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Introduction

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The explosive growth of sovereign wealth funds (SWF)—together with the increase in resources available to other government-linked investors such as central banks, public pension funds, and state-owned enterprises in recent years—has spurred intense discussions about the implications for the international financial system. The debate over SWF investments in particular has likely been fueled, at least in part, by a growing anxiety over globalization even in many of the most developed economies, including the United States and Europe. An ongoing reassessment of the costs and benefits of investment liberalization—which parallels a similar debate over trade—has led to a variety of new policy proposals for more rigorous investment screening and review procedures and for legal mechanisms to block foreign investment. Some observers have argued that many of these policies, if implemented, would have the effect of raising new barriers to cross-border investment flows.

As has been the case in debates over the benefits of trade in many countries, China has been a central focus of attention and concern. The activities and plans of the newly established Chinese sovereign wealth fund, China Investment Corporation (CIC), have received heavy publicity and growing scrutiny. This is a major concern for China, as the country is now generating the world's largest current account surplus and must seek international investment opportunities to recycle this surplus productively. The United States too has a critical stake in managing this issue properly. U.S. multinational firms depend on the open investment environment overseas that the U.S. government has done so much to promote. Beyond this interest in maintaining investment opportunities for U.S. firms abroad, the United States now runs the world's largest current account deficit, which reached nearly $740 billion in 2007. To fund this deficit, the country must attract foreign capital at the rate of more than $2 billion per day or risk a number of painful economic consequences.

The Context for the Current Debate over SWFs

The sudden furor over SWFs has struck some experts as odd, as the funds have been in existence since the 1950s, particularly in the Middle East. It is clear, however, that SWFs are now in a period of dramatic growth. While estimates vary, SWFs currently account for 1–2% of global financial assets, and may be growing by as much as $1 trillion per year. If this rate of increase continues, SWFs may account for 4% of global wealth within a decade. The rise of SWFs, moreover, is just one dimension of a broader shift of financial resources into emerging economies in the Middle East and Asia that has been fueled by soaring oil prices and rising Asian current account surpluses. In Asia, China is the big story. China's current account surplus has grown dramatically in recent years, topping $370 billion in 2007; the country's accumulated foreign exchange reserves are estimated now to exceed $1.7 trillion. The desire to earn higher returns on these swelling reserves than that provided by fixed-income sovereign debt has led China and Russia to follow in the steps of the Middle East countries and entrust some of these resources to sovereign wealth funds to invest more aggressively in a broader range of foreign assets.

The controversy that has accompanied this shift of financial power from developed economies in the West to both commodity exporters in the Middle East and export-oriented economies in Asia is not, then, all that surprising. A number of issues are often cited by those who seek new reviews or restrictions on the activities of SWFs. The first is the possibility that government ownership will affect the role that SWFs play in the global financial system—i.e., whether they will behave as other players in the market do or will instead have unique characteristics. The second is the lack of transparency of many SWFs with respect to investment objectives, strategies, holdings, and in some cases even governance. The third concern is the potential risk to national security that SWFs could pose if these funds choose to utilize their ability to mobilize significant resources in order to purchase ownership stakes in foreign firms and thereby acquire technology, information, or other resources in a way that undermines the security of the host government. The fourth is the possibility that SWFs may have a variety of unfair advantages over private sector actors in competition for investment opportunities because of SWFs' access to financial, diplomatic, or even intelligence support from their home governments. A closely related issue is the possibility that SWFs could be used to advance a state's industrial policy by supporting and subsidizing the outward expansion of home-grown "national champion" firms into new overseas markets, including by helping these firms to purchase stakes in foreign competitors or even to buy these competitors outright.

At the same time as critics have been sounding these alarms, however, the subprime financial crisis and its after-affects have caused many Western financial firms in need of capital infusions to turn to sovereign wealth funds as some of the few sources of liquidity available to shore up damaged balance sheets. As a result, many fund managers have found themselves in the unusual position of being both courted and vilified when exploring possible investment opportunities, particularly in the United States. Indeed, SWF investments in financial institutions such as Citigroup, Morgan Stanley, Standard Chartered, and Blackstone seem to have further fueled calls for more targeted mechanisms to regulate the activities of SWFs.

Seeking both to assess the risks and identify appropriate responses to the concerns that have been raised about SWFs and to allay growing concern that the global investment climate might be harmed by unnecessarily restrictive unilateral actions by recipient countries, officials at the U.S. Treasury Department, the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), and increasingly the host governments and the managers of the SWFs themselves have begun to take action. The U.S. Treasury Department reached agreement with SWFs from Singapore and Dubai on a set of principles and best practices that would guide their investment activities. The IMF has assembled a working group to develop a set of voluntary guidelines or best practices for SWFs to follow. The OECD has also begun work on a set of parallel best practices for the inward investment regimes of OECD member countries. There is clearly an understanding among many financial officials that a coordinated and credible approach to addressing the concerns that have been raised about SWFs will be essential to avoid a protectionist backlash.

In the United States, the debate over sovereign wealth funds comes on the heels of a series of controversies over foreign investment in recent years. High-profile cases include the unsuccessful bid for Unocal by the China National Offshore Oil Corporation (CNOOC), the controversial Dubai Ports World purchase of a company that managed six U.S. ports, and the more recent failed bid by Huawei and Bain Capital to purchase 3Com. While the United States has witnessed concerns about foreign investment in the past—particularly with Japan in the 1980s—the most recent series of investment controversies has raised more significant questions about whether the climate for foreign investment in the United States might continue to worsen in the future.

The United States and China have enhanced bilateral dialogue on investment issues over the past several years under the auspices of the Strategic Economic Dialogue (SED). At the most recent meeting of the SED on June 17–18 in Annapolis, Maryland, the two sides agreed to launch negotiations for a bilateral investment treaty (BIT) to enhance investment facilitation, increase investor protections, and enhance predictability and transparency. The United States and China also established not only an investment forum to focus on practical investor concerns, such as investment reviews and potential investment barriers but also an Investment Promotion Initiative that will conduct investment activities in the two countries. The two sides also addressed sovereign wealth funds directly in the joint statement released at the end of the meetings. Specifically, the United States noted that it welcomes sovereign wealth fund investment, including from China, while China stressed that the investment decisions by its state-owned investment firms will be based solely on commercial grounds. While it is unclear what the prospects are for successfully concluding a high-standard BIT or how effective these new mechanisms for dialogue on investment issues will be, these efforts, as well as the language included in the joint statement, certainly reflect an understanding of the importance of more effectively addressing investment issues.

Given the stakes involved for the United States and China, as well as for the global economy, it is important that the policy community is as well informed as possible about sovereign wealth funds in general and the Chinese SWF in particular. To that end, The National Bureau of Asian Research is pleased to present Michael Cognato's research on CIC. His paper provides an analysis of the political and economic debates that led to the formation of CIC, outlines what is known about the corporation's investment objectives and management structure, and details the domestic and foreign investments that CIC has undertaken to date. He also examines some of the specific concerns that have been raised about the potential risks posed by CIC to U.S. national interests and draws some preliminary conclusions about their validity.

As the paper points out, it is important to recognize that CIC is just one actor in an increasingly complex system of Chinese government-linked entities that now engage in foreign investment activities. The State Administration of Foreign Exchange, which had been managing China's foreign exchange in a fairly traditional portfolio of fixed-income sovereign debt, is now expanding into other asset classes. China's many state-owned enterprises not only have significant internal resources to fund overseas investments but can also turn to the state-owned banks for additional funding. This dynamic has already been apparent in a number of well-publicized cases involving natural resource investments, such as a possible bid by Chinalco for Rio Tinto. As Cognato notes, CIC has used much of its first tranche of capital to take controlling stakes in the largest Chinese state-owned banks as well as several securities firms. These ownership stakes enable CIC to act indirectly via these financial institutions, if it so chooses, to support overseas investments by Chinese companies.

China is clearly at the early stages of what is likely to be a large-scale and sustained role as a foreign investor. Assessing the investment strategies of the various Chinese entities engaging in foreign investment activities, as well as the role of the Chinese government in directing and coordinating these activities, will be an important area of research going forward.

China Investment Corporation: Threat or Opportunity?

Michael H. Cognato

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Executive Summary

This study examines the establishment, management, and investment decisions to date of China Investment Corporation (CIC), analyzes potential causes of concern, and identifies opportunities for engagement.

Main Findings:

- The need to generate higher returns was instrumental in CIC's establishment and was built into its funding structure.
- CIC's management consists largely of well-respected technocrats with investment experience and proven records as pro-market reformers.
- CIC's international investments have so far been unremarkable. Its ownership of much of China's banking sector may ultimately prove more consequential.

