

CRS Report for Congress

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.

Although many 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, seeking to maximize the return on investment. Since its creation, the CIC and its subsidiaries have already made several investments, including the purchase of 9.9% of the U.S. financial firm, Morgan Stanley, on December 19, 2007.

According to top Chinese officials, the CIC was created to improve the rate of return on China's \$1.5 trillion in foreign exchange reserves and to soak up some of the nation's excess financial liquidity. Depending on its performance with the initial allotment of \$200 billion, the CIC may be allocated more of China's growing stock of foreign exchange reserves.

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 potentially could 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 cause harm to the U.S. economy or global financial markets.

Despite China's reassurances, there have been calls for greater oversight and regulation of the activities of SWFs. A senior official in the Bush administration has called on the International Monetary Fund and the World Bank to develop guidelines for SWFs. 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 requirement, limits on SWF ownership of U.S. companies, and restrictions on the types of equity investments SWFs can make in U.S. companies.

This report will be updated as circumstances warrant.

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China's Sovereign Wealth Fund

Introduction

China announced in March 2007 that it would be creating a sovereign wealth fund (SWF) in the near future as a vehicle 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 \$3 billion non-voting stake in Blackstone Group, a U.S. private equity firm. After a few delays, China's new sovereign wealth fund — the China Investment Corporation (CIC) — officially started operations on September 29, 2007.

The CIC may prove 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 could arguably 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

Country	Fund	Size (\$ Billion)	Year Created
United Arab Emirates	Abu Dhabi Investment Authority (ADIA)	500 - 875	1976
Singapore	Government of Singapore Investment Corporation (GIC)	100 - 330	1981
Norway	Government Pension Fund - Global (GPF)	308	1990
China	China Investment Corporation, Ltd. (CIC)	200	2007
Kuwait	Future Generations Fund	174	1976
Russia	Stabilization Fund for the Russian Federation	122	2004
Singapore	Temasek Holdings	108	1974

Source: Edwin Truman, "Sovereign Wealth Funds: The Need for Greater Transparency and Accountability," Peterson Institute for International Economics, August 2007.

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.) For more information on sovereign wealth funds in general, see CRS Report RL34336, *Sovereign Wealth Funds: Background and Policy Issues for Congress*, by Martin Weiss.

With an initial capital fund of \$200 billion, the CIC is a significant new addition to the existing pool of SWFs (see **Table 1**). The CIC augments the over \$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 \$1.5 trillion as of December 2007.² Also, the conversion of the foreign exchange reserves into capital for the CIC may help mop up some of the excess financial liquidity in China that is reportedly contributing to China's recent inflationary pressures.³

However, China's decision to create the CIC has reawakened some concerns about the impact of SWFs on global financial markets and engendered new misgivings about China's involvement in the 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."⁴ 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."⁵ In June 2007, Clay Lowery, U.S. Treasury'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."⁶

Although the current value of CIC's working capital is small when compared to global capital flows, China could increase the size of CIC to over \$1 trillion if it makes more of its foreign exchange reserves available. The growth potential of CIC may prove important because, according to Setser, somebody with a working capital of \$1 trillion dollars (such as the CIC) would have the ability to push the U.S. economy into a recession.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 as U.S. Treasury bills (T-

² According to China's State Administration of Foreign Exchange (SAFE), its foreign exchange reserves as of the end of December 2007 totaled \$1.53 trillion; monthly data are provided on SAFE's webpage — [<http://www.safe.gov.cn>].

³ 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>].

⁴ David R. Francis, "Will Sovereign Wealth Funds Rule the World?," *The Christian Science Monitor*, November 26, 2007.

⁵ Adam Davidson, "U.S. Watches Nervously as Oil-Rich Nations Invest," *Morning Edition*, National Public Radio, November 30, 2007.

⁶ David J. Lynch, "U.S.: Secretive Global Funds May Hurt Treasuries Market," *USA Today*, June 21, 2007.

⁷ Davidson, op. cit.

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 As a result, most analysts expect the CIC to invest in equities and/or acquisitions in order to obtain higher rates of return on their investments.

