks

Normally, problems related to the supply of monies are managed via 'liquidity-providing transactions', which are the central banks' expertise (ECB, 2006, p.16). However, the economies with the excess reserves are in need for 'liquidity-absorbing'

38. Experts of ESCB explains that snowball effects with the following example, higher interest rate resulted from sterilisation (more domestic capital supply) tethered with speculative buys of domestic currency due to anticipated appreciation, 'thus forcing the central bank to sterilise even more', and so on (ECB, 2006, p.16–7).

measures, therefore it makes the job of the central banks very difficult (ECB, 2006, p.16). The task of PBOC, however, is even more difficult considering the fact that it needs to accommodate the export-led strategy which requires careful movements in exchange rates, as well as pressures from trading partners and influx of hot capital from the hype of investing in China.

In addition to risks, there are also costs of hoarding excess reserves that can be summarized as follows:

(1) Opportunity cost

Since the conventional wisdom of the central bank is to invest in the world's safest and most liquid financial instrument, US Treasury Bonds, it also needs to accept relatively low returns. While China's vast sum of wealth invested in US treasury that 'generates only around 3-6%' per year, foreign firms invested in China enjoyed a much higher return at 22% in 2005 (Zhang and He, 2009, p.102). And even a saving account in China could generate higher return than the US bonds; therefore China would make more money by just placing the money at home (Anderson, 2009).

(2) Sterilisation costs

Foreign capital inflows means that the central bank needs to buy foreign currency with new domestic currency, which increases the supply of the money in the domestic market, which will eventually lead to inflation. The central bank then needs to buy back those bank notes with bonds attached with interest at usually higher rates than the US treasury—meaning that the central bank kept losing money from sterilisation (ECB, 2006, p.16–7). Zhang and He have confirmed that in the attempt to regulate the inflation rate at a

favourable level, PBOC had been losing money in the process (Zhang and He, 2009, p.103).

From the above risks and costs of hoarding excess reserves, it is logical for China to look for alternative management of its reserves. Eventually, after years of searching for a solution, the State Council decided on the idea of setting up its own sovereign wealth fund (SWF). It was natural that the rest of the world paid careful attention when a country with the world's largest foreign reserves decided to invest its wealth. Therefore, since its inception in 2007, China Investment Corporation (CIC) was already on the radar of scholars, policy makers and financial institutions. After all, its starting investment kit of US\$200 billion was only around 12% of China's vast reserves.

3.3 China's politics over monetary power prior to CIC's inception

On 29 September 2007, in the attempt to solve the costs and problems related to excessive reserves, the Chinese state council decided to create its first SWF, the China Investment Corporation (CIC). Its starting capital of US\$200 billion had already placed itself at the top of world's top ten largest funds and it certainly had drawn attention around the world to its investments and business acquisitions.

Behind CIC's creation exist complicated political arrangements and complex financial preparations. These reveal to us the rivalry and conflicts within the monetary authorities that all wanted their shares to invest China's excess foreign reserves. This last section of the chapter will discuss the political struggles prior to CIC's establishment that would help to solve China's monetary problems, as well as the costs of hoarding foreign reserves.

3.3.1 Early political struggles of MOF, SAFE and PBOC

During Mao's centrally planned economy, where China's monetary policy basically just followed according to the plan, the PBOC was without ministry status as it has today, and was merely MOF's subordinate as an ordinary state-owned commercial bank (SOCB), while occasionally responsible for a 'limited function of a central bank' (Liew and He, 2010, p.27).

The important aspects of the relationships during this period were the term of governance and ownership structure. The MOF was by law the owner of all state-owned commercial banks (SOCBs), which more importantly included the PBOC. The MOF gained an upper hand especially during the Cultural Revolution, which saw the PBOC relegated to one of its departments (Liew and He, 2010, p.27).

It was not until September 1983 that the PBOC was given a role to act as de facto 'China's central bank', as well as finally becoming independent, out of the shadow of MOF's influence (PBOC, 2012, accessed May 2013), by having its level upgraded to ministerial status (Liew and He, 2010, p.27). The rearrangements of assets and ownerships for the rebranding of PBOC were initiated on the first of December in 1984 by consolidating three SOCBs, namely, the HuaBei bank, the Beihai bank and the Xibei Farmer bank (PBOC, 2012). Officially PBOC, however, had only been legally granted China's central bank status on March 18, 1995, by the 3rd Plenum of the 8th National People's Congress (PBOC, 2012). In addition, Liew and He (2010, p.27) argue that the change of the status of PBOC in the early 1980s was a result of Deng Xiao Ping's reform that had 'opened the political space for contests over influence and implicit rankings within

bureaucratic hierarchy'. This round of reform had stripped MOF of a considerable amount of power over China's monetary control, thus having PBOC as the clear beneficiary.

In regard to the management of foreign reserves, since the establishment of the PRC to 1979, prior to the inception of SAFE, it had always been the duty of the Bank of China (BOC) to supervise and manage China's foreign reserves. The inception of SAFE in 1979, however, did not change much in terms of operations, since SAFE is only another brand of the same institution with BOC (BOC, 2012, accessed May 2013). At that time, BOC, or SAFE, was China's specialised foreign exchange bank, which accumulated and managed foreign exchange funds as well as facilitating "interbank deposits and loans" (BOC, 2012).

Not until 1992, when roles and responsibilities between SAFE and BOC were clearly separated, did SAFE become a solely independent institution in charge of managing foreign exchange on behalf of PBOC (Wu and Seah, 2008, p.47). In other words, the tide of power struggles over management of foreign reserves had hit its milestone in 1992, because the reform stripped BOC of its operation over foreign reserves administrative duty, downgraded BOC into a purely SOCB and given the role to SAFE—meaning that MOF had lost all of its control over foreign reserves management to SAFE, a subordinate of PBOC.

To confirm SAFE's status, its legal identity was officially verified in the Law on People's Bank of China 1995, which indicated that SAFE was merely an assistant of PBOC to administer and manage foreign reserves, and that the PBOC is the sole owner of the foreign reserves and takes full responsibility over matters of foreign reserves (Hu,

2010, p.7). This served as a clear warning signal from the State Council to force MOF to stay away from the matter of foreign reserves, at least for the time being.

Nevertheless, despite clarification of the issue of authority over foreign reserves, the political struggle within China's monetary system between MOF and PBOC continued, especially on the issue of the SOCBs. Since MOF is the owner of the SOCBs, and PBOC is the designated regulator of the SOCBs —therefore, both MOF and PBOC have considerable power and influence over the state-owned banks, which played such a vital role to China's economy and finance (Liew and He, 2010, p.28).

3.3.2 PBOC and MOF battled over SOCBs through its NPLs problem

During Mao's central planning economy, where China's monetary policy basically just followed according to the plan, the PBOC was without ministry status as it has today, and was merely MOF's subordinate as an ordinary state-owned commercial bank (SOCB), while occasionally responsible for a 'limited function of a central bank' (Liew and He, 2010, p.27).

More woes for MOF befell a few years later, as China prepared itself for the Asian economic crisis, started in 1997. Premier Zhu Rongji, who was a once a governor of PBOC, used this crisis as an opportunity for reforming and lifted PBOC's hierarchy status to even further at the expense of MOF, argue Liew and He (2010, p.28).

In spite of safely going through the test of the Asian economic crisis in 1997, there was growing concern in non-performing loans (NPLs) of SOCBs that could force a few of them into bankruptcy, as well as posing a systematic risk to China's banking and financial sector as a whole. According to Adams, et al. (1998, p.152), there was a report from PBOC that the ratio of SOCB's NPL in 1998 stood at 20% while only '6% considered as

unrecoverable', nevertheless, Western scholars (such as Lardy, 1998), argued that in reality, the figure of China's NPL was much higher than the PBOC's estimate.

Moreover, they also argued that it was loans from state-owned enterprises (SOEs) that contributed as a main source of SOCBs' NPLs. It was clear that the problem of NPLs from loss-making SOEs, which were considered as 'an expensive burden' for Chinese government, would not go away unless dramatic measures were taken (Lee et al., 2001, p.165).

The problem of China's SOEs was not entirely new, its first net losses occurred in 1996. However, the more worrying facts were that almost half of industrial enterprises were experiencing losses, while there was speculation about SOEs hiding losses since 1993, thus, the job of estimating the size of NPLs had turned out to be very difficult (Lee et al., 2001, p.177). One important catalyst that increased the ratios of SOCBs' NPLs was the policy started in 1992, which tried to replace direct government subsidies with bank loans in the hope that the SOEs would be careful on their inefficient operations. As the loans went unpaid, and ratio of SOCBs' NPL became worse, the PBOC started to insert more influence through its supervisory and monitoring role over SOCBs, which were wholly owned by MOF (Liew and He, 2010, p.28).

Despite the growing concern, there were in fact reports of losses in SOEs and a few successful attempts of reforms. One of the early examples is the city of Zhucheng in Shandong Province in 1993, which after admitting years of losses and risks of bankruptcy of its SOEs, the local government privatised its 'small and medium-sized of SOEs' to workers and those in managements of the SOEs by selling shares as a way to improve the balance sheets and avoid insolvency (Zhang, WK 2009, p.7).

However, for the rest of the local governments and SOEs progress had been slow, and it was not until near the end of the millennium that the central government realised that its back was against the wall. By 1998, the central government had continued to provide fiscal subsidies to loss-making SOEs at the high ratio of 30%³⁹ to government deficit even though they had also been borrowing from the banks and, thus, had their unpaid debts stacked up to the level, which threatened the health of SOCBs' capital base (Liew and He, 2010, p.28). As a result, during the Fourth Party Plenum's CPC Central Committee in 1999⁴⁰, which was highlighted by China's willingness to accept 'private ownership of large enterprises', the State Council decided to push full-scale reform of SOEs by getting rid of the loss-making ones either through privatisation, downsize, or foreclosures (Lee et al., 2001, p.165).

The committee by now understood that the problem of saving SOCBs by lowering their NPLs and restructuring the debts that caused the NPLs in the first place were systematically linked and inseparable. Hence, the State Council initiated two parallel approaches to deal with both problems simultaneously as follows:

The first approach was designed to help improving SOCBs' balance sheet and lowering the ratio of NPLs. The responsibility was given to PBOC instead of MOF to raise the capital base of SOCBs to the benchmark of 8% capital adequacy ratio set by the Bank for International Settlements (BIS)—this was because the MOF had their hands full with a large fiscal deficit as a result of the Asian crisis. PBOC once again found itself in the position to show off its capacity and outshine its rival, MOF, in the attempt for the State

39. From 1993–1997 the ratio of subsidies to loss-making SOEs to the government deficit were in the range of 60%, not until 1999 that it has lowered to 16.6% and a more manageable figures from 2000s onwards thanks to stimulus package of 1997's Asian Crisis (Liew and He, 2010, p.29).

40. Economic strategy of 'Advance and Retreat' was the theme of The Fourth Plenum's CPC Central Committee (Zhang, WK 2009, p.7).

Council to clean up one of the most vital problems in the monetary system (Liew and He, 2010, p.28–9).

The second approach was tailored to help SOCBs clean bad debts off the balance sheets. Before the millennium, the State Council orchestrated to swap the ¥1.4 trillion worth of SOEs' NPLs to four Asset Management Commissions (AMCs) at par value with AMC's bonds worth 55% of the overall value, while the rest was given to PBOC as a payment for SOCBs' debts. In addition, the left over of SOEs' debts owed to PBOC was converted into AMC's equity. Liew and He (2010, p.30) In the meantime, the State Council also required local governments to re-evaluate their position of SOEs' ownerships (Lee et al., 2001, p.166).

As a result, the SOCBs had a more healthy balance sheet, while the SOEs took a long breather and had a decent period of time to restructure their operations, as well as having a chance to buy back some of its equity if they could become profitable businesses again. This was a great chess-playing move from the State Council; however, it only deepens the rivalry between MOF and PBOC. Below is the explanation.

Firstly, MOF was the clear beneficiary from the arrangement, since it could strengthen its own books through the larger size of overall capitalisation of SOCBs that MOF was the sole owner. Secondly, the AMC's bond used as collateral and payments owed to PBOC did not have any guarantor of the debts, therefore PBOC could be holding onto nothing but toxic financial waste if the plans to restructure SOEs did not work out (Liew and He, 2010, p.30).

3.3.3 PBOC—its comeback through the establishment of Central Huijin

AMCs found little success and effect on the State Council's main mission to save the SOCBs due to its difficulties in restructuring, especially, in the attempt to laying off workers in order to cut losses which contributed to NPLs. To elaborate, AMCs were pressured by CCP to lay off workers only in small amount since CCP was afraid of the political consequences and impact the lay-off might have to the society. To make things even more complicated for the Chinese government, its WTO entry meant that it had to surrender the monopoly of the financial sector and modernize its bank to international standards, within the time frame of a five-year grace period, which ended in late 2006. The State Council once again had to come up with a new plan to solve the SOCBs' NPLs much more quickly and they could not afford to fail.

As a result, the Third Plenum of the 16th CCP congress in 2003 established the Central Leading Group on Reforming the Shareholding of SOCBs (CLGRSS) to solve the difficulties and amend the rivalry between MOF and PBOC that had created deep mistrust between them from debt swap programs in 1999. However, it seemed as if the CCP congress understood that the PBOC was treated unfairly from the unsecured AMC's bonds, the members nominated in CLGRSS were heavily 'dominated' with either former or current leaders of PBOC; therefore, it is not a surprise that the reform initiated by this CLGRSS would be a great gift from the congress to even its chance at the expense of MOF (Liew and He, 2010, p.32).

After months of consideration, the goal was set within CLGRSS that they would try to strip the ownership rights of SOCBs from MOF to PBOC. However, before that could be achieved, they would need to go around the law that prevented the central bank from having the direct ownership rights to the SOCBs—by setting up a shell company,

Central Huijin Investment Ltd.⁴¹ to hold all SOCBs shares, with a governance structure as a subordinate to PBOC (Liew and He, 2010, p.32).

Central Huijin is a company set up with a starting capital of US\$45 billion transferred from SAFE's foreign reserves. At the time, Central Huijin had two major tasks. First was to make the SOCBs' financial statement attractive enough for global investors before putting them on the stock market. Second was to upgrade these banks so they were ready to compete with the foreign banks after the grace period was over. In order to achieve that, Central Huijin would use its capital to invest into SOCBs's shares and then convert those equities into capital to write off the debts for the SOCBs, and thus help to dramatically improve the balance sheet of the banks. It would also lift tremendous pressure off Beijing and its SOEs on the debt-structuring program.

Out of the overall portfolio of Central Huijin, 91% of its assets were concentrated in four main state-owned banks, namely, Bank of China (BOC), China Construction Bank (CCOB), China Development bank (CDB) and Industrial and Commercial Bank of China (ICBC), worth at US\$22.5, US\$20, US\$20 and US\$15 billion respectively (Zhang and He, 2009, p.105). The rest of the portfolios were the holdings in smaller banks and financial institutions (CIC, 2010).

41. 中央汇金投资有限责任公司

Table 3.1: Investment Portfolio of Central Huijin Ltd., 2003-06

Month	Year	Company	US\$bn
December	2003	Bank of China	22.5
December	2003	China Construction Bank	20
December	2003	China Jian Yin Investment	2.5
June	2004	Bank of Communications	0.36
April	2005	Industrial and Commercial Bank of China	15
June	2005	China Galaxy Securities Company	1.21
August	2005	Shenyin and Wanguo Securities Company	0.31
August	2005	Guotai Junan Securities	0.68
August	2005	China Galaxy Financial Holding Company	0.12
September	2005	China Everbright Bank	2.47
December	2006	China Development Bank	20

Source: Zhang and He (2009, p.105)

From the detailed portfolio of Central Huijin in Table 3.1, the historical data clearly hints at the nature and the strategic objectives behind its creation, as well as its importance to the development of Chinese's domestic banking and financial institutions.

According to Central Huijin's official website, Central Huijin is:

"...Authorized by the State council to the extent of its capital contribution, exercise rights and perform obligation as an investor in major state-owned financial enterprises on behalf of the State, with the goal of preserving and enhancing the value of state-owned assets" (CIC, 2011a, accessed May 2011).

The MOF lost considerable ground on this new round of competition between itself and PBOC. Central Huijin led both institutions to a new fighting arena—this time it was the right to invest China's vast foreign reserves that had been reserves for only SAFE.

From 2004 to 2007, however, as this chapter discussed earlier, China suffered more pressures to increase its domestic currency, as well as facing higher costs as a result of growing foreign reserves that had increased at dramatic pace. MOF saw this opportunity to

get back into a race against PBOC, and had expressed to the State Council that it had every right to manage the foreign reserves by using the case of Japan's Finance ministry that was in charge of the reserves (Eaton and Zhang, 2008, p.10). MOF started its cunning strategy by first presenting an idea to set up a Financial Assets Commission, which would be running in compliment of State-Owned Assets Supervision and Administration Commission (SASAC) that are in charge of all government assets except the financial sector (Eaton and Zhang, 2008, p.10–1). MOF proposed that this newly established commission would be responsible to absorb Central Huijin, since they felt that PBOC had enjoyed too great privilege over the inception of Central Huijin and its ability to invest China's foreign reserves.

After a fierce battle, top leaders made the decision that they would not allow the creation of the Financial Assets Commission. However, they bought the idea that SAFE was no longer an efficient machine to manage China's vast reserves, and therefore pushed for a new investment company that could put the growing reserves in other financial products rather than conservative US Treasury's bonds—China Investment Corporation, CIC.

Conclusion

Since the establishment of PRC in 1949, China and its economy has gone through various difficulties and adversities before it became the world's second largest economy and holding the greatest amount of foreign reserves ever recorded. From Mao's central planning, which led to expensive lessons of the Great Leap Forward and the Cultural Revolution, to Deng Xiao-Ping's Opening China its economic structure and policy had helped to shape a strong fundamental and a healthy environment for the foreign reserves to

grow. However, not until the aftermath of the Asian economic crisis in 1997 and China's WTO entry in late 2001 that the world witnessed a dramatic growth of foreign reserves due to staggering trade surpluses and speculative capital inflows. China was then faced with costs of holding excess reserves, and thus forced its State Council to find the best solution to solve the growing problem, which they experimented with in Central Huijin in 2004.

The attempt to correct the macro-economic problems revealed the political struggles within China's monetary authorities, namely, PBOC and MOF over the more concerning issues of SOCBs' NPLs. By 2007, it was clear that with the on-going pace of trade surpluses, China should urgently seek a new platform or agency to make better use of its foreign reserves. In September, China's first official SWF, China Investment Corporation was established. However, it was not created only to correct the micro-economic problems as a result of gigantic reserves as the State Council declared, it was designed to serve various dimensional purposes, of which we will find in more detail in the next two chapters on how CIC assisted SOCBs and SOEs to fulfill 'Go-global' strategy.

Chapter Four:

CIC—Competing with SIC and revolutionising SOCBs

"We will increase transparency without harming the commercial interests of CIC... Transparency is a really tough issue. If we are transparent on everything, the wolves will eat us"

—Lou Jiwei

CEO of CIC speaking at a dinner hosted by the Mayor of London, 9 December 2007

As they approached the fourth quarter of 2007, China's top leaders faced two rather mixed fortunes of issues regarding its economy. The first was quite good news: China had solidified itself as the world's largest foreign reserves holder, estimated at US\$1.4 trillion⁴² in August 2007, with the expectation to grow even larger due to its growing trade surpluses (PBOC, 2008, accessed June 2012). The second issue was a rather gloomy one: its reserves were losing value worth US\$4 billion every month (Mcgregor, 2008, accessed August 2008). This was due to the appreciation of China's local currency, the RMB, which had been appreciating since the abolishment of pegged-rate exchange against the US dollar in 2005. And to make matters worse, the RMB was expected to be even stronger, like a lurking shadow of China's growing economy.