Policy Implications:

- There is, as yet, little evidence to support worries that CIC will pose a national security threat or will engage in investments meant to serve China's broader strategic priorities.
- There are real causes for concern that CIC will abet financial corruption or provide unfair advantages to Chinese state companies.
- CIC's emergence could also produce benefits for the United States and other countries. In addition to providing increased investment capital for countries in which it invests, CIC investments could accelerate China's integration into the international financial system and drive liberal reforms in China's domestic economy.
- Seizing the opportunities that CIC presents would require active efforts at engagement from the U.S., other countries, and international organizations. Attempts to limit CIC's activities will limit these opportunities.

The emergence of sovereign wealth funds (SWF) has been one of the most prominent features of international finance in the past year. According to International Monetary Fund (IMF) estimates, SWFs worldwide hold between $1.9 and $2.9 trillion in funds and are growing at a rate of $800–900 billion per year.[1] High oil prices and large current account surpluses have allowed middle-income countries in Asia and the Middle East to amass capital, and assert themselves in international financial markets, to an extent unprecedented in modern history.

China Investment Corporation (CIC) has been one of the most prominent of the sovereign wealth funds. Established in September 2007 with $200 billion of China's then-$1.4 trillion in foreign exchange reserves, the fund drew widespread attention with early, high-profile investments in Blackstone and Morgan Stanley. Because of subsequent rumored involvement in huge outward investments by large state-owned firms, a dearth of information from CIC itself, and the current general fascination with China's emergence as a global power, CIC has caught the attention of financiers and policymakers alike.

CIC's motivations and likely behavior are not readily apparent. As a result, policymakers in countries that receive CIC investments have not known how or whether to respond. U.S. politicians have been quick to point to the growth and investment of foreign SWFs as a symptom of domestic economic problems, and at times as a problem in and of themselves. The fact that most SWFs are operated by nondemocratic governments whose foreign policies sometimes run counter to U.S. interests only heightens U.S. concerns.

Based on an extensive review of publicly available information (such as news reports, CIC officials' statements, and industry reports) this essay attempts to assemble a fuller picture of CIC, investigate some of the concerns that have emerged, and suggest policy options for the United States and other nations on the receiving end of CIC's investments. Though the preponderance of sources are in English, Chinese-language sources have been consulted where necessary. This paper also draws heavily on in-depth portraits of China's financial and political systems by a range of noted China experts in order to place CIC in the proper context.

The first section examines the establishment and financing of CIC, the fund's management, and its investment decisions thus far. The choices made in the fund's establishment and the method by which it was funded suggest that CIC is intended to do little more than earn a modest return on its investments. The officials chosen

[1] International Monetary Fund (IMF), *Global Financial Stability Report* (Washington, D.C.: IMF), 45.

to staff the fund are among China's most skilled financial bureaucrats, and many of them have a proven track record of supporting market-friendly reforms and financial modernization. So far, CIC's international investments provide little cause for concern. CIC's role in China's domestic financial sector may prove to be problematic, however, simply because the fund owns such a huge share of this sector.

The second section draws some preliminary conclusions about what can be expected from the fund in the future. Two frequently voiced concerns—that the fund poses a national security threat, and that it will engage in "strategic" investments meant to further broader Chinese foreign policy—appear to be overstated. Concerns over corruption and unfair advantages that CIC may enjoy because of its governmental status, on the other hand, seem better founded.

The final section suggests some benefits that may also result from the fund's emergence. In addition to providing access to capital to host countries, CIC's investments will also increase the Chinese government's interest in the stable and reliable functioning of international capital markets. Important questions about CIC's ultimate aims and relationship to other parts of China's economy remain, but a well-designed policy of engagement could minimize the risks while taking advantage of the opportunities the fund presents.

The China Investment Corporation: A Profile

Establishment

The establishment of CIC on September 29, 2007 was the result of a debate that had been occurring in think tanks and ministries in China for at least two years. Since the late 1990s the country had been running large current account surpluses and steadily building its cache of foreign exchange reserves. Monthly growth of between 2% and 4% in reserves had left China sitting on an enormous pile of money that now stands at more than $1.5 trillion. Through most of 2005 these reserves were likely almost entirely in dollars as a result of the peg maintained between the renminbi (RMB) and dollar.[2]

The opportunity cost of holding such large reserves is very high. Most of the reserves were parked in U.S. Treasury and Agency bonds, which are highly liquid and safe but provide relatively low returns. UBS has estimated that the returns that China earned on its reserves between 2003 and 2006 ranged between 2% and 4%—not a

[2] Barry Eichengreen, "China's Exchange Rate Regime," in *China's Financial Transition at a Crossroads,* ed. Charles Calomiris (New York: Columbia University Press, 2007), 327–31.

very efficient use of capital for an economy growing over 10% per year.[3] Moreover, the Chinese government is allowing the RMB to appreciate gradually against the dollar in response to the pressure of large inflows of money.[4] This may cost the Chinese government $120–50 billion (between 3–4% of GDP) or more in lost domestic purchasing power.

Any large move of the reserves out of the dollar, however, would immediately accelerate the loss in value of the remaining dollars. He Fan, a researcher at the China Academy of Social Sciences, a prestigious Chinese think tank, has described these pressures as putting China in a "hostage situation," whereby the very size of the reserves forces China to maintain the policies that cause the reserves to continue to grow.[5]

Maintaining these large dollar reserves is also growing increasingly costly for the central bank in RMB terms. To counteract the inflationary impact of its dollar purchases, China's central bank (the People's Bank of China or PBOC) issues short-term sterilization bonds that pay over 4%. At the time of writing, however, new issues of ten-year Treasuries pay a 3.5% return. The net effect is that the PBOC must run a loss to sustain China's monetary policy. Hong Liang of Goldman Sachs has recently estimated that China is losing $4 billion per month as a result of these effects, or 1% of GDP.[6]

The central government also needs higher returns to avoid being perceived to have squandered so much of the nation's wealth in pursuit of these policies. Richard McGregor of the *Financial Times* has reported that this issue is so politically sensitive—and potentially damaging—that few Chinese economists will even comment on it off the record.[7]

The prospect billions of dollars of losses began to sit increasingly uneasy on government officials early in the new century, leading them to cast around for other uses of the money. In 2003 $45 billion of the reserves was used to recapitalize troubled state banks. In late 2005 the CCP Policy Research Office, an official think tank, suggested that the reserves be used to buy physical assets, such as oil reserves, rather than purely

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[3] Jonathan Anderson, "The China Monetary Policy Handbook," UBS Investment Research, Asian Economic Perspectives, November 5, 2007.

[4] Most observers predict that the RMB will have gained 8–10% as a result over the course of 2008. Richard McGregor, "Beijing Begins to Pay for Forex 'Stabilization,'" *Financial Times,* February 1, 2008.

[5] "China Mulling Reserve Issue," Main Wire, January 17, 2006.

[6] Quoted in McGregor, "Beijing Begins to Pay for Forex 'Stabilization.'"

[7] McGregor, "Beijing Begins to Pay for Forex 'Stabilization.'"

financial assets.[8] Reports emerged a month later that China's State Council had begun to consider more active ways to manage China's foreign exchange in order to seek higher returns, with Singapore's Temasek and Government Investment Corporation both mentioned as potential models. In early 2006 Hu Xiaolian—administrator of the State Administration of Foreign Exchange (SAFE), which manages the reserves—suggested that China would diversify both the currency and investment uses of its hard currency.[9]

By early 2006 a broad consensus among academics in China seems to have emerged: something more proactive needed to be done to protect the value of China's reserves. With prices for oil and other resources at record highs, investment in financial markets was quickly deemed the best option. He Fan claimed that as much as $400 billion—or half of the country's reserves at that point—could be put into an investment fund.[10] SAFE began to manage its investments more actively over the course of the year and doubled its in-house trading staff to accommodate the new strategy.[11] Experts both within and outside China soon began to make additional suggestions for other uses of the reserves. A Yale business professor recommended China give away some of the funds through a "Chinese Marshall Fund."[12] Former U.S. Treasury Secretary Larry Summers suggested that China and other countries with large official reserves allow the IMF to invest on their behalf.[13] One Chinese scholar recommended using the cash to shore up China's smaller banks and national pension fund.[14] Others suggested using the cash to finance state firms' overseas expansion or for domestic social and infrastructure financing.

Over the course of the year opinion seemed to coalesce around the establishment of a new organization that would invest the funds abroad. Previous speculation had been that Central Huijin Investments (Huijin), a holding company set up to manage state-owned financial companies, would simply be repurposed to also serve as a foreign

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8 Cary Huang, "Forex Reserves May Boost Oil Stocks," *South China Morning Post,* September 27, 2005.

9 "China Will Not Sell Dollars, Could Diversify New Forex Reserves—Govt Adviser," AFX, January 1, 2006.

10 "China Mulling Reserve Issue," Main Wire.

