China's Sovereign Wealth Fund

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Summary

China established its major sovereign wealth fund, the China Investment Corporation (CIC) on September 29, 2007—six months after it first announced its intention to create such a fund. Financed with $200 billion in initial capital, the CIC is one of the largest sovereign wealth funds (SWFs) in the world.

The creation of CIC was somewhat controversial in China. Both the People's Bank of China (PBOC) and the Ministry of Finance (MOF) reportedly wanted the CIC under their authority. In the end, the CIC reports directly to China's ruling State Council. However, as part of the interagency struggle, it was decided that the CIC would have to make significant purchases in several state-owned banks, as well as purchase the Central Huijin Investment Corporation (CHIC) from the PBOC.

Although some of the CIC's initial investments were apparently political in nature, the CIC's top management have repeatedly asserted that future investments will be commercially based. The CIC and its subsidiaries have made several investments, including the purchase of 9.9% of the U.S. financial firm, Morgan Stanley, on December 19, 2007. Meanwhile other government-owned entities in China—including the State Administration of Foreign Exchange (SAFE)—have started to act like sovereign wealth funds and have been making sizable overseas investments.

According to top Chinese officials, the CIC was created to improve the rate of return on China's foreign exchange reserves and to prevent the nation's excess financial liquidity from contributing to domestic inflation. Depending on its performance, the CIC may be allocated more of China's growing stock of foreign exchange reserves in the future. However, its first-year results have raised questions about its investment strategy and calls for administrative reforms for CIC.

A number of experts in international finance have expressed some concern about the recent growth in SWFs and China's creation of the CIC. Analysts have cautioned that major shifts in SWF investments could potentially disrupt global financial markets and harm the U.S. economy. Other experts are less concerned about SWFs and the CIC, and welcome their participation in international investment markets. China has responded by maintaining that the CIC will prove to be a source of market stability. China has also stated that it has no intention of using its SWF to disrupt the U.S. economy or global financial markets.

There have been calls for greater oversight and regulation of the activities of SWFs. The International Monetary Fund (IMF), in consultation with many of the leading SWFs, has developed a set of voluntary "Generally Accepted Principles and Practices" (GAPP) for the operation of SWFs. The Organization of Economic Cooperation and Development (OECD) has drafted policy guidelines for countries that are recipients of SWF investments. Some international financial experts have suggested elements to be included in such guidelines, including standards for transparency, governance, and reciprocity. Other experts have suggested that the United States should review its current laws and regulations governing foreign investments in the United States, and possibly implement special procedures or restrictions on proposed investments by SWFs. These include financial reporting requirements, limits on SWF ownership of U.S. companies, restrictions on the types of equity investments SWFs can make in U.S. companies, and special tax provisions for SWFs. This report will be updated as circumstances warrant.

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Introduction

China announced in March 2007 that it would create a sovereign wealth fund (SWF) to invest its accumulated foreign exchange reserves more profitably.[1] In May 2007, China Jianyin Investment Company, a government agency that was designated to manage any asset purchases until the SWF was set up, bought a nearly 10% non-voting stake in Blackstone Group, a U.S. private equity firm for $3 billion. After a few delays, China's new sovereign wealth fund—the China Investment Corporation (CIC)—officially started operations on September 29, 2007.

The CIC has proven to be of interest to Congress for several reasons. First, some observers are concerned that its investment activities might have adverse effects on certain financial markets and possibly the U.S. economy. Second, its creation signals China's intention to diversify its foreign exchange holdings away from U.S. government securities into other forms of investment. Third, specific proposed investments by the CIC may raise national security concerns. Fourth, some see the possibility that China could use the CIC as a mechanism to pursue geopolitical objectives.

Table 1. Leading Sovereign Wealth Funds (as of April 2008)

Country	Fund	Size ($ Billion)	Year Created
United Arab Emirates	Abu Dhabi Investment Authority (ADIA)	500 - 875	1976
Norway	Government Pension Fund - Global	375	1990
Singapore	Government of Singapore Investment Corporation (GIC)	200 - 330	1981
Saudi Arabia	Saudi Arabian Monetary Agency	270	1952
Kuwait	Kuwait Investment Authority	213	1953
China	China Investment Corporation, Ltd. (CIC)	200	2007
Hong Kong	Exchange Fund Investment Portfolio	139	1993
Russia	Reserve Fund	128	2008
Singapore	Temasek Holdings	110	1974

Source: CRS summary of table in Edwin Truman, "A Blueprint for Sovereign Wealth Fund Best Practices," *Peterson Institute for International Economics*, No. PB08-3, April 2008.

With an initial capital fund of $200 billion, the CIC was a significant new addition to the existing pool of SWFs (see **Table 1**).[2] The CIC augmented the $2 - $3 trillion under management by SWFs worldwide. In addition, the SWF provides China with another avenue by which it can invest its growing foreign exchange reserves, which totaled $1.9 trillion as of December 2008.[3]

[1] According to the U.S. Department of the Treasury, a sovereign wealth fund is a "government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities." (U.S. Department of the Treasury, *Semiannual Report on International Economic and Exchange Rate Policies*, June 2007).

[2] For more information on sovereign wealth funds in general, see CRS Report RL34336, *Sovereign Wealth Funds: Background and Policy Issues for Congress*, by (name redacted).

[3] According to China's State Administration of Foreign Exchange (SAFE), its foreign exchange reserves as of the end (continued...)

Also, the conversion of the foreign exchange reserves into capital for the CIC may help "sterilize" some of the excess financial liquidity in China that is reportedly contributing to China's recent inflationary pressures.[4]

However, China's decision to create the CIC reawakened some concerns about the impact of SWFs on global financial markets and engendered new misgivings about China's involvement in international equity markets. David R. Francis, columnist for the *Christian Science Monitor*, started his November 26, 2007 article, "Will Sovereign Wealth Funds Rule the World?," with the words, "Sovereign wealth funds are huge, scarily big."[5] During a November 30, 2007 interview on National Public Radio's *Morning Edition*, Brad Setser of the Council on Foreign Relations stated, "The rise of sovereign wealth funds represents a shift in power from the U.S. to a group of countries that aren't transparent, aren't democracies, and aren't necessarily U.S. allies."[6] In June 2007, Clay Lowery, the U.S. Treasury Department's acting undersecretary for international affairs, indicated in an interview that the rise in government-owned investment funds could cause major changes in global markets and bring about "financial protectionism."[7]

There are also concerns about how China (and other nations) will invest the capital of their SWFs. Before the creation of the CIC, China had invested much of its foreign exchange reserves in U.S. government debt, such a U.S. Treasury bills (T-bills), that were relatively risk-free, but offered relatively low rates of return on the investment. Kenneth Rogoff, former chief economist for the International Monetary Fund (IMF), indicated in a recent interview, "Countries like China just don't need to hold any more T-bills. There's just no point."[8]

For the first half of 2008, most analysts expected the CIC to invest in overseas equities and/or acquisitions in order to obtain higher rates of return on their investments. One financial expert's analysis of China's foreign exchange reserve holdings from 2000 to 2007 shows a slight shift away from U.S. dollar denominated assets.[9] However, as the effects of the U.S. financial crisis spread across the U.S. economy and then around the world, the CIC's interest in overseas investments seemingly waned.

With its current capital stock, the CIC has the theoretical ability to purchase controlling interests in or acquire major corporations, raising potential national security concerns. According to financial journalist James Surowiecki, "Were China so inclined, it could buy Ford, G.M., Volkswagen, and Honda, and still have a little money left over for ice cream."[10] Surowiecki's

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of December 2008 totaled $1.946 trillion; monthly data are provided on SAFE's webpage—http://www.safe.gov.cn.

[4] "Sterilization" is when monetary authorities insulate their domestic money supplies from the foreign exchange transactions with offsetting sales or purchases of domestic assets. For more on the possible role of the CIC in solving China's excess liquidity problem and inflationary pressures, see the World Bank's Beijing Office's *Quarterly Update*, September 2007; and Michael Pettis, "China's Sovereign Wealth Fund," September 24, 2007, available at http://www.piaohaoreport.sampasite.com/blog/Guest-blog-2.htm.

[5] David R. Francis, "Will Sovereign Wealth Funds Rule the World?," *The Christian Science Monitor*, November 26, 2007.

[6] Adam Davidson, "U.S. Watches Nervously as Oil-Rich Nations Invest," *Morning Edition*, National Public Radio, November 30, 2007.

[7] David J. Lynch, "U.S.: Secretive Global Funds May Hurt Treasuries Market," *USA Today*, June 21, 2007.

[8] Lynch, op. cit.

[9] Brad Setser, "Has China been diversifying away from the dollar?," *RGE Monitor*, April 9, 2008.

[10] James Surowiecki, "Sovereign Wealth World," *The New Yorker*, November 26, 2007. In February 2009, China's
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observation was echoed by well-known investor Warren Buffett, who added that the annual U.S. trade deficit of approximately $700 billion means the United States has to "give away a little part of the country" every year.[11] Buffet continued by auguring that if these trade deficits continue the United States could wind up as a "sharecropper economy," in which U.S. citizens largely work for foreign-owned firms.[12] In the opinion of former Securities and Exchange Commission Chairman Christopher Cox, "the fundamental question presented by state-owned public companies and sovereign wealth funds does not so much concern the advisability of foreign ownership, but rather of government ownership."[13]

However, others are less apprehensive about the potential impact of SWFs on the global economy. Rogoff thinks SWFs will do "more good than bad."[14] Surowiecki maintains that "some of the worries about the dangers posed by sovereign wealth funds are overstated," and that the SWFs "will act much like other investors, and focus primarily on the bottom line."[15] Preston Keat of the global risk consulting firm Eurasia Group echoes Surowiecki's assessment, pointing out, "It's a context of mutual dependence. Blowing somebody else up does you at least as much financial damage."[16]

The investment activities of several SWFs—including the CIC—following the outbreak of the subprime-mortgage crisis in August 2007 lent support the views of Rogoff, Surowiecki and Keat. Some struggling financial firms received much needed injections of capital from SWFs. On December 19, 2007, CIC invested $5 billion in Morgan Stanley not long after the financial firm announced it was writing off $9.4 billion of loss-making mortgage investments.[17] On January 15, 2008, SWFs from Abu Dhabi, Kuwait, Singapore, and South Korea provided a $21 billion infusion of capital to Citigroup and Merrill Lynch.[18] During a period of global market uncertainty, SWFs appeared to be providing a source of stability.[19]

However, as the ripple effects of the financial crisis spread during the summer of 2008, the CIC and other SWFs seemed reluctant to take on additional ailing financial houses, indicating a possible limit to the willingness of SWFs to play the roles of financial rescuers and suppliers of

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privately-owned Geely Automotive Holdings Limited denied rumors that it was talking with Ford about acquiring Volvo ("Geely Says No to Plans to Buy Ford's Volvo Car Unit," China Daily, February 6, 2009).

[11] Francis, op. cit.

[12] Ibid.

[13] Christopher Cox, "The Role of Government in Markets," Keynote Address and Robert R. Glauber Lecture at the John F. Kennedy School of Government, October 24, 2007.

[14] Ibid.

[15] Surowiecki, op. cit.

[16] Davidson, op. cit.

[17] "China Fund Grabs Big Stake in Morgan Stanley," *AFP*, December 19, 2007

[18] Aaron Kirchfeld, "Sovereign Funds Beat Buffett with Stakes in Citigroup, Merrill," *Bloomberg*, January 22, 2008.