To solve this growing monetary concern, China's first ever SWF, China Investment Corporation (CIC), was established in 29 September 2007 (CIC, 2011a, accessed May 2012). However, this macro-economic difficulty was not the only concern for the State

42. China's accumulated foreign reserves was having a dramatic growth during 2007—starting the year with US\$1.1 trillion in January and ended the phenomenon year with US\$1.52 trillion by the end of December (PBOC, 2008, accessed June 2012).

Council. In the opposite, there were altogether at least four alarming main issues in regard to the financial sector, monetary supervision and the developments of local firms waiting for the Central Politburo of the Communist Party of China to find suitable solutions.

Firstly, as introduced above, People's Bank of China (PBOC), State Administration of Foreign Exchange (SAFE) and the Ministry of Finance (MOF) were all under pressure from the public to solve the on-going depreciation of its foreign-currency denominated assets. Secondly, the bitter relationships between the MOF and PBOC had reached the boiling point. This was due to the benefits PBOC received from setting up Central Huijin and getting a first ticket to invest China's foreign reserves. Thirdly, problems of NPLs of SOCBs and SOEs, as well as the local governments, were also still not fully dealt with. Fourthly, the big four banks which were equal to main bloodline for SOEs, local businesses and the economy, were not yet ready to face the fierce competition in the market now that the grace period given by the WTO was over.

This chapter, argues that these four issues are what the State Council was trying to solve by setting up CIC—far more than the conventional thought that CIC was only set up to help China offset its losses from excess reserves in US dollars.

In order to defend the arguments above, this chapter is divided into two smaller sections as follows: (1) the first section discusses how CIC helped to solve political problems within the monetary system, between MOF and PBOC, and how its starting capital helped to retain balance of power between the two rivals; (2) the second section explains how CIC helped to fix issues within the financial sector by strengthening the banking and insurance sector and the rest of credit providers, through helping them to dilute the NPLs ratio. It also discusses how CIC equipped them with the management know-how and partnerships with world leading financial institutions. The whole process

proved to be a highly innovative solution to the problems of excess reserves, inflation, and NPLs.

4.1 CIC and how the State Council used it to solve political rivalry within Chinese monetary system

This dissertation has discussed extensively, in Chapter Three, the bitter relationships between MOF and PBOC. To recall, MOF had been waiting for the moment to realign the balance of power within the monetary system after it had accepted the defeat in losing control of the newly created Central Huijin in 2004 to PBOC. Without a doubt, what MOF had in mind was the most precious of all assets in the system—the right to invest China’s growing foreign reserves.

This section aims to explain three main points on how the establishment of CIC could facilitate the State Council in making use of the existing rivalry within its monetary system. First is to describe the political development towards the creation of CIC and why CIC could help to solve a macro-economic paradox of loss-making excess reserves from China’s export led policy. Second is to examine CIC’s source of capital, ownership structure and its acquisition of Central Huijin, which were all considered as the re-alignment of Chinese monetary power. The State Council was determined to swing the favour back to MOF by allowing it to take part in investing China’s excess reserves with strong financial backing from the holdings of SOCBs’ lion shares through Central Huijin⁴³. The last section explains how the State Council utilised CIC to turn bitter rivalry between MOF and PBOC into a constructive and competitive race while handling the matters of

43. Central Huijin’s inception was previously considered as a heavily pro-PBOC, however, as CIC acquired the fund in 2007, MOF could exert its political influence into Central Huijin as well as using it to back the financial burden of CIC’s obligation.

excess foreign reserves. In order to meet these objectives, the section is divided into three smaller subsections as follows: (1) establishment of CIC—political product under macro-economic excuses; (2) the complicated starting capital of CIC and its awkward ownership structure; (3) rebalancing of power—through CIC’s portfolio and the inception of SIC.

4.1.1 Establishment of CIC—political compromised product under macro-economic rationale

Since 2005⁴⁴, China has experienced a dramatic increase of its annual net exports. The increase of export value was in parallel with China’s trade surpluses against other major trading countries, especially the US and EU. These surpluses were contributing to China’s vast foreign reserves, which by 2006, was already ranked as the world’s largest. These developments played an important part in the political rivalry within the Chinese monetary system, as described in the previous chapter. To recap, since 2004, the MOF had been looking for an opportunity to exert its influence on China’s growing reserves after its defeat by PBOC on the control of newly-established investment fund, Central Huijin, which had been given the permission to invest US\$45 billion worth of excess reserves in the ailing SOCBs.

(1) PBOC’s inability to deal with macro-economic paradox and political pressure

The moment MOF was waiting for had finally arrived in the second half of 2007 as China experienced an unprecedented loss from US dollar depreciation out of its gigantic US\$1.4 trillion reserves that had increased dramatically within the previous six months (PBOC, 2008 accessed June 2012). In addition, a great amount of capital inflows put

44. The increase in net export was heavily due to the lift of pegged exchange rate against dollars on 21 July 2005.

tremendous pressure on the central bank, PBOC, in allowing RMB to appreciate—otherwise, China could face a hike of inflation, as the economy was flooded with excessive domestic monies. According to the statistics, the amount of the capital inflows in first three quarters of 2007 is equal to 70% of China's GDP in 2007, while the historical chart of inflation rate shows that inflation is being pushed from 2.25% in January 2007 to over 6.5% in September 2007 (Bank for International Settlement–BIS, 2008, p.207; Inflation.eu , 2014, accessed July 2014). This made PBOC look very helpless, especially on its inability to cope with the inflation and loss-making from China's growing exchange reserves as the dissertation have described in Chapter Three. I called this phenomenon as a Chinese macro-economic paradox as a result of its export-oriented policy combined with a tight monetary control regime, especially on current account convertibility and artificially cheap local currency (Mercurio and Leung, 2009). The inability and the limitation of PBOC to deal with the above issues were believed to be one of the main impetuses that successfully convinced the State Council to establish CIC. This is proven by the consensus of Chinese leaders during the National Finance Working Meeting in January 2007 which they proposed a way to manage China's excess reserve through setting up new identity, separately from the PBOC (Shih, 2009, p.336). Luarens and Maino (2009) confirms that PBOC has great difficulties trying to manage either capital supply, foreign reserves and inflation rate, it has been heavily relying on increasing the Statutory Reserve Requirement Ratio (SRR) from the banks. To emphasize, the SRR ratio was raised three times in 2006 and 10 times in 2007, clearly PBOC was running out of new tricks (Luarens and Maino, 2009, p.139-40). Therefore, before we can fully understand how CIC would be utilised in solving the political struggle of the Chinese monetary system and its fundamental problem, we first need to be able to grasp the macro-economic developments during this period

prior to the establishment of CIC. Or in another words, we need to understand possible options that PBOC had—while dealing with problems of over-supply local monies and on-going depreciation of its foreign currency denominated assets.

In order to manage inflation, generally, a central bank would prefer to let the local currency appreciate in accordance with the country's increasing capital inflows that result from prosperous trades and a stronger economy (Castle, 2010, p.439-40). The appreciation of local currency then would effectively reduce the supply of monies flowing in as payments of trades, as stronger currency would lower local's trade competitiveness as its goods became comparatively more expensive than other goods denominated in foreign currencies from other countries (Castle, 2010, p.440-1). And for China, the cheap currency has been used for promoting exports and growth (Cheng, 2007). Unfortunately for PBOC, it could not follow this approach since the rapid RMB's appreciation could cause two significant results. Firstly, it would cost more losses on its US dollars holdings of foreign reserve assets as it was described in Chapter Three. By 2007, this trend was still expected to continue and the losses could even increase as the surplus continued to grow larger—this development did not sit well with Beijing's top leaders and they have long thought about the alternative fund as the Chapter mentioned earlier (Shih, 2009, p.336). Secondly, National Development and Reform Commission (NDRC), MOF and other agencies who had stakes in SOEs were against the currency appreciation since the stronger RMB would automatically increases the real interest rate—which meant higher cost of loan obligations for SOEs' stake holders (Liew and He, 2010, p.34).

Hence, having had to thrive through political power-plays with SOEs' stakeholders, as well as potentially putting itself in the firing line if foreign reserves holdings faced more losses, PBOC had no choice but to abandon this option and was left with the following

option. In order to survive the political pressures from NDRC and watchful eyes of the State Council, PBOC decided to use an unorthodox method to cope with the over-supply of domestic currency. Firstly, PBOC decreased the RMB's supply through currency sterilisation by selling bonds. It did this by a highly unconventional route—freeing up SOCBs capital by lowering SRR and then forcing them to buy PBOC's bonds at a set price (Liew and He, 2010, p.34). In the meantime, in order to stop the capital inflow, PBOC then pushed the interest rate to a lower than the market level. However, as the demand for domestic capital increased due to an artificially cheap interest rate, SOEs and other ailing enterprises were not able to compete for needed capital. As a result, PBOC then had to prioritise them with rationed-loans to keep them afloat (Liew and He, 2010, p.34). With the above method, PBOC could decrease the supply of domestic monies and sustained a slower rate of RMB's appreciation, but it came with a price that required them to distort the market.

Despite its ability to still hold the tight margin of RMB's appreciation and seemingly able to manage inflation as it were, these rather awkward measures had cost great losses for the overall economy. Firstly, non-state borrowers did not have access to the allocated soft-loans and, instead, had to compete for higher rates from the remaining amount of capital in the market. This caused them higher financial costs and indirectly affected their growth. Secondly, PBOC also gave loss-making SOEs unfair advantages—those, which indirectly prevented them from being effective in spending and efficient in their day-to-day operations. Most importantly, PBOCs' desperate measures could not stop losses out of its growing foreign reserves that had been climbing to its new high everyday—with no obvious indication to stop and break the trend. The increase of capital flight during this period could be used to support the argument that by preventing RMB to

appreciate naturally, it created the margin for speculative buys on RMB—considering its larger trade surpluses and double-digit growth economy. Thus the painstaking measures initiated by PBOC inversely caused even more capital inflows into China and, hence, an even larger size of foreign reserves.

Hence, without the ability to effectively stop the inflows of capital together with the fact that its sterilization plans had negative impact on the growth of the private sector and overall economy, PBOC was in a lose-lose situation with no positive solution—it was clearly in an extremely vulnerable position, waiting to be slaughtered by political oppositions and public criticisms.

(2) MOF seized the opportunity with the idea to set up SWF

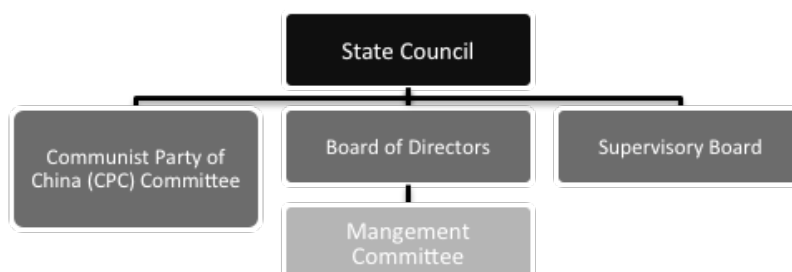
The MOF then seized this opportunity to point out the incapability and weakness of PBOC and SAFE in handling the reserves. The MOF used the above macro-economic developments and flaws of monetary management and the pro-export currency regime (which encourage trade surpluses, but foreign holdings assets are devalued as RMB appreciates) as an excuse to leverage its position with the State Council towards gaining access to China's foreign reserves. Finally, through diplomatic negotiations with main committees and governmental bodies that took charge of China's economic, financial and monetary developments such as the Central Leading Group on Reforming the Shareholding of SOCBs (CLGRSS), National Development and Reform Commission (NDRC), and PBOC, MOF got what it wanted: a compromised deal that would create a new organisation, China Investment Corporation, under the conditions which greatly favoured MOF (Liew and He, 2010, p.36–8). However, it turned out that CIC's creation was not quite enough for the MOF, as its officers wanted to make sure that they had capitalised this momentum well in further reducing PBOC's power within monetary

authority. For this reason, MOF persuaded State Council to also transfer Central Huijin to be a subsidiary under this newly created CIC. The argument MOF put forward was that PBOC's ownership of Central Huijin created a conflict of interests where monetary regulator (PBOC) became also the owner of the banks (SOCBs) through its control of Central Huijin (Liew and He, 2010, p.37).

As a result, on 29 September 2007, CIC was setup by the Chinese State Council as a Ministerial level organisation, with the starting capital of US\$200 billion (Zhang and He, 2009, p.104). To fully appreciate the significance of CIC and the shift of power within the monetary system, we have to look at the governance structure of CIC in the Chinese political system, as well as the composition of its assigned officers.

In regard to the governance structure, Zhang has confirmed the special status CIC possessed by singling out CIC as 'the only Ministry-level SOE' of all of the government's enterprises; even SAFE, responsible for most of China's gigantic reserves, is still only a vice-ministry level authority which belongs to the PBOC, one level down from CIC (Zhang and He, 2009, p.104). In another words, the Chinese State Council sent a signal to all communist party members and the rest of its organisation related to managing foreign reserves, especially SAFE, that CIC is indeed their favourite new-born son.

Figure 4.1: The governance structure of CIC



Source: Zhang and He 2009, p.104

Regarding the CIC's core staffs, in order to please monetary rivalries, the Chinese State Council assigned a mixture of former officials of MOF, MOC, PBOC, SAFE and NDRC as members of CIC's board of directors, management committee, as well as its supervisory board (Zhang and He, 2009, p.109). They were all to be under the leadership of Lou Jiwei, a former vice-minister of finance and deputy secretary-general of the State Council⁴⁵ as chairman of the board of directors.

Michael Cognato, Project Manager at National Bureau of Asian Research (NBR), commented that the selected CIC board members and its leading staff were 'China's most skilled financial bureaucrats', many of whom had proven records as pro-market reformers as well as strong supporters for 'financial modernisation' (Cognato and Altbach, 2008, p.11-2).

Having looked through macro-economic developments as well as the political background behind the CIC's establishment, it is not too bold to state that CIC was a clearly political product. It was regarded as 'a compromise' mainly between PBOC and MOF over the rights to invest excess reserves and how to efficiently manage them, with this time MOF has won a battle in inserting more influence over CIC. Shih (2009, p.334-5) added that Lou JiWei's appointment was made possible because Premier Wen Jiaobao was known to have MOF as his 'bastion of power in the economic bureaucracy'. MOF was also able to have Vice Minister of Finance, Zhang Hongli) as CIC's vice manager as well as getting two important seats on the board, while PBOC and SAFE could only secure the position of vice manager and seats of non-executive board (Shih, 2009, p.336-7).

45. Lou Jiwei was promoted to this position, which carries ministerial rank just in March 2007, less than just 6 months before the establishment for CIC. See Xu and Bahgat (2010, p.38). This might be a move to support Lou as a qualified candidate for the head of the CIC, since it is regarded as a ministerial level position in the governance structure.

Nevertheless, the governance structure and staff selections within CIC were not the only areas to be contested. In the next subsection, the dissertation will examine CIC's starting capital and ownership structure in detail and explain why they mattered to the State Council's attempt to steer its monetary rivalries in the right direction—towards a competition.

4.1.2 CIC—its starting capital and unique ownership structure

According to CIC's first ever annual report published in July 2009, CIC's starting capital was 'capitalised with US\$200 billion in (foreign) reserves, purchased from the PBOC in exchange for ¥1,550 billion in government bonds issued by the MOF' (CIC, 2009, p.10). Or in other words, it was a swapped asset between MOF's issued bonds and the US dollars-denominated foreign reserves of PBOC. In regard to the financial obligation, the bonds carried a liability of around 4.5%⁴⁶ interest per annum, payable directly to the MOF (Anderson, 2009, p.50, Thomas and Chen, 2011, p.473).

This rather complicated financial arrangement had two significant impacts: firstly, the consequences to the monetary management of China's foreign reserves and domestic supply of monies; and secondly, the implications of the ownership structure of the CIC itself. These two impacts are elaborated in the following sections.

(1) Impacts on monetary management

Although this might look to be a good start for PBOC as a way to effectively sterilise its excess reserves through this similar process, it produced four benefits as follows: (1) PBOC could diversify its foreign reserves to assets with higher rates of

46. Anderson (2009) explained that there are three tranches of bonds being issued from August 2007 to December 2007, each worth around US\$67 billion, all with slightly different rate of interest, 4.3%, 4.45% and 4.5%, with the first has the maturity of 10 years while the other two bonds' maturities were 15 years. See Anderson (2009, p.50, 213).

returns; (2) PBOC could decrease the supply of RMB denominated monies in the domestic market; (3) despite its sour relationships with MOF, the swapped program could help MOF to generate 4.5%, which still beat rates received from the US Treasury; (4) the liability should keep CIC on its edge to generate at least 4.5% plus its operational cost, in order to break even.

In reality, however, it was not that simple. This complicated matter can be explained three fold: (1) the liability owed to MOF was merely a symbolic arrangement the State Council arranged in order to verify the status of CIC that neither MOF nor PBOC was the owner of CIC. Moreover, by having CIC to borrow from MOF, MOF, therefore, was not a shareholder of CIC (Liew and He, 2010, p.37); (2) the hope of PBOC to use this currency-bond swap as a model to go forward was tarnished, since two-thirds of the ¥1.55 billion issued bond ended up in the hands of PBOC and other state-owned banks, rather than being purchased by Chinese individuals or enterprises (which would have been a more effective outcome for the problem of over-supply of RMB in the domestic market) (Thomas and Chen, 2011, p.474); (3) the task of overcoming a 4.5% interest rate liability payable to the MOF might sound plausible for CIC to be hopeful and defiant, considering examples of successful SWFs such as Temasek Holdings and GIC of Singapore, which could generate extremely high annual return rates since their inceptions, averaging 18% and 7% respectively. Unfortunately for CIC, when taking into account its primitive objective of solving the opportunity costs and negative returns from holding the foreign reserves in US dollars (Eaton and Zhang commented on this particular point), CIC's real term goal was not simply 4.5% returns. Instead, CIC needed at least a 10% returns in US dollar terms when 'factoring in RMB's appreciation against other major currencies' to turn any profit on its overseas investments (Eaton and Zhang, 2008, p.12). As I have indicated

in the figure above, this cruel fact had put tremendous pressure on CIC, which Lou Jiwei, CIC's Chairman and CEO, had expressed his calculated figure that CIC had to generate roughly ¥300 million a day to keep up with its liability and operational costs (Bradsher, 2011).

Figure 4.2: The process of CIC's acquired starting capital



Source: (Zhang and He 2009, p.105-6; Eaton and Zhang 2008, p.12-4)

(2) Implications to the ownership structure of CIC

It is difficult for us to identify CIC against the two well-known existing orientation models of SWF in regard to its relationship to the capital it invests. This is due to CIC's complicated origin of starting capital, described above. The first orientation model is to have SWF as a fund manager. A good example of this model would be GIC, which has been responsible for managing the capital on behalf of Government of Singapore and its central bank, the Monetary Authority of Singapore (MAS) since its inception in 1983 (Zhang and He, 2009, p.107). Within this model, the MOF has only a limited role as a representative of the Singaporean government in communicating with the SWF (Zhang and He, 2009, p.107). Both MAS and GIC official websites clearly stated that all assets invested in GIC belonged to the Singaporean government while GIC is merely a professional fund management organisation to assist MAS in managing city-state's reserves

(Ministry of Foreign Affairs of Singapore, 2012, accessed January 2012). In other words, GIC is only a caretaker of the fund and has no ownership over the fund; its capital can be increased or withdrawn according to the wish of the state — the true owner of the fund.