11 Richard McGregor, "China to Beef up Exchange Trading," *Financial Times,* December 13, 2006.

12 Jeffrey Garten "Why China Should Marshall Its Reserves to Do Good," *Financial Times,* October 20, 2006.

13 Lawrence H. Summers, "Reflections on Global Account Imbalances and Emerging Markets Reserve Accumulation" (speech presented at the L.K. Jha Memorial Lecture, Reserve Bank of India, Mumbai, March 24, 2006), http://www.president.harvard.edu/speeches/2006/0324_rbi.html.

14 "China Should Use Forex Reserves to Bolster Pension Fund, Small Banks: Scholar," Xinhua, September 1, 2006.

exchange investment vehicle.[15] In December 2006, however, PBOC vice-governor Wu Xiaoling came out in favor of setting up an investment agency independent from SAFE and the central bank. The decision to establish the fund was apparently finalized at the January 2007 National Financial Work Conference held in Beijing, where Premier Wen Jiabao gave his blessing to plans to "explore new means and extend channels" to manage the reserves.[16] Several weeks later Lou Jiwei, a deputy minister of finance, was moved over the State Council as a deputy secretary-general to begin to piece together the organization.[17] The government announced the decision to establish the fund in March, though details about its funding and organization would only emerge later.[18]

Throughout 2007, debate evidently grew very heated within the State Council over the proper structure and governance of the new fund, with various arms of the Chinese government vying to take on a role in the fund's decisionmaking. Divisions between the PBOC and Ministry of Finance (MOF) over who would have ultimate authority were reportedly particularly sharp.[19] The establishment of CIC resolved the debate by removing both the banks and the foreign exchange that CIC would manage from the PBOC's direct purview, but without returning them to the MOF. In a move that seemed designed to placate all possible stakeholders, the new fund was made directly accountable to the State Council.

The new fund was financed in a relatively complicated procedure. The finance ministry issued RMB1.5 trillion in bonds, bearing interest rates of between 4.3% and 4.7%. The bonds were then mostly sold to the PBOC using the Agricultural Bank of China as an intermediary to skirt legal restrictions. The proceeds of the bond sale were used to purchase the foreign exchange from the PBOC. The net effect of the complex transactions was to replace $200 billion in foreign exchange on the PBOC's books with the bonds, which the MOF will pay off using CIC proceeds.[20] This initial amount appears to be only a preliminary figure. Statements by PBOC governor Zhou Xiaochuan

[15] Wang Xiangwei, "Rural Finance, Forex Reserves, Top Agenda of Key Conference," *South China Morning Post,* January 15, 2007.

[16] "New Firm to Tap Forex Reserves," *China Daily,* February 2, 2007.

[17] McGregor, "Beijing Closer to Managing Reserves More Actively."

[18] Jim Yardley and David Barboza, "China Acts to Become Huge Global Investor," *International Herald Tribune,* March 10, 2007.

[19] Tadanori Yoshida, "Foreign Funds Spark Tug of War," *Nikkei Weekly,* March 26, 2007.

[20] Rachel Ziemba, "How is China Funding the Chinese Investment Corporation (CIC)?" RGE Analysts' EconoMonitor web log, December 7, 2007, http://www.rgemonitor.com/blog/economonitor/230764/.

and other officials that reserves of $800 billion were "enough" imply that any amount over that level could eventually be placed under the care of CIC.[21]

Management

The fund is managed by well-respected technocrats, several of whom have experience in managing government and private sector investments. **Table 1** presents summary information on the management committee. These individuals are responsible for the operation and international investment decisions of the fund.[22]

Four of the seven committee members are relatively well-known outside of Chinese official circles: Lou Jiwei, Gao Xiqing, Xie Ping, and Jesse Wang Jianxi have all held relatively high-profile posts before and have been profiled and quoted in Western media.

Lou Jiwei, CIC's chairman, has been the most visible representative of the fund. Prior to organizing CIC's establishment he had spearheaded fiscal reforms in the finance ministry in the 1990s, served as vice governor in Guizhou Province from 1995 to 1998, and further reformed China's tax system as vice minister at the MOF after 1998. A trained computer scientist and economist, Lou recently co-edited a book published by the World Bank on China's public finance system. His talent has been apparent for the last ten years, however; in 1998 the *Washington Post* published a profile of Lou as representing "the best hope for China's troubled Communist Party," dubbing him "the prototype for a generation of technocrats rising through the upper ranks of government." Lou is considered to be a protégé of former premier Zhu Rongji.[23]

Despite Lou's frequent appearance as spokesman for the fund, general manager Gao Xiqing is likely to have more of a direct say in investment decisions. He combines academic credentials, investment experience, and a proven track record as a reformer. Gao has extensive overseas experience; he earned a law degree from Duke in 1986, after which he worked as a lawyer on Wall Street for several years. In 1988 Gao returned to

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[21] Richard McGregor, "The Trillion Dollar Question," *Financial Times,* September 25, 2006.

[22] *"Zhongguo touzi gongsi ben yue 29 ri guapai dongshihui chengyuan jueding"* [China Investment Corporation Established on the 29th, Board Officials Decided], Xinhua, September 27, 2007, http://news.xinhuanet.com/fortune/2007-09/27/content_6798386.htm.

[23] Rick Carew, "Moving the Market: China Names Top Official to Plan Fate of $1 Trillion," *Wall Street Journal,* February 16, 2007; Rick Carew, "Beijing Appoints Official to State Council Position," *Wall Street Journal Asia,* March 7, 2007; Cary Huang, "State Technocrat Takes on Job as Global Fund Manager," *South China Morning Post,* August 20, 2007; Lou Jiwei and Shuilin Wang, eds., *Public Finance in China—Reform and Growth for a Harmonious Society* (Washington, D.C.: World Bank, 2008); and Steven Mufson, "Even for the Party, Talent Counts the Most," *Washington Post,* June 17, 1998.

TABLE 1 CIC Management Committee

Member	Position(s)	Prior Position(s)	Background
Lou Jiwei	Chairman	Deputy Secretary General, State Council; Vice Minister, Ministry of Finance	Primarily a bureaucrat in the Finance Ministry; one stint as provincial vice governor in late 1990s
Gao Xiqing	President and General Manager	Vice Chairman, National Council for the Social Security Fund	U.S. law degree; instrumental in establishing China's stock markets and China Securities Regulatory Commission
Xie Ping	Deputy General Manager	Chairman, Central Huijin Investments	Central bank official and economist; has been responsible for banking sector reforms
Wang Jianxi ("Jesse")	Chief Risk Officer and Deputy General Manager	Chairman, Jianyin Investments; Chairman, China International Capital Corporation; Vice Chairman, Central Huijin Investments	Prior experience managing Chinese government investments for several entities; prior stints at China Securities Regulatory Commission
Zhang Hongli	Deputy General Manager	Vice Minister, Ministry of Finance	Ministry of Finance bureaucrat
Yang Qingwei	Deputy General Manager	Department Director, National Development and Reform Commission	No information available; Yang is considerably outranked by his colleagues on the management committee
Hu Huaibang	Chief Supervisor	Vice Chairman and Commissioner for Inspections, China Banking Regulatory Commission	Long-time economics professor at Shaanxi Institute of Finance and Economics; has also worked at Chengdu branch of central bank

China and was instrumental in establishing the country's first stock markets. He went on to serve as general counsel and director of public offerings for the China Securities Regulatory Commission (CSRC) in its first years of operation, during which time he was a strong advocate for opening China's financial markets to foreign participants and publicly listing more state-owned firms. In 1996 Gao left the CSRC along with other reform-minded officials, evidently as the result of a decision at higher levels to rein in chaotic markets. After a short teaching stint, Gao took over Bank of China's investment banking unit in Hong Kong for two years, then returned to the CSRC as vice chairman. Most recently, Gao was vice chairman of the National Council for the Social Security Fund (NCSSF). His position there was considered relatively low-profile in 2003 when

Gao was assigned to it, but the experience managing government investment funds likely left him well placed to negotiate the various conflicting goals that he is expected to meet at CIC. NCSSF reportedly manages $38 billion in foreign assets, perhaps $1 billion of it through money managers such as UBS and T. Rowe Price.[24]

Like Lou Jiwei, Gao too drew attention from Western media some time ago, but for a different reason—in late May, 1989 the *New York Times* ran a profile of the young lawyer and professor, who had just joined his students for a night in Tiananmen Square. Despite worries by Gao at the time that he risked professional retaliation or even imprisonment, his involvement with the protests does not appear to have hurt his career.[25]

Though not schooled abroad, Jesse Wang Jianxi has had a career similar to Gao's. Wang has also invested money for the state before, both while as chairman of Jianyin Investments and China International Capital Corporation (CICC) and as vice chairman of Huijin. Jianyin Investments, owned by Huijin, was formed from non-bank assets of the China Construction Bank (CCB) in 2005. Until being transferred to CIC in 2007, Jianyin acted as the PBOC's investment banking arm, recapitalizing a large number of brokerages and securities firms; the company is now also a joint-venture partner of Morgan Stanley in CICC. These positions put Wang at the heart of China's complex capital markets. Wang, like Gao, has also twice worked at CSRC: first as chief accountant during its formative years, then again as assistant chairman in the early 2000s. Wang has also spent time abroad, training for six months at the National

[24] James Sterngold, "Calls for Economic Changes Rise Among Chinese Officials," *New York Times,* July 28, 1990; Sophie Roell, "Reining in the Free Market," *Euromoney,* July 1996; Peter Chan, "BOC International Boss Gao Goes to Securities Watchdog," *South China Morning Post,* July 12, 1999; Bei Hu, "CSRC Vice-chairman Removed from Post," *South China Morning Post,* January 3, 2003; Bei Hu, "Former CSRC Vice-Chairman Lands Fund Job," *South China Morning Post,* February 26, 2003; Carter Dougherty, "Riskier Business Tempts China Fund," *International Herald Tribune,* January 27, 2005; Henny Sender, "New China Agency Appoints Official to Make Key Investment Decisions," *Wall Street Journal,* August 31, 2007; and Shirley Yam, "Technocrats May Find Rough and Tumble Too Tough," *South China Morning Post*, August 11, 2007.