[19] There are indications that CIC and other Chinese investors have been reluctant to invest in more financial firms because of the perceived criticism of and discrimination against Chinese investments in U.S. companies. For example, CITIC Securities cancelled a planned $1 billion investment and joint venture in Bear Stearns on March 14, 2008—the same day the Federal Reserve announced its plan to bail out the ailing U.S. financial firm. For more details, see Ma Wenluo, "Crisis and Opportunity in CIC's 'Fire Sale' Acquisitions," *China Stakes*, March 17, 2008. Similarly, China Development Bank's planned investment in Citigroup failed to receive the required government approval in January 2008. For more details, see "Surprise: No CDB Funds for Citi," *China Stakes*, January 12, 2008.

market stability.[20] While news accounts in June 2008 reported that China's sovereign wealth fund was preparing to go on a "global spending spree,"[21] by December 2008, CIC was stating it was in "no hurry to invest overseas."[22] At the end of 2008, a senior CIC official offered his view of China's role in solving the global financial crisis, "China can't save the world. It can only save itself."[23]

Administrative Structure of the China Investment Corporation

The China Investment Corporation, Ltd. (CIC) is a semi-independent, quasi-governmental investment firm established by the Chinese government to invest a portion of the nation's foreign exchange reserves. The CIC reports directly to China's State Council,[24] conferring it with the equivalent standing of a ministry, and the State Council's leader, Premier Wen Jiabao. According to one source, the CIC will have three major departments for its investment functions—1. Central Huijin Investment Company (CHIC), which will provide capital to domestic financial firms; 2. China Jianyin Investments, which will manage domestic assets and the disposal of nonperforming loans; and 3. A new department to manage overseas investments.[25]

CIC's Management

The investment activities of the CIC are nominally directed by an 11-member board of directors, which reports directly to China's State Council. A separate seven-person Executive Committee, however, is generally considered to be in charge of the day-to-day operation of the SWF (see **Figure 1**). The CIC also reports to a semi-independent Board of Supervisors, which monitors the ethical conduct of the members of the Board of Directors and senior executives, as well as oversees its accounting and financial activities.[26]

The chairman of the CIC's board is Lou Jiwei, China's former deputy finance minister and former State Council deputy secretary general. Chairman Lou also serves as CIC's Chief Executive Officer (CEO) and chairman of the CHIC. The CIC's Chief Investment Officer (CIO) and president is Gao Xiqing, previously vice chairman of China's national pension fund, the National Council for the Social Security Fund. Other people serving on the CIC's board of directors include:

[20] For example, see Jamil Anderlini and Sundeep Tucker, "China Wearies on Its Long March for Acquisitions," *Financial Times*, September 5, 2008.

[21] Michael Sheridan, "China's Sovereign Wealth Funds Set for Global Spending Spree," *The Sunday TImes*, June 22, 2008.

[22] "China Sovereign Fund in 'No Hurry to Invest Overseas'," *China Daily*, December 17, 2008.

[23] "China Investment Corp. Won't Invest Massively Overseas till Uncertainty Clears," *Xinhua*, December 3, 2008.

[24] China's State Council is the nation's highest executive and administrative body, consisting of Premier Wen Jiabao, four Vice Premiers, five State Councilors, Secretary General Hua Jianmin, and the heads of China's various ministries and special commissions. There are approximately 50 members of China's State Council.

[25] Pettis, op. cit.

[26] There are five members of the CIC's Board of Supervisors, two of whom are CIC employees.

- Zhang Hongli, the CIC's Chief Operating Officer (COO) and past vice minister of finance;
- Fu Ziying, vice minister at the Ministry of Commerce (MOFCOM);
- Hu Xiaolian, deputy governor of the People's Bank of China (PBOC) and Administrator of SAFE;
- Li Yong, vice minister of finance;
- Liu Shiyu, vice governor of the People's Bank of China;
- Wang Chunzheng, ex-vice chairman of the National Development and Reform Commission (NDRC);
- Liu Zhongli, currently chair of the Chinese Institute of Certified Public Accountants;
- Zhang Xiaoqiang, vice chairman of NDRC; and
- Yu Erniu, the CIC's human resource director.[27]

Three of the members of the board of directors also serve on CIC's Executive Committee – Gao Xiqing, Lou Jiwei, and Zhang Hongli. The other four members are:

- Jin Liqun, chairman of the Board of Supervisors and past vice president of the Asian Development Bank;
- Wang Jianxi (Jesse), the CIC's chief risk officer; previous positions include chairman of China Jianyin Investments, chairman of China International Capital Corporation (CICC), and vice chairman of the CHIC;
- Xie Ping, president of the CHIC; and
- Yang Qingwei, previously a department director at the NDRC.[28]

Initial reports indicated the CIC was to have a staff of about 1,000 employees, including 100 to 200 investment specialists.[29] To date, the CIC has not released information on the actual size of its staff. Many of the CIC's workers came from the absorption of CHIC and China Jianyin Investments, but it has periodically advertised for new staff.[30] In the first few months following the formation of the CIC, its chief spokespeople were Lou Jiwei and Li Yong, a vice minister of finance. More recently, Gao Xiqing has been CIC's top spokesperson, including an extensive interview on CBS's "60 Minutes" on April 6, 2008.

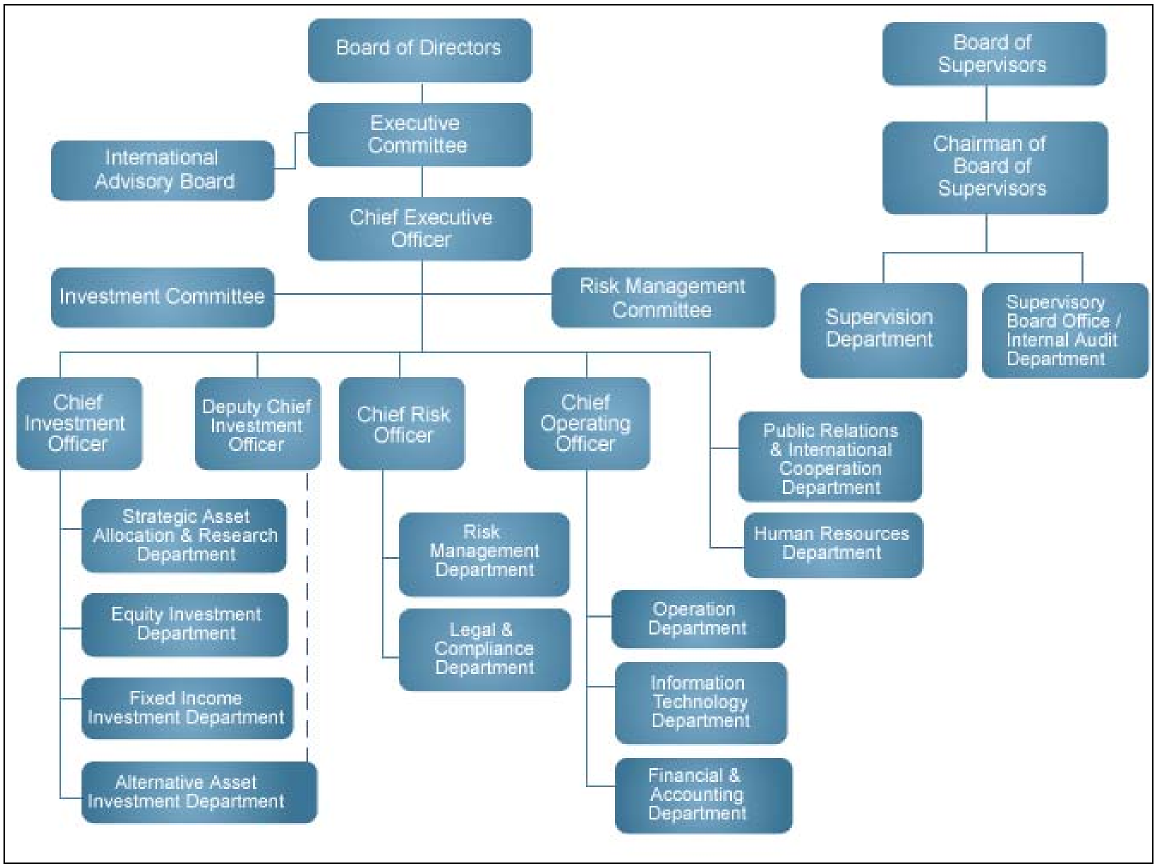
[27] Information from CIC's webpage—http://www.china-inv.cn/cicen/governance/governing_bod.html.

[28] Information from CIC's webpage – http://www.china-inv.cn/cicen/governance/management_executive.html.

[29] "China's Forex Investment Company May Debut this Week," *Xinhua*, September 10, 2007.

[30] The latest such advertisement was posted on the CIC's webpage on September 20, 2008.

Figure 1. CIC's Organizational Structure



Source: CIC's webpage (http://www.china-inv.cn/cicen/governance/organizational.html)

CIC's Working Capital

The working capital for the CIC came indirectly from China's approximately $1.5 trillion in foreign exchange reserves at the time of CIC's creation. Under a plan approved by the Standing Committee of China's National People's Congress in June 2007, the Ministry of Finance was to issue up to 1.55 trillion yuan ($200 billion) in special treasury bonds to provide the CIC with capital to purchase foreign exchange from China's central bank, the People's Bank of China (PBOC). The CIC was to be responsible for servicing the newly created debt—at an estimated cost of $40 million per day.[31]

The first tranche of the special treasury bonds—worth 600 billion yuan ($77 billion)—was sold on August 28, 2007, to the PBOC, using the Agricultural Bank of China (ABC) as an intermediary.[32] The 10-year bonds had a coupon value of 4.3%.[33] A second tranche of bonds worth 103 billion yuan ($13 billion) was sold to the Chinese public in mid-September 2007. The

[31] Cost of debt estimate based on a statement by CIC Chairman Lou.

[32] The PBOC cannot directly purchase bonds from China's Ministry of Finance, so it used the ABC as an intermediary in the financial transaction.

[33] Rachel Ziemba, "How is China Funding the Chinese Investment Corporation (CIC)?" *RGE Analysts' Economonitor*, December 5, 2007.

September bonds were a mixture of 10- and 15-year bonds with coupon rates ranging from 4.46% to 4.68%.[34] A third tranche worth 96 billion yuan ($12 billion) was sold to the public during November and December 2007, again with varying maturation periods of 10 and 15 years, with coupon rates of 4.5%.[35] The remaining 750 billion yuan ($97 billion) was sold to PBOC on December 10, again using the ABC as an intermediary, with 15-year maturations and a coupon rate of 4.45%.[36] No additional bonds were sold in 2008.

In converting China's foreign exchange reserves into $200 billion in capital for the newly created CIC, China limited the amount of new debt issued to the public to 199 billion yuan ($26 billion). Most of the newly issued bonds ended up in the hands of the PBOC, effectively sterilizing some of the perceived excess liquidity in China's money markets.

Investment Activities of China's Sovereign Wealth Fund

The investment objectives of the CIC have been gradually revealed by the CIC's leadership. Just prior to the creation of China's sovereign wealth fund, Jesse Wang Jianxi, a member of the CIC's preparatory group, stated, "The mission for this company [CIC] is purely investment-return driven."[37] However, the actual meaning of "purely investment-return driven" is open to interpretation. In April 2008, Wang, in his new role as the CIC's executive vice president and chief risk officer, provided a more specific statement of the CIC's investment goals, indicating that the company was "quite conservative at this time," seeking a rate of return on its investments of "about mid-one-digit or slightly above one digit."[38] Since the onset of the global financial crisis, there are indications that the CIC's expectations for the rate of return on its current and future investments may have been lowered.

CIC's Existing Investments

A fair amount of information is available about the existing investments of the CIC. However, because of the manner by which China typically publicizes CIC-related activities, it is often difficult to obtain specific information about investment transactions. In particular, China frequently announces planned investments shortly before the financial transaction is to take place and subsequently mentions in passing that the planned investment has occurred, but rarely reports on the investment the day the actual transaction happens. In other cases, Chinese and CIC officials refuse to comment on investments reported by generally reputable media sources. While this pattern demonstrates some relative transparency about CIC activities, it also indicates an apparent reluctance to be completely forthcoming about the details of the CIC's investments.

[34] Ibid.

[35] Ibid.