The second orientation model is having SWF acting as an investment fund, which accumulates revenues from particular sources, mostly from taxations or profits from natural resources. The Kiribati fund and the Stabilisation Fund of Russian Federation (SFRF) are examples of this second model; as the former accumulates its income from taxing bird manure, while the latter receives income from export duties and taxing oil mining (Zhang and He, 2009, p.107). Or in layman's terms, in the second model of SWF, it is the owner of the funds that are allocated by the state, and it is responsible to manage and utilise those funds according to the objectives set by the state. The key differences of the above two types of SWF's orientations is capital ownership and the governance structure of the funds, in other words, the first type is there to manage the fund, while the second is de facto the owner of the fund (Zhang and He, 2009, p.107).

On the issue concerning the CIC's ownership of the capital it is investing, Zhang and He have commented as follows:

“China Investment Corporation's orientation is very awkward, because it is neither a fund manager like GIC, nor a real fund like SFRF. We do not know how much capital CIC owns. We do not know who the real shareholder is of CIC. What we do know for sure is that CIC has a huge debt amounting to US\$200bn” (Zhang and He, 2009, p.107).

The State Council was fully aware of the ambiguity surrounding the CIC's ownership structure, and that the burden of paying debts, which was presumably assigned to stop PBOC from opposing the establishment of CIC, had truly become a difficult task

for CIC to overcome and be effective. They had to find way to lift and eliminate this burden off CIC's shoulders in order to make it into a real viable investment fund.

For this reason, the State Council had carefully planned in using sticks and carrots to please both PBOC and MOF over the matter of CIC. In 2008, to tame PBOC and keep them off the back of CIC (and MOF), the State Council quietly allowed PBOC's secretive subsidiary in Hong Kong, State Administration of Foreign Exchange Investment Company (SIC), to invest its fund in non-traditional assets. The move proved to be effective, as in 2009, the State Council could manage to keep PBOC quiet while it granted the agreement which converted CIC's liability owed to MOF into the latter's equities. As a result, CIC no longer had to pay any interest and also was free from any kind of financial obligations previously owed to MOF (Thomas and Chen, 2011, p.474).

Without a doubt, this then dramatically changed the relationship of the CIC and MOF—from a debtor and its creditor into a company and its shareholder. Still, the MOF was not the sole shareholder of the CIC since its US\$200 billion would be converted into only around 60% of CIC's equities. CIC was then transformed into a partly state-owned fund. Moreover, in terms of governance, MOF had neither any directly assigned seat on CIC's board, nor the direct control over, it had only a special relationship and influence through its former officials who came to be in charge of CIC's management and supervisory boards. In addition, the changed relationship had a much positive effect on CIC, as it helped to eliminate CIC's pressure of paying bond liability.

More importantly, a series of asset shuffles of China's foreign reserves clearly showed the two-horse-race competitive model the State Council had in mind—for having

MOF to influence CIC, while letting SAFE to invest abroad under PBOC's supervision. The details of these developments are to be discussed further in the following subsection.

4.1.3 Rebalancing of power within the Chinese monetary system through CIC's pre-arranged portfolio and arrangements with SAFE

Shortly after its establishment, CIC had revealed its pre-arranged portfolio and plans of how the US\$200 billion was going to be used. The initial plan was to have the fund separated equally into three portions. The first one would be used to acquire Central Huijin from PBOC at the par cost of US\$67 billion (Eaton and Zhang, 2010, p.496). The second portion was designated to be injected and recapitalize State Development Banks (SDBs) of around US\$67 billion (Eaton and Zhang, 2010, p.497). The third⁴⁷ and final remainder of its cash would then be spent on CIC's global operations—allocated to invest exclusively in foreign assets (CIC, 2009).

Within months after CIC's establishment in 2007, SAFE under PBOC was allowed by the State Council to invest its assets under management in non-traditional assets. The size of the allocated fund was believed to be approximately close to US\$90 billion as (Setser, 2009, accessed April 2010). The pre-designated portion of CIC's portfolio and the entrepreneurial spirit shown by SAFE in exploring unfamiliar territory of risk financial assets, I argue, were the re-adjustment of balance of power within China's monetary system—especially the MOF and PBOC.

This subsection discusses the implications of these two pivotal developments and therefore is divided into two smaller sections as follows: (1) the first is the changed relationship between CIC and Central Huijin, their respective objectives and scopes of

47. The remainder of the fund for CIC's global operation, however, was increased to US\$90 billion, due to the capital needed to recapitalize SDBs were scaled back (Zhang and He, 2009, 104).

responsibility as Central Huijin was transferred from the hands of PBOC in MOF-dominated CIC; (2) the second is how the State Council cleverly managed to maintain the rivalry between MOF and PBOC, but changed it into a competitive model—by allowing SAFE to invest in non-fixed income securities to compete with the performance of CIC under MOF's influence.

(1) CIC and Central Huijin's relationships

The role of rescuing and improving the health of SOCBs that had been transferred to CIC has not been paid much attention by both scholars and the media. To the contrary, it was one of most important tasks in improving the competitiveness and raising the standards of the Chinese financial institutions in the hope of creating its own domestic capital and future markets (Interview: C5, 2009). Interestingly, the US\$67 billion fund required to recapitalise China Development Bank (CDB) would have been given directly to Central Huijin if CIC was not created. As a result, CIC's officials could then enjoy the privilege of owning this second US\$67 billion capital pot including future available funds from PBOC (in case there was any more need for SOCBs or SDBs to be rescued) before passing the funds through Central Huijin. This also meant that the future profits from the acquired stakes in state-owned banks, including those that Central Huijin were holding, were due to be collected by CIC. The decision to let CIC acquire Central Huijin was in fact an attempt to re-adjust and re-align interests between MOF and PBOC officials (Interview: C5, 2009). However, this was just the beginning of the new battle. In regard to its structure, Lou explained that CIC consisted of two elements—(1) its own management operation which 'makes non-RMB investments globally' and (2) Central Huijin that invests 'exclusively in domestic state-owned financial institutions' (CIC, 2009, p.4-5).

Moreover, CIC claimed that it 'does not intervene in the day-to-day business operations of the firms it (Central Huijin) invests', which is in line with what CIC had been trying to show the world, that it only meant business and sought neither company's control nor political objectives (CIC, 2011a, accessed May 2012). This was supported by Central Huijin's statement on its website that despite its being a part of CIC, its investment business and management was conducted on behalf of the State Council (Huijin, 2012, accessed April 2012). In addition, Central Huijin's principal shareholder rights belonged to and were exercised by the State Council, more importantly, that its 'board of directors and board of supervisors are appointed by and are accountable to the State Council' (Huijin, 2012, accessed April 2012). However, by having its own boards apart from those of CIC might only be the attempt to conceive that they are operating separately—in the next subsection, the chapter will reveal the cooperation and how Central Huijin became part of the bigger strategy of CIC and State Council.

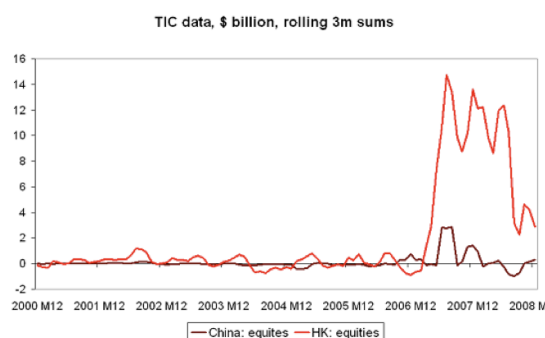
(2) SAFE's Hong Kong Subsidiary and its changing investment behaviour—battle for the right to invest excess reserves with CIC

PBOC and SAFE would not let the loss of Central Huijin haunt them too long. In April 2008, there were claims surfacing from *Caijing* magazine that SAFE had worked its way to get permission from the State Council to invest 5% of the foreign reserves (which had already piled up to a staggering US\$1.757 trillion) worth approximately US\$87.8 billion into non-fixed income investments (Wright, 2008, accessed May 2012). Wright commented that this amount is even greater than the portion CIC set aside for its global operations in 2008, US\$67 billion, moreover, he explained that the motive for SAFE to pursue the license to invest was that SAFE⁴⁸ would like to show that it too had the ability

48. SAFE was usually known for its duty for managing the investments in traditional assets such as US Treasury bonds and other fixed income assets.

to venture in riskier non-traditional assets (Wright, 2008, accessed May 2012). SAFE's Hong Kong subsidiary, SAFE Hong Kong Investment Company (SIC), is a rather secretive organisation. Hu Yu Wei, a Consultant of Chinese pensions at the OCED, claimed that 'SAFE did not publicly admit existence of this HK subsidiary until 2008' (Hu, 2010, p.7). So far until 2008, SIC has only spent about US\$7 billion altogether in funds of TPG, British Petroleum and France's Oil company, Total (Wright, 2008, accessed May 2012). In 2007 and 2008, it also invested in three promising Australian banks for US\$185 million (Schena, 2012, p.5) and also UK troubled Banks and for almost US\$700 million—US\$345.5 million in Barclays and US\$340.9 million in Royal Bank of Scotland (Hu, 2010, p.17). Despite that the invested value was not significant by SWF standards, however, this was due to the lack of information about SIC's operation. In March 2009, Brad Set argued from his analysis from Treasury International Capital⁴⁹ (TIC)'s data and quotes from Jamil Anderlini of Financial Times that SAFE had been investing through its Hong Kong subsidiary in equities since 2007, and that the invested value could be as high as US\$70 billion (Setser, 2009, accessed April 2010).

Figure 4.3: China's influence on the Hong Kong TIC data



Source: (Setser, 2009, accessed April 2010)

49. According to the US Treasury Department website, TIC system is a reporting system which monitored cross-border portfolio investment flows and positions between U.S. residents (including U.S. based-branches of firms with HQ in other countries) and foreign residents (including offshore branches of U.S. firms) (US Department of Treasury, 2012, accessed April 2013).

This figure was much closer to Wright's estimate at US\$87 billion than what we could gather from the press of around US\$7 billion. It revealed that State Council was playing a two-horse race for the CIC and SAFE to be on the edge and try to out-perform each other for investing in riskier assets. The more important development for SAFE might be its overall changing behaviour—the move from US treasury to other conservative assets. As of 2000, SAFE invested 77.2% in US Treasury, however, by 2008, the year that its Hong Kong subsidiary ventured into risky assets, the overall portfolio of SAFE also changed dramatically—the portfolio in US Treasury was reduced to a mere 43.3% and shifted the emphasis into government agency bonds at 43.7% and equities which stood at 8.3% (Hu, 2010, p.10). This dramatic shift in assets might frighten the US policy makers and Federal Reserve's staffs, however, what was considered scarier was the poor level of returns the US treasury bonds gave to holders, especially China. Hu argued that within eight-year investments, on average, China had received only 0.4% return in real terms, with the highlight of 2008 when it lost about 11.1% of its investment in RMB value (Hu, 2010, p.13).

As CIC became more and more transparent, the information about SIC remained very opaque. Moreover, as Chinese currency continued to appreciate even in 2012, SAFE's return on investment could not compare to CIC's results, despite its hiccup in 2011 with the losses. Therefore, it was more likely that the State Council would direct larger funds to CIC than SAFE due to CIC's better reputation on transparency and investment results, but this remained to be seen.

Nevertheless, it is better to have two agencies competing for the same job—if it could lead to better returns from its excess reserves. Eaton and Zhang (2010, p.13) believed that the Chinese leaders has 'tacitly endorsed' the competition between that the

competition between CIC and SAFE (SIC) even if they believed that the competition between the two SWFs might be unintended consequence of bureaucratic politics. This is because there clearly are benefits to be had for the administration since the competition would force both CIC and SIC to perform for high-rate of returns (Eaton and Zhang, 2010, p.13).

To conclude, politically, the establishment of CIC can be interpreted as a means to retaliate and readjust the balance of power of the internal struggle within the Chinese monetary system, especially between MOF and PBOC. From the board of directors, its political status and starting capital reveal the level of dedication and efforts of the State Council in trying to strike the right balance through a mediator such NDRC to keep both rivals content in their shares of investing China's excess reserves. The two-horse race between SAFE's SIC and MOF's dominated CIC present a new light in China's monetary rivalry—one which could bring them a more efficient mode of investing its growing foreign reserves.

4.2 CIC—how it revolutionises the Chinese Banking Industry

The previous chapter has already introduced the problems that Chinese banks were facing before the State Council decided to use Central Huijin to inject them with the needed cash. This section will recap and elaborate on those problems that continued to trouble the Chinese banking sector. More importantly, it will explain how the establishment of CIC can help to effectively and seemingly permanently cure those problems for the banking sector. Since the conventional acknowledgement of CIC using Central Huijin to inject more capital into the banks was seen as ways to ease the problem of undercapitalisation of the sector, this section will show that what CIC has been doing

was actually truly new and unconventional—it had found solutions not only on the issue of NPLs but also on how to make the banks into a better, more competitive, and most powerful group of financial conglomerates the world ever seen.

In order to meet the above intention in describing the developments and capabilities of CIC, this section is divided into three smaller parts. The first subsection explores in detail the problems that the Chinese banking sector was facing—which were underdevelopment and inefficiency, NPLs and tough requirements from Basel II. The second subsection discusses how CIC solved the problem of NPLs through the use of capital injections. Moreover, it also explains the impact of this measure as well as describing the benefit of CIC’s innovative use of China’s excess reserves by making its banks bigger. The second section will also describe how CIC capital injections and its global investment could help the Chinese banks to compete with foreign counterparts in the globalised world under market-based principles.

4.2.1 Problems of the Chinese banking sector

From decades of central planning prior to the 1980s, where the banks were merely suppliers of capital needed in the planned economy, to the attempts to reforms towards modernisation throughout 1990s and late 2000s, the Chinese banking sector in 2007, prior to CIC’s inception, was still troubled with problems of underdevelopment and inefficiency in how it operates and lends out money. Despite the four largest SOCBs having become a group of the largest banks in the world since its IPO in Hong Kong, their immaturity and lack of real world experience in a truly competitive market-based environment had prevented them from being in the same league with top Western counterparts.

However, if we are to blame the SOCBs or the whole Chinese banking industry overall for failure, that would not be a fair judgement of them. As discussed in the previous chapter, the SOCBs, despite their name of being commercial, were still practically only arms-length tools of Beijing in channelling funds to China's gigantic state-owned enterprises and various development projects, while the funding to the private sector was not a priority. Or in other words, much of the operations of SOCBs until 2007 had only been operating under the political order and guidance of the state, without ever actually having had much freedom to do what they were supposed to do.

As a result, when the five year grace period of having banking and financial industries protected, after the entry of WTO in late 2001 was over in 2006, the SOCBs were in the stage of learning how to walk on their own. The irony is that, even after the State Council's two great assistances of transferring their NPLs into the AMCs, and injecting more capital into the system, the SOCBs had needed more and more recapitalisation in order to improve the debt-asset ratios. This was the alarming sign that maybe the problems of the Chinese banking sector were far more complex than the State Council and policy makers ever thought they would be. It was the overall environment where the banks were operating in that had prevented their chance to be effective and profitable.

This subsection discusses the existing problems within Chinese banking sector prior to the establishment of CIC as well as the on-going concerns for the banks after CIC was in operation. This subsection is split up into two parts, each represents key issues as follows: (1) issues of NPLs and undercapitalisation and requirement from BASEL II and (2) underdevelopment and inefficiency of the Chinese banking industry as a result of China's internal environment.

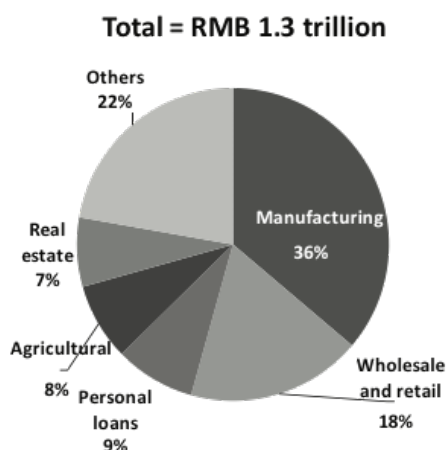
(1) Issues of NPLs and undercapitalisation and pressures from BASEL II

Prior to CIC's establishment in 2007, China's SOCBs—despite their successful IPOs and appreciation of prices in the stock market that made them, as a group, the largest banks in the world, they were still troubled by problems of undercapitalisation. The situation that China's policy banks had was similar—they were in difficulties due to massive NPLs from their local governments' lending as the latter commissioned local developmental projects and infrastructures. To recap, US\$33 billion were injected into the Big Four in 1998, and within two years later, US\$173 worth of NPLs was transferred into AMC's to improve the banks' balance sheet (Hamid and Tenev, 2008, p.450). And as we have learned from the previous chapter, Central Huijin had used its US\$60 billion kit to once again raise the capital-ratio of three of the Big Four, namely CCB, BPC and ICBC (Hamid and Tenev, 2008, p.450). Last but not least, before the Big Four went to their IPOs in 2006, ¥780 billion of NPLs were cleared off the books of CCB, BOC, ICBC and Bank of Communications (BOCOM) (Hamid and Tenev, 2008, p.450–1).

With a series of gigantic recapitalisations, it can be implied that many of the assets under Chinese banks could turn into NPLs or that the estimate of bad debts since early 2000s was indeed too optimistic about the size and ability of the banks to manage the risks of those debts. Even by the end of 2007, the NPLs of State Development Banks was still as high as ¥90.7 billion, it was clear too that policy bank would soon need more capital injection (Li, 2009, p.415). Nevertheless, with AMC's taking the most part of the NPLs, Chinese commercial banks could reduce NPLs to 6.17% by the end of 2007 from 13.6% at the end of 2004. However, it was clear to them that any new NPLs which were not considered as 'historic reasons' or what were considered as the costs of reforms from

central planning to a market-oriented economy would not be transferred to AMCs (Li, 2009, p.408, 412).

Figure 4.4: Li Tong's estimate on Composition of outstanding NPLs in the Chinese commercial banks' portfolio (as of December 2007)



Source: Li (2009, p.413)

One of the main reasons, besides increasing the incentive and attractiveness of the IPOs for investors, was to prepare itself to comply with international banking standards or the BASEL II, initiated in 2004. BASEL II consisted of three main parts, or what the BIS called the three pillars—(1) minimum capital requirements, (2) supervisory review process and (3) market discipline (BIS, 2004, accessed December 2011). What mattered most, with our concern here, is the first pillar which set various requirements for the bank's capital and debts ratios. The most widely used and discussed figure is the total capital ratio which 'must not be lower than 8%' (BIS, 2006, accessed December 2011).