[25] Sheryl WuDunn, "Upheaval in China: Reluctant Rebel Joins Students' Cause," *New York Times,* May 28, 1989.

Association of Securities Dealers in the United States and working as CFO of Bank of China's (BOC) London-based merchant banking operation.[26]

Wang's boss at Huijin, Xie Ping, is also highly regarded by market observers. Xie spent almost his entire career at the PBOC, and hence lacks the breadth of experience of those of his colleagues mentioned above. His work over the past several years driving reforms through China's largest banks, however, has evidently made him indispensable to the new investment fund. As chairman of Huijin since 2005, he has had primary responsibility for representing the state's controlling interests in BOC, CCB, and the Industrial and Commercial Bank of China (ICBC). Unusually outspoken for a Chinese bureaucrat, Xie was a strong advocate of inviting foreign banks to take stakes in the large state-owned banks. In addition to being a respected economist, Xie is also said to enjoy the support of premier Wen Jiabao.[27]

The other three members of the committee have been less prominent as individuals. Hu Huaibang, CIC's chief supervisor, was previously chief inspector of the CBRC, from which post he regulated many of the financial institutions that CIC now owns. Zhang Hongli, another vice minister of finance, has spent his entire career with the finance ministry.[28] Yang Qingwei, formerly of the National Development Reform Commission (NDRC), is considerably outranked by his colleagues. His experience as head of fixed asset investment for the NDRC, however, likely makes him a valuable part of domestic investment decisions undertaken by the fund.

The fund's board of directors includes representatives of all of the government ministries that have a direct stake in the fund's operations (see **Table 2**). The independent directors—older officials who have previously served on the CCP's Central Committee—replicate the balance between the NDRC and MOF that characterizes both the management committee and the board as a whole. Only Hu Xiaolian (who as

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[26] Rick Carew, "Beijing May Fortify CICC," *Wall Street Journal,* February 15, 2008; Pierre Paulden, "Stepping-Stone Interpreting the First Deal by China's State Investment Co.," *Institutional Investor,* June 2007; Bei Hu, "Calls Grow for Capital Market Reform," *South China Morning Post,* October 20, 2005; "China's CICC Plans to Add Capital and Expand Equity," *Asia Pulse,* September 20, 2005; Bei Hu, "CICC Raises Fresh Capital to Expand," *South China Morning Post,* September 17, 2005; Jamil Anderlini, "Jianyin Acquires Collapsed Brokerage," *South China Morning Post,* August 2, 2005; "China Names Former Stock Market Regulator to Head CICC – Report," *AFX International Focus,* April 18, 2005; Bei Hu, "China Urged to Adopt Class-Action Suits," *South China Morning Post,* November 21, 2002; Christine Chan, "Former Accounts Chief at the Helm of New BOC Unit," *South China Morning Post,* November 11, 1996; and Christine Chan, "Senior CSRC Official Opts for Private Sector," *South China Morning Post,* August 1, 1996.

[27] Andrew Browne, "China's Banks Get Mr. Fix-It," *Wall Street Journal,* January 5, 2005; and "China to Retain Control over State-owned Banks for 10 Years—Central Huijin," AFX, April 6, 2006.

[28] See "Biography of Zhang Hongli," China Vitae, website, http://chinavitae.com/biography/Zhang_Hongli.

TABLE 2: CIC Board of Directors

	Name	Current Position(s) and Affiliation(s)
Executive Directors	Lou Jiwei	Chairman, CIC
	Gao Xiqing	General Manager, CIC
	Zhang Hongli	Deputy General Manager, CIC
Non-Executive Directors*	Zhang Xiaoqiang	Vice Chairman, National Development and Reform Commission
	Li Yong	Vice Minister, Ministry of Finance
	Fu Ziying	Assistant Minister, Ministry of Commerce
	Liu Shiyu	Vice Governor, People's Bank of China
	Hu Xiaolian	Administrator, State Administration of Foreign Exchange Vice Governor, People's Bank of China
Independent Directors	Liu Zhongli	Former Minister, Ministry of Finance
	Wang Chunzheng	Deputy Director, National Development and Reform Commission

* One additional non-executive board member is to be chosen by CIC's employees. This individual has yet to be announced.

SAFE administrator is responsible for China's official foreign exchange reserves) and the retired Liu Zhongli hold full ministerial rank.

The role that the board will play is still unclear. At the very least, it seems likely to serve as an information clearinghouse; board members will be able to keep their home ministries apprised of the fund's plans and activities. The board might also function as a coordinating committee, providing the various ministries a forum in which to attempt to shape CIC's strategy to better reflect their home ministries' priorities. The distribution of posts to government bodies seems to reflect the fund's conflicting mandates—the board may play a role in domestic finance, investment planning, monetary policy, and government fiscal policy.

Media reports also indicate that CIC has been hiring financial professionals to fill out its ranks. Initial plans were to pay officials and staff salaries commensurate with the private financial sector. After other government officials objected, however, the pay scale was lowered to mirror that of state banks. According to *Caijing* magazine, a "front-line staffer" can expect to earn roughly $100,000, far below market standards for investment professionals.[29]

[29] Li Qing, Yu Ning, Ling Huawei, and Chen Huiying, "China Sets a Course for Sovereign Wealth," Caijing, March 2008.

Investments

Foreign investment. Despite criticisms of a lack of transparency, the basic outline of CIC's initial investment strategy is relatively clear. Roughly $110 billion of the fund's capital has been dedicated to the domestic financial sector. The remaining $90 billion, slated for international markets, has drawn the most interest from international observers.[30] **Table 3** presents the investments that CIC has made or announced intentions to make to date.

The first $8 billion of international investments went to high-profile stakes in Blackstone ($3b) and Morgan Stanley ($5b). Both came as surprises to the market; the Morgan Stanley investment evidently surprised CIC's own staff.[31] The Blackstone deal was a direct, pre-IPO stake that has since lost nearly half of its value, provoking withering criticism from within China. CIC's stake in Morgan Stanley, however, is structured to limit CIC's potential downside: CIC holds convertible bonds with a 9% return, convertible to stock after a tie-up period. Still, the fund's leadership has grown wary of the U.S. financial sector as a result of its recent losses.[32]

Both deals at least appear to have been helped along by personal connections. The chairman of Blackstone's Greater China operations, Antony Leung, is a former finance secretary of Hong Kong and known to be on very good terms with the mainland's financial authorities.[33] Morgan Stanley, meanwhile, has a long-standing (although sometimes difficult) relationship with Central Huijin; as mentioned above, the two are joint-venture partners in CICC, the mainland's largest investment bank.

CIC officials have gone out of their way to describe these two stakes as anomalous, insisting that most investments would be made in international stock markets through third-party managers. Chairman Lou has stressed that CIC would be "focusing on

[30] Initial plans were to dedicate only $67 billion to international investments. In late April, however, Gao Xiqing announced that less cash than expected was needed at home, and the fund's international spending would increase commensurately. See Jamil Anderlini, "CIC Raises Global Spending Power," *Financial Times,* April 23, 2008.

[31] Keith Bradsher, "Morgan Investment Marks Shift for China Fund," *New York Times,* Dealbook web log, December 19, 2007, http://dealbook.blogs.nytimes.com/2007/12/19/morgan-investment-marks-shift-for-china-fund/.

[32] "China Investment Corp Suspends Investments in Overseas Financial Cos—Report," XFN-Asia, March 7, 2008.

[33] Pierre Pauldin, "Stepping-Stone Interpreting the First Deal by China's State Investment Co." *Institutional Investor,* June 2007.