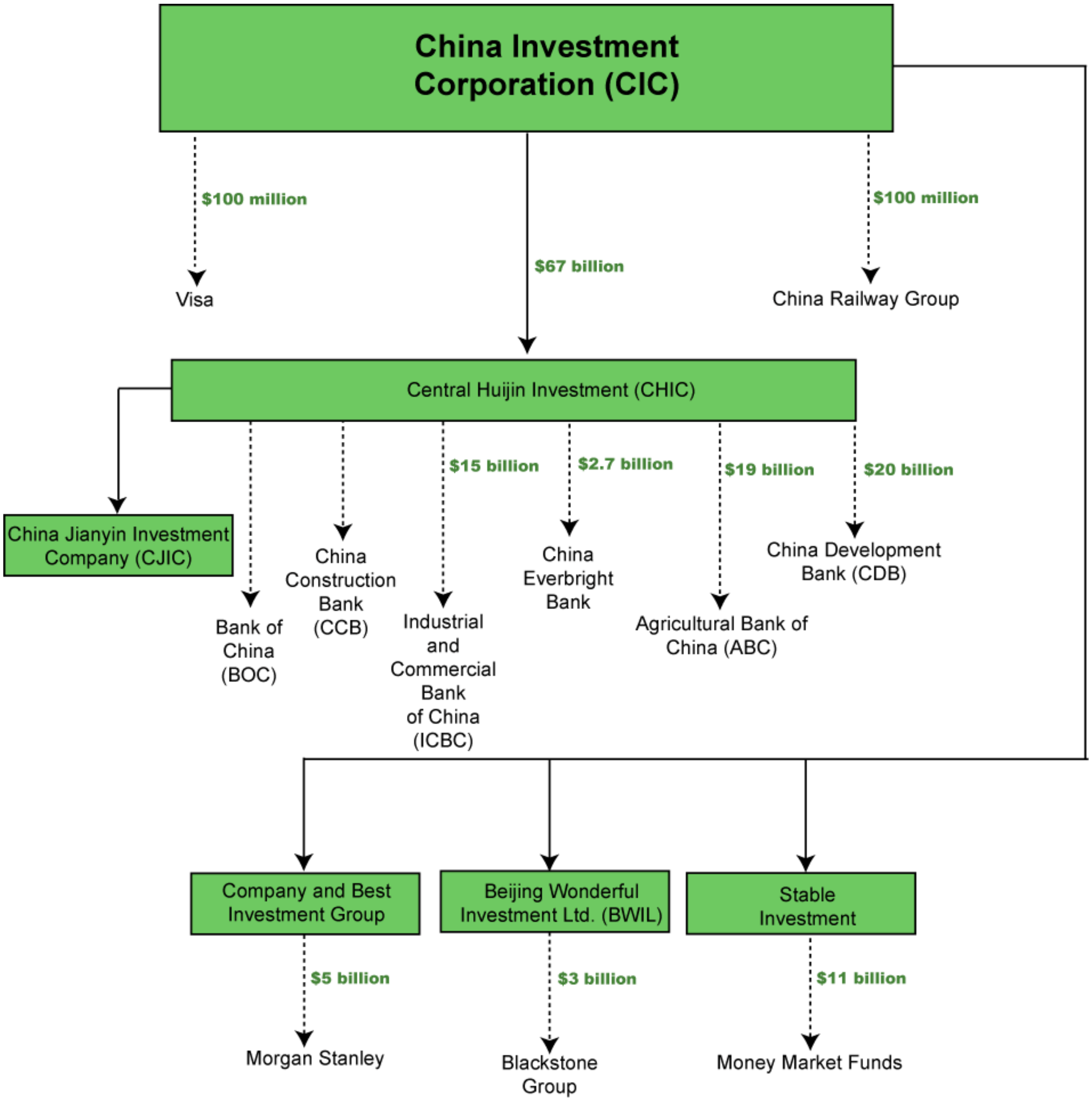
[36] "China Central Bank Takes Up 750 Bln Yuan in T-bonds to Fund CIC," *AFX News Limited*, December 10, 2007.

[37] Jason Dean and Andrew Batson, "Beijing to Take Passive Investment Approach," *Wall Street Journa*l (Europe), September 10, 2007.

[38] Michael Flaherty and Dominic Whiting, "China's CIC Defends Transparency, Eyes Modest Returns," *Reuters*, April 2, 2008.

Figure 2 provides an overview of CIC's current direct and indirect investments as of December 2008, based on available news reports.

Figure 2. CIC's Major Investments (as of 12/08)



Source: CRS research.

Tracing CIC's investment activities is also complicated by its pattern of using subsidiaries or fund managers to make investments. In little over a year, CIC has either purchased or created several subsidiaries and investment companies, including the Central Huijin Investment Corporation (CHIC); China Jianyin Investment Company (CJIC); and Beijing Wonderful Investments, Ltd (BWIL). CIC has also reportedly invested some of its capital with private equity funds and fund managers. To date, CIC has generally not announced or publicized its investment activities with equity funds and fund managers.

Direct CIC Investments

The investment options of the CIC are constrained in part by commitments made before the formal start of its operations. On May 20, 2007, CJIC, a wholly-owned subsidiary of the CHIC, signed an agreement to purchase a nearly 10% stake in Blackstone Group in nonvoting shares worth $3 billion.[39] The decision to purchase less than 10% of Blackstone's shares, and to purchase nonvoting shares, was apparently not an arbitrary one. According to Blackstone's CEO and Chairman Stephen A. Schwarzman, "The deal is 'purely commercial' and do [sic] not need the U.S. government approval as the stake is less than 10 percent."[40] According to executive vice president Wang, CIC would hold onto its Blackstone stock for five to seven years, or longer.[41]

In October 2008, the CIC reportedly increased its holdings of Blackstone to an unknown level reportedly near a 12.5% limit established between the CIC and Blackstone.[42] According to a Form 8-K filed with the U.S. Securities and Exchange Commission (SEC) on October 16, 2008, Blackstone and the CIC entered into a "new letter agreement" which raised the limit of BWIL and its affiliates' holdings to 12.5% of Blackstone's non-voting common units.[43]

In November 2007, the newly formed CIC assumed responsibility for the assets and liabilities of the CHIC, which was previously owned by the PBOC. It was reported that the PBOC obtained about 500 billion yuan ($67 billion) in compensation for the CHIC.[44] This transaction utilized approximately one third of the CIC's working capital. As a result, the CIC became the parent company for the CHIC and China Jianyin Investment Company, plus owner of $3 billion in Blackstone Group stock. In addition, the CIC indirectly became a major stock holder in China Construction Bank (CCB) and the Industrial and Commercial Bank of China (ICBC) by way of the investments of the CHIC and China Jianyin Investment Company in those two banks.[45]

The precise nature of the CIC's relationship to China's various state-owned banks continues to be difficult to determine due to contradictory announcements from various sources containing ambiguous statements of China's intentions. In November 2007, China's State Council reportedly decided that the CIC was to provide capital totaling $67 billion to two of China's state-owned banks, the Agricultural Bank of China (ABC) and the China Development Bank (CDB).[46] After its investment in the ABC, the CIC would supposedly own one-third of the bank with another third owned by China's Ministry of Finance.[47] Other sources reported that a financial restructuring plan for the ABC – a plan to convert the ABC into a publicly-owned commercial bank – was submitted to the State Council for approval, and the plan included $40 billion from

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[39] "China to Invest $3 Bln in Equity Giant Blackstone," *Xinhua*, May 21, 2007.

[40] Ibid.

[41] Shangguan Zhoudong, "CIC May Hold Blackstone Stake for 5 to 7 Years," *China Daily*, March 6, 2008.

[42] "CIC Raises Stake in Blackston to 12.5%," *China Daily*, December 18, 2008.

[43] The Blackstone Group, Form 8-K, submitted to the Securities and Exchange Commission, October 16, 2008.

[44] "$200 Billion Investment Firm Starts Operation," by Xin Zhiming, *China Daily*, October, 1, 2007.

[45] According to CCB's webpage http://www.ccb.com, the CHIC owns 70.69% of CCB's shares, including 9.21% owned by its subsidiary, Central Jianyin Investment Company. According to the ICBC's webpage http://www.icbc.com.cn, the CHIC owns 35.33% of ICBC's shares.

[46] "China Investment Co to Invest a Third of Its 200 Bln USD 'Cautiously'—Official," *AFX News Limited*, November 7, 2007.

[47] Yidi Zhao and Janet Ong, "Chinese Banks to get $67 Billion from Sovereign Wealth Fund," *International Herald Tribune*, November 8, 2007.

the CIC, possibly through the newly acquired CHIC.[48] However, on December 5, 2007, a representative of the ABC stated that "overseas media reports concerning the bank's shareholding reforms were false," but did not indicate which aspects of those reports were incorrect.[49] A news article in March 2008 cited an ABC spokesman as saying that reports of the CIC's investment in ABC were "not true."[50]

For several months, there was little news about the CIC's relationship to China's state-owned banks, creating uncertainty if any investments had been made or if any investments would ever be made. Then, in August 2008, it was reported that CIC's capital injection into ABC was to be reduced to $20 billion, to free up more funds for overseas investments.[51] Two months later, the ABC reportedly signed an agreement with the CHIC in which it was to receive a capital injection of 130 billion yuan ($19 billion) in preparation for an eventual stock listing.[52] According to the ABC's vice president, the CHIC's investment in the bank would result in it holding half of the bank's equity, with the other half owned by the Ministry of Finance.[53] The vice president also stated that the ABC's initial public offering "would be finished in the second half of 2009."[54]

The nature of the CIC's relationship with the CDB is somewhat clearer. According to the Chinese press, the CHIC signed an agreement on December 31, 2007 to invest $20 billion into the CDB.[55] A separate source reported on January 2, 2008, that the investment had already occurred and confirmed both the amount of the investment and the use of the CHIC to make the investment.[56]

The CIC has made several other major direct investments since its establishment. On November 21, 2007, the CIC announced plans for its first investment following its formal launch—the purchase of $100 million in shares of Hong Kong's initial public offering for the new China Railway Group (CRG).[57] China Railway Group is a railway construction company in China, and reportedly one of the largest construction companies in the world. The Government of Singapore Investment Corporation, another SWF, reportedly also bought shares in CRG.[58]

The second major investment took place on December 19, 2007, when the CIC purchased "around 9.9%" of Morgan Stanley, one of the largest U.S. investment banks.[59] According to the Form 8-K filed with the SEC, the CIC investment in Morgan Stanley – made via another CIC subsidiary, Company and Best Investment Corporation – amounted to $5.579 billion.[60] At the time of the investment, Morgan Stanley stressed that the CIC would have "no special" rights of

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[48] "Agricultural Bank of China to Announce Financial Restructuring Plan Soon," *AFX News Limited*, December 3, 2007, and "Agricultural Bank of China Sets Up Investment Banking Operations," *AFP*, December 4, 2007.

[49] "Agricultural Bank of China Denies Shareholding Reform Approval Rumor," *Xinhua*, December 5, 2007.

[50] "Agricultural Bank of China Says Report on CIC Unit's Investment Plan Not True," *AFX News*, March 2, 2008.

[51] "CIC to Halve Capital Injection, So Have More to Invest Overseas," *China Stakes*, August 20, 2008.

[52] "Agricultural Bank of China Receives 130b Yuan Injection," *Xinhua*, October 22, 2008.

[53] Ibid.

[54] Ibid.

[55] Xin Zhiming, "Huijin to Inject $20b into China Development Bank," *China Daily*, December 31, 2007.

[56] "China Investment Corp Injects $20 Bln in CDB," *China Business News*, January 2, 2008

[57] Jamil Anderlini, "CIC to Buy Stake in HK Rail Group Float," The Financial Times, November 21, 2007.

[58] "CIC Invests in China Railway IPO," *China Economic Review*, November 21, 2007.

[59] "China Fund Grabs Big Stake in Morgan Stanley," *AFP*, December 19, 2007.

[60] Morgan Stanley, Form 8-K, submitted to the Securities and Exchange Commission, December 19, 2007.

ownership and no role in corporate management.[61] The third major CIC investment occurred on March 24, 2008, when it invested "more than $100 million" in Visa's initial public offering (IPO).[62]

There were unconfirmed reports that the CIC was a party to the negotiations to rescue Lehman Brothers from bankruptcy in mid-September 2008. A group headed by Bank of America and including J.C. Flowers and CIC reportedly expressed an interest in buying Lehman Brothers, but the possible takeover talks proved unsuccessful.[63] Similarly, the CIC reportedly headed a consortium of companies that considered acquiring portions of the U.S. insurance company American International Group (AIG) in November 2008, but in the end, no agreement was reached.[64] In early February 2009, there were reports that the CIC was talking with CITIC Pacific, a Hong Kong-based conglomerate, about purchasing up to 50% of CITIC Capital Holdings Limited, a China-focused investment management and advisory firm.[65] There have also been reports that the CIC is considering investing "several billion dollars" in Australia's Fortescue Metals.[66]

The CIC has also reportedly invested some of its capital in money market funds. On October 13, 2008, it was reported that CIC – through another of its wholly-owned subsidiaries, Stable Investment Corporation – had invested $10.3 billion in U.S. money market funds, including $5.4 billion in Reserve Primary Fund.[67] In September 2008, Reserve Primary Fund suspended withdrawals after it posted $785 million in losses on worthless Lehman Brothers debt securities.[68] The CIC announced on October 15, 2008, that it had notified Reserve Primary Fund to withdraw its investment before the fund suspended withdrawals.[69] Reserve Primary Fund, however, issued a press release on the same day indicating the CIC would receive its share of the Fund's liquidated assets at the same time as the Fund's other investors and there was no guarantee that the CIC would receive 100% of its investment.[70] The following day, the CIC stated it had "written documents" from Reserve Primary Fund "that it will pay back both principal and interest of our investment."[71] The settlement of Reserve Primary Fund's assets has not yet occurred.