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.”⁹ Surowiecki’s 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.¹⁰ 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.¹¹ In the opinion of 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.”¹²

However, others are less apprehensive about the potential impact of SWFs on the global economy. Rogoff thinks the SWFs will do “more good than bad.”¹³ 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.”¹⁴ 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.”¹⁵

The investment activities of several SWFs, including the CIC, since the outbreak of the subprime-mortgage crisis tend to support the views of Rogoff, Surowiecki and Keat. Struggling major financial firms have 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

⁸ Lynch, op.cit.

⁹ James Surowiecki, “Sovereign Wealth World,” *The New Yorker*, November 26, 2007.

¹⁰ Francis, op cit.

¹¹ Ibid.

¹² 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.

¹³ Ibid.

¹⁴ Surowiecki, op. cit.

¹⁵ Davidson, op. cit.

billion of loss-making mortgage investments.¹⁶ 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.¹⁷ During a period of global market uncertainty, SWFs appear to be providing a source of stability.

Policy Responses to SWFs

In response to the perceived potential risks posed by the SWFs of China and other nations, there has been discussion about ways to regulate or monitor the activities of SWFs, including China's CIC. Edwin Truman, of the Peterson Institute for International Economics, maintains that "a strong case can be made for a collective effort to establish an internationally agreed standard to guide management by governments of their cross-border investments."¹⁸ According to Truman, the international standards should cover four topics — 1. Objectives and investment strategy; 2. Governance; 3. Transparency; and 4. Behavior. Jeffrey Garten, professor at the Yale School of Management and former Undersecretary of Commerce for International Trade, also sees a need for rules to regulate SWFs, echoing Truman's call for greater transparency, and adding reciprocity and ownership guidelines to the list of topics to be included in the international standards.¹⁹ In June 2007, U.S. Treasury's Assistant Secretary for International Affairs, Clay Lowery, called on the International Monetary Fund and the World Bank to develop guidelines for sovereign wealth funds.²⁰

Congress recently 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."²¹ 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

¹⁶ "China Fund Grabs Big Stake in Morgan Stanley," *AFP*, December 19, 2007

¹⁷ Aaron Kirchfeld, "Sovereign Funds Beat Buffett with Stakes in Citigroup, Merrill," *Bloomberg*, January 22, 2008.

¹⁸ Edwin Truman, "Sovereign Wealth Funds: The Need for Greater Transparency and Accountability," Peterson Institute for International Economics, August 2007.

¹⁹ Jeffrey Garten, "We Need Rules for Sovereign Funds," *The Financial Times*, August 7, 2007.

²⁰ Lynch, *op. cit.*

²¹ For more information about the Foreign Investment and National Security Act of 2007 and CFIUS, see CRS Report RL33388, *The Committee on Foreign Investment in the United States (CFIUS)*, by James K. Jackson.

government-controlled transaction.”²² 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.

Despite the passage of P.L. 110-49, there are commentators that do not believe the new law sufficiently protects the United States from the risks posed by the emerging SWFs. Some 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, 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.”²³ 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.

Administrative Details 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

²² 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.”

²³ 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.

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.

Investment Company (CHIC), which will provide capital to domestic financial firms; 2. China Jianyin Investment, which will manage domestic assets and the disposal of non-performing loans; and 3. A new department to manage overseas investments.²⁵

CIC's Management Team

The investment activities of the CIC is to be directed by an 11-member board of directors. The chairman of the CIC's board is Lou Jiwei, China's former deputy finance minister and former State Council deputy secretary general. The CIC's general manager is Gao Xiqing, vice chairman of China's national pension fund and also one of CIC's executive directors. Other people serving in CIC's top management include:

- Zhang Hongli, another of CIC's executive directors and vice minister of finance;
- Fu Ziyang, assistant minister of commerce;
- Hu Xiaolian, deputy governor of the People's Bank of China (PBC) and Administrator of SAFE;
- Li Yong, vice minister of finance;
- Liu Shiyu, deputy governor of the People's Bank of China ;
- Wang Chunzheng, ex-vice minister of the National Development and Reform Commission (NDRC);
- Liu Zhongli, former minister of finance; and
- Zhang Xiaoqiang, vice minister of NDRC.²⁶

The final member of the board is to be elected by the company's employees. Initial reports indicate the CIC is to have a staff of about 1,000 employees, including 100 to 200 investment specialists.²⁷ Many of CIC's workers will come from the absorption of CHIC and China Jianyin Investment. In the first few months following the formation of the CIC, its chief spokespeople have been Lou Jiwei and Li Yong.