TABLE 3: CIC International Investments

Investment	Amount	Details
Morgan Stanley	$5 billion	9.9% stake through convertible bonds with 9% yield
Blackstone	$3 billion	9% pre-IPO stake
J.C. Flowers fund	~$3 billion	80% of private equity fund focused on financial sector
Visa	$100 million	Pre-IPO stake
China Railway (Hong Kong)	$100 million	Pre-IPO stake

financial portfolios."[34] Gao Xiqing has specified that the fund would concentrate on "the cash market, fixed income, equity and hedge funds," as well as private equity.[35]

The fund's early activities have indeed followed through on these pledges. At the time of writing CIC was in the final stages of a recruitment drive for international fund managers in global and emerging market bond investments, with a particular emphasis on finding aggressive managers who had beat benchmark returns over the last three years.[36] The recruitment was surprisingly wide-ranging: applications were solicited on a public website, and more than 100 applicants were contacted by the fund to continue the process.[37]

The information released along with the recruitment drive and public statements by CIC officials have provided additional details of the fund's investment plans. CIC claims to seek returns of 5–6%, just above its financing costs.[38] Up to $30 billion will initially be farmed out to external investment managers.[39] Reports from Japan indicate that CIC will put roughly $10 billion into Japanese securities, seeking a 6% annual return.[40] Though investments will initially be confined to stocks on the Nikkei, CIC will reportedly eventually seek direct stakes in several Japanese companies, notably the large oil and gas company, Inpex. Another $4 billion has been committed to a fund run

[34] "China CIC Chief Says Investment Focus to Be on 'Portfolios,' Not Individual Cos," AFX Asia, February 4, 2008.

[35] "Wealth Fund Hiring Foreign Money Managers," *China Daily,* February 29, 2008.

[36] "China Investment Corp Seeks Fixed-income Product Managers," Asia Pulse, February 4, 2008.

[37] Jamil Anderlini, "CIC Gears Up for $30bn Drive," *Financial Times,* February 11, 2008.

[38] Robin Kwon, "China Sovereign Wealth Fund Rebuffs Critics," *Financial Times,* April 2, 2008.

[39] Mark Konyn, "CIC Tender Sparks International Feeding Frenzy," *Financial Times,* January 7, 2008.

[40] "China's Sovereign Wealth Fund Favors Japanese Investments," *Marketwatch,* February 21, 2008.

by hedge fund manager J.C. Flowers that will focus on smaller financial institutions.[41] CIC has also taken $100 million pre-IPO stakes in state-owned China Railway and Visa, which both listed in recent months (the former in Hong Kong).

In addition to plans CIC has already confirmed, rumors abound of potential tie-ups with Chinese SOEs looking to expand abroad. Soon before the formal establishment of CIC in September 2007, Li Rongrong, head of the State Assets Supervision and Administration Commission (SASAC), publicly lobbied for the new institution's funds to be used to assist Chinese state-owned firms to grow into more "influential" multinational firms.[42] Unnamed sources in December claimed that CIC would shift its attention to natural resources, and specifically work to assist Chinese SOEs in their outward investment plans. Rumors that CIC would assist China Petrochemical Corporation in acquiring overseas assets seemed to buttress these reports.[43] Later in the year, the fund was engaged in discussions with Hainan Province concerning a potential investment in a commercial crude oil reserve.[44] Following this, CIC also discussed assisting Shenhua Energy to purchase 15.85% of Fortescue.[45]

Domestic investment. Though receiving less attention, CIC's role in the domestic economy may ultimately prove to be more important than its role internationally. By absorbing Huijin, CIC has assumed ownership of a majority of China's most important banks and financial institutions. CIC has, moreover, been expanding its role through cash injections into other banks. **Figure 1** depicts the size of CIC's banks relative to China's total banking market in terms of assets and loans.

Huijin owns an outright majority of CCB and BOC, and, with the MOF, shares of a controlling stake in ICBC.[46] In addition to these three banks, Huijin also purchased

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[41] "Report: China Fund Preparing to Allocate $30US billion to Foreign Investment Managers," Associated Press, February 11, 2008.

[42] Li Yanzheng, "*Li Rongrong: Zhongtou gongsi jiang bangzhu yangqi jiada haiwai touzi lidu*" [Li Rongrong: China Investment Corporation Will Help Central SOEs to Increase Overseas Investment], *Shanghai Securities Journal*, September 13, 2007, http://news.xinhuanet.com/newscenter/2007-09/13/content_6713982.htm.

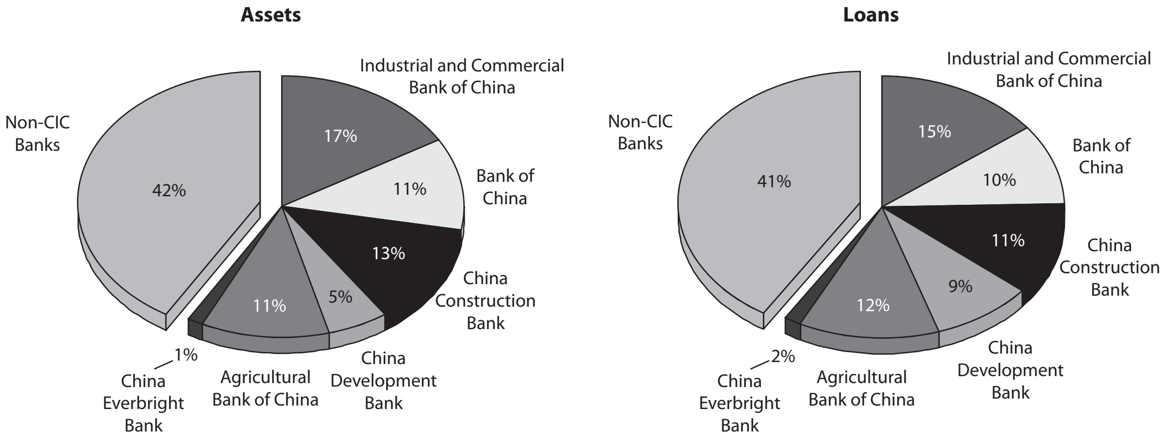
[43] Tan Wei, "China's CIC Likely to Diversify Away from Further US Banking Sector Investments, Source Says," *Financial Times,* December 30, 2007.

[44] "China's Hainan Kicks Off Oil Storage Project," *Platts Oilgram News,* December 14, 2007.

[45] "China Shenhua, CIC to Make Biggest Investment Yet in Reported Fortescue Bid," AFX, February 4, 2008, http://www.forbes.com/afxnewslimited/feeds/afx/2008/02/04/afx4608890.html.

[46] For the purposes of the figures above, ICBC is counted as a subsidiary of Huijin and, hence, CIC. Kumiko Okazaki, "Banking System Reform in China: The Challenges of Moving Toward a Market-Oriented Economy," Rand Corporation, Occasional Paper, 2007, http://rand.org/pubs/occasional_papers/2007/RAND_OP194.pdf.

FIGURE 1 Assets and loans of CIC-owned banks as percentage of China's total banking sector, 2007



a 71% stake in China Everbright Bank in November 2007.[47] Together, these banks accounted for 42% of all assets and 38% of all loans in China's banking sector as of year-end 2007.

CIC is also taking on a role in restructuring two banks not yet under Huijin's ownership. The fund recently injected $20 billion into China Development Bank (CDB), which is in the process of converting from a policy to a commercial lender. The injection nearly doubled the bank's capitalization, from RMB158 billion to RMB300 billion.[48] Another sum of up to $40 billion dollars has been earmarked for the Agricultural Bank of China (ABC), the only large state-owned commercial bank yet to be restructured and listed.[49] Counting these banks' assets and loans as CIC's makes clear the dominance it will exercise in China's banking market, as CIC's banks account for 58% of all bank assets and 59% of all loans.

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[47] "Subsidiary of China Investment Corp Buys Out Everbright," Xinhua, November 7, 2007; and "China CIC's Lou: Everbright Bank Injection Completed," Main Wire, December 24, 2007.

[48] Natalie Chiu, "CDB Gets $20USb from CIC," *South China Morning Post,* January 1, 2008.

[49] There has been some confusion over just when and how this injection would be completed. An ABC spokesman has heartily denounced "rumors" that CIC was to take a stake in the bank as part of its restructuring. The "rumors," however, were statements made by Lou himself at the 2007 China Financial Forum. See "CIC to Support Banks," *China Securities Journal,* December 26, 2007; and "Agricultural Bank of China Says Report on CIC Unit's Investment Plan Not True," AFX Asia, February 3, 2008.