There are also reports that the CIC was considering hiring several independent financial consultants to manage its investments. On April 3, 2008, Reuters reported that the CIC had signed a deal with J.C. Flowers & Company, a U.S.-based investment firm, launching a $4 billion private equity investment fund that would focus on investments in U.S. financial assets.[72] Neither the

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[61] Ibid.

[62] "China Wealth Fund Invests $100 Mln in Visa IPO," *Reuters*, March 24, 2008.

[63] "NY Meeting to Prop Up Lehman Brothers: CIC a Possible Buyer?" *China Stakes*, September 14, 2008.

[64] "CIC in Talks with AIG over Unit Acquisition," *China Daily*, November 22, 2008.

[65] "Sovereign Fund Eyes State in CITIC Arm," *China Daily*, February 5, 2009.

[66] George Lekakis, "Forrest Boasts of 'Model' for China Investment," *Herald Sun*, February 25, 2009. China's Hunan Valin Iron and Steel Group has already negotiated an investment of $558 million in Fortescue Metals.

[67] Miles Weiss and Belinda Chao, "China's CIC May Have $5.4 Billion Frozen in Money-Market Fund," *Bloomberg*, October 13, 2008; and "CIC Denies Reports of Hugh Losses in US," *China Daily*, October 16, 2008.

[68] "CIC Rescues Investment But Still Faces Criticism at Home," *China Stakes*, October 16, 2008.

[69] "CIC Says US Reserve Primary Fund to Return All Its Investment," *China Daily*, October 15, 2008.

[70] Li Qing, "Reserve Contradicts CIC's Claim," *Caijing Magazine*, October 17, 2008.

[71] "CIC Denies Reports of Hugh Losses in US," *China Daily*, October 16, 2008.

[72] George Chen, "China's CIC to Launch $4 Billion Fund with JC Flowers," *Reuters*, April 3, 2008.

CIC nor J.C. Flowers has confirmed the deal. Since April 2008, there have been no additional reports of the CIC hiring independent financial consultants.

Investments by the CHIC

The CHIC also has been adding investments to its existing portfolio (see **Table 2**). Although it is a wholly-owned subsidiary of the CIC, according to the CHIC's website, "the investment business of CIC and the share management function conducted on behalf of the State Council by Central Huijin are completely separated."[73] The CIC's website reinforces the apparent administrative separation between the CIC and the CHIC:

Central Huijin Investment Ltd. (Central Huijin) is a wholly-owned subsidiary of CIC with its own Board of Directors and Board of Supervisors. It was established to invest in key state-owned financial institutions in China; it does not conduct any other commercial activities and is not involved in day-to-day issues within the institutions in which it invests.[74]

In addition to its investments in the state-owned banks ABC and CDB, the CHIC has been investing in China's commercial banks. On November 8, 2007, the CHIC announced it intended to purchase a 70.92% stake in China Everbright Bank, a Beijing-based joint-equity commercial bank founded in August 1992.[75] On November 28, 2007, the shareholders of China Everbright Bank agreed to accept a 20 billion yuan ($2.7 billion) capital injection from the CHIC.[76] The CHIC's financial support to China Everbright Bank reportedly was supposed to be sufficient for China Everbright Bank to go ahead with its planned initial public offering (IPO) on the Hong Kong Stock Exchange (HKSE) and China's A-share stock market.[77] On December 5, 2007, China Everbright Bank announced that it is planning on holding its IPO in June or July of 2008.[78] As of January 2009, China Everbright Bank's IPO had not occurred.

Table 2. CHIC's Investments

(as of June 30, 2008)

Company Name	Percentage Ownership
Bank of China (BOC)	67.49%
China Construction Bank (CCB)	59.12%
China Development Bank (CDB)	Not yet determined
China Everbright Bank	70.88%
China Galaxy Financial Holdings	78.57%
China Jianyin Investment	100.00%
China Reinsurance (Group) Corporation	85.50%

[73] http://www.huijin-inv.cn/hjen/aboutus/aboutus_2008.html?var1=About

[74] http://www.china-inv.cn/cicen/about_cic/aboutcic_overview.html

[75] Mao Lijun, "Central Huijin Bails Out Everbright Bank," China Daily, November 8, 2007.

[76] "China Everbright Agrees to Capital Injection Plan," *China Daily*, November 28, 2007.

[77] Ibid.

[78] "China Everbright Bank Reportedly Plans IPO Next Summer," *Xinhua*, December 5, 2007.

Company Name	Percentage Ownership
Guotai Junan Securities	21.28%
Industrial and Commercial Bank of China (ICBC)	35.33%
Shenyin & Wanguo Securities Co., Ltd.	37.23%

Source: The CHIC's website – http://www.huijin-inv.cn/

In September 2008, the CHIC reportedly purchased 2 million shares in three of China's largest commercial banks – Bank of China (BOC), China Construction Bank (CCB), and the Industrial and Commercial Bank of China (ICBC) – to help stabilize China's sliding stock market.[79] As a result of the purchases, the CHIC owns over two-thirds of BOC, nearly two-thirds of CCB, and just over a third of ICBC. The CHIC's holdings in China's commercial banks has raised concerns about the autonomy of the banks.

CIC's 2008 Performance and Future Investments

An anonymous source close to the CIC told the press on February 24, 2009, that the CIC's total profits for 2008 amounted to about $10 billion – an approximately 5% rate of return on its total working capital.[80] Since the CIC or its subsidiaries purchased equity positions in Blackstone and Morgan Stanley, the share prices of those companies have fallen 82% and 48% respectively, amounting to an estimated loss of nearly $4 billion.[81] This would imply that the CIC has earned approximately $14 billion in profits on its various existing domestic investments in 2008.

Overall, the reported existing direct and indirect investments of the CIC total leave about $80 billion available for future investments. So far, most of the CIC's investments have apparently been made based on non-commercial criteria. For example, there are indications that the State Council, the PBOC and the NDRC insisted that the CIC provide help in the restructuring of these two state-owned banks as a condition of the CIC's establishment.[82] Similarly, the payment to the PBOC for the CIC's acquisition of the CHIC and its subsidiary, China Jianyin Investment Company, may have been driven more by political considerations than economic ones. The non-commercial character of the CIC's existing investments may lead to increased interest and surveillance on its future investments.

Another factor that may subject the CIC to greater scrutiny is the poor performance record of its major overseas investments (see above). In addition, the CIC may lose part of its principal invested in the Reserve Primary Fund. Some government officials, as well as members of the public, have been critical of the CIC's investment performance. In December 2008, assistant minister of finance Zhu Guangyao stated that he had not heard of any plans to increase the CIC's capital above its initial $200 billion.[83]

Since the day China announced the formation of the CIC, senior representatives of the new corporation and various government agencies have been actively publicizing that China's SWF

[79] "China Huijin Increases State in Three Top Commercial Lenders," *Xinhua*, September 23, 2008.

[80] Eadie Chen, "China's CIC Fund Making Near 5 Pct Profit—Source," *Reuters*, February 24, 2009.

[81] Stock price comparison based on prices on reported day of purchase and on February 6, 2009.

[82] Pettis, op cit.

[83] "Official: CIC Has No Plans to Add New Capital," *China Daily*, December 5, 2008.

would operate with a high degree of transparency utilizing an investment strategy based on commercial principles. China has also shown some sensitivity to existing apprehensions about the possible overseas investments the CIC might make, and CIC representatives have publicly announced that the new SWF will not invest in certain sensitive sectors and markets. However, the Chinese government has also made it known that it is concerned about undue criticism or scrutiny of the CIC, and in particular, is worried that other nations (including the United States) may try to use the creation of China's SWF as an opportunity to implement protectionist measures targeted at the Chinese economy. In sum, China has handled the creation of the CIC in a fairly common Chinese fashion of combining reassuring statements with veiled warnings.

Investment Strategy

Prior to the creation of the CIC, Chinese officials were already making statements indicating that its investment strategy would be to maximize the rate of return on its investments. Jesse Wang, a member of the CIC's preparatory group, stated on September 10, 2007, "The mission for this company is purely investment-return driven."[84] On the day the CIC was created, CIC deputy general manager Yang Qingwei stated, "The company's principal purpose is to make profits."[85] More recently, during his first overseas trip as the CIC's chairman, Lou provided a more nuanced explanation of the company's investment strategy, "We will adopt a long-term and prudent investment principle and a safe, professional portfolio strategy that adapts to market changes, which will put emphasis on a rational match of returns and risks."[86]

The CIC's need for relatively high rates of return on their investments is partially being driven by the manner in which the company has received access to China's foreign exchange reserves. According to one of the CIC's top managers, the company is responsible for servicing the interest on the 1.55 trillion-yuan of bonds issued by the PBOC (see above). According to CIC Chairman Lou, the interest cost on the outstanding bonds amounts to 300 million yuan ($40 million) per day.[87] With a minimum return of $40 million per day, the CIC will need to earn at least $14.6 billion per year in profits—or at least 7.3% on its total capital of $200 billion. There was a report that CIC was late in making its first interest payment to the PBOC, despite the receipt of a dividend payment from Blackstone.[88] However, for its second interest payment, the CIC was able to draw on its dividends from its investments in domestic banks to cover the installment.[89]

Also, as Lou points out, the CIC's ability to obtain access to more of China's foreign exchange reserves will depend on its profitability. There has been some domestic criticism of the CIC's investment in Blackstone, which as of February 6, 2009, was down 82% from its purchase price. Similarly, the CIC's other major U.S. purchase—Morgan Stanley—was trading about 48% below

[84] Jason Dean and Andrew Batson, op. cit.

[85] "China's Trillion-dollar Kitty is Ready," *Asian Times*, October 2, 2007.

[86] "CIC to be Stable Force in Global Financial Market," *Xinhua*, December 11, 2007.

[87] "China's Sovereign Wealth Fund Seeks to be a Stabilizing Presence in Global Markets," *Xinhua*, November 30, 2007.

[88] "China's Sovereign Wealth Fund in Interest Troubles," *China Stakes*, March 5, 2008.

[89] Technically, the CIC does not directly pay the interest; China's Ministry of Finance services the debt and the CIC reimburses the Ministry. For more details, see "Interest Payments? That's None of CIC's Business," *China Stakes*, August 28, 2008.

the lower range of the agreed transaction price.[90] "If I am making losses every day, how can I face asking the government for more money?" asked Lou.[91]

There have also been some indications on the actual types of investments the CIC will be making and where it will be making investments. A CIC representative reportedly stated in 2007 that it will focus its international investments on a "portfolio of financial products."[92] Also in 2007, CIC Chairman Lou told a group of financial experts in Beijing that most of the CIC's investments would be in publicly traded securities, but that it would also make some direct investments.[93]

In the first few months following the CIC's establishment, officials with the CIC indicated that it is considering making investments in Hong Kong and Taiwan, and it held talks with stock exchange officials in London. The CIC was also expected to set up branches overseas, with the locations of its overseas branches to be determined. Since the onset of the global economic crisis, the CIC has not actively pursued either avenue of overseas expansion.

At the same time, China made reassuring statements about the types of investments the CIC would *not* be making. Chinese officials reportedly told German Chancellor Angela Merkel during her visit to China in August 2007 that the future CIC "had no intention of buying strategic stakes in big western companies."[94] CIC Chairman Lou has indicated that the CIC will not invest in infrastructure.[95] China's Vice Minister of Finance Li Yong also dismissed "rumors that China would try to buy out European and American companies in large numbers."[96] Vice Minister Li has stated that the CIC would not buy into overseas airlines, telecommunications or oil companies.[97] An unnamed contact at CIC indicated that the SWF also would not make investments in foreign technology companies as a means of obtaining advanced technology, pointing out, "That's political, and we don't do that."[98]

Despite the reassurances provided by the CIC, some observers are unconvinced that China's SWF has a clear investment strategy that is free from political influences. Setser gave a negative answer to his own rhetorical question, "Does the China Investment Corporation (CIC) have a coherent investment strategy?"[99] According to Setser, "There clearly isn't a consensus inside China on what the CIC should be doing."[100] A reporter for the *Financial Times* mirrored Setser's appraisal, writing, "Such a concentration of the country's wealth in one entity has inevitably

[90] In their agreement, CIC and Morgan Stanley set a transaction price range for Morgan Stanley stock of between $48.07 and $57.684 per share.