The more capital required for the banks to set aside, meaning that their working capital that could generate profits, was lessened. Trouble dealing with or managing the rest of its assets efficiently could mean another round of recapitalisation. Nevertheless, what BASEL II does is to provide the banking industry around the world with some sort of

checks and quality-control of their operations and assets, to prevent potential meltdown or an unserviceable situation of bad debts ratio. In 2007, prior to CIC's establishment, none of the Chinese banks were ready to meet the requirements of the three pillars set by BASEL II. They needed more cash injections as well as reforms at SOEs and increasing size of the private sector to change their course towards having better debt-assets ratios.

(2) Underdevelopment and inefficiency of the Chinese banking industry due to institutional environment(s).

Apart from being used as political tools in allocating needed funds for SOEs and a few state projects, SOCBs had a small portion of capital left to provide for the private sector, which had domino effects on other social and financial developments in economic life outside of the state-led sphere. It is important to look at how those effects had impact on the operations of the banks once they were presented with new cash injections, and were ready to explore the market-based businesses. First of all, when the SOCBs were moving towards expanding their true commercial operations throughout the country, started in late 2001, they were not well-prepared and were inexperienced. SOCBs tried to enter into new local areas with various types of financial products and services without a proper understanding of the market they encountered. There are various works that studied the effect of diversification of the banks' assets and expansions. Boyd and Prescott (1986) proved with their models that diversification helps the banks to share the risks when accepting their prospective borrowers' loan applications. Berger et al. (2009, p.375) argued that diversification 'across sectors and regions' would help the banks to reduce their risks, moreover, they argued that diversification in their financial products and services would allow them access to customers who are in the market for 'multiple products'.

In addition, Iskandar-Datta and McLaughlin (2005) commented that the overall performance within the banks could benefit from having variety of managers with different sets of skills and local knowledge under a diversified organisation (cited in Berger et al 2009, p.375). On the other hand, Laeven and Levine (2007, p.363-4) argued that the banks with various operations and activities through multiple financial product offerings are worth more if they are to be broken into separate financial identities, or in another words—having too many diversified lending services leads to lowered overall value for the banks. In addition, Servaes (1996, p.1222-3) concluded from his research, based in the 1960s and 1970s, that diversification 'has not been beneficial for US corporation' and that it 'adversely affects shareholder wealth'.

Nevertheless, in the case of China, it came down to the lack of development in the private sector and the proper legal enforcement that would smoothen and protect the rights of both the banks and borrowers, as well as need for a sound credit rating mechanism. Berger et al. (2009, p.373) commented that the implementation of laws regarding financial contracts were being adopted 'unevenly across' China. More importantly, Hasan et al. (2009, p.168-9) argued that the development and presence of 'rule of law, more property rights awareness and protections' have direct effect on the economic improvement in Chinese provinces. Li (2009, p.420), a senior research analyst at the Milken Institute, argued that China lacked 'a mature credit rating system for businesses and individuals', therefore, the banks had put themselves in great vulnerability to risks and possibility of having their lending assets turning into NPLs. In regard to the size of the private sector, Berger et al. (2009) argued that even in 1999 the size of the private sector was rather small and that they had been relying on other sources of capital to fund their businesses. As a result, the profit making opportunity in this sector, in which the banks had proved to be

quite successful, was then limited by the economy of scale, as well as their previous operational regime, which never gave priority to the private sector.

Without the mature implementation of a legal framework, as well as an adequate size of the private sector, together with the inexperience in operating outside of its comfort zone, the SOCBs were in the position of still being in a learning process and needed more help from the State Council to assist them with more reforms and large capital. Hamid and Tenev (2008, p.450) gave the overall insight that the problems the Chinese banking industry had were not 'a fiscal issue', but rather it was about 'institutional building'.

4.2.2 How CIC solves the NPLs problems of SOCBs, SDBs and other financial entities

After CIC had acquired Central Huijin as one of its main subsidiaries, the responsibilities in maintaining and improving capitalisation of SOCBs, SDBs and few other key financial agencies were then automatically passed on to be an integral part of CIC's investment and operational strategies.

This section aims to describe two main points. Firstly, it discusses how CIC helps to solve problems of Chinese banks through the use of Central Huijin. Secondly, the section explains benefits and points of concern for CIC in taking this role of supervising and nurturing the banking industry.

(1) Improving the Chinese Banking industry through capital injections

Since being a part of CIC, Central Huijin continued to provide needed capital and expand its influence in China's domestic financial institutions. The first massive capitalisation of Central Huijin under CIC was to inject US\$43 billion worth of cash into

the China Development Bank (CDB) and the Agricultural Bank of China (ABC) in 2007. Other than direct cash injection, Central Huijin had used its strong financial status in issuing bonds, in order to raise cash for capitalising SOCBs and other financial firms. For instance, in August 2010, it was reported that Central Huijin would issue US\$27.6 billion worth of RMB-denominated bonds in order to increase its share in China's five biggest banks (China Daily, 2010a, accessed May 2013). Martin commented that the raised cash would be injected into the likes such as BOC, CCB, ICBC to gain extra shares and 'prevent the dilution of Central Huijin's holdings in the banks' (if those banks were to raise cash again in the future through issuing new shares) (Martin, 2010, p.7).

In addition, in August 2010, Central Huijin also used this method to acquire shares of the Export-Import Bank of China and the China Export and Credit Insurance Corporation through the sale of its bonds worth US\$7.9 billion (Martin, 2010, p.7). According to CIC's 2010 annual report, Central Huijin had altogether issued ¥109 billion or approximately US\$16.6 billion in bonds to refinance and recapitalise 'selected financial institutions in its portfolio' (CIC, 2011b, p.10). Central Huijin was also very active in acquiring more assets. According to its website, on 19th November 2009, Central Huijin had agreed with the China Insurance Security Fund Co. Ltd (CISF) to buy 38.815% of the New China Life Insurance Co. Ltd. (NCI). In August 2010, it bought 43.5% of the China Investment Capital Corporation (CICC) which was also owned by Morgan Stanley, Singapore's GIC, China National Investment and Guaranty Co. and Mingly Corp (Bright, 2010). The recapitalisation from CIC's capital injections had allowed Chinese banks to be in the position of meeting BASEL II requirements. According to sources reported by Reuters, by 2009, seven Chinese banks, namely, ICBC, CCB, BOC, ABC, BOCOM, China Merchants Banks and CDB were 'technically ready' to apply BASEL II standards (Reuters,

2009, accessed December 2011). However, the healthy state of SOCBs and SDBs were not only due the recapitalisation from CIC that had worked, but because Chinese banks were not feeling much of the effects from the 2007-8 financial crisis due to their relatively closed nature to international markets—or in other words, Chinese banks were lucky not to be fully-integrated yet with the global network and they were in good shape, not due to excellent management (Reuters, 2009, accessed December 2011).

In conclusion, Central Huijin can actively serve as fundraiser for any banks that needed extra capital or even with the possibility to raise cash for CIC's global operations. It was reported that, in September 2010, it had issued US\$8.1 billion without stating any intention of where the raised capital would be heading (Martin, 2010, p.7).

(3) Benefits and points of concerns for CIC on having Central Huijin as its subsidiary

Despite having to pay a third of its overall investment kit on Central Huijin, the amount required to recapitalise the China Development Bank (CDB), China's largest policy bank, and the Agricultural Bank of China (ABC), it was less than the amount previously anticipated at only US\$43 billion. Therefore, the rest of the fund of around US\$24 billion had been then directed towards CIC international ventures instead. The acquisition of Central Huijin and buying shares in SDBs were probably the best investment CIC could ever make. This is because the combined US\$110 billion that was used to purchase those entities in 2007, by the end of 2008, had turned into a massive profitable⁹ investment with the total value of US\$171 (CIC, 2009, p.47). Zhang and He explained that this was due to the dramatic jump of share prices of BOC, CCB and ICBC that Central Huijin owned on the stock exchange (Zhang He, 2009, p.105-6). We, however, should not feel overly excited about an unrealistic rate of ROI since the price that CIC paid

for Central Huijin was much lower than that of a market value; instead, it was the initial cost the PBOC paid to set up the Central Huijin. Therefore, even in 2007, the overall assets of Central Huijin was worth much more than US\$67 billion. In CIC's 2008 annual report, Lou Jiwei, Chairman & CEO of CIC, restated this point that it was Central Huijin's 'excellent performance' that had made possible for an overall 6.8% return on registered capital despite losses from its global operation at -2.1% (CIC, 2009, p.5). The acquisition of Central Huijin had also strengthened and secured CIC's position to honour its responsibility in paying interest to MOF, since the SCOBs would definitely generate handsome profits when listed on the stock exchange. This would show later that CIC had used Central Huijin's equities of SCOBs to pay the interest to the MOF in the first year, for example, on 25 March 2008, Central Huijin transferred 3 billion shares of the Bank of Communication as a payment to the MOF (Zhang and He, 2009, p.109).

Overall, in the dimension of a benefit, Central Huijin gave CIC tremendous support on five accounts. Firstly, CIC would be able to enjoy substantial profits from its domestic operations, due to the low price of SOCBs share Central Huijin acquired, which would help it to pay interests to MOF. Secondly, the growing size of Central Huijin's assets could be converted into cash in the future and transferred to CIC's global operations if needed. Thirdly, CIC then could initiate its influence over SOCBs as well as some big debtors through Central Huijin and SOCBs themselves. Fourthly, CIC could use Central Huijin as a fundraiser to its needs. And lastly, the profits from Central Huijin's shares gave CIC a good start and faced less criticism at home. On the other hand, despite that Central Huijin had strengthened CIC's position in covering future liabilities to the MOF, as well as helping to offset future losses incurred from overseas investments, especially in Blackrock and Morgan Stanley, it also brought the 'strategic' label to the office of CIC. This was

because CIC would find it difficult to deny its link with the Central Huijin operations. This was especially so when the critical time came facing the fates of those SOCBs, either selling or buying more of their shares, that would eventually drag CIC into the spotlight. Hence, the characteristics and assigned objectives of Central Huijin designed by the State council indeed made life difficult for CIC to present itself as a purely financial investor in the way its management team and China would like the world to see. The ‘strategic’ part of CIC would come back and haunt its management team in the future, especially when the host countries were in doubt whether there were any political intentions behind CIC’s investments.

In conclusion, the buy-out of Central Huijin, as well as owning the assets that would be directed towards restricting SOCBs had given CIC both benefits and some setbacks. Nevertheless, the following discussion will show that the benefits China had from having CIC to take over Central Huijin were far more rewarding than the potential setbacks.

4.2.3 How CIC revolutionised the Chinese banking industry by making it ready for competition with foreign peers

This subsection discusses the impacts of CIC’s operations on Chinese banks as well as drawing up the unconventional model of using CIC to utilise its excess reserves while making the banks much more competitive. The subsection is divided into two main parts. Firstly, the subsection explains how CIC operates and utilises China’s reserves in nurturing its banking industry—by injecting capital and by rigid control over banks’ dividend payouts. The second part will discuss how CIC’s global investment has offered new incentives

to growth of Chinese banks in a positive direction through joint ventures and foreign ownerships.

(1) Better by becoming larger

CIC and SOCBs capital injections as an attempt to meet BASEL II, to recapitalise the SOCBs, had at least three benefits to the banks themselves: (1) the larger size and lowered NPLs ratios; (2) more attractive balance sheets and incentives for investors due to association with CIC; (3) becoming more competitive against other foreign counterparts.

First of all, the capital injections, which would then convert into more shares, had automatically made them into a group of world's largest banks calculated by market capitalisation. According to Banksdaily.com (2012), a website which collects all banks' press releases into a database, the Industrial & Commercial Bank of China (ICBC), as of the end of 2011, was standing at world's number one with US\$240.95 billion. The second largest bank was also held by another Big Four bank, the China Construction Bank (CCB), with the market capitalisation of US\$195.85 billion. While the third and fourth place were held by the US and UK banks, namely Wells Fargo & Co and HSBC Holdings with the size of US\$161.05 and US\$150.9 billion respectively, the fifth place belonged to a Chinese bank—the Agricultural Bank of China, which had its value standing at US\$141.73 billion. The smallest brother of all in the Big Four, the Bank of China (BOC), had taken 7th place with market capitalisation of US\$128.8 billion in 2011. In other words, the total market value of the Big Four was a staggering US\$707.33 billion (Banksdaily.com, 2012, accessed May 2013). The recapitalisation would buy more time for the banks to carefully manage and refinance the debts if needed. However, the more direct effect of capital

injection was the sudden lowered NPLs ratio achieved through conversions of new shares from capital injections.

capital injection dramatically improved the balance sheets of the banks. However, there is one catch to this—the new shares that were issued by the banks to raise cash, would also automatically dilute the investors' earnings, due to more shares having to split the same potential pot of profits or dividends. CIC, being an owner of SOCBs through Central Huijin, had been pulling a trick from its sleeve—it could manage to force those banks to continue to pay out impressive dividends. This was voiced by Xiang Junbo, the chairman of the Agricultural Bank of China (ABC) who stated that the banks should 'avoid high levels of dividend payments' since they were put under pressure to meet the capital requirements and, therefore, need to execute more 'fund-raising exercises' (Bradsher, 2011, accessed January 2012). This is indeed a conflict in balance sheet management of the banks, however Keith Bradsher, the New York Times journalist who ran the story, commented that this might be because the CIC was in need of capital to service its bonds obligations and that the banks had been paying high dividends ever since being under control of CIC (Bradsher, 2011, accessed January 2012). As the chapter discussed earlier, the comment from Bradsher might not be entirely correct, since the debt obligation had been waived since 2009 when the State Council allowed the conversion of MOF's bonds that funded CIC into equities. Therefore, the high level of dividends were for CIC to make for itself a stronger position on the balance sheet— more impressive results to show the State Council that it was capable of investing China's excess reserves. The possible bonds' obligations were those that Central Huijin issued to raise extra needed capital in order to recapitalise banks.

Nevertheless, the high dividend gave CIC two main benefits. Firstly, being an majority holder itself, CIC would then receive the most benefits, and secondly, by giving out high ratios of dividends, the investors would not back out from the SOCBs—making them even more attractive with larger size and the indirect backing from CIC in case if the banks ran into problems of NPLs of liquidity shortage. A larger size that has put them in the elite group with the likes of HSBC, Well Fargo and JP Morgan Chase, has helped to boost their profiles as well as accessibility in business abroad. With sound reputation, potential to grow and a large and healthy cash to venture—CIC has indeed laid out a strong platform for SOCBs to go out and compete with the world's bests.

(2) CIC's abroad investments—knowledge, management and human capital benefits for SOCBs

The idea of teaching Chinese Banks to comply with international standards, while also making them to be competitive is not entirely new. In fact, the International Finance Corporation (IFC), the private sector of the World Bank Group, had been trying to get the Big Four and the rest of the Chinese banking industry on board with the rest of the modern world since 1995 (Hamid and Tenev, 2008, p.449). The idea behind it was to create a model bank locally so the rest of the country could watch and learn the international business practices and other management techniques, such as risk evaluation and standards (Hamid and Tenev, 2008, p.449, 457). The progress of the Chinese banks under supervision of IFC had been 'spectacular' (Hamid and Tenev, 2008, p.468).

The partnership and guidance from foreign counterparts with proven experience and of international pedigree was what CIC could do for its SOCBs. CIC's investments abroad since its inception had been largely concentrated on the financial sector. There is no

doubt that its investments were aimed at becoming more and more familiar with the world's savviest players in banking and finance.

The global operations of CIC began even before its official establishment; it acquired 101 million shares in Blackstone's IPO, for 9.9%, at around US\$3 billion in May 2007. Within the same year it poured another US\$5.6 billion, for a little less than 9.86%, into shares of Morgan Stanley (CIC, 2009, p.11, 33). CIC's appetite for financial entities did not stop there, it also made an investment worth US\$100 million in Visa Inc's IPO in March 2008 (Wu and Seah, 2008, p.53). In 2008, CIC also invested in JC Flowers for US\$3.2 billion in April and in October increased its holding in Blackstone to 12.5% (Sekine, 2010, p.10).

In the second half of the year 2009, CIC, despite huge losses from former investments in the financial sector, decided to invest more in Morgan Stanley in order to keep the 9.86% stake by pouring additional US\$1.2 billion in June (Sekine, 2010, p.10). In addition, only a month later in July 2009, CIC then invested in CITIC capital for HK\$2 billion for a 40% stake in the company, together with CITIC which holds the remaining 60% (Sekine, 2010, p.10). In December 2010, it made more investments in financial entity BTG Pactual worth US\$300 million (CIC, 2011b, p.35). By the end of 2010, the investments in the financial sector stood at 17% of CIC's overall portfolio, which by this time had reached US\$409 billion, or in other words, the investment in the financial sector would be close to US\$70 billion (CIC, 2011b, p.51). This striking example is what the chapter introduced earlier, that Central Huijin also participated in expanding the operations to improve the channel to learn from Western counterparts, in which CIC invested 43.5% to be a major holder along with Morgan Stanley and Singapore's GIC on China Investment Capital Corporation (CICC) in August 2010.

Besides the investments and commercial banks, CIC was always on the hunt to be the part of a high profile player. There were reports of CIC preparing an up to US\$6 billion fund to invest in 'account-type hedge fund or US\$500 million' in a hedge fund set up by Blackstone (Sekine, 2010, p.13).

In addition, besides merely buying and partnering with foreign financial institutions, CIC also helped the SOCBs to have more chances for direct engagement with foreign counterparts. The recapitalisation process, which required new shares being issued, allowed more foreign investors (mostly institutions) to invest in Chinese banks due to the attractiveness of high ratio dividend payouts. The knowledge and management transfer can be achieved by this plan of CIC. In addition, the foreign ownerships also have direct positive effects on the value of the banks. This was proved by Berger et al. (2009, p.375), who collected and analysed data of Chinese Banks ownership and the effect of having foreign investors on board, where he concluded that the banks with minority foreign ownership 'tend to perform better' than their peers. That was exactly the scenario that CIC gave SOCBs, since the Central Huijin would always try to buy more shares through issuing more bonds if needed in order to keep its holding stakes.

Lastly, in regard to human capital, with more exposure to foreign financial institutions, either directly or indirectly, together with Chinese banks' ability and capability to match the competitive wages, the Chinese banking industry would then be in the position to recruit from among the best, if not the very best financial minds in the world as they try to expand and compete in the globalised world.

Conclusion

The inception of CIC represents the compromise between PBOC, MOF and NDRC over an on-going rivalry, especially between PBOC and the MOF, which was represented by the mixture of staff from various organizations, as well as the complicated structure of its starting capital. CIC's establishment also created direct competition of returns on investment over non-conservative financial products with the department of SAFE in Hong Kong (SIC), as well as presenting as an organization to climb the ladder within the core of the Chinese political system.

From the date of its inception in 2007 until the end of 2008, given the first full year of CIC's operation, its domestic portfolio in Central Huijin and that of its global operations had confirmed that CIC should indeed be considered as strategic, despite the fund was operating with the goal to maximize long-term profits. Within its portfolio, Central Huijin accounted for more than half of its overall portfolio. It has continued to serve the Chinese State Council as an investment arm designed to facilitate and rescue SOCBs in the matter of capitalisation and to list them on the Stock Exchange both in Hong Kong and Shanghai indexes.

CIC's responsibility of improving bank's book balance also covered State-policy-banks, such as the China Development Bank, which has played an important role in modernising China's infrastructure, for instance providing the capitalisation for Beijing's Olympics in 2008. This represents an important intention of the Chinese government towards the debt problem of local governments and public projects, that they will eventually be a part of CIC's responsibility. In addition, CIC can be seen as a strategic solution to Beijing in helping its local governments by writing-off or restructuring their

debts in order to allow them to further invest in infrastructures needed for future developments and to sustain high economic growth, as well as employment in public sectors.