With the exception of ABC, all these banks also have been major overseas investors. BNP Paribas calculates that, if the banks' own foreign investments are taken into account, CIC could actually be considered to be a $450 billion fund.[50]

Through a joint-venture with Morgan Stanley, Huijin also owns the China International Capital Corporation (CICC), the mainland's largest investment bank. CICC has taken public every SOE to have been involved in recent high-profile outward investment: Chinalco, Shenhua, CNOOC, PetroChina, and Sinopec, among others. CICC is also looking to expand its role in China's financial markets by developing into a full-service financial outfit offering private equity, asset management, and wealth management services. The firm's president is the son of former premier Zhu Rongji.[51]

Parsing the Concerns

The debate over the possible threats from CIC and other SWFs has been intense. In a January 2008 presidential debate, for instance, Senator Hillary Clinton pointed worryingly to the rise of SWFs, claiming, "We need to have a lot more control over what they do and how they do it."[52] A drumbeat of criticism is just beginning on Capitol Hill. Earlier this year Congresswoman Marcy Kaptur's warned from the House floor that, "the Chinese Government…is projected to have more than $3 trillion by 2010 that can be used to buy our stocks, bonds, real estate, and entire corporations."[53] The U.S. administration, meanwhile, has been largely welcoming, warning that the most dire threat from SWF investment may be the aggravation of heightened protectionist measures that would in turn limit other foreign investment into the United States.[54]

Four principle concerns can be identified. The first two—over national security risks and the potential for strategically motivated investments—appear to be overstated. Though they have received less attention, the other two concerns—failings in the domestic regulation of the fund and the potential for CIC to engage in unfair competition—are much more legitimate grounds for worry.

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[50] Brad Setser, "Wall Street, the New Development Frontier," Brad Setser's Blog, January 12, 2008, http://rs.rgemonitor.com/blog/setser/237287.

[51] "CICC Broadens Range of Services," *Asiamoney,* September 2007.

[52] Transcript, "The Democratic Debate in Las Vegas," Federal News Service, via the N*ew York Times,* January 15, 2008, 9, http://www.nytimes.com/2008/01/15/us/politics/15demdebate-transcript.html?pagewanted=1&_r=1.

[53] Marcy Kaptur, "Sovereign Wealth Funds," *Congressional Record,* 110th Cong., 2nd sess. (January 29, 2008), H541, http://frwebgate.access.gpo.gov/cgi-bin/getpage.cgi?dbname=2008_record&page=H541&position=all.

[54] Robert M. Kimmitt, "Public Footprints in Private Markets," *Foreign Affairs* 87, no. 1 (January–February 2008).

National Security

A commonly voiced worry has been that CIC's investments may threaten U.S. national security. Academic Peter Navarro, one of the most strident critics of the fund so far, has warned of "strategic dangers" from Chinese SOEs' attempts to "gain control of critical sectors of the U.S. economy—from ports and telecommunications to energy and defense."[55] Senators Evan Bayh and James Webb have both also voiced worries that SWFs could gain access to sensitive technologies and classified information through their equity stakes in U.S. companies.[56] These concerns are not unique to CIC; both the China National Offshore Oil Corporation (CNOOC) and China's Huawei Technologies have in recent years provoked national security concerns by their attempts to acquire U.S. firms: CNOOC's attempt to acquire Unocal, a U.S. oil company, was torpedoed by criticism from the media and Congress that convinced CNOOC not to attempt to beat a bid from a rival U.S.-based firm; Huawei's attempt to purchase 3Com, a computer and telecommunications firm, was scuttled during review by the Committee on Foreign Investment in the United States (CFIUS).[57]

Because CIC's investments in the United States are subject to the same CFIUS review as are those of any other foreign firm, however, it is unlikely that the fund would pose any additional security threat. The fund's board does not include representatives from any government bodies involved in military or security affairs. CIC has also already opened up to far more scrutiny than other state companies; fund officials have, moreover, stated unequivocally that CIC would not even consider investments that might trigger CFIUS review.[58] If CIC does limit its future investments in this way and avoids purchasing firms outright, then conceiving of a scenario whereby the fund is able to do any real harm is difficult. The only influence CIC would exercise would be that of any large stockholder—namely, the ability to affect the value of a firm by buying or selling shares. CIC and other SWFs are different in scale from previous foreign investments, but not in kind. If export controls and CFIUS reviews have been sufficient to respond to national security concerns previously, there is no reason these

[55] See Peter Navarro, "Testimony of Business Professor Peter Navarro before the U.S.-China Economic and Security Review Commission," Washington, D.C., February 7, 2008, http://www.uscc.gov/hearings/2008hearings/written_testimonies/08_02_07_wrts/08_02_07_navarro_statement.pdf.

[56] Evan Bayh, "Time for Sovereign Wealth Rules," *Wall Street Journal,* February 13, 2008; and James Webb, "Remarks to the U.S.-China Economic and Security Review Commission," February 7, 2008, http://www.uscc.gov/hearings/2008hearings/written_testimonies/08_02_07_wrts/08_02_07_webb_statement.php.

[57] Richard Waters and James Politi, "Huawei-3Com Deal Finally Collapses," *Financial Times,* March 20, 2008.

[58] Stephanie Kirchgaessner, "Washington Obstacle Course Sees Chinese Companies Re-examine Their US Ambitions," *Financial Times,* March 4, 2008.

same methods would not be sufficient now. If these procedures are found wanting, then the problem is far broader than CIC or SWFs alone.

Strategic Investments

A different, but related, concern is that CIC will invest to pursue other non-commercial goals. Senator Bayh has warned that "sovereign nations have interests other than maximizing profits and can be expected to pursue them with every tool at their disposal, including financial power."[59] Edwin Truman has pointed to the potential that governments may pursue "economic power objectives, for example, promoting state-owned or state-controlled national champions as global champions."[60] These concerns apparently underlay the agreement by the U.S. Treasury, Singapore, and Abu Dhabi stating that "SWF investment decisions should be based solely on commercial grounds, rather than to advance, directly or indirectly, the geopolitical goals of the controlling government."[61]

There is no general framework of controls or restrictions to prevent companies from investing for non-commercial purposes. As a result, such concerns over strategic investments by CIC are more plausible than threats to national security. Thus far, however, the evidence indicates that CIC will not likely be used for these purposes.

First, and most importantly, CIC's funding structure does not allow for long-term loss-making investments. The motivation to earn high returns was not only instrumental in the establishment of the fund but was also built directly into the structure of the institution's financing. The bond issues that were used to finance CIC forced the fund to begin making interest payments to the MOF almost immediately. Lou Jiwei has estimated that he needs to earn $40 million per day simply to meet these funding obligations—which would work out to $14.6 billion a year, or a 13.7% annual return on assets.[62] Senior officials have already expressed serious worries over the ability of CIC to pay the RMB12.9 billion in interest that came due in February, pointing to over-concentration in the ailing U.S. financial sector as an impediment to maintaining

[59] Evan Bayh, "Time for Sovereign Wealth Rules," *Wall Street Journal,* February 13, 2008.

[60] Truman, "A Blueprint for Sovereign Wealth," 3.

[61] "Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi," U.S. Treasury Press Office, March 20, 2008, http://www.ustreas.gov/press/releases/hp881.htm.

[62] Alan Wheatley, "China's Wealth Fund Sets Out Its Stall," Reuters, January 4, 2008.

liquidity.[63] "Strategic" tie-ups, with little prospect for dividends or fast valuation gains, would only increase the rate of return necessary on the remaining funds.

Second, the large number of technocrats in the fund's leadership lends credibility to claims that investment decisions will be driven by market principles. Most decisionmakers have demonstrated their bona fides as responsible financial stewards, economists, and reformers. Even the ministry representatives on the board are professionals who have worked their way up through their respective organizations, rather than politicians parachuted in to their ministries.[64] Like other high-ranking technocrats, CIC officials have steered clear of corruption scandals; they have even occasionally led efforts to rein them in. Their career advancement has evidently depended more on the successful execution of their official duties than the creation of networks of supporters or cultivation of factional loyalties.[65]

The fact that the State Council ratified the selection of these individuals suggests that the top leadership recognizes the importance of expertise over political credentials in these positions. None of these individuals have connections to the "Shanghai Gang" associated with former president Jiang Zemin or the Communist Youth League faction of Hu Jintao; none of them are the oft-maligned "princeling" offspring of prior generations of leadership.[66] Only Lou has spent any significant time in a provincial post. Important parts of the state bureaucracy have also been left out of the fund's management—several ministries and government bodies that could be expected to make use of the funds to pursue non-financial goals do not have representation at CIC. The fund seems as safe as any central government institution could be from pressure to support loss-making SOEs.

Having bureaucrats of a relatively senior rank in CIC's top echelons may also, paradoxically, protect the fund from official interference. China's policymaking apparatus

[63] Li Liming, "Day of Reckoning for China's Sovereign Fund," *Economic Observer,* January 31, 2008, http://www.eeo.com.cn/ens/finance_investment/2008/01/31/92109.html.