CIC's Working Capital

The working capital for the CIC is coming indirectly from China's approximately \$1.5 trillion in foreign exchange reserves. 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 is to be responsible for servicing the newly-created debt — at an estimated cost of \$40 million per day.²⁸

²⁵ Pettis, *op. cit.*

²⁶ "China's Trillion-dollar Kitty is Ready," *Asia Times*, October 2, 2007.

²⁷ "China's Forex Investment Company May Debut this Week," *Xinhua*, September 10, 2007.

²⁸ Cost of debt estimate based on a statement by CIC Chairman Lou.

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.²⁹ The 10-year bonds had a coupon value of 4.3%.³⁰ A second tranche of bonds worth 103 billion yuan (\$13 billion) was sold to the Chinese public in mid-September. The September bonds were a mixture of 10- and 15-year bonds with coupon rates ranging from 4.46% to 4.68%.³¹ A third tranche worth 96 billion yuan (\$12 billion) was sold to the public during November and December, again with varying maturation periods of 10 and 15 years, with coupon rates of 4.5%.³² 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%.³³

In converting 1.55 trillion yuan of 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 soaking up 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 are yet to be determined. According to Jesse Wang, a member of the CIC's preparatory group, "The mission for this company [CIC] is purely investment-return driven."³⁴ However, the actual meaning of "purely investment-return driven" is open to interpretation depending on the investor's level of risk aversion. Recent developments appear to indicate that the CIC may be a fairly "risk adverse" investor, both economically and politically. In addition, recent statements by senior CIC executives indicate that it wishes to avoid unnecessary controversies when selecting investments.

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 is publicizing CIC-related activities, it is often difficult to obtain specific information about investment

²⁹ The PBoC cannot directly purchase bonds from China's Ministry of Finance, so it used the ABC as an intermediary in the financial transaction.

³⁰ Rachel Ziemba, "How is China Funding the Chinese Investment Corporation (CIC)?" *RGE Analysts' Economonitor*, December 5, 2007.

³¹ *Ibid.*

³² *Ibid.*

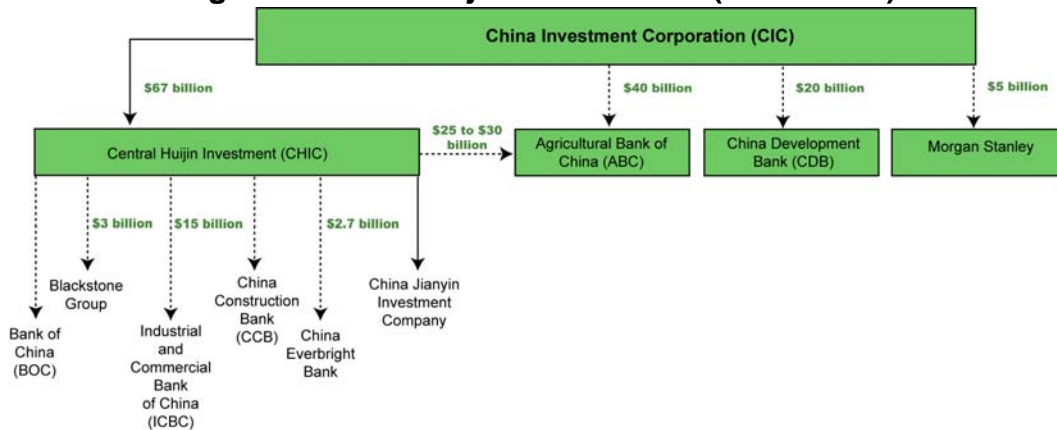
³³ "China Central Bank Takes Up 750 Bln Yuan in T-bonds to Fund CIC," *AFX News Limited*, December 10, 2007.

³⁴ Jason Dean and Andrew Batson, "Beijing to Take Passive Investment Approach," *Wall Street Journal* (Europe), September 10, 2007.

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. 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. **Figure 1** provides an overview of CIC's current direct and indirect investments, based on available news reports.