More importantly, CIC's capital injection to recapitalise the banks has given them many benefits such as becoming attractive firms in which to be invested, as well as having themselves regarded as elite banks, as they all placed in the world's top seven largest banks, and it helped them out in the time of crises, such as liquidity shortage or failing to meet capital requirements. In addition, CIC's global investment also assists the Chinese banking industry greatly through the partnership with foreign counterparts which would benefit them both in the value of the firms, the management know-how, and the accessibility to businesses and the world's top human resources.

CIC's losses in its global operations have told us that it is still in a great learning curve towards becoming a solid investor in sophisticated markets. It has also tells us about its vision, that it aims to learn from the best in industry and that the knowledge is what it is after. CIC investments in the world's top financial firms has also shown that it is eager to get acquainted with top human resources and to absorb closed circle market information and management. Lastly, it gives CIC a wide range of opportunities to invest in the future by collaborating with those firms. On this particular point, the talents, information and the partnership with Blackstone, Morgan Stanley, CITIC and other leading financial names would prove to be very valuable resources for CIC and the Chinese banking industry in the decade as they learned to become a steady earner and investor in the global financial market.

This dissertation now will move on to the next core strategic task of CIC—revolutionise Chinese SOEs, and how its coordinated management with SOCBs could be

orchestrated to drive China in becoming more competitive and ready to compete in the global market through the unconventional use of its excess reserves.

Chapter Five:

SOEs problems, China's go-global challenges, and how CIC could assist them

"SWFs are by definition, an extension of the state. They are therefore viewed as maximising their country's long-term strategic interests rather than as profit-maximising actors" (Drezner, 2008, p.117).

—Daniel Drezner

Through its dealing with monetary management problems and those of the Chinese State-owned Commercial Banks (SOCBs) and the State Development Banks (SDBs) through the cunning use of its SWF (the CIC), along with the extra bonds issued by Central Huijin, the State Council and CIC has erected two solid pillars for the foundation of Chinese economy: a much healthier financial sector with room for expansion, coupled with an innovative monetary authority with better returns on its reserves. Nevertheless, despite this success, their work was not done. There were still other pillars that needed to be strengthened and put in place. In this chapter I argue that SOE is the institution that requires significant help from CIC. If CIC could not render this assistance, China will not be able to progress in a stable manner in its quest to develop the national economy.

To become a developed economy, the Chinese economy needs to have cost-effective, modernised and competitive SOEs. The CIC-led reform, which addressed the problematic NPLs and banks' undercapitalisation, was largely a fix for years of underdevelopment, poor management and bad lending practices. These practices were, in

part, a result of political manipulation and pressure aimed to ease the servicing of SOEs' debts. Even by 2009, it was still clear that the reform of SOEs was far from complete. The cost of the previous reforms of SOCBs and SOEs is certainly frightening—considering the total amount of gigantic NPLs sitting in AMC's waiting to be written off as losses on PBOC's account. This serves as a great reminder that if the next phase of reform was not a success, its consequences could pose as great obstacle to overall economic development.

The job of permanently fixing SOEs is certainly not an easy task. Firstly, the State Council could not rush into a dramatic cost-cutting program for the remaining loss-making SOEs through measures such as mass lay-offs, since these measures would then create another set of problems for the government. In the case of lay-offs, these would have severe social costs and consequences. Secondly, even the currently profitable SOEs could still expect to face difficult time ahead, as they have to compete with foreign counterparts who have successfully penetrated the Chinese market since China's WTO entry in 2001. To elaborate on this point, local producers are losing their potential buyers due to the growing popularity of foreign brands and imported products among the middle class and younger generations. In short, SOEs will certainly face great internal and external challenges in their quest to survive, given their inefficiency and underdevelopment, together with increased competition from the private sector within local market. Therefore, they desperately need urgent help from both State Council and CIC.

Now let us consider options and tools the Chinese leaders have in their disposal: the resources they have are the large amount of excess reserves, a potential of creating the largest internal market in the world, a group of the world's biggest banks, a growing private sector and a few successful State-owned Enterprises (SOEs). Of course, the State Council also had its relatively young SWF – CIC.

This final chapter argues that given the difficult circumstance that the SOEs have found themselves in, the State Council has mobilised the CIC, SIC, SOCBs, and SDBs to assist SOEs through the 'Go-global Strategy' that the Chinese government announced in 2001. The chapter will describe how China planned to realise its economic development that will focus more on growth in the domestic market, with an emphasis on nurturing its capability to compete both domestically and globally. Furthermore, the chapter will argue that it is the holistic model of CIC operations that explains how it fits into the Chinese economic development strategy and enables the actualisation of these grand ideas.

This chapter will be divided into three sections. The first section discusses the problems of SOEs. The second section will explain policies that Chinese leaders has been imposed to deal with above issues. The final and most important section then discusses how CIC, along with its Central Huijing, could fit into the grand picture of policy imposed by the State Council and also show how they conduct a coordinated investment strategy with the help from Big Four banks and various SOEs in order to secure prized assets and vital resources abroad.

5.1 Problems of SOEs

Historically, prior to 'opening up' policy in 1978, SOEs were the biggest providers of most domestic goods and services in the Chinese planned economy. Consequently, they were and continue to be one of the biggest employers of the available workforce, as well as being the largest receivers of the available capital within the Chinese financial system. Under the central planning model of management, SOEs' mandate was fairly simple: to follow the top-down orders from central government and produce what the leaders

believed the country needs. The banks, under state's provision, have been designated the role of supporters of SOEs, via loans and working capital.

According to Lee et al. (2001, p.167-8), in 1996, there were roughly 300,000 SOEs—more than 250,000 of which belongs to small sized enterprises, 40,000 at medium, 7,000 as large and 400 as extra-large ones. As of 1998, the total net value of assets was worth some ¥4 trillion. In the macro-economic dimension, SOEs served as a provider of social services, as well as being regarded as institutions of mass employment. Therefore, even if SOEs are making losses, the state would still regard that the SOEs were fulfilling its role as a state employer, despite the increasing burden of debt and the prospect of substantial and continual losses. In terms of their producing power, SOEs' industrial output during the early period accounted for 70% of all production in 1978, but it has gradually fallen into a less than third of the total output by 1999 (Lee et al., 2001, p.170). However, by 2000, its contribution to the government revenues still stood at 60% (Lee et al., 2001, p.166). Even today, despite a series of reforms that has reduced the number of SOEs through privatisation, mergers or closures, SOEs are still able to maintain their output at around the one-third ratio.

Nevertheless, this fact has not yet taken into account the gigantic costs that to the state via subsidies, the NPLs that were created as a part of reforms, and the highly concentrated and gigantic size of the remaining ones. Research conducted by the World Bank in 1997 found that out of 102,200 SOEs, only 8,000 of them are considered to be "viable enterprises". To give an even clearer picture on the severity of the SOEs' problems, China's State Economic and Trade Commission admitted that half of SOEs 'should be radically reconstructed, while the rest should be declared bankrupt, be merged or even auctioned off' (Lee et al., 2001, p.166).

The problems of SOEs can be summarised into three main issues: (1) the political burden derived from a planned economy; (2) productivity and lack of efficiency as they compete with private counterparts; (3) ideological barrier to reforms and unwillingness to let go the ownership of large SOEs.

The dissertation will now continue with a brief historical discussion of the origin of the problem and follow with a description of the aforementioned three issues.

5.1.1 Origin of SOEs' problems—China's reluctance in the change of ownership

Between 1984 and 2000, there were two main reforms in regards to the structure and the management of SOEs in the early period of SOEs reforms, namely: the operational and ownership reforms. While the former reform proved to be effective, the delayed and unwillingness to initiate the latter reform has backfired. The consequence has led to difficulties in further reform efforts and unnecessary high costs for the whole process of modernising SOEs; much of which can still be witnessed today.

Reform of operational rights

Following the successful pilot program of six SOEs that began in 1978 in Sichuan Province, the State Council decided to expand the implementation of the programme and issued the 'Regulations on Expanding SOE Management and Operational Autonomy' in July 1979 (Zhang, WK 2009, p.2). These reform, which would last for a decade, set a unique path for China's SOEs that was separate from other concerns in the planned

economy. Zhang WK (2009, p.2) argued that China conceived the idea to increase productivity and efficiency through the adjustment of operational rights, rather than the normal approach of privatising ownership like other countries. This is the first example that expressed China's unwillingness⁵⁰ to let go of state ownership in these enterprises.

The operational rights reform was centred on the policy of sharing profits and giving the SOEs more autonomy to operate by themselves as incentives to increase output. Riding on the momentum of a shortage of industrial goods, especially textiles, in the Cultural Revolution's aftermath, the reform led to 'substantial growth in output of industrial goods, economic gains of enterprises, and income of employees' (Zhang, WK 2009, pp.2–3). With this success behind them, the State Council decided to go further by issuing 'Regulations on Deepening Corporate Reform and Invigorating Corporate Vitality', in order to push the contract and leasing systems as new methods in reforming SOEs (Zhang, WK 2009, pp.4). The reform was built around the idea of setting fixed profits or fees payable to the government while also giving them even more freedom⁵¹ to run their own enterprises, which was seen as incentives for SOEs' workers and those in management.

The two phases of the above operational reforms were also important since they were considered to be reforms that were pushed by the 'grassroots government and enterprises' before being endorsed by Beijing, or in another word, it was a down-top movement (Zhang, WK 2009, p.4). As more and more SOEs followed the contracting and leasing models, the central government felt that they were on the losing side of the

50. Zhang explained that the main reason that China decided to use this approach is that it was not ready to embrace the market principle and consequences of its potential failures, which they considered as unknown "uncertainties", such as who should be responsible for losses (Zhang, WK 2009, p.2).

51. It is noted by Zhang WK (2009, p.4) that SOEs would still have to comply with the State's rules and regulations, such as regulations on social environment.

negotiations with the SOEs' insiders in regard to the fixed rate and eventually had to settle for a 33% income tax rate on SOEs, which both parties accepted (Zhang, WK 2009, p.5). During this period, in addition to the operational reforms, there was also pressure from millions of SOEs workers who requested another type of reform—the ownership reform that Beijing had been trying to avoid.

Ownership reforms

These reforms were initiated in 1984, where a number of SOEs in Jiangsu Province in Changzhou City were being transformed into part- or fully-collective operations. For the more progressive SOEs, they went as far as issuing shares, which could be regarded a truly official ownership reform (Zhang, WK 2009, p.5). Nevertheless, the authorities were not very keen with the idea of rapid privatisation and, instead, still preferred to have a gradual approach in regard to the process of ownership reforms. Lee et al. (2001, p.3) explained this 'gradual approach' by arguing that China's main concern was to 'avoid the shock caused by drastic reforms and maintain social stability'.

To support this movement, the first company law of PRC was passed in 1993. It was followed with the most successful ownership reform,⁵² which aimed to reduce the number of loss-making SOEs, especially the smaller ones (Zhang, WK 2009, p.6). Starting in 1993, unprofitable small and medium size SOEs were privatised and sold to respective workers and management. By this time, the government has learned three important lessons in regard to the reform. Firstly, it is important that the workers and management of SOEs were eager to take on the enterprises, or in another word, down-top demands must exist for viable transfers of ownership. Secondly, in order for reforms to succeed, the

52. There was a top-down attempt to enact the ownership reform in 1993, which involved 2,000 selected local government's SOEs and 100 large and medium sized SOEs, but the move failed prematurely due to an inability to drastically change their ownership structure (Zhang, WK 2009, p.6).

government needs external investors (domestic private or foreign firms) to join in the bidding wars in order to get maximised return, as well as create competition to force SOEs and banks to improve their 'corporate governance and operating efficiency' (He and Zhang, 2010, p.88). Finally, Beijing came to understand that privatisation of SOEs is difficult to avoid and that a proper support both from appropriate legal framework and large budgets are needed to make it possible.

With their enhanced understanding of the situation, together with the unprecedented increase of debts incurred from the remaining loss-making enterprises, the central government was more than willing to push for larger-scale privatisations. They also accepted that they would have to release much of the remaining medium-sized SOEs that they had previously been reluctant to let go. Therefore, in 1999 during the 15th Party Congress, the strategic plan for SOEs was laid out. The strategy was to focus on the larger SOEs, released the smaller ones to take care of themselves, while maintaining the socialist ideology⁵³ (Mattlin, 2007, p.7). This plan became official policy in the 9th Five Year Plan (1996-2000) and paved the way for 'concentrating government resources on the larger SOEs, while relaxing state control over smaller ones' (Mattlin, 2007, p.7-8). This also included the policy that calls for the development of 'mixed sector of the economy' by turning a number of medium size SOEs into shareholding enterprises (Zhang, WK 2009, p.7).

The above policy paved the way for a nation-wide reform, which was highlighted by its mammoth cost of turning 'lifelong employment into market-based labour contracts' (Zhang, WK 2009, p.7-8). This was the start of the vicious cycle of deteriorating the prospect of remaining SOEs, which the chapter will discuss more extensively in the latter

53. This ideological hangover would prove to be costly in the next decade of SOEs reform, as the burden to fulfil the socialist promise of providing benefits for workers became financially impossible to maintain.

part⁵⁴ of this subsection. Building on this historical background, the chapter now will show that embedded problems within the structure of SOE and its heritage from the days of the planned economy proved to be two major blockages on the road of SOE reforms.

5.1.2 Problems inherited within China's SOE from days of planned economy

There are two main problems, which were considered as blockages to the development and reforms of SOEs on the eve of the Second Millennium. First was China's failure to tame SOEs' habit of inefficient spending. Second was the problem inherited from the planned economy's management and rewarding system.

For the first factor, we learned from the previous chapter of how SOCBs were plagued with NPLs as a result of lending to state-preferred SOEs. With the generous soft-loan packages from SOCBs to help whenever they ran out of working capital (De Jong et al., 2010, p.301), ran into debts or were in need of financial restructuring. Together with the occasional direct subsidy⁵⁵ from the government whenever they need new machinery or improvements, these SOEs saw no good reason, therefore, to strive to become more effective and efficient—both in their budget spending and management.

Moreover, besides spoiling them with SOCBs, the state also could not create a viable platform to be an alternative source of funding for SOEs, which would have allowed them to engage more in market-based mechanisms, such as bonds markets. This argument is supported by Hasan et al. (2009, p.158) who argued that in the early period of

54. The extensive explanation and discussion of this point is to be found on the third problem of SOEs: 'The delay of larger SOEs and the following consequences'.

55. According to Lee et al. (2001, p.180), within a decade from 1988 to 1998, approximately ¥377 billion of direct subsidies was given to loss-making SOEs.

the ownership reforms, China failed to effectively facilitate the SOEs with a sizeable⁵⁶ bonds market to support the growth of SOEs and private firms. In addition, despite the establishing of two stock exchanges in the early 1990s, which could be seen as channels to facilitate SOEs in its ownership reforms, as well as putting them into a market principle environment (Chen et al., 2010, p.109), for almost a decade, the securitisation of SOEs assets continued to be hindered by influential leaders, who interfere with the listing process and the enforcement of market regulations (Hasan et al., 2009, p.158).

In addition, without the strong enforcement of good governance in financing, in order to improve their books, Lee et al. (2001, p.184) explained that SOEs found an innovative but hazardous practice of conducting 'triangular debts'. This can be simply described by having 'Firm A indebted to Firm B, Firm B to Firm C and then Firm C to Firm A'. By 1996, this type of debt amounted to more than one trillion RMB. Therefore, without a market-based financing mechanism to tame and educate SOEs' management, they were inactive and unwilling to improve the cost-efficiency in their spending.

With regard to the second factor, under a planned economy, SOEs were employers that offered lifelong job security, similar to those enjoyed by civil servants, where the rewards and benefits were based on worker's seniority and position, rather than their actual productivity. The security-net protection and atmosphere of the SOEs is even dubbed as '以厂为家', which means—'seeing the factory as (their) home' (Lee et al., 2001, p.186). The benefits included the likes of healthcare for the family, residential perks, and child support. In more extreme cases, even the daily use of energy supplies were also covered by

56. Hasan et al. (2009, p.158) commented that despite the first appearance of bond markets in 1986, the overall size of corporate bonds issued in 1999 was only about 1.5% of the GDP. This lack of size has hindered the growth of SOEs, the newly securitised enterprises, and private firms in general.

the SOEs, which it regarded as 'non-productive energy' (Leung, 2010, p.938). As a result, all these expenses contributed to the heavy burden as of the cost of running SOEs.

In addition to the high maintenance costs of their workers, the productivity of SOEs was also considered to be much lower than those of private sector. Overstaffing of workers with no skills or experiences that related to the tasks was a regular practice, since the SOEs' governance was run on the principle of personal connections (Lee et al., 2001, p.193). To make matters worse for the central government in supervising these SOEs, the use of artificial reports was commonplace in hiding losses.⁵⁷

More importantly, SOEs were used to operating within the planned economy's mode of operation—waiting for decisions and orders from central government of what to produce, instead of producing what they think the market really needs. This lack of initiative caused the problem of mismatching and imbalance in the equilibrium of demand and supply. Therefore, even if later they tried to adopt market principles, they were considered as 'slow learners' relative to private counterparts, especially when it came to the ability to read the market's demand and locating potential buyers. In addition, the workers are also highly 'unmotivated', due to 'ambiguous property rights',⁵⁸ while important decisions are limited to government officials. Hence the environment was un conducive to creative thinking or hard work, since there were no incentives in place (Lee et al., 2001, p.193).

In sum, problems embedded during years of planned economy, such as a lack of penalties or reward mechanisms that could motivate workers to strive for higher productivity and efficiency has made the task to modernise SOEs very difficult.

57. Lee et al. (2001, p.177) commented that there were at least one-third of the SOEs that chose not to report their losses in 1993.

58. See Lee et al. (2001, p.205) for a more extensive discussion of SOE ownership and profits.

5.1.3 Newly privatised SOEs became competitors for market share

Despite the State Council's best efforts to find solutions to SOEs' lack of development, its obsessively pragmatic approach to experimentation and to begin reform from a rather small unit as an agent of change, has put itself into a cycle of difficulties, where it is competing against its own actions—the privatised enterprises, as well as the private sector, which has gained an upper hand from the consequences of early SOEs reform.

This can be summarised into two accounts: (1) the former loss-making SOEs quickly turned into profitable firms, after being privatised and became superior competitors alongside the foreign firms in the market; (2) the delayed reforms of larger SOEs has caused them to be one or two steps behind the privatised and foreign invested firms.

After large numbers of loss-making small SOEs were privatised, either through being collectivised or sold to SOEs' workers or foreign investors, especially under the 'Seizing the Big, Letting the Small Go' campaign (Xu and Uddin, 2008, p.164), it turned out many of these enterprises soon found their way to profitability and effectively became competitors with the remaining SOEs that offered similar products. There are three factors behind this development: (1) the newly privatised enterprises are more cost effective; (2) they utilised market-oriented principles in hiring according to needs, as well as producing the goods in relation to the market demands; and (3) the new compensation scheme and ownership structure provided much more attractive incentives to workers.