[64] Noted China observers Barry Naughton, Willy Lo-Lap Lam, and Cheng Li have all noted an important distinction between "politicians" and "technocrats" in China's political system. The politicians boast a wide geographical and substantive experience and rely heavily on personal networks for advancement. Technocrats' experience is narrower but deeper, and their advancement has generally been a result of successful policymaking. Staffing CIC with the latter may insulate it from pressure from the former to use the fund to advance political goals in China. See Barry Naughton, "China's Economic Leadership after the 17th Party Congress," *China Leadership Monitor,* no. 23, Winter 2008; Willy Lo-Lap Lam, *Chinese Politics in the Hu Jintao Era* (Armonk: M.E. Sharpe, 2006), 22–3; and Cheng Li, "China's Economic Decisionmakers," *China Business Review,* March–April 2008.

[65] Lam, *Chinese Politics in the Hu Jintao Era,* 22–3.

[66] These factions are also described in Li, "China's Economic Decisionmakers."

is notoriously status-conscious. Individuals without a long career and deep network of support in the bureaucracy tend to do poorly.[67] Despite decades of institutional reform, officials in the government and CCP both still have access to impressive reservoirs of power—hence China's well-known problems with corruption. Strong local interests have been able to extract loans from state-owned banks for years despite increasingly harsh attempts by the PBOC to halt such loans.[68] Although situations in which private sector hires at CIC are pressured into putting funds into dubious state-owned projects, or are outmaneuvered on bid decisions at the State Council, are easy to imagine, CIC's current management team likely has the clout and the political skill to resist such pressures.

The international activities of China's other SOEs—which are engaged in a comprehensive expansion effort, dubbed the "go out" strategy by the Chinese government—also undercut the fear that Beijing will use CIC to further foreign policy objectives.[69] Individual state firms are much better candidates for pursuing such goals; introducing CIC funding would only complicate policy execution. The largest of the SOEs are flush with cash and enjoy preferential access to bank loans and relatively opaque funding. Company managers, moreover, are appointed as state civil servants. The companies answer directly to SASAC, which does not face the conflicting mandates and widespread attention that CIC does.[70]

The state-owned banks would also have been better choices for helping to implement Beijing's foreign policies. CIC now owns most of these banks, so "political" investments by these banks would be indistinguishable from the use of CIC. If the government had intended to employ the banks in the service of policy goals internationally, however, rolling them in to CIC would not have made much sense, as they already have a fairly sizable domestic policy mandate.[71]

The cost to the Chinese state of these inefficient lending practices had been relatively hidden, nominally affecting only the balance sheet of the PBOC, which is not

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[67] Cheng Li, "The Status and Characteristics of Foreign-Educated Returnees in the Chinese Leadership," *China Leadership Monitor,* no. 16, Fall 2005.

[68] Shih, *Factions and Finance in China,* 45–6.

[69] See Aaron L. Friedberg, "Going Out: China's Pursuit of Natural Resources and Implications for the PRC's Grand Strategy," *NBR Analysis* 17, no. 3, September 2006.

[70] See Barry Naughton, "SASAC and Rising Corporate Power in China," *China Leadership Monitor,* no. 24, Spring 2008; Naughton, "Claiming Profit for the State: SASAC and the Capital Management Budget," *China Leadership Monitor,* no. 18, Spring 2006; and Naughton, "SASAC Rising," *China Leadership Monitor,* no. 14, Spring 2005.

[71] "2006 Annual Report," China Banking Regulatory Commission, 51.

primarily motivated by profit. Now, however, the costs of these practices will directly affect the bottom line of an institution that is explicitly mandated to be concerned with profits. Had the State Council or other politicians wanted to gain better access to bank funds, they would have been better served by establishing Huijin as a separate institution reporting directly to the State Council, on a par with, rather than subordinated to, CIC. Moving the banks out from under the PBOC's umbrella and under that of CIC insulates them from policy pressures, rather than exposing them to more.

China also has other state investment funds that have been much less high-profile than CIC. SAFE, which manages the official reserves, has become more active in its investments, purchasing small stakes in three Australian banks through a Hong Kong subsidiary; a 1.6% share of Total, a French oil company; and nearly 1% of BP.[72] An obscure domestic investment vehicle, the RMB150 billion ($20 billion) State Development Investment Corporation (SDIC), has also announced plans to begin investing internationally.[73] China's pension fund also actively invests at least $1 billion abroad (and possibly more), with plans to increase that amount to $14.9 billion.[74]

None of the foregoing guarantees that the Chinese government will not decide tomorrow to begin to use CIC to further state goals, or that some faction or other of the government will not eventually gain control over the money. All of this information does, however, suggest that the Chinese government was not taking the steps that could have been expected had it been planning to deploy its reserves in a political or "strategic" manner. CIC has not really augmented China's ability to direct investment abroad in any way.

Corruption

Weaknesses in China's regulatory environment could open the door to corruption. CIC or SOE officials could exploit CIC's position to gain access to protected information and engage in insider trading, fraudulent transactions, or other illegal activities. Although this is a concern with any large investment fund, the regulatory environment in which CIC operates is particularly problematic.

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[72] Richard McGregor, Peggy Hollinger, and Henny Sender, "China Buys 1.6% Stake in Total," *Financial Times,* April 3, 2008; and Tom Miller, "SAFE Seen Behind Purchase of GBP1b Stake in British Oil Giant BP," *South China Morning Post,* April 16, 2008.

[73] "China's State-Owned Investment Giant Plans Overseas Investment," Xinhua, March 5, 2008; and "Chinese State Investment Firm Eyes Overseas Projects—Report," AFP, March 13, 2008.

[74] "Official: China's Pension Fund to Invest US $1 Billion Abroad," Associated Press, October 10, 2006; and Josephine Lau, "China Pension Fund Seeks Managers for Global Stocks," Bloomberg, May 22, 2008.

Because CIC reports directly to the State Council, supervising the fund effectively will almost certainly prove to be a problem for other parts of the Chinese government. As the fund is currently constituted, none of China's financial regulatory institutions have clear authority over CIC. Moreover, the fund is on the same level of authority as the PBOC, CBRC, and other possible regulatory agencies. As a result, the dictates of these other agencies would be of questionable force.[75] This opens the possibility that CIC, or its employees, could exploit both the fund's privileged position in the Chinese government and its high profile to gain an unfair advantage over competitors at home and abroad. Linda Thomsen, of the U.S. Securities and Exchange Commission (SEC), voiced concerns over this issue in recent testimony to the U.S.-China Economic and Security Review Commission. Insider trading, preferential access to government officials and information, and lax enforcement from other government bodies, she pointed out, all present challenges to ensuring SWFs play by the same rules as all other market participants.[76]

Unfair Competition

A second, broader concern is that the entire architecture of China's economy funnels subsidized capital to state companies. Through ownership of the banks, CIC now sits at the apex of this system, and constitutes the main conduit through which official reserves are funneled to state companies.

Much of this capital flow occurs as a result of rational, profit-maximizing behavior by firms within a system characterized by a few key restrictions. The deposit rate cap, for instance, (currently at just over 4%) ensures that banks will be able to earn a healthy spread on their loans (the reference lending rate is nearly 7.5%).[77] Limits on the rates that banks are permitted to offer depositors create artificially cheap capital for the banks, which in turn lend disproportionately to state companies. The low rates also protect the dominant market position of the large state banks, as new market entrants are not allowed to offer higher interest rates to attract depositors. Moreover, the banks are beginning to use this cheap capital to purchase stakes in international financial institutions. ICBC's 20% stake in Standard Chartered appears to be only the beginning of a push outward by CIC's banks.

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[75] Shih, *Factions and Finance in China,* 30.

[76] Linda Chatman Thomsen, "Sovereign Wealth Funds and Public Disclosure," testimony before the U.S.-China Economic and Security Review Commission, February 7, 2008.

[77] "China PBOC to Sell 32 Bln Yuan in Sterilization Paper Thurs," Main Wire, December 26, 2007.

Direct investment ties between CIC and other SOEs may also prove problematic. The swirl of rumors around the bid of Chinalco, a state aluminum company, to block a takeover of Rio Tinto by BHP Billiton (both international mining giants) is a case in point. The *Times* of London reported that CIC had put $120 billion at Chinalco's disposal, allowing it to buy Rio Tinto outright if it so chose.[78] If true, these reports raise the possibility that China's companies may have the financial wherewithal, through access to government reserves, to prevent any undesirable merger or acquisition on international capital markets. Such moves, though perfectly logical for CIC from a commercial perspective, could still be problematic from the perspective of policymakers concerned about the scale of state ownership of the world economy.