The investment options of the CIC are constrained in part by previous commitments made before the formal start of its operations. On May 20, 2007, China Jianyin Investment Company, a wholly-owned subsidiary of the Central Huijin Investment Company (CHIC), signed an agreement to purchase a less than 10% stake in Blackstone Group in non-voting shares worth \$3 billion.³⁵ The decision to purchase less than 10% of Blackstone's shares, and to purchase non-voting 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."³⁶

Figure 1. CIC's Major Investments (as of 12/07)



Source: CRS research

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 is reported that the PBoC obtained about 500 billion yuan (\$67 billion) in compensation for the CHIC.³⁷ This transaction utilized approximately one third of the CIC's working capital. As a result, the CIC became the parent company for CHIC and China Jianyin Investment Company, plus owner of \$3 billion in Blackstone Group stock. In addition, CIC indirectly became a major stock holder in China Construction Bank

³⁵ "China to Invest \$3 Bln in Equity Giant Blackstone," *Xinhua*, May 21, 2007.

³⁶ *Ibid.*

³⁷ "\$200 Billion Investment Firm Starts Operation," by Xin Zhiming, *China Daily*, October, 1, 2007.

(CCB) and the Industrial and Commercial Bank of China (ICBC) by way of the investments of CHIC and China Jianyin Investment Company in those two banks.³⁸

Also in November 2007, a decision was made that the CIC was to provide capital totaling a reported \$67 billion to two of China's state-owned banks, the Agricultural Bank of China (ABC) and the China Development Bank (CDB).³⁹ 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.⁴⁰ Other sources reported that a financial restructuring plan for the ABC submitted to the State Council for approval was to be announced in late 2007, and the plan would include \$40 billion from the CIC, possibly through the newly acquired CHIC.⁴¹ 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.⁴² As a result, it is uncertain exactly when and how much the CIC has invested in the ABC.

More details of the CIC's investment in the CDB were announced on the final day of 2007. CIC's subsidiary, the CHIC, signed an agreement on December 31, 2007, to invest \$20 billion into the CDB.⁴³ According to CIC chairman Lou, the actual capital injection would take place "soon," but no exact date was provided.⁴⁴

The CIC has reportedly made two other major investments since its establishment. On November 21, 2007, the CIC supposedly announced plans for its first post-inaugural investment — the purchase of \$100 million in shares of Hong Kong's initial public offering for the new China Railway Group (CRG).⁴⁵ China Railway Group is a railway construction company in China, and reportedly the one of the largest construction companies in the world. The Government of Singapore

³⁸ 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.

³⁹ "China Investment Co to Invest a Third of Its 200 Bln USD 'Cautiously' — Official," *AFX News Limited*, November 7, 2007.

⁴⁰ Yidi Zhao and Janet Ong, "Chinese Banks to get \$67 Billion from Sovereign Wealth Fund," *International Herald Tribune*, November 8, 2007.

⁴¹ "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.

⁴² "Agricultural Bank of China Denies Shareholding Reform Approval Rumor," *Xinhua*, December 5, 2007.

⁴³ Xin Zhiming, Huijin to Inject \$20b into China Development Bank," *China Daily*, December 31, 2007.

⁴⁴ *Ibid.*

⁴⁵ Jamil Anderlini, "CIC to Buy Stake in HK Rail Group Float," *The Financial Times*, November 21, 2007.

Investment Corporation, another SWF, reportedly also bought shares in CRG.⁴⁶ Then, on December 19, 2007, the CIC purchased “around 9.9%” of Morgan Stanley, one of the largest U.S. investment banks.⁴⁷ The CIC investment in Morgan Stanley amounted to \$5 billion. Morgan Stanley stressed that the CIC will have “no special” rights of ownership and no role in corporate management.⁴⁸

CIC’s newly-acquired subsidiary, the CHIC, also has been making investments. 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 1992.⁴⁹ On November 28, 2007, the shareholders of China Everbright Bank agreed to accept a 20 billion yuan (\$2.7 billion) capital injection from the CIC.⁵⁰ The CIC’s financial support to China Everbright Bank reportedly will be sufficient for it to go ahead with its planned initial public offering (IPO) on the Hong Kong Stock Exchange (HKSE) and China’s A-share stock market.⁵¹ On December 5, 2007, China Everbright Bank announced that it is planning on holding its IPO in June or July of 2008.⁵²

Overall, the reported existing direct and indirect investments of the CIC total about two-thirds of its total working capital, leaving about \$70 billion available for future investments. So far, most of 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.⁵³ Similarly, the payment to the PBoC for the CIC’s acquisition of 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.