Firstly, the newly privatised firms have much lower operational costs than at the time when they were operating as SOEs. Despite each having gone through different

routes to becoming cost-effective, in general, these new enterprises would no longer have obligations to sustain high running cost of perks and expensive social welfare to all workers. Instead, they could concentrate their resources on the most able employees that they would like to acquire or keep in the long run.

Secondly, as these newly established enterprises adopted market-based compensation scheme, as well as hiring in accord to the needs of the industry and expertise, the result was a dramatic jump in efficiency and productivity. Moreover, with the use of market information, these firms had a better rate of success in meeting sales targets, since they understood who their potential customers were and what products were in demand in the market.

Thirdly, for the enterprises where its shareholding were either partly or fully sold to workers, the worker-investors then had much more incentive to work hard for the firms as their incomes and bonuses were closely tied to the profits of the firms.

Hence, in relatively short order, productivity and efficiency was increased in business operations and management. A large number of former SOEs were able to become profitable – but they, in turn, emerged as strong competitors for the remaining less-profitable SOEs. This has reduced the market share for the struggling SOEs and increased the difficulties in reforms.

5.1.4 The delay of larger SOEs and its following consequences

An uneven start of reforms between the smaller and larger SOEs has had a lasting impact on the overall development of Chinese SOEs. As we have learned, the smaller loss-making SOEs were privatised first, and have since grown into strong competitors in the market, especially vis-à-vis the later reformed SOEs of the larger sizes that the State had

been reluctant to release. This latter group of SOEs fell into a loop of disadvantages. Hence, larger SOEs were considered as a step or two behind the private enterprises.

This situation can be elaborate further into three accounts as followed: (1) SOEs faced a ‘brain drain’ to the private firms, while large expenses arose from redundancy; and (2) the vicious circle of increasing NPLs further weakened their positions against the private sector.

Brain Drain

In regard of the first account of brain drain and the unintended consequence of redundancy, since the start of the reforms that eliminated loss-making SOEs, the foreign-owned firms, newly privatised enterprises and the private firms all have benefited from gaining access to a large number of skilled workers who previously worked for SOEs. The private firms' success in acquiring the needed workers, however, was considered as highly innovative compared to the system SOEs had. To elaborate, the private sector's willingness to open more job search channels and offer more lucrative salaries for those with ability were the main reasons behind their success (Wu, 2003, p.2).

Hence, after having acquired more qualified workers who appreciated merit and performance-based compensation system, the private sector could increase productivity even further. But more importantly, it was not a one-way advantage for the private firms. In the opposite spectrum, more and more skilled workers in SOEs decided to abandon ship and join the SOEs' redundancy scheme—one that was designed to change the lifelong workers into performance-based contracts, and supposedly get rid of the excess and unproductive parts of the workforce. Instead, it was the most productive workers that asked for redundancy, so that they could join the private firms.

The aftermath of this development was that, SOEs were left with the gigantic cost of restructuring its remaining workforce. Furthermore, despite SOEs beginning to adapt to market-based contract, which would translate into better pays for skilled workers, the amount they could offer and the prospects for career advancement were not as attractive as those offered by private firms. As a result, the remaining SOEs ended up with millions of relatively unproductive workers, who might not have such brilliant prospects in the private sector, while also fearing the loss of the type of job security they enjoyed in SOEs.

This view is supported by Wu (2003, p.2) who commented that the rapid growth in the non-state sector was exacerbated by the human capital hijacking process, which sent the most able and talented workers to the private firms that could offer the most attractive wages (despite the firms spending less on budget in overall due to their cost-effectiveness). This has then inversely hindered the productivity of SOEs, increased the number of non-profitable SOEs, and caused more difficulties for the latter's reform (Wu, 2003, p.2). This argument was proven by Gordon and Li (1999), who found that the number of skilled workers in SOEs has declined, while the productivity of non-state players have increased with newly acquired skilled workers (Wu, 2003, p.3).

The Vicious cycle of SOEs

For the second account, the vicious cycle of increasing NPLs and weakening SOEs position against the private sector, this development can be explained in three continuing sequences, which forms a vicious cycle.

Firstly, we learned earlier that privatised enterprises has turned into competitors of the remaining SOEs, as the formers were more productive, cost efficient and had a much better understanding of the markets. This has turned against the remaining SOEs as they

faced a much tougher competition, while having their share of the market reduced. This view is shared by (Siqueira et al., 2009, p.209) who commented that profitable SOEs were privatised while the remaining large SOEs still faced problems of 'poorly defined property rights and persistence of a soft budget constraint'.

The second sequence began when the number of loss-making SOEs increased, especially the remaining small and medium sized SOEs which held much of the soft-loans provided by SOCBs, provided at the behest of government pressure. To cope with this development, the state decided to push a great number of these loss-making SOEs towards ownership reforms. The aftermath of this round of reform is what we learned above: SOEs suffered from brain-drain and were strangled with gigantic costs of redundancy,⁵⁹ while they were left with less-skilled workers, which contributed to lower productivity.

From this second sequence onwards, the remaining medium and large SOEs will trigger a snowball effect to the enterprises in the same business sector, if they are privatised. This situation could not be allowed to continue. Therefore, Beijing decided to slow the reforms and focused on modernising the remaining ones with substantial loans from SOCBs—which eventually dragged SOCBs into problems of NPLs and undercapitalisation.

To wrap up this difficult period, by the end of 1999, despite taking in various government subsidies and loans from SOCBs, which made SOEs hoard over half of the total national investment, they only produced less than 30% of overall output (He and Zhang, 2010, p.89).

59. Some SOEs could not even declare bankruptcy due to have not enough capital to pay out as compensation to laid-off workers (Lee et al., 2001, p.187), thus it is assumed that they may even have to borrow before bankruptcy can be declared.

5.2 The Go-Out Strategy and how CIC contributed to the development of SOEs and other agencies.

After 2000, Chinese SOEs continued to experiencing funding problems. Besides direct subsidies and the SOCB loans, there were also attempts to assist them with national savings. The increase in the assets transferred to SOEs as capital fixed formation is frightening; rising from the already high level of 63% of overall national savings in 1992 to a hyperbolic 83% in 2001 (He and Cao, 2007, pp.10-1). He and Cao (2007, p.11) argued that this assistance to SOEs has resulted in a shortage in the government's national savings. Consequently, the government was forced to issue a large amount of bonds to offset the used cash. A way had to be found to stop this unhealthy development. This part of the chapter will describe the State Council's attempts to fix the SOEs' problems by setting up a State-owned Assets Supervision and Administration Commission of the State Council (SASAC) and will highlight the importance of the Central Huijin and CIC (the establishment of which has been discussed in Chapters Three and Four) in this solution.

5.2.1 SASAC's establishment to help SOEs

Having absorbed the difficult experiences and expensive lessons from almost two decades of relentless reforms, China eventually came up with a more strategic and long-term approach that departed from merely arranging a quick financial fix from the banks or government subsidies. This long-term solution came in the form of the establishment of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) in March 2003, which took over 196 centrally-owned SOEs (Xu and Uddin, 2008, p.164). This was an attempt to eliminate problems of the ambiguity of SOEs'

ownership since SASAC would 'represent the state as the enterprise owner', as well as act as the collector of the SOEs' profits (Siqueira et al., 2009, p.209).

Despite this measure, there were many other challenges awaiting SASAC. As SASAC pushed for the efficiency of SOEs through an increase in the number of privatised SOEs as IPOs on stock exchanges, more issues were found with the listed firms. Wan and Yuce (2007, p.375) argued that these firms were troubled by 'lack of protection for minority shareholders' rights and poor closer information' and, more importantly, suffered from problems of concentrated ownership and non-tradable shares (most of which were owned by the state). These factors resulted in the disappointing performances of these listed firms.

To cope with this problem, in September 2005, SASAC decided to dissolve the concentrated ownership of listed firms, and issued the 'Circular on Issues Regarding the Pilot Reform of Listed Companies Split Share Structure'. As a result, by April 2006, 441 out of 924 listed SOEs that accounted for 68.46% of market capitalisation, had completed the reforms, while 164 others were still in the process, and the rest of 319 SOEs needed to be processed by December 2006 (Wan and Yuce, 2007, p.377).

In the meantime, there was still more bad news in the overall picture of SOEs. By 2005, it was reported by Li Rongrong, the Minister of SASAC, that 1,828 of large and medium sized SOEs had to declare bankruptcy with cumulative net losses of ¥122 billion (Wan and Yuce, 2007, p.374-5). This negative picture was confirmed by Siqueira et al. (2009), who argued that SASAC's ownership structure and its governance could not increase efficiency and instead, recommended SASAC to let go more of its wholly owned firms.

Bear in mind that 2005 was only one year after the Central Huijin was set up to help SOCBs through the injection of some US\$44 billion, designed to raise its capitalisation and deal with NPLs. Up to this point, China was seemingly walking straight into another reform failure. In fact, there was actually a bigger strategy behind this development.

5.2.2 The Go-Global Strategy

China's Go-Global Strategy is nothing new. Since 1994, Beijing was already working to prepare Chinese SOEs for the international market. However, the strategy became much more relevant in the 2003 National People's Congress (Backer 2009, p.102). According to Backer (2009, p.102-3) it was one of the two elements ('Bring in' and 'Go out') of a campaign that was promoted through the China Council for the Promotion of International Trade, with schemes aimed at assisting local firms to 'develop global strategies' and expand into global markets.

The policy was primarily designed to get local businesses and firms ready for the aftermath of China's entry into the WTO in late 2001. The idea was to make those firms more competitive, both at home and abroad. Moreover, the policy would also support the growth of the domestic market, through the securing of access to overseas resources, particularly energy and raw materials. In addition, there might be additional benefits from the combination of these two strategies. Chen and Liu (2007, p.421) believed that the strategy of bring in and go out has two benefits to China: (1) it has weakened US balance sheet by encouraging more US account deficits; and (2) China could then use its vast reserves to acquire key US firms and influence them to buy even more Chinese products, which in turn created a loop of increasing advantages to China's current account.

Backer (2009, p.104) also made an important argument that the Chinese leaders have been carried away by this 'Go-global' idea and can no longer see the 'notion of separation of function and character' between SOEs, SWFs and other state-owned entities, where all have become tools to achieve this strategic goal. In addition, there were five other goals China hoped to achieve from this strategy: (1) increase in its FDI; (2) product diversification; (3) improve the level and quality of the projects; (4) expand financial channels with respect to the national market; and (5) promote brand recognition of Chinese firms in EU and US (Backer, 2009, p.104).

At the same time, Deng (2009, p.74-5) viewed the 'Go-Global strategy' as an important policy tool for pushing SOEs to go out and acquire 'strategic assets in order to offset their competitive disadvantages' through the use of FDIs. He added that the goal was to go after resources and find ways to increase the firms' capabilities via the acquisition of established firms in developed economies (Makino, Lau, Yeh, 2002; Mathews, 2002 cited in Deng, 2009 p.75).

In addition, the use of outward FDIs was also seen as a successful model to establish competitive advantage for firms from an emerging economy (Deng, 2009, p.75). Chung and Alcacer (2002) added that such acquisitions will also help firms to gain reputation, prestige as well as knowledge management, human capital and better access to local markets.

In 2004, even before the creation of CIC, NDRC and Export-Import Bank of China (EIBC) have already start promoting overseas investments, since they know that SOEs needed not only a vision but also incentives and financing if they were to achieve the goal of preparing Chinese firms to be competitive (Deng, 2009, p.77). Deng (2009) uses the

case studies of BOE Technology⁶⁰, TLC and Lenovo Group⁶¹ to prove how strategic acquisition can assist Chinese firms to penetrate the international market. It is also important to note that firms from emerging countries have been enjoying plenty of opportunities for possible strategic acquisition because many firms in developed economies also looked for the chance to 'divest from their noncore sectors' (Deng, 2009, p.83).

5.2.3 CIC as one of the main agency of the Go-global Strategy and how it helps SOEs

I argued that until 2012, it was clear that CIC was not just a SWF that officially served to maximise returns from its portfolio (by competing with SIC). On the contrary, I would suggest that the State Council also cleverly used CIC, along with the SOCBs and State Development Banks (SDBs), as one of the important agencies that will contribute to the 'Go-Global' Strategy. More importantly, CIC has played a key role in assisting SOEs from behind-the-scenes. The most obvious example is through CIC's ability to provide more recapitalisation for SOCBs and SDBs, by having the Central Huijin as its core operator.

In order to understand the picture of how CIC, SOCBs and SOEs played their part in the 'Go-Global' Strategy, one cannot purely focus on the CIC's global investments alone, as it was regarded as only a tip of the iceberg. This is due to the fact that most of its investments vis-a-vis the 'Go-Global' Strategy in term of capital assistance are conducted

60. In 2003, BOE Technology Group acquired Korea's Hydis for US\$380 million and a 26.46% stake in TPV for the company's knowhow in semiconductors and capacity to manufacture display products (Deng, 2009, p.80).

61. Lenovo acquired IBM's PC unit for US\$1.75 billion, thereby instantly making them 'the world's third-largest PC maker' (Deng, 2009, p.80).

through its subsidiary—Central Huijin⁶². Therefore, what we really need to examine more closely are all the investments made by SOCBs, Central Huijin, other leading SOEs, as well as other local firms that are indirectly owned by SOEs. In addition, knowledge of the relationship between all these entities and the government is also crucial in understanding the overall picture of what the State Council was actually up to.

My argument is supported by Cognato and Altbach (2008, p.29) who commented that SOEs 'are engaged in a comprehensive expansion effort' under the 'Go out' Strategy. However, with regard to CIC, while I argue that CIC is one of the key players, Cognato and Altbach (2008) had the opposite view. They argued that given the flexibility and the fewer roadblocks the SOEs would face in their investments, China would be less inclined to use CIC under this strategy. I would contend, however, that the examples of recent investments would prove their argument to be mistaken.

There are clear examples that CIC (through SOCBs and SDBs) has helped SOEs to secure business deals or joint ventures for natural resources. In June 2007, China National Offshore Oil Corporation (CNOOC) and Shell borrowed US\$2.9 billion from Chinese domestic banks to set up a joint venture for the US\$4.3 billion Chemical plant at Daya Bay in Nanhai (China Daily, 2007, accessed May 2014). Furthermore, in 2008, CDB released loans to Aluminium Corporation of China Limited (CHINALCO), which they used to bid for a 12% stake of Rio Tinto worth some US\$14 billion in the same year (Eaton and Zhang, 2010, p.499).

When the deal involved large amounts of capital, many SOCBs have formed an alliance to assist SOEs in making the acquisition possible. For example, in February 2013,

62. In spite of this, its global operations are accumulating more and more assets as the State Council transferred injected even more cash into its investment kit. Hence, if China's foreign reserves continue to grow, CIC's global operations and its portfolio would have even greater impact in the future.

CNOOC acquired Canada's oil and gas company, Nexen, for US\$15.1 billion. It was subsequently reported that several billions were borrowed from the Bank of China (BOC), China Development Bank (CDB), Industrial & Commercial Bank of China (ICBC), along with the Export-Import Bank of China (Poh and Wu, 2012, accessed May 2014). What is interesting about this acquisition is that CNOOC was using an innovative financing model. It was reported that CNOOC would first borrow short-term capital through the SOCBS, before they would issue long-term bonds or seek other financing options. For this purpose, they had at least US\$6 billion in bridge loans from the Industrial and Commercial Bank of China (Zhu and Desai, 2012, accessed May 2014).

For the banking and financial sectors, CDB also invested in Barclays for EUR2.2 billion for a 3% stake in 2007, as well as getting a seat on the board to improve its global competitiveness. Moreover, it was also reported that CDB officials commented that the seat provided them with a great opportunity to learn from Barclays (Eaton and Zhang, 2010, p.499). It is important to note that CDB was previously recapitalised by CIC, so that it would be in a position to pursue strategic assets, as well as giving out loans to SOEs.

In 2010, it was reported that CDB was a bank which financed the China Three Gorges Corporation (CTGC) for more than US\$11 billion through 'loans and a variety of investment vehicles' for both domestic and overseas projects (China Daily 2010, accessed May 2014).

There are also examples of how SOEs could form alliances to go after the resources China needed to fuel economic growth under the 'Go-Global' Strategy. Bean (2010, p.41) gave another good example of how this system of synchronised investment works. For instance, CNOOC was bidding for 6 billion barrels of Nigerian oil, while

Sinochen was also pursuing a US\$939 million gas and oil deal with producers in Kazakhstan.

A more interesting use of CIC, besides recapitalising SOCBs, was when CIC used its capital power directly. In October 2009, CIC loaned a Canadian mining group, South Energy Resources, US\$300 million to allow the company to fund more mines and coal processing projects (Reuters, 2009, accessed December 2011). CIC also bought a US\$1.5 billion stake of Teck Resources, a metallurgical coal producer in 2009.

The above examples are only part of the story of what has actually happened. During 2005-2012, SOEs' outward investment accounted for 86% of overall investments, which were estimated to stand at \$54.2 billion. In contrast, private entities only accounted for 14% of all outward investments (USCC, 2013b, p.93-4). Chinese FDIs to SOEs are also be supported by extra funds, as indicated in 12th Five-Year Plan (2011-2015) with the aim for SOES to establish an international sales networks and global reputation, invest in R&D, and also shifting from resource-based assets to clean and high-tech firms (USCC, 2013b, p.92-3). More importantly, my argument on synchronised strategic investments was also supported by testimony of Derek Scissors:

"There is almost surely a plan behind Chinese investment, both globally and in the U.S. state-owned enterprise, to dominate outward investment volume, making it feasible to have a coordinated strategy beyond simply seeking demand or higher financial returns. More specifically, Beijing has repeatedly indicated that ownership of overseas commodities is a valuable means of ensuring the continuous imports the [Chinese] economy so badly needs" (Dereck Scissors Testimony, quoted in USCC, 2013b, p.95).

The idea of financing the above plan with the help of CIC or other state agencies and SOCBs, are clearly supported and wrapped up by Andrew Szamosszegi of Capital Trade Inc. He argued that SOEs' investments were motivated by both market forces and Chinese government policies and approval. He called the Chinese government the 'gate

keeper⁶³ for the investment plan (USCC, 2013b, p.95). My argument is further bolstered by Huang Guobo, the chief economist of the SAFE, which controls SIC:

"Foreign exchange funds have been offered to back up some key foreign co-operative projects and industries with national support. We have provided substantial financial support not only to SOEs but also to banks (including private banks), private enterprises, and small and micro enterprises to 'go out' and 'bring in' so as to mitigate their shortages of foreign exchange funds. In addition, we have cooperated with some international financial agencies, with a focus on the economies in the emerging markets, to meet local needs for investment and financing and to create a favourable international environment for Chinese enterprises to 'go global', to make investments, and to develop local trade (SAFE, 2014a, accessed July 2014)."

In addition, SAFE also officially announced the 'Circular of State Administration of Foreign Exchange Concerning Foreign Exchange Administration for Domestic Residents Conducting Overseas Financing and Round-trip Investments via Special Purpose Companies' so as to support the implementation of the 'Go-global' Strategy with the following objectives:

"...to fully utilise international and domestic resources and markets, to promote the facilitation of cross-border investments and finance, practically serve development of the real economy, and to increase the convertibility of cross-border capital and financial transaction in an orderly manner" (SAFE, 2014b, accessed July 2014).