[91] "China Wealth Fund Aims for Stability, Openness," *China Daily*, October 16, 2007.

[92] Xin Zhiming, "China's State Forex Investment Company Debuts," *China Daily*, September 29, 2007.

[93] "China's Sovereign Wealth Fund Seeks to be a Stabilizing Presence in Global Markets," *Xinhua*, November 30, 2007.

[94] Pettis, op. cit.

[95] "China's Sovereign Wealth Fund Seeks to be a Stabilizing Presence in Global Markets," *Xinhua*, November 30, 2007.

[96] "Investment Fund Announces Strategic Plans," *Xinhua*, November 9, 2007.

[97] "China Investment Corporation Unveils Investment Plan," *Xinhua*, November 7, 2007.

[98] Keith Bradsher, "$200 Billion to Invest, But in China," *The New York Times*, November 29, 2007.

[99] Brad Setser, "Does the China Investment Corporation (CIC) Have a Coherent Investment Strategy?" online blog #234551, available at http://www.rgemonitor.com/blog/setser/234551/.

[100] Ibid.

drawn intense interest ... from powerful forces within the state bureaucracy. Each of these groups has its own ideas on how the money can best be spent."[101]

There are some indications that these past assurances may be under review, in light of the current global economic crisis. Wang Shuilin, one of CIC's managing directors, told reporters on February 24, 2009, that the CIC would increase its investments in "alternative assets, such as infrastructure, real estate, and renewable energy in 2009."[102] Also, as previously mentioned, there continue to be reports that the CIC is considering investments in overseas mining companies.

Transparency

CIC officials and other leading economic figures in China have also made reassuring statements about the transparency of the CIC's operations and management, but often with caveats. For example, on the day the CIC was launched, Chairman Lou said, "We will adopt a prudent accounting system ... adhere to commercial lines and improve the transparent [sic] on the condition that company interest will not be jeopardized."[103] In April 2008, CIC's Wang contrasted CIC's operations to the Government of Singapore Investment Corporation (GIC) indicating that while CIC discloses its investments in the United States, the GIC does not.[104] According to Wang, "CIC is one of the most transparent sovereign funds in the world."[105]

However, the degree and pace at which China will make the CIC transparent remains uncertain. While the CHIC provides a listing of its major investments in its website, the CIC's has been less forthcoming with the details of its investment portfolio. During a dinner at the mayor of London (England)'s mansion, Lou offered an explanation for the CIC's hesitation to reveal its investment holdings by expanding on his previous statement, "We will increase transparency without harming the commercial interests of CIC. That is to say, it will be a gradual process... If we are transparent on everything, the wolves will eat us up."[106]

Reciprocity

The creation of the CIC was not done in isolation from China's overall policy on inward and outward capital movements. At the time the CIC was created, much of the rest of the world would have preferred that China had focused on liberalizing various aspects of its inward capital flow policies, much of its efforts were centered on laws and regulations governing its outward capital flows. At present, more foreign direct investments (FDIs) are flowing into China than are flowing out of China. The combination of China's net FDI inflows and overall trade surplus is financing the growth of its foreign exchange reserves.

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[101] Jamil Anderlini, "China Wealth Fund's Early Coming of Age," *Financial Times*, December 21, 2007.

[102] Elizabeth Pfeuti, "China SWF Speaks Out on Protectionist Threat," *Financial Times*, February 24, 2009.

[103] Xin, op cit..

[104] Michael Flaherty and Dominic Whiting, "China's CIC Defends Transparency, Eyes Modest Returns," *Reuters*, April 2, 2008.

[105] Ibid.

[106] "China Investment Corp Warns Western Governments Against Protectionism," *AFX News Limited*, December 10, 2007.

The Bush administration repeatedly pressured China to make its stock and bond markets more open to foreign investors, matching the comparative openness of its inward FDI policies.[107] However, at the time, China was more concerned about increasing the avenues by which it can redirect more of its domestic foreign exchange holdings towards investments outside of China. Some advocated that China push the United States to make the U.S. financial industry more open to foreign investment.[108] It remains to be seen how the Obama Administration will approach the issue of capital market reciprocity with China.

Over the last few years, the Chinese government has gradually introduced reforms to its outward FDI laws and regulations. For example, China rolled out a program in April 2006 creating "qualified domestic institutional investors" (QDIIs) that would allow Chinese nationals to invest in global investment funds offered by the QDIIs.[109] On February 23, 2009, China's State Administration of Taxation announced that dividends of QDIIs would be subject to a 10% capital gains tax.[110] The goals of the QDII program are to offer Chinese investors new options, and to soak up some of China's excess liquidity by moving funds overseas.

China has approved a number of QDIIs (including Bank of Communications Schroder, China AMC, China International, China Southern Fund, Fortis Haitong, Fortune SGAM, Harvest Fund, Yinhua) and reportedly plans on approving more QDIIs in the future. As part of China's controls on foreign exchange, each fund is provided a quota limiting the size of its fund by the State Administration of Foreign Exchange (SAFE). China has also placed restrictions on the overseas markets in which the funds may invest. It has already approved Hong Kong and London, and is considering the United States.

At the end of September 2007, just under $11 billion had been invested in the existing QDIIs.[111] In December 2007, JP Morgan estimated that about $90 billion would be invested in QDIIs by the end of 2008.[112] However, declines in international stock markets have hurt China's QDIIs. A group of Chinese investors recently filed suit against one QDII in England, alleging insufficient disclosure of investment risk led to major losses.[113] As of January 2009, the total amount invested in QDIIs was $7.58 billion.[114]

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[107] China does restrict inward FDI in what it considers economic sectors related to national and economic security, including certain agricultural and fishing industries, selected mining industries, traditional Chinese medicine processing, nonferrous metal industry, electric machinery manufacturing, postal services, geological surveying, news agencies, publications industry, and radio and televisions stations and networks. For a complete list of "prohibited foreign investment industries," see "Decree of the State Development and Reform Commission, the Ministry of Commerce of the People's Republic of China, No. 57," Department of Foreign Investment, November 22, 2007, available online at

http://english.mofcom.gov.cn/column/print.shtml?/policyrelease/announcement/200711/20071105241195.

[108] Ma Wenluo, "China Should Press for Wider Openness to US Financial Industry," *China Stakes*, April 15, 2008.

[109] China has also created a "qualified foreign institutional investors" (QFIIs) program that allows foreigners to invest in Chinese companies via funds offered by the QFIIs. In May 2007, China pledged to increase the limit on QFIIs to $30 billion during the Strategic Economic Dialogue (SED) held in Washington, but did not officially raise the limit until just before the SED held in Beijing in December 2007.

[110] Wu Ying and Song Yanhua, "State Administration of Taxation Clarifies QDII Dividends and Bonus Tax Payable," *Caijing*, February 23, 2009 (in Chinese).

[111] "China's CIC Wins $5 Bln Investment Quota - Paper," *Reuters*, December 17, 2007.

[112] Ibid.

[113] Fan Junli and Lu Yanzheng, "Overseas Investment Deals Mired in Disputes," *Caijing*, February 19, 2009.

[114] "Foreign Funds Outperform in China Rally," *Reuters*, February 17, 2009.

China's efforts to improve the reciprocity of its investment policies have often been accompanied by warnings to other nations about using the creation of the CIC and the possible rise in Chinese overseas investments as an excuse to raise inward investment barriers, especially on the ground of "national security." On December 10, 2007, CIC Chairman Lou cautioned during a dinner at the Mayor of London's mansion, "If an economy will use national security as a criteria for entry of sovereign wealth funds, we will be reluctant to tap the market because you are not sure what will happen."[115] Lou continued by stating that "any protectionist backlash" against SWFs could "change the stability and security of global financial markets."[116]

During the December 2007 Strategic Economic Dialogue (SED) in Beijing, Zhang Xiaoqiang, Vice Minister of the National Development and Reform Commission, made an apparent indirect comment on the recently passed Foreign Investment and National Security Act of 2007 (P.L. 110-49), "We hope U.S. policies and regulations do not become a barrier for Chinese investors."[117] According to Zhang, "Investors both from the U.S. and China have shown a strong desire to invest in each other, and it's necessary for both countries to create a sound investment environment for them."[118] Zhang specifically cited China's concerns about U.S. use of national security as a barrier to Chinese investors, and greater scrutiny and possible discrimination against China's state-owned enterprises (SOEs) that wish to invest in the United States.

Market Stability

In the first few months following the creation of the CIC, China indicated that they see sovereign wealth funds being a "stabilizing force in the international market," in contrast to hedge funds, which are "a source of market instability."[119] For example, at a 2007 conference in Beijing, CIC Chairman Lou noted that SWFs have been injecting capital into financial institutions "that suffer from the subprime crisis; they are stabilizing the market. CIC will also do the same thing."[120]

However, China has been cautious about its assertions about the stabilizing power of SWFs. According to CIC Chairman Lou, "Judging from our (CIC's) investment strategy and scale, we are unlikely to present a major impact on the international market."[121] China's Vice Minister of Finance, Li Yong, has indicated that the CIC's investments will be made "gradually" and "cautiously."[122]

[115] "China Investment Corp Warns Western Governments Against Protectionism," *AFX News Limited*, December 10, 2007.

[116] Ibid.

[117] Fu Jing, "US Policies May Deter Investors from China," *China Daily*, December 12, 2007.

[118] Ibid.

[119] "China Wealth Fund Aims for Stability, Openness," *China Daily*, October 16, 2007.

[120] Xin Zhiming, "CIC Aims for Overseas," *China Daily*, November 30, 2007.

[121] "CIC to be Stable Force in Global Financial Market," *Xinhua*, December 11, 2007.

[122] "China Investment Co to Invest a Third of its 200 Bln USD 'Cautiously'—Official,"*AFX News Limited*, November 7, 2007.

Rethinking CIC's Role?

Starting in the summer of 2008, there emerged indications that China was rethinking CIC's role. CIC's poor overseas investment performance, plus internal and external administrative tensions, gave rise to discussions about reforming CIC. Internally, there were problems reconciling CIC's overall investment mission with the CHIC's domestic investment focus. Externally, the State Administration of Foreign Exchange (SAFE), which reports directly to the PBOC, made an apparent bid to challenge CIC's role as the Chinese government's leading overseas investment fund. While there have been no major changes to CIC so far, there are clear indications that China's leaders are keeping an eye on CIC's progress.

In July 2008, sources in China reported that Chinese officials were discussing the possible separation of CIC and the CHIC.[123] The officials perceived a tension between CIC's commercial orientation and the CHIC's role as investor in China's larger financial institutions. In addition, the connection between CIC and the CHIC apparently led the U.S. Federal Reserve to postpone granting licenses for CCB and ICBC branches in New York City.[124]

On October 22, 2008, China's State Council announced that it was assigning new roles to the CHIC and China Jianyin Investment Company, but keeping both firms under CIC.[125] The CHIC was to serve as a investment institution holding majority stakes in China's larger state-owned banks. As a result, China Jianyin Investment Company will transfer some of its holdings over to the CHIC, so it can focus on its new function as an "investment platform for companies."[126] In January 2009, it was reported that the CHIC had taken control of five securities firms (including CIC Securities and UBS Securities) from China Jianyin Investment Company, but not China Investment Capital Corporation (CICC).[127]

Stories about possible competition between CIC and SAFE also surfaced during the summer of 2008. As described below, SAFE made a number of overseas investments in 2008 in a variety of firms, including banks and oil companies. In April 2008, *Caijing Magazine* reported that the State Council had authorized SAFE to invest up to 5% of China's foreign exchange reserves – the equivalent of nearly $90 billion – in non-fixed income investments.[128] Financial analyst Logan Wright wrote in June 2008 that SAFE's "encroaching on the CIC's turf is likely more reflective of these bureaucratic conflicts than a coordinated government strategy for investing China's foreign exchange reserves."[129]

China's Quasi-Sovereign Wealth Funds

In addition to the CIC, China has other government entities that act as quasi-sovereign wealth funds. The key entities are SAFE, the State Development and Investment Corporation (SDIC),

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[123] "A Simmering CIC-Huijin Separation," *China Stakes*, July 8, 2008.