CIC’s Future Investments

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 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

⁴⁶ “CIC Invests in China Railway IPO,” *China Economic Review*, November 21, 2007.

⁴⁷ “China Fund Grabs Big Stake in Morgan Stanley,” *AFP*, December 19, 2007.

⁴⁸ *Ibid.*

⁴⁹ Mao Lijun, “Central Huijin Bails Out Everbright Bank,” *China Daily*, November 8, 2007.

⁵⁰ “China Everbright Agrees to Capital Injection Plan,” *China Daily*, November 28, 2007.

⁵¹ *Ibid.*

⁵² “China Everbright Bank Reportedly Plans IPO Next Summer,” *Xinhua*, December 5, 2007.

⁵³ Pettis, *op cit.*

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."⁵⁴ On the day the CIC was created, CIC deputy general manager Yang Qingwei stated, "The company's principal purpose is to make profits."⁵⁵ More recently, during his first overseas trip as 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."⁵⁶

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.⁵⁷ 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. Plus, as Lou points out, the CIC's ability to obtain access to more of China's foreign exchange reserves will depend on its profitability. "If I am making losses every day, how can I face asking the government for more money?" asked Lou.⁵⁸

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 that it will focus its international investments on a "portfolio of financial products."⁵⁹ CIC Chairman Lou told a group of financial experts in Beijing

⁵⁴ Jason Dean and Andrew Batson, op. cit.

⁵⁵ "China's Trillion-dollar Kitty is Ready," *Asian Times*, October 2, 2007.

⁵⁶ "CIC to be Stable Force in Global Financial Market," *Xinhua*, December 11, 2007.

⁵⁷ "China's Sovereign Wealth Fund Seeks to be a Stabilizing Presence in Global Markets," *Xinhua*, November 30, 2007.

⁵⁸ "China Wealth Fund Aims for Stability, Openness," *China Daily*, October 16, 2007.

⁵⁹ Xin Zhiming, "China's State Forex Investment Company Debuts," *China Daily*, September 29, 2007.

that most of the CIC's investments would be in publicly-traded securities, but that it would also make some direct investments.⁶⁰

Officials with the CIC have indicated that it is considering making investments in Hong Kong and Taiwan, and it is talking with stock exchange officials in London. The CIC is also expected to set up branches overseas, but the locations of its overseas branches are still to be determined.

At the same time, China has also been providing 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."⁶¹ CIC Chairman Lou has indicated that the CIC will not invest in infrastructure.⁶² 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."⁶³ Vice Minister Li has stated that the CIC would not buy into overseas airlines, telecommunications or oil companies.⁶⁴ An unnamed contact at CIC indicated that the SWF also will 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."⁶⁵

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?"⁶⁶ According to Setser, "There clearly isn't a consensus inside China on what the CIC should be doing."⁶⁷ A reporter for the *Financial Times* mirrored Setser's appraisal, writing, "Such a concentration of the country's wealth in one entity has inevitably 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."⁶⁸

⁶⁰ "China's Sovereign Wealth Fund Seeks to be a Stabilizing Presence in Global Markets," *Xinhua*, November 30, 2007.

⁶¹ Pettis, *op. cit.*

⁶² "China's Sovereign Wealth Fund Seeks to be a Stabilizing Presence in Global Markets," *Xinhua*, November 30, 2007.

⁶³ "Investment Fund Announces Strategic Plans," *Xinhua*, November 9, 2007.

⁶⁴ "China Investment Corporation Unveils Investment Plan," *Xinhua*, November 7, 2007.

⁶⁵ Keith Bradsher, "\$200 Billion to Invest, But in China," *The New York Times*, November 29, 2007.

⁶⁶ 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/>].