The statements from Huang Guobo and SAFE's Circular made it very clear that private firms will also be receiving support for its Go-Global operation. There is an example to prove that the supporting measure and policy are already in use. In 2003, Shuanghui International Holdings, the largest meat producer in China, took over Smithfield Foods for US\$7 billion. This action was made possible by the US\$4 billion

63. During the testimony before the U.S.-China Economic and Security Review Commission in February 2012, Paul T. Saulski, Adjunct Professor in Georgetown University Law Center, commented that China big four banks serve as gatekeeper for capital allocation for SOEs. He also mentioned that despite private sector firms have been access to capital, the majority of the credit financed big four banks 'is still directed to SOEs at extremely low costs' (USCC 2012, p.105).

loan from the Bank of China (BOC) (Lee and Ho, 2014, accessed July 2014). It was considered to be the largest-ever Chinese acquisition in the US.

We learned from Chapter Four of the three important tasks that CIC achieved: (1) CIC stabilised and turned the monetary management of China's reserves into a contractive and competitive race for better returns; (2) CIC, through its subsidiary, has strengthened SOCBs by using capital injections and made them into a group of world's largest banks; (3) with its global operations, CIC, could attract its partners to invest in the SOCBs and let them cooperate, which, in the long-run, will help SOCBs to learn from their foreign counterparts. With the help of SAFE or SIC, the above goals are clearly achievable.

To conclude, building on the above evidence, there were many ways that CIC, SIC, SAFE, SOCBs and SDBs have been used to assist SOEs in preparing them for the Go-Global Strategy. Firstly, CIC helped SOEs indirectly through its ability to recapitalise SOCBs and SDBs. The banks then would have a better NPLs ratio and can offer struggling SOEs further long-term debt restructuring plans. This would give SOEs more time readjust their operational management and opportunity to be profitable again.

Secondly, via its global operations, CIC and SAFE have gained access to new markets, and potential partners for SOEs or SOCBs to collaborate with, such as the cases of CNOOC and CDB. This could translate into technology-transfer, new opportunities for both parties, and more importantly, the efficiency and effectiveness they could learn from the world's leading MNCs (e.g. Levono, TLC and BOE).

Thirdly, CIC and SOCBs also invested extensively in the Western financial firms. With seats on the boards, the problem of funding was solved, as investors were keen to

invest in high-growth economies like China (CNOOC was able to borrow from both domestic and foreign banks, as already described above).

Fourthly, CIC and its financial counterparts have been very keen on issuing Chinese local currency bonds, and encourage the trades in RMB. If China and CIC succeeded in luring more investors or trade counterparts to use RMB as trading currency, SOEs will benefit greatly from the lowering cost of business transaction, and less uncertainty related to exchange rate fluctuation.

Lastly, CIC and SOEs have also been recently very active in acquiring companies in the energy and raw materials sector. These acquisitions served to greatly lower the operating costs of SOEs by way of cheaper supplies, which in turn increased its competitiveness. Consequently, this factor will have positive impact via increased product sales, which would lead to even larger foreign reserves (Chen and Liu, 2007, p.421). With more excess reserves, SAFE and CIC will possess more financial power to help SOEs and fulfil their roles within Go-Global Strategy further.

Conclusion

This chapter discussed how the State Council cleverly made use of CIC, SAFE (SIC), SCOBs and SDBs in order to improve the competitiveness of SOEs under the 'Go-Global' Strategy that the Chinese Government declared in 2001.

The chapter first examined problems and limitations that SOEs have inherited, along with failures of past reforms. It illustrated that the early rounds of privatisation have lowered the competitiveness of the rest of SOEs, and worsened their chances of becoming profitable. Secondly, the chapter explains the 'Go-Global' Strategy and its development, before discussing how CIC assisted SOEs through SCOBs and SDBs in supporting

required loans, for either the restructuring debts or financing strategic overseas acquisitions under the 'Go-Global' Strategy. The chapter also provided extensive list of examples to demonstrate how CIC, SOCBs, SDBs and SAFE have made possible the 'Go-Global' Strategy for SOEs. Lastly, the chapter showed how China uses SOEs to secure raw materials, know-how, and technology needed to fuel the domestic economy, as well as to enhance the capacity of the Chinese economy and move it onto the high-value chain economy.

Conclusion:

This dissertation seeks to advance our understanding of the nature of the Chinese SWFs. As I have argued in the dissertation, much is written about the Chinese SWF, most of it alas is speculative and draws on specific anecdotes and instances. SWF studies are dominated largely by two opposing views of SWF. The first group of scholar of realist bent see that SWFs are tools of state and power, and believe that it must be viewed as such by host states. Notions of state capitalism and mercantilist policy, national security and protectionist measures were discussed extensively within this realist group. The second group of scholars, primarily, financial economists, regard SWFs as tools intended to address macroeconomic problems that arise out of excess reserves. Financial economists focus their attention, therefore, on issues such as sources of funds, asset allocation, investment portfolio, risks and costs of excess reserves, the rationale for setting up SWF and performance. There are also other scholars within this second group, the neo-liberal bent. They are naturally suspicious of any form of publically owned or publically-run economic entities. Moreover, many of the literature focused more on the potential market distortive mechanism that state actor in the guise of SWF may impose, while is less concerned with the state power. The neo-liberal bent are also concerned with the potential mismanagement of funds subject to extraneous political interests, lack of transparency, accountability and good governance.

The dissertation is founded on the premise that the best way of adjudicating among these conflicting claims is to conduct a thorough and systematic historical study based on available information. For gaining the needed information, I conducted a series of

interviews with state officials, private sector actors as well as academic experts, in addition to consulting primary sources, in Chinese, as well as secondary sources in Chinese and English literatures. I discovered that CIC officials and organisation as a whole were more open and willing to engage with media and the recipient countries, while SIC has been remained as a secretive investment arm of SAFE, but slowly and gradually coming out of the shadows as it seeks to engage more in investments in global equities rather than just concentrated on conservative government bonds. Nonetheless, I have gathered sufficient evidence, either directly, or as the case may be, indirectly, to support three core propositions claimed in this dissertation.

First is that the establishment of China Investment Corporation (CIC) in September 2007 gave the Chinese government another agency to utilise the excess reserves in addition to the already active SAFE Investment Company (SIC). This create a two-horse race competition for both SWFs to outperform each other in order to gain favours with the Chinese bureaucracy. The winner would earn the right to receive more capital of China's growing reserves, which in late 2007, already surpassed US\$1.4 trillion. SIC, a subsidiary of State Administration of Foreign Exchange (SAFE) in Hong Kong, was established in 1997. It was under the supervision of PBOC, the central bank, in managing China's foreign reserves. The creation of CIC was seen as a solution to mitigate pressures from Ministry of Finance (MOF) who believe that it also have the ability and capacity to manage China's excess reserves, as it is seen as a practice in other country, such as Japan that MOF is responsible in investing excess reserves.

This dissertation shows that the inception of CIC carries both macro-economic and political messages. Firstly, Chinese State Council made use of the financial arrangement to mitigate microeconomic problems of over-supply of domestic monies through CIC's

starting capital. This was orchestrated by swapping MOF's newly issued bonds worth of ¥1,550 billion with the foreign exchange under SAFE of US\$200 billion, thus PBOC received extra help in dealing with short-term excess money supply and inflation. This also gave monetary authority an alternative macro-economic and monetary management tool. Secondly, for political mitigation, CIC is an organisation which reports directly to the State Council. This tactical decision is seen as a compromise which was intended to keep both MOF and PBOC agreeable to the arrangement, since if CIC was to be directly under the MOF, the PBOC might feel that it has loosen too much control over the management of foreign reserves to MOF. The liability of around 4.5% per year payable to MOF attached to CIC starting capital was another important message that shows both MOF and PBOC that CIC does not officially belong to MOF, but rather borrowed debt. The board of directors and management officers who were appointed for posts at CIC, showed that MOF has considerable power and influence within the state-sponsored-fund nonetheless.

Being a new established investment institution, with huge amount of liability to pay, CIC was expected to mature quickly to live up the task. In comparison SIC, the Hong Kong subsidiary of SAFE, has been accumulating experience in investing excess reserves since 1997, and thus equipped with better institutional capacity. In order to create a level playing field for competition between the two SWFs, MOF successfully lobbied the State Council to have one-third of CIC starting capital to be used to take over state-owned financial entity, the Central Huijin, at par price. This is a significant early win for CIC and MOF since Central Huijin was the majority shareholder of the Chinese State owned Commercial banks, and with the arrangement of paying at par price, CIC only needed to pay US\$67 billion for shares in SOCBs that worth much more. In addition, as an owner of those shares, CIC was entitled to receive all payable dividends from SOCBs which CIC

could use to pay liability attached to its US\$200 billion initial capitalisation. In addition, CIC also used another US\$43 billion to inject into SOCBs to improve the banks' book balance and raised the NPL ratio to respectable and healthy level, which will eventually benefit both SOCBs and the CIC as the majority shareholders in the long run. The leftovers of around US\$90 billion was given to CIC as its funding for its global investment operation. Under this setting, the race for the competition was on.

The second proposition I put forward in this dissertation is that as a result of the above, both CIC and SIC were driven primarily by profit maximisation motives, as each fund sought to demonstrate its superiority over the other by achieving higher rate of return. This has created a positive platform for both SWFs as the competition for rate of return ensured that the funds would first and foremost, prioritise commercial interests and profits over political objectives to the Chinese state. Against the realist bent that believed CIC and SIC investments were based wholly on the strategic calculation, the dissertation shows that both SWFs were focused on commercial returns and developed their institutional capacity and competency accordingly. CIC invested only a small portion of its global budget in the first few years since its inception due to two main reasons, i.e. building institutional capacity and capabilities, and due to the credit crunch crisis that forced it to reconsider and readjust its investment strategy. CIC has been actively focusing on establishing appropriate methodology and developing its internal management and staffs. As a result, investment made by CIC during this learning period was largely about aimed at building knowledge and knowhow rather employing its assets to the full. SIC, similarly, has also been on the institutional building period since 2007, had to learn to co-exist and compete with CIC.

The dissertation showed that SIC has been very active on investing and speculating in US Treasury Bonds. In addition, SIC also experimented with high risk and high return

class of financial assets. The rather low level of investment the two SWFs have made in high risk assets such as equity was interpreted by scholars with realist bent as a selective investment focusing on strategic motivation, while the losses in those investments were viewed by Neo-liberalists and financial economists scholar as risks and costs in which are attached to the SWF investments. My argument, however, that both theories, realists and liberals see only part of the picture and fail to acknowledge the learning period that is needed for such funds to operate. The Chinese State is keen on future profitability rather than aiming purely for strategic purposes in which the State should transfer even more sizable fund (CIC received only a further US\$40 billion) and push SWFs to invest in large amount for substantial stakes in targeted assets.

CIC has played a vital role in making various ground breaking investments globally. Those include the purchase of 9.4% share in the Blackstone group, one of the world's largest private equity funds for US\$3 billion, 9.9% in Morgan Stanley the investment bank for US\$5.6 billion. Yet, more significant, I argue, was the fact that almost two-third of the initial capitalisation of US\$200 billion of CIC were used to buy and recapitalise state-owned commercial Banks (SOCBs). The first one-third funds of US\$67 billion was used to take over Central Hui Jin which owns majority shares of Chinese-State-owned-Commercial Banks (SOCBs). The second pot of fund worth around US\$43 billion was spent on recapitalising the SOCBs to improve its financial sheets, or specially improve its non-performing loans (NPLs) ratios. The leftover was therefore left for CIC's global operation. This shows again that CIC was less concerned with developing an international strategic investment for political purposes as often argued.

My third proposition is that as the two SWFs had to operate under certain preconditions and controls set by the Chinese state, paradoxically, they end up advancing

political and economic aims of the Chinese state in a number of respects. The most obvious example is the case of CIC. The complicated arrangement of CIC's initial capitalisation, proved significant in the long run. Capital injection to SOCBs have allowed the banks to have a much healthier book balance, especially the non-performing loans or ratio and cash-ratios. These banks, then, have turned into sought-after assets for investments since they could operate and pay out handsome rate of dividends; hence, their share prices have increased dramatically. CIC, as a major shareholder through Central Huijin benefited from the solid stream of annual income, while its total share values also dramatically increased and improved the overall rate of return of CIC portfolio. More importantly, the recapitalisation of the banks, allowed the banks to be in an attractive position to raise even more cash due to its healthy operational status, and they are able to offer the re-financing loans to trouble clients and customers and minimised the future NPLS losses. This has a dramatic impact on Chinese state-owned-enterprises (SOEs) as they were the largest group of borrowers and many of SOEs were heavily operating at a loss. In this regard, the dissertation also explain the problem that China has with struggling SOEs as they try to privatise and get rid of the loss-making ones, the state would run into other issues such as brain-drain and unemployment. In addition, only the successful SOEs were in demand from private investors, and its privatisation will only hurt the rest of the SOEs. Hence, healthy SOCBs were crucial to mitigate this difficult transitional period for China as it has to equip SOEs to compete with multi-national corporations (MNCs) for both domestic market and international market.

CIC and SIC global investments are cleverly used by the State Council to access wider range of international business opportunities, gain management knowhow, as well, I acknowledge, as technology transfers and access to new markets and secured the needed

for raw materials and energy resources. This strategic use of the funds is undeniable (although not their main tasks, as I showed). The aim, however, is to ensure that both SOEs and SOCBs compete with international counterparts, and further sustain a higher economic growths while also bolstering the demand side within domestic economy, as the rest of the world is still trying to find the way back after the credit crunch crisis began in early 2008. In this regard, the dissertation also shows that it fits well with China's Go-global strategy and evidences are supporting that despite CIC and SIC are pursuing for their commercial gains, there seem to be a synchronised investing strategy to secure strategic assets, resources and know-how as I mentioned above. However, it has to put into the consideration of other actors such as the SOEs themselves, and it is not in interest of CIC and SIC to openly investing strategically, as it will surely receive more response abroad, especially in the US and European Union.

Appendix

Interview findings on CIC from 2009 to 2010

(I) Research methodology of the qualitative interview

This section will describe the research methodology of the qualitative interviews that were conducted during my fieldwork research, which was conducted from 2009 to early 2010 in Singapore, China and Thailand. There were all together 14 interviewees.

The first five interviews were conducted in Singapore. The interviewees consisted of three leading academic figures in a prestigious university, all of whom have conducted research or are interested in SWF. For the other two interviewees, one is the diplomat who has been working in Singapore for three years, while the last interviewee is a senior economist in one of the largest bank in the world. It is to be noted that I have tried to secure two appointments through recommendations, one being officer in the Monetary Authority of Singapore (MAS) and also of the business officer in GIC, but unfortunately received no response from these sources.

The next set of interviews was conducted in Bangkok, Thailand. The interviewees consisted of a senior-level manager in Thailand's Central Bank, two senior figures from Thailand's stock exchange (one is currently holds a senior managerial position, while the other is a former President). A further interview was conducted with one of Thailand's wealthiest businessmen.

For China, I held two interviews in Beijing, both with academics in China's top university. I was also able to secure two interviews with another two leading academic

figures in Shanghai, who also teach in the China's leading institution. Lastly, I interviewed a businessman who has experience in doing business with SOEs. It is also to be noted here that, I tried to utilise contacts during my high-school undergraduate year in Shanghai to secure appointments with officials from CIC, but also cannot get any response or agreement for interviews.

The backgrounds of the interviewees can be categorised as follows: Seven academic figures (C1, C2, C4, C5, S1, S2, S4); three officers in regulatory institutions (T1, T2, T4); three interviewees from private sector (C3, S5, T3); and one government official, a diplomat (S3). (See details of anonymised list of interviewees in Bibliography under Primary Research.)

These interviewees have extensive experience and knowledge in financial markets and all either have researched or have been exposed to the development of CIC or SWF in general. In addition, the interviews were conducted in a semi-constructed manner, in order to ask the interviewees to stay on topic, but allow some freedom to roam in accordance to their expert areas and knowledge. Generally, interviews were conducted within 25 minutes, although there were some that consumed much more time due to the depth of the answer the interviewee was willing to explore.

The four main questions were as follows:

(1) What exactly are SWFs? How do you see them today in global finance and politics?;

(2) What is the real intention of China to set up the SWF, and is there any possibility for them to utilise the rest of their reserves?;

(3) Do you see any familiarity of Singaporean SWFs or Norwegian SWFs in CIC?;

(4) What is the future of CIC, and what should be the best way to understand it?

(II) Analysis from the findings

(1) What exactly are SWFs? How do you see them today in global finance and politics?

In this first question, 12 out of 14 interviewees described SWFs as an investment vehicle for states with implicit political objectives. Only two of the interviewees (S5, T3) saw SWFs as microeconomic tools that assist the government's efforts to manage foreign exchange reserves. However, they mentioned that it is too early to judge on SWFs such as CIC, since its investments were concentrated in the domestic market.

A lecturer in Singapore (S1) even used the word 'predatory' in explaining SWFs. However, he believed SWF received its rather unpleasant reputation due to many of Temasek Holding investments in sensitive sectors within ASEAN countries, such as Indonesia and Thailand. The acquisition of Shin Corporation and its consequent political fallout was a case in point.

In regard to this question, most of the interviewees from the academic sector (6 out of 7) mentioned the word 'state capitalism' and suggested that the best model that could explain SWFs are Singapore's Temasek Holdings and GIC as they have been active for many years, and were well-known for their high rate of returns, as well as their controversial investments which have raised concerns regarding national security in at least one recipient country. The remaining academic figure in Singapore (S2) argued that like other investment funds, all state investments are strategic, but at the same time, these investments must comply with local laws. It was also unwise to treat SWFs with a

suspicious attitude. Instead, recipient countries should prepare adequate monitoring systems for SWFs, especially if acquisitions concern national security.

The diplomat (S3) had a similar view on this approach to the question but went further as he stated that although SWFs could be political, the state-sponsored-fund can be used in a positive and constructive way, such as developmental projects to solve global problems such as environmental problems, or even be used as a direct capital investment into specific countries and regions.

Nevertheless, the Thai stock exchange executives (T2, T4) who regarded SWFs as a strategic investment vehicle that carry political goals, stated that with the regulation many countries have in place, it is not too difficult to monitor the investment of SWFs if they invest directly, and not through subsidiaries or second and third tiers holding companies they owned. In the case of Thailand, the investment will be regarded as 'strategic' if one company or SWF invest more than 5% of the overall share of the targeted firm.

At the same time, an academic in Beijing (C2), mentioned that while SWFs are prone to be driven by political objectives, besides the Singaporean SWF in the form of Temasek Holding, he see no solid evidence for other SWFs behaving strategically. In addition, he says, if SWFs decide to disclose more information about how they operate and what portfolios they are holding, there will be a change of attitude within both the academic and business communities. For now, it is safer to discuss the likely nature of being strategic.

Interestingly, the business consultant who works in Shanghai and throughout China (C3) also believed SWFs are strategic and sees nothing inherently wrong with that. He

even mentioned that many developing countries in ASEAN have been benefitting from this type of funds as a new important source of capital. He believed that as the fund accumulate more experience and institutional capacity, it can be a real driving force in this region, and it will not surprise him if many SWFs choose to invest in a region with the fastest growing economy, after all, what they also seek is high returns as they divert capital from traditional assets, such as US Treasury bonds.

(2) What is the real intention of China to set up the SWF, and is there any possibility for them to utilise the rest of their reserves?