[124] Ibid.

[125] Li Qing, "Reshuffling Begins for State Finance Arms," *Caijing Magazine*, November 4, 2008.

[126] Ibid.

[127] Li Qing, "New Roadmap for Central Huijin's Brokers," *Caijing Magazine*, January 6, 2009.

[128] Yu Ning, "SAFE's Reserve Investments Accelerate," *Caijing Magazine*, April 28, 2008, in Chinese.

[129] Logan Wright, "CIC and SAFE: Coordination or Bureaucratic Conflict?," *China Stakes*, June 24, 2008.

and the National Social Security Fund (NSSF). Each of these entities has recently taken actions indicating a greater willingness to invest overseas.

State Administration of Foreign Exchange

The State Administration of Foreign Exchange, or SAFE, reports directly to China's State Council and the PBOC.[130] Its main function is to manage China's foreign exchange, including the maintenance of balance of payments statistics, regulating and monitoring foreign exchange transactions, and managing China's foreign exchange reserves. It is in this last capacity that SAFE has the ability to operate like a SWF.

SAFE generally invests China's foreign exchange reserves in traditional items, such as U.S. Treasury bonds. According to one source, 70% of SAFE's assets are in U.S.-dollar denominated bonds.[131] However, there are signs that SAFE is diversifying its investment portfolio. Late in 2007, SAFE purchased minority stakes of less than 1% in three of Australia's larger banks—ANZ Bank, Commonwealth Bank of Australia, and National Australia Bank—for $176 million per bank.[132] A spokesman for ANZ Bank indicated that SAFE had stated that SAFE's share purchase was a "portfolio investment" and "a better way of managing their exposure to the Australian dollar."[133]

In April 2008, SAFE made two major investments in the petroleum industry. On April 4, 2008, the *Financial Times* reported that SAFE had accumulated 1.6% of the French oil company, Total, for $2.8 billion in a series of smaller purchases spread over several months.[134] Eleven days later, *Reuters* reported that SAFE had also accumulated "just less than 1%" of the British oil company, BP, through a similar process involving a total investment of approximately $2 billion.[135]

SAFE's move to diversify its portfolio into equities continued through the summer of 2008. By the end of August 2008, SAFE held less that 1% of shares of over 50 British listed companies, according to one financial reporting service.[136] Among the companies in which SAFE holds an equity position are: Barclays, British Gas, Cadbury, Drax Group, Royal Bank of Scotland, Tesco, and Wire & Plastic Products Group.[137]

SAFE's recent forays into overseas equity investments have raised two major issues among market analysts. First, some people wonder if SAFE's overseas investments are a sign of dissatisfaction among China's leadership with the performance of CIC, or alternatively, an indication of institutional competition between the PBOC and CIC.[138] There is a report that the

[130] SAFE's webpage in English is: http://www.safe.gov.cn/model_safe_en/index.jsp.

[131] Leona Chen, "Will China Buy into BHP Billiton?" *China Stakes*, April 13, 2008.

[132] Tim Johnston, "Beijing Buys into Australian Banks," *International Herald Tribune*, January 4, 2008.

[133] Ibid.

[134] Richard McGregor, Peggy Hollinger, and Henny Sender, "China Uses Foreign Reserves to Buy 1.6% Stake in France's Total," *Financial Times*, April 4, 2008.

[135] "China Takes Stake in BP," *Reuters*, April 15, 2008.

[136] "Report: SAFE Expands Investments in Britain," *China Daily*, September 8, 2008.

[137] Ibid.

[138] "China Takes Stake in BP," *Reuters*, April 15, 2008.

leadership of CIC is "furious" about SAFE's purchases of overseas equities.[139] According to one analyst, SAFE's recent investments have blurred the distinction of responsibility between itself and CIC.[140]

Second, there is uncertainty on how to interpret SAFE's willingness to invest in petroleum companies, given CIC's previous assurances that it would not invest in this potentially politically sensitive industry. Rumors that SAFE may be considering an investment in the Anglo-Australian BHP Billiton have given a modicum of credence to claims that SAFE is willing to make more politically-charged investments that CIC has forsworn.[141] In November 2007, CIC denied market rumors that it was considering making a bid to buy Rio Tinto to block BHP Billiton's takeover bid.[142]

State Development and Investment Corporation

The State Development and Investment Corporation (SDIC) was established by the State Council in May 1995 to function as a government-owned holding company to invest in basic economic infrastructure.[143] According to SDIC's annual report for 2006, SDIC had 62 wholly-owned subsidiaries and holding companies with over 50,000 employees, and 113.8 billion yuan ($16.3 billion) of total assets, making SDIC's the largest state-owned investment company in China. Until recently, much of SDIC's investment was in power projects, especially electricity-generation facilities. SDIC also has investments in port facilities, fertilizer production and financial services.

On March 5, 2008, SDIC announced that it intended to "focus on overseas investment and the financial sector in the next five years."[144] According to SDIC's general manager, Wang Huisheng, the company's planned overseas investment in 2008 was 7 billion yuan ($1 billion), mostly in infrastructure construction and resources-fueled industries.[145] More recently, however, it seems the SDIC has been refocused on providing capital to China's domestic energy companies and to help in the process of selling off selected state enterprises.

National Social Security Fund

In August 2000, China's State Council and the Central Committee of the Chinese Communist Party (CCP) created the National Social Security Fund (NSSF) "as a strategic reserve fund accumulated by the central government to support future social security expenditures."[146] The National Council for the Social Security Fund (NCSSF) was also created to manage the NSSF's assets. Capital for the NSSF is derived from the proceeds from reduction of state-owned shares, fiscal outlays, allocations made by the State Council, and returns on NSSF investments. Outlays

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[139] Alan Wheatley, "Tuft Wars Hobble China's Financial Markets," *Reuters*, April 28, 2008.

[140] "SAFE, not CIC, Makes Strategic Move on France's Total," *China Stakes*, April 8, 2008

[141] Leona Chen, op. cit.

[142] "China Investment Denies Rio Tinto Bid," *Xinhua*, November 27, 2007.

[143] SDIC's webpage in English is: http://www.sdic.cn/en/index.htm.

[144] "China's SDIC Plans Overseas Investment," *Xinhua*, March 5, 2008.

[145] "SDIC Eyes Overseas Investment," *China Business News*, March 6, 2008.

[146] Quote from NSSF's webpage: http://www.ssf.gov.cn/enweb/Column.asp?ColumnId=35.

for social security purposes are jointly determined with the Ministry of Finance and Ministry of Labor and Social Security. The NCSSF currently uses a number of external fund managers to manage the NSSF's investment decisions. The NSSF had assets worth 516 billion yuan ($73.7 billion) as of the end of 2007, including $1.66 billion in overseas investments.[147]

From 2003 to 2007, the NSSF realized an average rate of return on its investments of 10.7%.[148] In 2008, however, the NSSF suffered its first ever annual loss – a reported $5.7 billion – since its establishment in 2000.[149]

In February 2008, Zheng Bingwen, a scholar at the Chinese Academy of Social Sciences (CASS), one of China's premier thinktanks, suggested that China create a fund similar to Norway's Government Pension Fund.[150] According to Zheng, "CIC has sparked a new round of the China investment threat theory and a new wave of financial protectionism. We may hear fewer of those kinds of voices if we set up a sovereign pension fund to make investments in developed countries."[151] While Zheng's comments were unclear about the relationship between his proposed sovereign pension fund and the existing NSSF, he did suggest that the NSSF should increase its overseas investments, with a focus on neighboring nations.[152]

Implications for China

Besides offering a new vehicle for managing its foreign exchange reserves, the CIC was supposed to help China sterilize some of its excess liquidity. In 2007 and 2008, China experienced a major inflow of foreign exchange due to its merchandise trade surplus and the continuing stream of foreign direct investment. If the net inflow of foreign exchange was not "sterilized," the excess liquidity in China's money supply would have contributed to domestic inflation or a speculative bubble in China's domestic asset markets (principally the real estate and stock markets).[153]

Prior to the creation of the CIC, China had been absorbing some of the excess foreign exchange by issuing government bonds, and then purchasing foreign government debt—much of it U.S. Treasury bills—with the accumulated foreign exchange.[154] However, this was generating two economic forces considered undesirable by the Chinese government. First, to attract the foreign exchange away from its citizens, China was offering a relatively high rate of return on the government bonds, raising the cost of "sterilization." Second, because the rate of return was relatively high, overseas investors were attracted to the Chinese bonds, fostering an additional influx of foreign exchange. This influx of so-called "hot money" placed more pressure on China to appreciate its currency when there were already widespread claims that China's renminbi was

[147] Charlie Zhu and David Lin, "China Needs Sovereign Pension Fund - Govt Scholar," *Reuters*, February 28, 2008.

[148] "National Pension Fund Reports First Ever Loss," *China Daily*, February 24, 2009.

[149] Charlie Zhu and David Lin, "China Needs Sovereign Pension Fund - Govt Scholar," *Reuters*, February 28, 2008.

[150] Ibid.

[151] Ibid.

[152] Ibid.

[153] "Sterilization" is a process by which a government absorbs excess foreign exchange in circulation. One common method is by issuing government debt instruments in exchange for the foreign exchange.

[154] For more information on China's accumulation of U.S. debt, see CRS Report RL34314, *China's Holdings of U.S. Securities: Implications for the U.S. Economy*, by (name redacted) and (name redacted).

undervalued.[155] Ironically, the expectation that the renminbi would appreciate would tend to foster the inflow of even more "hot money," creating a potentially unstable speculative spiral.[156]

In addition, China's accumulation of U.S. debt has not been very profitable given the appreciation of the renminbi (RMB) against the U.S. dollar. For example, the yield on 10-year U.S. treasury bills fluctuated between 4.5% and 5.0% throughout 2007. However, the renminbi appreciated 6.0% relative to the U.S. dollar. As a result, the effective rate of return on U.S. treasury bills valued in Chinese currency was negative in 2007.[157] When evaluated in its domestic currency, China lost money on its investments in U.S. government debt in 2007.

In theory, the CIC offered a new avenue for the government to utilize the accumulated foreign exchange and possibly earn a positive rate of return on its investments. The sale of the "special treasury bonds" placed the foreign exchange in the hands of the CIC's investors, who could then invest the capital in domestic assets other than real estate or stocks, as well as foreign assets. In theory, this would reduce upward pressures on China's real estate and stock prices, lower China's investments in U.S. government debt, and generate positive yields on its investments in foreign assets.

The thinking behind the creation of the CIC failed to anticipate the U.S. financial crisis and the ensuing global economic recession. China's rising rate of inflation in early 2008 evaporated, to be replaced with a growing concern about the slowdown in overall economic growth. As a result, the need to "sterilize" the inflow of foreign exchange disappeared. At the same time, the inflow of "hot money" abated, partly because of the stabilization in the renminbi-U.S. dollar exchange rate, and partly due to a shift in international investor's attitudes towards risk.[158]

The rise in risk adversity also struck Chinese investors – including the CIC – in 2008. CIC Chairman Lou reported told a Hong Kong audience in late 2008 that the CIC was "not brave enough" to invest in foreign firms.[159] Instead, the CIC shifted its focus to domestic investments, injecting capital into several of China's state banks (see above), to stimulate economic growth. Premier Wen Jiabao reportedly pledged to "do whatever was necessary" to maintain economic growth at 8% in 2009, including using China's foreign exchange reserves.[160]

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[155] The name of China's currency is the "renminbi," or "people's currency." It is denominated in units called "yuan." On September 15, 2008, the exchange rate between the renminbi and the U.S. dollar was 6.8475 yuan = $1.

[156] For more information on China's "hot money" problems, see CRS Report RS22921, *China's "Hot Money" Problems*, by (name redacted) and (name redacted).