⁶⁷ *Ibid.*

⁶⁸ Jamil Anderlini, "China Wealth Fund's Early Coming of Age," *Financial Times*, December 21, 2007.

Transparency. CIC officials and other leading economic figures in China have also been making reassuring statements about the transparency of the CIC's operations and management, but often with a caveat or two. 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."⁶⁹ The CIC's pledge of transparency was reiterated by Vice Minister Li in November 2007 during an international investment forum.⁷⁰

However, the degree and pace at which China will make the CIC transparent is uncertain. During a dinner at the mayor of London (England)'s mansion, Lou expanded 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."⁷¹

Reciprocity. The creation of the CIC is not being done in isolation from China's overall policy on inward and outward capital movements. However, while much of the rest of the world would apparently prefer that China focus on liberalizing various aspects of its inward capital flow policies, much of its recent effort has been 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.

The Bush administration has been pressuring China to make its stock and bond markets more open to foreign investors, matching the comparative openness of its inward FDI policies.⁷² However, of late, China has been more concerned about increasing the avenues by which it can redirect more of its domestic foreign exchange holdings towards investments outside of China. In addition to the creation of the CIC, the Chinese government is gradually introducing 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

⁶⁹ Xin, op cit..

⁷⁰ "China Investment Corporation Unveils Investment Plan," *Xinhua*, November 7, 2007.

⁷¹ "China Investment Corp Warns Western Governments Against Protectionism," *AFX News Limited*, December 10, 2007.

⁷² 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, non-ferrous 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>].

in global investment funds offered by the QDIIs.⁷³ China has already approved a number of QDIIs — 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. By the end of September 2007, just under \$11 billion had been invested in the existing QDIIs.⁷⁴ JP Morgan estimates that about \$90 billion will be invested in QDIIs by the end of 2008.⁷⁵ 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's apparent efforts to improve the reciprocity of its investment policies have 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."⁷⁶ Lou continued by stating that "any protectionist backlash" against SWFs could "change the stability and security of global financial markets."⁷⁷ 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."⁷⁸ 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."⁷⁹ 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.

⁷³ 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.

⁷⁴ "China's CIC Wins \$5 Bln Investment Quota - Paper," *Reuters*, December 17, 2007.

⁷⁵ *Ibid.*

⁷⁶ "China Investment Corp Warns Western Governments Against Protectionism," *AFX News Limited*, December 10, 2007.

⁷⁷ *Ibid.*

⁷⁸ Fu Jing, "US Policies May Deter Investors from China," *China Daily*, December 12, 2007.

⁷⁹ *Ibid.*

Market Stability. China has also indicated that they see sovereign wealth funds (like the CIC) being a “stabilizing force in the international market,” in contrast to hedge funds, which are “a source of market instability.”⁸⁰ For example, at a 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.”⁸¹

According to CIC Chairman Lou, “Judging from our investment strategy and scale, we are unlikely to present a major impact on the international market.”⁸² As a precaution, China’s Vice Minister of Finance, Li Yong, has indicated that the CIC’s investments will be made “gradually” and “cautiously.”⁸³

Implications for China’s Economy

Besides offering a new vehicle for managing its foreign exchange reserves, the CIC is expected to help China soak up some of its excess liquidity. In 2007, 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 is not “sterilized,” the excess liquidity in China’s money supply may contribute to domestic inflation or a speculative bubble in China’s domestic asset markets (principally the real estate and stock markets).⁸⁴

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.⁸⁵ 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

⁸⁰ “China Wealth Fund Aims for Stability, Openness,” *China Daily*, October 16, 2007.

⁸¹ Xin Zhiming, “CIC Aims for Overseas,” *China Daily*, November 30, 2007.

⁸² “CIC to be Stable Force in Global Financial Market,” *Xinhua*, December 11, 2007.

⁸³ “China Investment Co to Invest a Third of its 200 Bln USD ‘Cautiously’ — Official,” *AFX News Limited*, November 7, 2007.

⁸⁴ “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.

⁸⁵ 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 Wayne Morrison.

already widespread claims that China's renminbi was undervalued.⁸⁶ 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.