The relative lack of transparency so far on display by CIC compounds both the risk of corruption and that of unfair competition. Opaque operations also raise the risk that investments could be injurious to host countries or contribute to market instability.[79] CIC has come in for a great deal of criticism on this account. The fund has yet to establish a website, let alone publish detailed information on an investment strategy or goals. A recent study by the Peterson Institute for International Economics ranked the fund 26th out of 34 funds on accountability and transparency.[80] The tight grip that the Chinese leadership generally keeps on information about internal debates and policy processes only adds to the air of secrecy surrounding the fund.

Fund officials have bristled at the critiques. CIC president Gao remarked in an interview on *60 Minutes* that the firm is so new that it has not yet had a chance to determine its strategy, much less publish one. Gao then vowed that CIC will be as transparent as Norway's SWF—which, if true, would put to rest such debates. Jesse Wang has declared that CIC is already "one of the most transparent sovereign wealth funds in the world."[81]

CIC has a great deal of work to do in order to live up to such a pledge. Wang's declaration is simply untrue; the fund does not issue press releases or confirm transactions, nor has CIC made its governing structure public. Wang seems to be referring to his and others officials' willingness to talk to the press—a laudable, but insufficient, practice. Moreover, as long as information and press restrictions in China

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[78] John Waples and Dominic O'Connell, "Chinese Gear Up for Rio Battle," *Times* (London), February 3, 2008.

[79] "Sovereign Wealth Funds—A Work Agenda," IMF, February 29, 2008, 13, http://www.imf.org/external/np/pp/eng/2008/022908.pdf.

[80] Edwin M. Truman, "A Blueprint for Sovereign Wealth Fund Best Practices," Peterson Institute for International Economics, Policy Brief, April 2008, 7, http://iie.com/publications/pb/pb08-3.pdf.

[81] Robin Kwong, "China Sovereign Wealth Fund Rebuffs Critics," *Financial Times,* April 2, 2008.

remain so restrictive, CIC will never be able to claim that it is fully transparent. Much information—about the composition of state reserves, the investment decisions of other state companies, and government policy debates, for instance—is still tightly controlled by the government.

Looking beyond the Concerns

The emergence of CIC also presents several possible benefits to policymakers in the United States and other developed economies. Three in particular stand out.

First, and probably most important, is access to capital. Given the recent turmoil in international capital markets, that is no small thing. Stephen Schwarzman, chairman and CEO of Blackstone, has praised SWFs as "model-type investors" for their intelligence, professionalism, and long-term outlook.[82] Federal Reserve Board Chairman Ben Bernanke has expressed similar views, stating in congressional testimony that SWF investment was "quite constructive" and that the United States "should be open to allowing that kind of investment."[83] Senator Chris Dodd noted in a recent hearing on the issue that more than two-thirds of the capital that U.S. banks raised during the recent credit crisis came from SWFs.[84] Though this point is often overlooked in the debate, investment from China will help the economies of host nations in the same ways that investment everywhere is beneficial.

A second potential benefit is the emergence of new partners for the pursuit of other policy goals. World Bank President Robert Zoellick, for instance, has proposed that SWFs dedicate a portion of their investment to Africa to aid in development efforts.[85] CIC Chairman Lou Jiwei has indicated that CIC would avoid investments in tobacco or environmentally damaging industries; a mandate could go further, however, by requiring the fund to invest in clean energy or underdeveloped rural areas.[86] By

[82] Quoted in Warren Fernandez, "Sovereign Funds: Lively Debate over Whether Voluntary Codes of Conduct Are Needed to Calm 'Hysteria' Surrounding SWFs," *Straits Times,* January 25, 2008.

[83] "Bernanke: Sovereign Wealth Funds Constructive in US," Reuters, February 27, 2008.

[84] See Christopher Dodd, "Statement of Chairman Dodd," opening statement before the Senate Banking Committee hearing "Turmoil in U.S. Credit Markets: Examining the U.S. Regulatory Framework for Assessing Sovereign Investments," Washington, D.C, April 24, 2008, http://banking.senate.gov/public/_files/DoddOpeningStatement1.pdf.

[85] Robert B. Zoellick, "A Challenge of Economic Statecraft" (speech presented at the Center for Global Development, Washington, D.C., April 2, 2008), http://www.cgdev.org/doc/events/4.02.08/Transcript_Zoellick_Event.pdf.

[86] Steven Weisman, "China Tries to Reassure US About Its Investing Plans," *New York Times,* February 1, 2008.

working with the World Bank's private arm, the International Financial Corporation, CIC could channel its investment into Africa and Southeast Asia in profitable ways that nevertheless complement broader development efforts.

Such cooperative efforts may be particularly important in China's case, as deepening China's integration with the world through increased economic ties has long been a goal of the United States and other developed nations. As CIC establishes an increasingly large direct stake in international capital markets, the fund will also develop a greater stake in the proper functioning and openness of those markets. Zoellick spoke in 2002 of China assuming a role as a "stakeholder" in the international community;[87] via CIC investments, China would become a literal shareholder in that community.

CIC investments could even create opportunities to sidestep thorny political problems and establish mutual interests. Japan's discussions with the fund over energy investment, for instance, could help break an impasse between Japan and China over disputed sovereignty rights to gas fields in the East China Sea.[88] China would have a direct financial stake in the development of the field, regardless of which country's energy companies were involved. Such a positive outcome is by no means assured, but CIC investment would at least increase China's stake in finding a mutually beneficial solution and provide policymakers with another tool to use in trying to forge a compromise.

A third possible opportunity is the potential for CIC to become a force for further reform in China's domestic economy. The conflicts between the central bank, the finance ministry, and other regulatory agencies that currently divide the Chinese government have hampered the emergence of a domestic bond market, interest rate liberalization, and changes to China's exchange rate policy.[89] Other conflicts further divide these financial technocrats from policymakers in the central government and the provinces. These divisions are often blamed for the maintenance of a large range of state interventions in the economy, from price controls to prohibitions on foreign investment. CIC's creation may increase the bureaucratic strength of those officials that favor liberalization.

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[87] Robert B. Zoellick, "USTR Zoellick Speech before the U.S.-China Business Council" (New York City, January 31, 2002), http://www.uschina.org/public/speeches/2002/01/31-zoellick.html.

[88] Leo Lewis, "Big-Spending Chinese Eye Up Japan's Energy 'Champion' in $10 Billion Drive for Investment," *Times* (London), February 23, 2008.

[89] See Shih, *Factions and Finance in China,* 47–63; Lam, *Chinese Politics under Hu Jintao,* 262–9; and Li, "China's Economic Decisionmakers."

The fund's officials can themselves be expected to push for reforms, largely because they have spent their careers doing so. CIC would also benefit financially in a number of ways from reforms. A more liberalized currency policy, for instance, would remove longstanding pressure on its balance sheet and uncertainty over the scale of eventual currency losses. As the owner of most of China's larger banks, CIC would benefit from an end to most of the various methods of state intervention and restrictions in the banking sector. As a shareholder of large international financial institutions, moreover, CIC stands to share in their gains from obtaining access to the Chinese market.

None of these benefits is certain; the fund's leadership may choose not to get involved in State Council policy discussions. There is, however, at least an opportunity to attempt to draw CIC into these deliberations. The United States, for instance, could seek CIC involvement in the Strategic Economic Dialogue led by the Treasury Department. The World Bank or IMF could reach out directly to CIC and build on the relationship that Lou Jiwei already has established with the Bank. The Organisation for Economic Co-operation and Development (OECD) could seek cooperation with CIC officials on issues other than sovereign wealth funds alone by, for instance, soliciting input on the analyses OECD publishes of China's economy and financial sector.

On balance, these opportunities to engage with CIC, and through this engagement encourage positive change in China, may outweigh the potential risks from the fund's investments abroad because the dependencies that CIC's investments create go both ways. The criticisms of CIC and other SWFs can all be reduced to one overarching concern: a firm or economy that accepts outside investment is dependent on its investors, and if those investors are foreign governments, they may use that relationship to compel behavior in line with other national goals. As anyone who has ever invested their own money knows, however, the dependency is mutual—investors rely on those to whom they have entrusted their money, and on the broader economic environment, to generate sufficient returns. China depends on the country's foreign exchange earning a profit, or at least declining in value less rapidly. CIC's management also depends heavily on the fund's ability to generate returns. If recognized, that dependency could create an opening for other governments to encourage further positive changes in China's government policies.

Questions of transparency, effective regulation, and fair competition do remain outstanding, and addressing them will be paramount. Maintaining vigilant systems to monitor compliance with restrictions on investments in sensitive industries and technologies will of course remain crucial tasks. The emergence of CIC, however, could be a major opportunity to increase China's stake in a modern, open financial system. Seizing this opportunity would require openness to CIC's investments and a change in the tone of the debate in Washington and other capitals. Creativity and a willingness to reach out to the fund on the part of policymakers would be even more important. With the right approach, turning this perceived threat into a genuine opportunity for enhanced cooperation—and enmeshing China even more deeply in an international financial system to which, only twenty years ago, it was almost a complete stranger—may be possible.

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