[157] For example, on January 1, 2007, the exchange rate was 1 yuan of RMB = 12.82 cents of U.S. dollars. If China had invested 100 billion yuan in one-year U.S. treasury bills on January 2, 2007, it would have been offered a return of 5.0%. After conversion into U.S. dollars, China would have invested $12.82 billion. At the end of the year, China would have been paid $13.461 billion by the U.S. Treasury for its investment. However, the exchange rate at the end of 2007 was 1 yuan = 13.59 cents. So, after converting the U.S. dollars back into RMB, China would have received the equivalent of 99.051 billion yuan for its investment—a loss of 949 million yuan, or a -0.9% return on its investment.

[158] There was a notable "flight to U.S. dollars" in 2008 as international investors became increasingly risk adverse, contributing to a strengthening of the U.S. dollar against many other currencies.

[159] Andrew Ross Sorkin (editor), "After Wall Street Losses, China Fund Said to Shift Focus," *New York Times*, February 20, 2009.

[160] Ching Cheong, "Tapping China's Huge Reserves Carries Risks," *The Straits Times*, February 13, 2009.

Implications for Global Financial Markets and the U.S. Economy

From a macroeconomic perspective, it is unclear how the arrival of the CIC will affect global financial markets. From a microeconomic perspective, the critical issue will be the types of investments the CIC makes. Furthermore, the entrance of CIC has invigorated discussion of how sovereign wealth funds are regulated, and what standards, or codes of procedure guide their operations.

Implicit in the creation of the CIC is a shift in China's overseas portfolio away from U.S. Treasuries and other sovereign debt into other assets. There has been some speculation that China may be considering shifting most of its $1.5 trillion in reserves to the CIC—if it manages its investments well.

According to some analysts, a shift in China's portfolio away from U.S. debt could put upward pressure on U.S. interest rates at a time when the Federal Reserve is trying to lower interest rates to prevent a possible economic recession.[161] With a reported daily trade volume of existing U.S. Treasuries of $600 billion,[162] a large divestment of U.S. Treasury holdings by China might also cause more severe market disruptions. However, there would be little impact on the exchange rate between the renminbi and the U.S. dollar because of China's policy of keeping the exchange rate within a narrow band.[163]

The arrival of a new investor with over $90 billion to invest initially attracted the interest of many major financial markets around the world. On October 26, 2007, Mayor of London (England) John Stuttard met with CIC Chairman Lou in China to lobby for the new SWF to set up a branch office in the City of London.[164] On November 22, 2007, Hong Kong's Chief Executive Donald Tsang met with representatives of the CIC in Beijing for similar discussions.[165] In early December 2007, Lou traveled to London, Paris, and Singapore for additional talks about possible CIC activity in those financial centers. Since the initial flurry of interest and talks, the CIC has neither opened overseas branches nor ventured significantly into any of these overseas equity markets.

However, CIC's Blackstone Group investment made some observers wary about the specific types of investments the new SWF will make. The observers were concerned that China might use the CIC to secure energy resources or purchase strategic assets for geopolitical purposes. There were also market apprehensions that the CIC could seek to increase its market share in important industries via targeted acquisitions or takeovers. Others were concerned that CIC might make investments in particular companies in order to obtain access to sensitive technology or information. These various forms of possible strategic investments fueled calls for international guidelines for SWFs, including China's CIC. In September 2008, following four months of

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161 For an analysis of the potential impact of a shift in foreign holdings of U.S. debt on the U.S. economy, see CRS Report RL32462, *Foreign Investment in U.S. Securities*, by (name redacted).

162 Liz Moyer, "Cornering the Bond Market?," *Forbes*, September 28, 2006.

163 For more information on China's exchange rate policy, see CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by (name redacted) and (name redacted).

164 Mao Jilun and Li Weitao, "City of London Woos China Investment Corp," *China Daily*, October 26, 2007.

165 Carol Chung and Carrie Chan, "Stock Scheme on Agenda at Tsang Chat with PBOC," *The Hong Kong Standard*, November 22, 2007.

negotiations and several international meetings, members of the newly-formed International Working Group of Sovereign Wealth Funds (which included CIC and the United States) agreed to a voluntary code of conduct at meetings in Santiago, Chile.[166]

Initially, there were indications that the global financial markets were ill-prepared for the introduction of its $70 billion into the marketplace. Shares in the Hong Kong stock market rose in October 2007 in response to rumors that the CIC had secretly invested in Hong Kong stocks. There was a similar jump in the Tokyo stock market following rumors that the CIC was considering investing in undisclosed Japanese companies.[167] Plus, rumors in November 2007 that the CIC was a party to a consortium of Chinese companies planning to bid on Australia's mining company, Rio Tinto, led to a one-day 7.5% rise in the share price of Rio Tinto and a 4.5% rise in the share price of its other alleged suitor, BHP Billiton, despite repeated denials by CIC representatives.[168] CIC continued to be mentioned as a possible party in rumored investments throughout the summer and fall of 2008, including stories linking CIC with possible investments in Australia's Fortesque Metals Group, Germany's Dresdner Bank, Sweden's Nordea, a major financial services group, and unknown Japanese equities.[169] However, since the onset of the global economic recession, there have been signs that attitudes have shifted, and market analysts and equity markets would now welcome a major investment by the CIC.

There are also apprehensions about the potential for abuse or corruption created by the greater proximity SWFs create between governments and the private sector. As the existing investments of the CIC reveal, there is a growing network of interlinked investments between banks and other financial firms within China and overseas. Some U.S. financial analysts have expressed concern that CIC's investment in Morgan Stanley will provide the U.S. financial firm unfair preferential access to China's domestic financial markets. Others are worried that China will place pressure on overseas financial firms in which it has invested to provide more positive and optimistic assessments of China's economic prospects and the financial status of major Chinese companies courting international investors.

Multilateral Responses to SWFs

Misgivings about the potential impact of the CIC and other SWFs on financial markets and local economies are fostering calls for multilateral organizations to develop greater monitoring procedures and regulations of SWF investments. In June 2007, then-U.S. Treasury's Assistant Secretary for International Affairs, Clay Lowery, called on the IMF and the World Bank to develop guidelines for sovereign wealth funds.[170] Following a meeting of their finance ministers

[166] CRS Report RL34336, *Sovereign Wealth Funds: Background and Policy Issues for Congress*, by (name redacted).

[167] "Shares Rally on Signs of US Retail Strength," *Reuters*, November 27, 2007.

[168] The flow of "hot money" into China has apparently abated or possibly reversed in the last few months. For more information see Michael Pettis, "China: Hot Money Inflows Down, Nervousness Up," *Seeking Alpha*, October 15, 2008.

"China Investment Denies Involvement in Alleged Rio Tinto Bid," *CNN*, November 26, 2007; "China Investment Denies Rio Tinto Bid," *Xinhua*, November 27, 2007.

[169] "CIC, China Shenhua Plan to By 15.85% of Australia's Fortesque," *China Business News*, February 11, 2008; "China Sovereign Fund Denies Report on Dresdner Bank Acquisition," *MarketWatch*, March 27, 2008; "CIC Interested in Buying Nordea's Stake," *China Business News*, March 7, 2008; and "China Investment Corp to Start Investing in Japan Stocks, *China Daily*, September 1, 2009.

[170] Lynch, op. cit.

in October 2007, the G-7 nations asked the IMF, the World Bank, and the Organization for Economic Cooperation and Development (OECD) to develop a set of "best practices" for SWFs to follow.[171] The IMF formed the International Working Group of Sovereign Wealth Funds (IWG) to develop guidelines for SWFs. In addition, the OECD is working on a parallel project to provide recipient countries with suggested guidelines for handling SWF investments as part of their ongoing "Freedom of Investment" project.[172] Also, individual nations are considering implementing laws and regulations governing SWFs. For example, the Indian government is examining the need for a special investment framework for SWFs because "even a trickle from these funds could have huge ramifications for the Indian stock markets and the economy on the whole."[173]

Role of the IMF

The IMF has responded to the calls of Lowery and others, initiating "a dialogue among and with SWFs, with the goal of identifying best practices."[174] In November 2007, the IMF held a roundtable discussion on SWFs involving representatives of key IMF members (including the United States) and several major SWFs (including CIC). On February 29, 2008, the IMF released a "Work Agenda" on SWFs that "set out ways to improve the Fund's surveillance over the operations of SWFs" and examined "the issues surrounding the development of a set of best practices which would provide guidance on how to improve institutional arrangements, organizational structures and risk management, and information dissemination practices."[175] The report concludes with recommended "next steps" for the IMF including the establishment of an international working group of SWFs to meet in April 2008 to began drafting a set of best practices, with the goal of completing the first draft by August 2008.[176] On May 1, 2008, the IMF announced the formation of the International Working Group of Sovereign Wealth Funds (IWG), comprised of representatives of 25 IMF member countries, including China and the United States.[177] The OECD and the World Bank participate as permanent observers to the Working Group.

Initially, Chinese officials and CIC representatives were somewhat critical of the IMF project. In January 2008, deputy administrator for China's State Administration of Foreign Exchange (SAFE) Wei Benhua contrasted the financial arrangements of SWFs to those of hedge funds, stating, "SWFs rarely make investment with leverage, and thus will not cause the imbalance of the international financial system."[178] Wei went on to say, "The newly-formed CIC, since its birth, has attracted lots of attention from the international community. A few nations, on purpose, disseminate the argument of China's investment threat. The international community should

[171] "Statement of G7 Finance Ministers and Central Bank Governors," Washington, October 19, 2007; available online at http://www.dt.tesoro.it/Aree-Docum/Relazioni-/G7-e-gli-a/G7/Documentaz/2007/G7-Finance-Ministers-Meeting-October-2007.pdf. The G-7 nations are Canada, France, Germany, Great Britain, Italy, Japan, and the United States.

[172] For more information on the OECD's "Freedom of Investment" project, see http://www.oecd.org/document/62/0,3343,en_2649_33783766_38760254_1_1_1_1,00.html.

[173] "Government Wakes Up after China Floats $200 Bn Fund," *The Economic Times*, November 22, 2007.

[174] "Sovereign Wealth Funds—A Work Agenda," *International Monetary Fund*, February 29, 2008.

[175] Ibid.

[176] Ibid.

[177] "International Working Group of Sovereign Wealth Funds is Established to Facilitate Work on Voluntary Principles," IMF Press Release No. 08/97, May 1, 2008.

[178] "China SWF: We Behave Better than Hedge Funds," *China Stakes*, January 9, 2008.

clearly oppose different forms of investment protectionism and financial protectionism."[179] In March 2008, CIC executive vice president Wang referred to the G-7 proposal as "unfair."[180] Wang went on to say, "The claim that sovereign wealth funds are causing threats to state security and economic security is groundless. We don't need outsiders to come tell us how we should act."[181] During an interview on CBS's "60 Minutes," CIC president Gao said that the proposed IMF guidelines were "stupid" and would lead to "hurt feelings."[182]

Despite their apparent misgivings about the IMF project, China and the CIC decided to participate in the IMF's IWG. In addition to attending the November 2007 roundtable, China also made public statements supportive of the development of international standards for SWFs. Minister of Foreign Affairs Yang Jiechi stated that "the good use of SWF according to all international regulations should benefit all parties involved," but also noted that "all stakeholders should work together to make the rules."[183]

On September 2, 2008, following two days of meetings in Santiago, Chile, the IWG announced it had reached a preliminary agreement on a draft set of 24 voluntary principles and practices for sovereign wealth funds.[184] Although the IWG did not at that time release copies of the "Generally Accepted Principle and Practices for Sovereign Wealth Funds (GAPP)," it did state its hope that the document "will promote a clearer understanding of the institutional framework, governance, and investment operations of SWFs, thereby fostering trust and confidence in the international financial system."[185] The IWG presented the GAPP to the IMF's International Monetary and Financial Committee (IMFC) meeting held on October 11, 2008, in Washington, DC, and released the entire GAPP – also known as the Santiago Principles – to the public.[186]

Following the IWG's announcement in September 2008, the CIC stated that it intended to abide by the GAPP's provisions.[187] This will probably require some changes in CIC's relationship with CHIC, as CHIC engages in some policy activities (such as injected capital into state-owned banks) that violate the GAPP. However, there had already been earlier in the summer of 2008 some indications of a possible change in the CIC-CHIC relationship, including a possible separation.[188]

Two of the key issues motivating the possible separation are the desire to avoid potential regulatory problems and a clarification of the roles of CHIC and CIC. The licenses for CCB and ICBC branches in New York City were reportedly delayed in part because of the combined shareholdings of CIC and CHIC in the two banks.[189] In August 2008, the U.S. Federal Reserve

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179 Ibid.