On this question, the academic in Beijing, (C1), stated that although he might see that SWFs can be strategic, but in the case of CIC, he believed not many people within the government have a true understanding of what the real intentions or objectives of the fund are. The economists will answer that the CIC is a macro-economic and monetary tool for managing excess reserves, while political economists might see that the fund is a representation of the state and it can be used to achieve a mercantilist policy. On the other hand, normal Chinese citizen might believe that it is set up to serve the interests of the elites within the government as ways to gain business connections.

The other three lecturers in China (C2, C4, C5) conceded that while he also believed in the possibility of CIC being strategic, they believe that it will not be used in the same way that Singapore utilised Temasek Holdings since China is the world's second largest economy, and pursuing strategic goals abroad could provoke even more resistance and protectionist policies against China. One of the three academics (C2), however, believe that if CIC can prove to the world for a respectable period of time that it was only interested in commercial interests, then it may be possible to buy a few key important

strategic assets without much resistance. An academic in Shanghai (C4) also argued that the Chinese people increasingly believe that the capital held by CIC should be used to improve the educational infrastructure and other domestic projects.

A lecturer in Shanghai (C5) added an interesting angle, he believed that CIC can be viewed as strategic but it is an unexpected outcome from the attempt to solve political struggle between PBOC and MOF, who were so eager to invest China's excess reserves, in the same way that Singapore managed to have GIC. He added that the key investment of CIC now lies in Chinese SOCBs. However, he was worried that by injecting more capital into the banking industry, if the bank could not improve the lending standards and quickly adjusted their ties with debt-ridden SOEs, Chinese banking and financial industries could find themselves in deep trouble if the NPL ratio rise again against the overall assets of the banks. This is also because the Central Bank is trying hard to regulate them by increasing the capital requirement.

A lecturer who works in Singapore (S1) see CIC as a passive investor who wishes to maintain a low profile and do not want to receive too much attention of what they are doing. He believed that CIC would seek external fund managers to help them manage the fund. In addition, he mentioned that from his knowledge in following the CIC, the fund was careful in the amount of investments made, in order to avoid entitlement to board seats. He thought that it is not in CIC's interest to follow the Temasek Holdings model at the moment, though that may change if CIC obtains more access to disposable funds. There is a good chance that CIC will receive more funds, if China continues to accrue excess reserves. The lecturer also thought that the most profitable or the new trend in investment for SWF is green technology.

The rest of the academic interviewees (S2, S4) saw that with large funds at its disposal, together with the growing need for China to expand its economy and access to energy and raw materials would be the key to sustain the growth. They see that CIC will eventually accumulate and expand institutional capacity to invest in energy firms and resource suppliers. They also agreed that the size of CIC can be expanded if China continued to have trade surpluses and rely on export-led strategy to grow.

The diplomat (S3) sees CIC as a great potential for China to fix its own problems in SOEs as it has been known that SOEs are a big burden to its financial system. However, at the moment rather limited information is available and so a clear picture of CIC's intentions cannot be formed. It is believed that the fund is still new to the game, and could take more time for capacity building. Nevertheless, he believe that more reserves will be earmarked for CIC, and that CIC could be involved in more of the developmental projects, which will do them good if they played their cards right (i.e. building good reputation through constructive investments, which will improve its image in public relations).

A business consultant based in Shanghai (C3) sees CIC as a cash-cow holding for the Chinese government to utilise in whichever way it sees fit: either as a profit maximiser or strategic investment vehicle for access to natural resources. Either way, it is the logical route for China. Furthermore, he believed that China is not only benefitting itself through these investments, but if by being strategic can help China to sustain growth by supporting the economy, then the world will profit also.

An economist (S5) in Singapore, a banker in Thailand's Central bank and a Thai businessman (T1, T3) concurred that CIC seems to be undergoing a learning curve. The economic crisis in 2008 and the subsequent recovery period had taught them many lessons. They see that CIC is still trying to find its own strategy to maximise profits, but at the

moment are still trying out strategies while building up its institutional capability and capacity. The economist (S5) strongly believes that the losses during the crisis will only help CIC in the long run to be more prudent. With the successful rate of returns Singapore SWFs can achieve, he believed that CIC would be able to mimic and adapt its strategy to earn decent returns. The three (S5, T1, T3) also think it is not in the best interest for CIC to pursue the strategic route. Naturally, this will not solve the problem of access to resources, but it does not have to be CIC who has to take the lead on this matter. In addition, they think that the prospect of further entitlement of funds from excess reserve would depend on CIC's performance.

Lastly, the Stock Exchange executives (T2, T4) see that CIC will operate on the basis of profits, however, if the opportunity arises, they will not hesitate to acquire strategic assets, taking into consideration the attractive price and arrangement that it will receive. In addition, they believed that CIC will start to do more of the relationship-building with the community and regulator in countries they are interested or have already invested in. This strategy will also be a vital part during their time of gaining more experience and building up profile.

(3) Do you see any familiarity of Singaporean SWFs or Norwegian SWFs in CIC?

For most of the academics, they believed that the Singaporean and Norwegian model are on two opposite sides of the spectrum. One hand, the idea of setting up CIC might be similar to what Singapore has done to GIC, as it was funded through foreign reserves. However, the Singaporean SWF is a representation of a strategic SWF. On the other hand, the Norwegian SWF derives its capital from natural resources, and therefore,

its main concern is to preserve the wealth and hedge against the volatility of oil prices. The Norwegians can serve as a model for CIC as a gold standard in transparency and accountability.

In particular, a lecturer in Singapore (S1) believed that there is a slight chance that CIC will follow the strategic route like Temasek Holdings. However, he believes it is better and more logical for CIC to be a passive investor, so that it will face less resistance.

The other two academics (S2, S4) see CIC to be quite similar to what Temasek Holdings and GIC are doing. The key for CIC is to invest in energy and raw materials that China needs for its economic growth. It is also very possible that they may explore other strategic sectors such as communications, advanced technology, since in the long run, China could benefit by leapfrogging technological development. Again, they emphasised that future directions will depend on the prospects of China's foreign reserves. If it continue to grow, CIC will have more funds to invest in the above-mentioned sectors and have a longer investment horizon, which does not necessary go after profit-driven and short-term benefits, but long-term growth.

In contrast, the other three lecturers in China (C2, C4, C5) do not envision CIC following Temasek Holdings due to the possible resistance from the recipient countries, especially in the US and European Union. The US and EU have many attractive investments CIC can make, as many of the firms are picking themselves up from the crisis, while share prices are still considered as undervalued. The academic in Shanghai (C4) believe that sooner or later, CIC will start to listen to the voices of ordinary Chinese citizens. However, in the meantime, the best way for CIC to avoid domestic criticism is to perform well and be more transparent.

A business consultant (C3) and a diplomat (S3) shared similar views on this question that there might be similarities for CIC with regard to expectations to perform successfully like Temasek Holdings or GIC. Meanwhile, there will also be calls for CIC to be transparent like the Norwegian fund. They, however, see that CIC does not have to be the same to these two models. CIC can choose to be strategic in sectors that they are interested in, but still maintain good relations with the recipient countries by keeping shares at around 5%, and by being transparent. These measures will only help CIC in the long run, and increase its own opportunities for investment. This view is also supported by the Thai businessman (T3), who believes that the most important strategy for CIC is to keep its options open by being straightforward in what they want and will do – essentially by becoming more transparent.

A banker in Thailand Central bank (T1), and the two stock exchange executives (T2, T4) along with an economist (S5) in Singapore made an important point in addressing this question. They stated that at the moment it is too early to see if there are any similarities between CIC and the Singaporean or Norwegian SWFs, due to the fact that CIC has had a relatively short record of investment history. More importantly, they think that the picture will be clearer in the next few years, as CIC are trying hard to recruit top human resources, develop its own internal fund manager team, and overall institutional capacity and capability. A stock exchange manager (T2) also added that reputation in the financial community is a precious asset and that CIC should learn from the Norwegian experience in order to put itself in a respectable position and be welcomed abroad. For Thailand, we are closely monitoring the possibility of increasing strategic investment that goes beyond the 5% threshold, however, good communication and transparency will be

very helpful for CIC if they choose to invest in substantial amount and ratio, since there will also be an impact to the firms that they invest in.

(4) What is the future of CIC, and the best way to understand it?

A lecturer in Shanghai (C5), an economist in a private bank in Singapore (S5) and (T3) see that there is a possibility that CIC will take on a more prominent role to support the development of the domestic economy. A lecturer in Shanghai (C5), in particular, believed that CIC might be even more active in rescuing some strategic domestic SOEs, and sees that the most effective way it can do so in the future is to both support SOCBs and SOEs through financing, while also seeking business opportunities for them by partnering with other financial institutions. They believed that the best way to understand CIC completely, is to start analysing what domestic role CIC had played in the past and will be doing. After that, an analysis of their foreign investments will become more meaningful. On this point, a lecturer in Shanghai (C5) added that the relationship between PBOC and MOF is worth a closer examination since there seems to be a tug-of-war as to who should manage excess reserves.

The two stock exchange executives of Thailand (T2, T4) think that from CIC's relatively short investment history, and despite difficulties in forecasting the future, it will not be too surprising if CIC will increase its global investments, as they continue to build up the institutional capability and capacity, to understand each market in depth with adequate knowledge in sector and type of financial products they will invest in. They see the best way to understand CIC is from going through its portfolios, and its interests from the way they construct business strategies and hire human resources, however, this could be a difficult task as it is dependent on the transparency of CIC.

A lecturer in Singapore (S1) sees that CIC will continue in the role of passive investor, though how long it will continue in this role will depend on the amount of capital it has access to in the future. If it is to receive a substantial amount, CIC also could put aside some funds for strategic investments if needed. He also added that the sector that it has potential to focus on is green technology. Lastly, he recommended that the best way to understand CIC is to look through its investment pattern, which again is dependent on the disclosure of information, in which the Santiago Principle will be extremely useful.

Another two leading academic figures in Singapore (S2, S4) believe that the future of CIC is dependent on its potential size, which is directly linked to the funding it will have access to. Nevertheless, they believe that CIC will continue to increase its role in helping China to secure the energy and raw materials that are required for maintaining economic growth, while technology industries will also be of interest. In addition, one of the lecturers (S2) believes that the needs of China and the recipient countries should be assessed on a cost-opportunity basis for both sides, before substantial investments are made. Therefore, he believed that CIC will face more scrutiny both at home and abroad, but it will be a positive development and better for the CIC in the long run. A lecturer in Beijing (C4) also had similar views on the future of CIC, that it should listen more of the domestic demands and voices of citizens, where they have proposed investments in education rather than spending billions in private equity firms like Blackrock.

The above three academics (C4, S2, S4) also believed that the best way to understand CIC, is to look at what China wants, while a thorough analysis of portfolios will be very indicative of future directions. However, the lack of information will pose a substantial challenge, as transparency is still not taken seriously.

Another lecturer (C2) believes that the future of CIC lies in the CIC becoming a hybrid between the Norwegian and Singapore models. He argued that in order to be accepted and welcomed, it is best to practice transparency. Moreover, years of operation without issues with a recipient country will be a valuable asset for CIC if it intends to tap strategic assets in the future, since these moves will be judged by CIC's reputation. In his recommendation, he thinks the best method to understand CIC is to look at its investment patterns, as well as the vision of the management.

A managerial level officer at Thailand's central bank (T1) sees that the future of CIC is being dependent on its ability to manage and develop institutional capability and capacity in order to generate a respectable rate of returns. The performance will affect its prospect in receiving more funds in the future. The best way to understand CIC, he said, was to understand its management goals and visions along with analysing the portfolio.

A lecturer in Beijing (C1) argued that the future of CIC will be a mix of macro-economic tools to lower the opportunity cost of holding excess reserves and a mechanism for buying the strategic assets that China needs. He also added that in the future, CIC might need to invest more in domestic development projects in order to forestall domestic criticisms.

The diplomat (S3) thinks that CIC should rely on its honesty in improving its transparency and public relations with the world, so that everyone will understand its intentions. He sees that the best way to do this is to direct part of this fund into development projects. The fund could also even play a role in Chinese diplomacy, as a useful tool for making friends and allies.

(III) Example of the interview:

(S1) Lecturer/Academic

Date: 19/10/2009

Location: Singapore

Language used: English

(1) What exactly are SWFs? How do you see them today in global finance and politics?

SWFs are seen as predatory. The Singaporean SWFs are very sensitive in enquiries anyone has with them. Their investments in Indonesia faced many political implications, were highly controversial, political, and resulted in a bunch of legal actions. Thailand has also had similar experiences with Singaporean SWFs. This perception also prevails within ASEAN countries in general, which is problematic for Singapore in its operation of GIC and Temasek in the region. The funds were seen as predatory, having too much money, too much confidence. By default, it will alarm these states, which will result in protectionist policies towards the Funds.

This is because Singapore already dominates FDI in the region (70% of ASEAN FDI went through Singapore). There is a perception in ASEAN that any further financial integration or harmonisation, will unfairly benefit Singapore more than any other country.

GIC and Temasek are well aware of this, and operate in a very funny vortex. Singapore government does not like transparency. Both GIC and former Prime Minister Lee Kwan Yu did make a statement about we are too small to be transparent, can't afford

to be transparent, and Singapore is not competing in a level-playing field. However, they see that other SWFs can and should be transparent because they have bigger constituencies, and not so much at stake as Singapore. This is bread and butter for us, it's our future, our only savings, if this goes, we go.

(2) What is the real intention of China to set up the SWF? Is there any possibility for them to utilise the rest of their reserves?

The Chinese SWFs are using the passive approach through big private equities - they want to keep a low profile. They also increasingly use external fund managers. The Chinese have learned not to avoid getting controlling stakes by not asking for a seat on the board, or at least by not investing so much that they would obtain board seat. It is not in their interest to follow the Temasek Holdings model at the moment, but in the future, it is difficult to know if they will have access to more disposable funds, though there is also a good chance that CIC will receive more funding if China continues to have growing excess reserves.

(3) Do you see any familiarity of Singaporean SWFs or Norwegian SWFs in CIC?

First let me explain what I know about Singapore and its SWFs.

The Funds are modernised according to OECD, but in reality Singapore and funds were put in the grey list (i.e. not so transparent). Together with Singapore's nature of being an offshore tax-haven, it is difficult to get themselves off the list. Some said Singapore, is the largest Bank for Myanmar, believed to have US\$40 billion deposited by the Junta there. Also, there are reports that the US are suspicious about the deposit, as these monies

might not comply with all the banking requirement standards. So the Financial Action Task Force of OCED has put them in the grey list. I believe in the future many more countries will cooperate to close down the tax havens.

Singapore has a lot of leverage by being an offshore banking facility, with little or no levy on transactions, and it does not want to comply with banking standards, mainly because Singapore is designed to be a little bank, a little Switzerland of Asia. Being transparent is going to cost them. This is a big task for MAS, as they try to position themselves to comply with OCED, the G-20 but, at the same time, maintain the leverage of being an attractive financial centre. Singapore opted to grow on the back of the offshore banking facility without being innovative about its financial products - basically it has been acting as a safety deposit box for Chinese and Indonesian money that want to get out of the mainland.

This is the game that the Singaporean government play. They like to see themselves as being squeaky clean in politics. However, in business, they are not quite complying with the standards. Singaporeans see the maintenance of the financial centre and its associate leverage as an imperative. It is very difficult to get any official statistics on offshore transactions. Also, Singapore still offers very attractive tax structure.

Temasek and GIC, try to play the game of transparency also. When the PM's wife was the head of the Temasek, she had to step down due to a bad investment in UBS. The constituencies had also put pressure on the CEO, while the new CEO, could not stand so long. The possibility of the government selling shares in Temasek Holdings arose from this incident. This is what the Singaporean government does very well – they effectively turned the opposition into stakeholders – and they will call this their mode of transparency.

So this is how they do things in Singapore, share the profits and benefits, and stop talking about it. The biggest call for transparency is from the domestic constituency. They (the people) have to respond to the domestic demand, they are all aware that their pensions are tied to the fund, and when its value goes down, there will be a great concerns and people will start complaining. The government however, successfully control the media, this is not like in UK or US.

Temasek and GIC, talking to ST technology, they invest in many things, but I suspect that they receive money from Temasek or GIC, from their complicated structures. You never know whether it is Temasek's initiative, or Temasek holdings.

SWF is the most rational thing to do, in the historical context of Singapore, which has developed from poverty to a well-off, rich city state. Malaysia was trying to do the same thing, creating the national champions. There is nothing wrong in this developmental model. In the case of Singapore, under this growth model, there is almost no indigenous capital that can form into a large and competitive company like what we see in the US. They gained their strength by monopolising the market. The Communication sector is a case in point because it began by dominating the domestic market then, when it was strong enough, it expanded to invest in the region.

All of Singapore's large businesses have very close connections to the government. The Singaporean government is very good at sending signal to close business allies or circles of what is permitted, and what is not. If you do things the wrong way, you could lose your license. As for the housing market, they don't control that by increasing interest rates, but they control the units or which parcel of land gets the building permission.

Singaporean businesses see the government as a big enabler to capital. The Asian Model, in my point of view, is something that only Singapore can do - not like SOCBs in China, which was not working. Singapore has targeted itself to be a champion in business, for small businesses they might get incentives like cheap rent. They are very pragmatic, the government.

So to wrap up, there is a slight chance that CIC will follow the strategic route that Temasek Holdings is doing, however, it is best for CIC to be a passive investor since they will face less resistance that way.

(4) What is the future of CIC, and what should be the best way to understand it?

I anticipate that CIC will continue to play the role of a passive investor. However, if it is to receive a substantial amount of additional funding, CIC could also put aside some funds for strategic investments, if needed. Therefore, it depends on the amount of capital CIC will have access to in the future.

To understand CIC, I think the best way to understand them is to look through its investment patterns, but this will depend on how much information CIC is willing to disclose. In this regard, the Santiago Principles will be extremely useful. At the same time, GIC and Temasek are not yet ready for transparency. In fact, it's a dirty word for them. But I'm sure in the long-term that they will come to realise the importance of transparency and be able to adjust themselves to it. Given the impact of SWFs in the last 10 or 20 years, the Santiago Principles will be very important. These principles should be applied to CIC, since transparency will help them in the long run.

Bibliography

Primary Research

China interviews

No.	Position/Organisation	Date	Location of Interview	Language
C1	Lecturer/ Academic	5 /1/2010	Beijing	Chinese
C2	Lecturer/Academic	5 /1/2010	Beijing	Chinese
C3	Business Consultant/ Consultancy firm	27/12/2009	Shanghai	Chinese
C4	Lecturer/Academic	28 /12/2009	Shanghai	Chinese
C5	Lecturer/Academic	28/12/2009	Shanghai	Chinese

Singapore interviews

No.	Position / Organisation	Date	Location of Interview	Language
S1	Lecturer/Academic	19/10/2009	Singapore	English
S2	Lecturer/Academic	21/10/2009	Singapore	English
S3	Diplomat/Government	21/20/2009	Singapore	Thai/English
S4	Lecturer/Academic	22/10/2009	Singapore	English
S5	Economist & Banker/ Financial institution	22/10/2009	Singapore	English and Chinese

Thailand interviews

No.	Position / Organisation	Date	Location of Interview	Language
T1	Banker/Central Bank	3/12/2009	Bangkok	Thai
T2	General Manager/ Stock Exchange Regulator	26/11/2009	Bangkok	Thai
T3	Businessman/Large company owner	30/11/2009	Bangkok	Thai
T4	Former President/Stock Exchange of Thailand	22/11/2009	Bangkok	Thai

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