In addition, China's accumulation of U.S. debt in 2007 was not very profitable given the appreciation of the renminbi (RMB) against the U.S. dollar. The yield on 10-year U.S. treasury bills fluctuated between 4.5% and 5.0% throughout the year. However, since the beginning of 2007, the RMB has 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 2007.⁸⁷ When evaluated in its domestic currency, China lost money on its investments in U.S. government debt in 2007.

The CIC offers 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" places the foreign exchange in the hands of the CIC's investors, who can then invest the capital in domestic assets other than real estate or stocks, as well as foreign assets. In theory, this could 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.

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. treasury 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

⁸⁶ The name of China's currency is the "renminbi," or "people's currency." It is denominated in units called "yuan." On October 10, 2007, the exchange rate between the renminbi and the U.S. dollar was 7.51188 yuan = \$1.

⁸⁷ 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.

is trying to lower interest rates to prevent a possible economic recession.⁸⁸ With a reported daily trade volume of existing U.S. debt of \$600 billion,⁸⁹ 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 China's policy of keeping the exchange rate within a narrow band.⁹⁰

The arrival of a new investor with over \$70 billion to invest is attracting 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.⁹¹ On November 22, 2007, Hong Kong's Chief Executive Donald Tsang met with representatives of the CIC in Beijing for similar discussions.⁹² In early December 2007, Lou traveled to London, Paris, and Singapore for additional talks about possible CIC activity in those financial centers.

However, CIC's Blackstone Group investment has made some observers wary about the specific types of investments the new SWF will make. There is concern that China may use the CIC to secure energy resources or purchase strategic assets for geopolitical purposes. There are also market apprehensions that the CIC could seek to increase its market share in important industries via targeted acquisitions or takeovers. Others are 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 are fueling the calls for international guidelines for SWFs, including China's CIC.

Even if the investments of the CIC remain "purely commercial," there are already indications that the global financial markets may be ill-prepared for the introduction of its \$70 billion into the marketplace. Shares in the Hong Kong stock market rose in late October 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.⁹³ Plus, rumors 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

⁸⁸ 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 James K. Jackson.

⁸⁹ Liz Moyer, "Cornering the Bond Market?," *Forbes*, September 28, 2006.

⁹⁰ 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 Wayne M. Morrison and Marc Labonte.

⁹¹ Mao Jilun and Li Weitao, "City of London Woos China Investment Corp.," *China Daily*, October 26, 2007.

⁹² Carol Chung and Carrie Chan, "Stock Scheme on Agenda at Tsang Chat with PBOC," *The Hong Kong Standard*, November 22, 2007.

⁹³ "Shares Rally on Signs of US Retail Strength," *Reuters*, November 27, 2007.

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.⁹⁴

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.

Misgivings about the potential impact of the CIC and other SWFs on financial markets and local economies are fostering calls for greater monitoring and regulation of SWFs. The United States and other nations have asked the IMF to consider developing guidelines for SWFs. 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."⁹⁵

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.⁹⁶ U.S. Treasury Undersecretary for International Affairs David McCormick recently 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.⁹⁷ To that end, the Bush administration has been pushing the IMF to develop a system of best practices for SWFs.⁹⁸

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

⁹⁴ "China Investment Denies Involvement in Alleged Rio Tinto Bid," *CNN*, November 26, 2007; "China Investment Denies Rio Tinto Bid," *Xinhua*, November 27, 2007.

⁹⁵ "Government Wakes Up after China Floats \$200 Bn Fund," *The Economic Times*, November 22, 2007.

⁹⁶ Michael Richardson, "Barriers to Trust: Sovereign Wealth Funds Must Become More Transparent to Avoid Causing Alarm," *South China Morning Post*, December 29, 2007.

⁹⁷ *Ibid.*

⁹⁸ Francis, *op. cit.*, and Lynch, *op. cit.*

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 a SWF may own — other nations have such limits; for example, Hong Kong 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%; and
- Restrictions on the type of investment SWFs may make in U.S. companies — alternatives include restricting SWFs to the purchase of non-voting shares, banning SWFs from negotiating a seat on the company's board of directors or representation in the company's senior management.

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 review of SWFs will precipitate a period of financial protectionism.⁹⁹ The issue is whether the value of protection obtained outweighs the forgone benefits of investments prevented in a more restrictive global financial market.

⁹⁹ Truman, *op. cit.*