180 Victoria Ruan, "China's Investment Fund Pushes Back," *Financial Times*, March 7, 2008.

181 Ibid.

182 Video of Gao's interview available at"60 Minute's webpage:
http://www.cbsnews.com/stories/2008/04/04/60minutes/main3993933.shtml.

183 "China Wants to Help Draft the SWF Investment Rules," *China Stakes*, March 13, 2008.

184 "International Working Group of Sovereign Wealth Funds Reaches a Preliminary Agreement on Draft Set Generally Accepted Principles and Practices - 'Santiago Principles,'" IWG Press Release No. 08/04, September 2, 2008.

185 Ibid.

186 The text of the GAPP is available online at http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf.

187 "CIC Ready to Accept a SWF Code of Conduct," *China Stakes*, September 3, 2008.

188 "A Simmering CIC-Huijin Separation," *China Stakes*, July 8, 2008.

189 Ibid.

informed the CIC that it could not subsidize loans for its companies via an ICBC branch in New York City.[190] Also, if the two investment agencies are separated, it is expected that CIC will remain primarily an investor in overseas assets, while CHIC will become an administrator of state-owned financial assets—such as ABC, BOC, CCB, CDB, and ICBC.

OECD Guidelines for Recipient Countries

In April 2008, the OECD's Investment Committee released its report, "Sovereign Wealth Funds (SWFs) and Recipient Country Policies," spelling out principles and policy guidelines for "fair treatment of SWFs."[191] On June 5, 2008, the Ministers of the OECD countries adopted a declaration on SWFs that "welcomed" the report of the Investment Committee and endorsed several policy principles, including: (1) opposition to the erection of "protectionist barriers to foreign investment;" (2) non-discriminatory treatment for foreign and domestic investors; and (3) investment safeguards for national security concerns should be transparent, proportional, and subject to accountability.[192] On October 8, 2008, OECD members – including the United States – adopted what was termed the "first tranche" of guidance on recipient country policies towards SWFs, which included the OECD Ministers' June 5 declaration and the Investment Committee's report, as well as additional guidelines on recipient country policies related to national security. The OECD intends to release a final report on guidelines for investment policies for recipient countries by mid-2009. The final report is to include a list of "best practices," and "if appropriate, suggestions for clarifications to existing OECD instruments."

The Investment Committee report recommended that recipient countries abide by five investment policy principles: (1) Non-discrimination; (2) Transparency; (3) Progressive liberalization; (4) "Standstill;"[193] and (5) Unilateral liberalization. The report also contained a list of investment policy guidelines for recipient countries, including:

- Similar treatment for similarly situated investors;
- Codification and publication of investment laws and regulations;
- Prior notification to changes in investment policies;
- Consultation on possible investment policy changes;
- Procedural fairness and predictability; and
- Disclosure of investment policy actions.

On the issue of "national security" concerns, the OECD Investment Committee recognized that "each country has a right to determine what is necessary to protect its national security," but recommended that in making this determination, countries should keep a "narrow focus" in their investment restrictions, use appropriate expertise to make national security determinations, tailor

[190] Scott Lanman, "Fed Sets Limits on ICBC Loans to China Fund-Owned Companies," *Bloomberg*, September 4, 2008.

[191] "Sovereign Wealth Funds and Recipient Country Policies," *OECD Investment Committee Report*, April 4, 2008.

[192] "OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies," Meeting of the Council at Ministerial Level, June 4-5, 2008.

[193] "Standstill" refers to the concept that no nation could withdraw or retreat from a previously made commitment.

their responses to the specific risks posed by a proposed investment, and block investments only as a "last resort" when national security-related concerns cannot be eliminated.

In addition to developing investment policy principles and guidelines, the OECD is holding regular meetings among its members to conduct peer reviews of their investment policies.[194] While the group does not have the authority to alter or amend member investment policies, the presentations are subject to what Ervin referred to as the "red face" test.[195] In response to a question on the OECD's understanding of the meaning of "national security," Ervin indicated that there is a clear consensus that it included military risks, government procurement and "critical infrastructure," but also recognized that each OECD member had to make the determination of what constituted a risk to national security. Ervin also stated that the OECD thinks that members should strive to keep their definitions of national security as narrow as possible.

Congressional Initiatives

The 110th Congress took action regarding the monitoring and regulation of foreign investment in the United States. The "Foreign Investment and National Security Act of 2007" (P.L. 110-49) requires that the Committee on Foreign Investment in the United States (CFIUS) investigate any foreign investment transaction (including mergers, acquisitions, or takeovers) which results in "foreign control of any person engaged in interstate commerce in the United States" or if the transaction would result in foreign control of "critical infrastructure that could impair the national security."[196] The new law also adds new criteria for CFIUS to use when determining if an investigation is warranted, including whether the transaction is a "foreign government-controlled transaction."[197] In addition, P.L. 110-49 increases congressional oversight of CFIUS by requiring more detailed reports on its operations and the results of its investigations. However, the authority to suspend or prohibit foreign investments in the United States remains with the President.

Even with the passage of P.L. 110-49, some Members of the 110th Congress were concerned that the new law may not sufficiently protect the United States from the risks posed by the emerging SWFs. In a February 2008 letter to their fellow Senate Banking Committee members, Chairman Christopher Dodd and Ranking Member Richard Shelby indicated their willingness to consider appropriate legislation.[198] In an editorial opinion published in the *Wall Street Journal*, Senator Evan Bayh wrote, "... China's drive for economic advantage—including rampant intellectual property theft, currency manipulation, and subsidies for manufacture and export—raise serious concerns about how sovereign wealth funds might be used."[199] Senator Bayh also suggests that

[194] Information obtained from an OECD Breakfast Series presentation by Carolyn Ervin, Director for Financial and Enterprise Affairs, OECD, on April 11, 2008.

[195] Ervin's "red face" test refers to the notion that no participant would be willing to present an investment policy that would subject him or her to public embarrassment.

[196] For more information about the Foreign Investment and National Security Act of 2007and CFIUS, see CRS Report RL33388, *The Committee on Foreign Investment in the United States (CFIUS)*, by (name redacted).

[197] According to Section 2 of P.L. 110-49, "The term 'foreign government-controlled transaction' means any covered transaction that could result in the control of any person engaged in interstate commerce in the United States by a foreign government or an entity controlled by or acting on behalf of a foreign government."

[198] Christopher G. Kelley and Robert J Burns, "Sovereign Wealth Funds, Corporate Liquidity Problems, and the Foreign Investment and National Security Act of 2007," *The Metropolitan Corporate Council*, March 2008, page 22.

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

the CFIUS 10% review threshold may not be a sufficient standard, and calls for the United States to implement a "passive investment" requirement on SWF investments.[200]

Some commentators maintain that while P.L. 110-49 effectively dealt with the *national security risks* posed by foreign investments, it did not adequately mitigate against the *economic security risks*. In his November 14, 2007 testimony before Senate Committee on Banking, Housing, and Urban Affairs, Edwin M. Truman mentioned that "some observers" are concerned about the stability implications for the U.S. economy and financial systems of SWF investments in "private equity firms, hedge funds, and regulated financial institutions."[201] There have been suggestions that the United States should prohibit a SWF from investing in the United States unless its home nation meets certain criteria, such as those proposed by Truman and Garten.

On September 5, 2007, the House of Representatives passed H.Res. 552 (110th Congress) by a vote of 401 to 4, which included a reciprocity requirement that "United States financial service regulators, in assessing whether applications from Chinese financial institutions meet comprehensive consolidated supervision standards, should consider whether the applications are for operations and activities in the United States that are currently prohibited for United States financial institutions in China ..." However, others warn that such restrictions could lead to a wave of financial protectionism that would cause undue damage to the U.S. economy.

Since the creation of the CIC, Congressional committees have held several hearings the SWFs in general. These have included:

- Senate Committee on Banking, Housing, and Urban Affairs hearing, "Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the U.S.: Assessing the Economic and National Security Implications," November 14, 2007;
- Joint Economic Committee hearing, "Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks?," February 13, 2008;
- House Financial Services Subcommittee on Domestic and International Monetary Policy, Trade and Technology, and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises hearing, "Foreign Government Investment in the U.S. Economy and Financial Sector," March 5, 2008; and
- House Financial Services Subcommittee on Domestic and International Monetary Policy, Trade, and Technology hearing, Sovereign Wealth Funds: New Challenges from a Changing Landscape," September 10, 2008.

In addition, the U.S.-China Economic and Security Review Commission[202] held a hearing, "The Implications of Sovereign Wealth Fund Investments for National Security," on February 7, 2008.

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[200] Ibid.

[201] Edwin M. Truman, "Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications," Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, November 14, 2007.

[202] The Commission was created on October 30, 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 (P.L. 106-398, as amended by P.L. 109-108). The commission is to focus its work and study on eight areas: proliferation practices, economic transfers, energy, U.S. capital markets, regional economic and security impacts, U.S.-
(continued...)

On February 27, 2008, Representatives Jim Moran and Tom Davis announced the formation of a "new bipartisan task force to explore sovereign wealth funds (SWF)."[203] According to a press release from Representative Moran's office, the SWF task force "will study issues surrounding SWFs including their potential to affect geopolitics, and the U.S. and international economy." The SWF task force includes designated members from the House Ways and Means Committee and the House Financial Services Committee.

Congressional Considerations

The initial reaction of the Bush administration to the CIC's creation was generally favorable. President Bush reportedly said that he was "fine" with foreign investors buying shareholdings in U.S. banks and financial firms.[204] U.S. Treasury Undersecretary for International Affairs David McCormick commented the investments of SWFs have "largely been long-term, very commercially focused, and very stable," but also indicated that more transparency and governance was needed.[205] To that end, the Bush administration pushed the IMF to develop a system of best practices for SWFs.[206]

There have been no direct policy statements from the Obama administration on sovereign wealth funds or the CIC. As a presidential candidate, President Obama stated, "I am concerned if these … sovereign wealth funds are motivated by more than just market considerations, and that's obviously a possibility."[207]

As previously mentioned, P.L. 110-49 broadened the investigatory authority of CFIUS in cases of national security risk, and increased the committee's reporting requirements to Congress. However, there have been suggestions that the recent changes do not adequately protect the United States from economic risks posed by SWFs. These potential economic risks are seen as including financial market instability, undesirable foreign control or influence over key industries or companies, access to sensitive technology, and other forms of unfair competitive advantages. Among the regulatory changes being suggested are:

- Requirements that any SWF interested in investing in the United States publicly release audited financial statements that follow international accounting standards on a regular basis;
- Restrictions on the percentage of a U.S. company an SWF may own—other nations have such limits; for example, Hong Kong authorities have said they may withdraw the authority of Standard Chartered Bank to issue Hong Kong currency if the share of its stock owned by a Singaporean SWF exceeds 20%;

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China bilateral programs, WTO compliance, and the implications of restrictions on speech and access to information in the People's Republic of China.

[203] "Moran Unveils Sovereign Wealth Funds Task Force," press release, Office of Representative Jim Moran, February 27, 2008.

[204] Michael Richardson, "Barriers to Trust: Sovereign Wealth Funds Must Become More Transparent to Avoid Causing Alarm," *South China Morning Post*, December 29, 2007.

[205] Ibid.

[206] Francis, op. cit, and Lynch, op. cit.

[207] "Obama Says Concerned about Sovereign Wealth Funds," *Reuters*, February 7, 2008.

- Restrictions on the type of investment SWFs may make in U.S. companies—alternatives include restricting SWFs to the purchase of nonvoting shares, banning SWFs from negotiating a seat on the company's board of directors or representation in the company's senior management; and
- Changes in U.S. tax code—under current U.S. law, the profits of SWFs are generally tax-exempt; it has been suggested that the tax-exemption for SWFs be eliminated or restricted.

In addition, there have been suggestions that access to U.S. financial markets should be contingent on the successful conclusion of a reciprocity agreement that would allow U.S. banks and financial institutions comparable access to the other nation's investment and financial markets.

However, some commentators are concerned that increasing the regulatory constraints on SWFs will precipitate a period of global financial protectionism.[208] In addition, China might respond to additional restrictions on Chinese investments in the United States by restricting U.S. companies' access to China's financial markets. The issue is whether the value of protection obtained outweighs the forgone benefits of investments prevented in more restrictive global and/or Chinese financial markets.

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[208] Truman, op. cit.