The Rise of China's Sovereign Wealth Funds

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Global economic order of the 21st century has now been challenged by the rise of the Chinese model of economic development which has bolstered China's double-digit growth during the early 1990s. *The Economist* (2012) dubs this phenomenon as "the Rise of State Capitalism." The global economic recession in 2008 seems to further aggravate the robustness and credibility of the Western-based economic model. At its worst, China and its state-based policy astounds the world as it is among the very first nations to wither away from the global economic slump. In other words, the crisis in 2008 has empowered the rise and reliability of China's pathway of economic development.

Nonetheless, this essay examines the tool employed by state capitalism disciples, particularly the so-called sovereign wealth funds (SWF) of China. The main argument of this essay focuses on how China's utilization of SWFs serves to fulfill political objectives in spite of the international regulations which tend to inhibit the combination of political and economic goals, and China's self-proclamation that its SWFs investments unknot politics from economic objectives.

This essay will be divided into four sections. The first section begins with the two core concepts which are crucial to further discussion in the essay, that is, state capitalism and SWFs. This essay argues that the very two notions complement one another. The second section substantiates the main argument of this essay by tracing the origins of the rise of China's SWFs in order to exemplify how China has been deploying its SWFs to serve political goals. The third section investigates the current issues of China's SWFs and how it surreptitiously and cunningly implements SWFs to achieve its political schemes. The final section will conclude and briefly depict the possible future trend of the 21st century.

SWFs and State Capitalism

The term "SWF" seems to be new to anyone in this century. It is nonetheless not conceptually unheard of. For instance, in accordance with Ian Bremmer's (2010, 71) account, the origin of SWFs, albeit not regarded as such, was in Kuwait 1953. Nevertheless, the very SWFs are the byproduct of the 21st century.

SWF has been coined by Andrew Rosanov in 2005. In his article, "Who Controls the Wealth of Nations?" the word SWF has attractively drawn scholarly attention and has been pervasively used to associate with state capitalist nations. Therefore, the International Monetary Fund (Pihlman 2009) has naively defined the SWFs as "special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage or administer assets achieve financial objectives and employ a set of investment strategies that include investing in foreign assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports." Another approach which defines SWF can be detected from Sovereign Wealth Funds Generally Accepted Principles and Practices (SWFGAPP) or Santiago Principles. In the latter's notion, states "pursue investment decisions and investment operations free of political influence (IWG 2008, 5)."

Despite those two definitions proposed by the two authoritative organizations well-capture the essence of the SWFs, it, nevertheless, neglects the reality of the nature of the role of the state in economic activities. The state *ipso facto* maintains elements which constitute and drive economic activities.

In contrast to economic objectivism outlined by the IMF and SWFGAPP, Benjamin J. Cohen (1986), a political economist from the University of California, arduously advocated that "high finance can no longer be kept separate from politics." To bluntly put in the context of SWFs in which the state plays an assertive role as an investor, it is of futility to take it for granted that the state has a pure economic intention with value-free political ambitions.

Contrary to the claims of the mainstream economists, this essay proposes to view SWFs as a part of state capitalism. Explicitly speaking, this essay advises not to subjugate the state's role in economic activities.

State capitalism, in accordance with an authority in this area, Bremmer (2010, 29-30), refers to "a system in which the state plays the role of leading economic actor and uses markets primarily for political gain." Hence, in a broad definition which contains the elements of both SWFs and state capitalism, this essay is inclined to rectify SWFs as "assets controlled and managed by sovereign governments; they are commonly funded by foreign exchange reserves, resource revenue or general taxation; they can be invested domestically; and they are used to achieve certain national objectives (Blundell-Wignallet al.2008)." In brief, the definition of SWFs deployed throughout this essay incorporate the political relations into the usage of SWFs.

The Origin of China's SWFs

As mentioned in the first place, this essay traces the origin of China's SWFs in order to provide a holistic picture of how the Chinese government can hardly disentangle its politically ulterior objectives from the SWFs. Although the Chinese government cunningly declared that "CIC will deal with its SWFs investment independently by persisting in the principle of separating government functions from company management (Financial Times 2007)," by and large, this section extracts four structural conditions which clarify how the Chinese government has breathed China's SWFs into lives and how the SWFs have served political aims of the communist government.

The first condition is China's export-oriented economy. Since 1979 in which China has reformed its economic development model from central planning economy to market economy, in contrast with Soviet's *perestroika* in which the state utterly and shockingly severed its role from economy, the Chinese government abuses the privileges of the statist status in order to develop its economy hand in hand with cultivating its political legitimacy (Rodrik 2012, 273-279). As a result of China's economic reforms, its economic growth has tremendously increased since the early 1980s and 1990s. China's success concomitantly coincided with its annual increases in exports.

The sequential condition after the first one is China's repercussion of excessive foreign exchange reserves (FERs). Following China's economic reforms, it has successfully championed the economic model which the state plays a pivotal role in steering economy. The first condition breaths the second variable into life. This can be exemplified by exploring the correlation between China's economic reforms with export-oriented as a main strategy and its FERs' surpluses since the 1990s.

The third condition concerns the domestic contestation between the two policymaking entities, namely, the People's Bank of China (PBC) and the Ministry of Finance (MOF). The two state agencies have wriggled over the question of which body should be authorized to "influence over broad economic policy and control the country's financial assets (Leong and Liping 2010, 27)." Notwithstanding the general trends of clashes between the central bank and ministry of finance throughout the world in other nations, the battle between the PBC and MOF incipiently conditions the birth of China's SWFs. The role of the PBC is to regulate and supervise all of the Chinese state-owned commercial banks (SOCBs) whereas those state-owned financial institutions are owned by the MOF. This will be further elucidated later in this section.

Finally, the fourth condition which is the triggering event is the 1997 Asian financial crisis. As mentioned earlier the contest for supremacy between the PBC and MOF has always been intact. The advent of Zhu Rongji as premier of the PRC in the early 1990s elevated the strategic position of the PBC due to the fact that Zhu was a former governor of PBC. The 1997 crisis portrayed the danger of national insecurity as a result of languishing financial system.

Hence, Zhu initiated a reform in banking sector which was then undercapitalized.

After almost two decades of growth in both GDP and FERs, China's SOCBs were under serious undercapitalized problems in 1998. As a result of the shift of financial policy which replaced state subsidies to SOEs with bank loans, the SOCBs which had financed the SOCEs since 1992, were in quagmire due to the SOEs which incurred losses in the aftermath of the economic crisis in 1997. Subsequently, money which the SOEs owed the SOCBs became what economists and financiers mutually recognize as "non-performing loans (NPLs)." In 1998, it was estimated that the share of the SOCBs' NPLs was at 20 percent (Adams et al. 1998, 152). However, some unofficial remarks calculated that the NPLSs of SOCBs should be as high as 40 percent. This banking sluggish stemmed mainly from the loss-making SOEs after the hit in 1997 (Lin 1998, 176). Hence, some critics viewed the NPLs as "de facto subsidies" because they were *not* to be repaid. For them, "the switch from fiscal subsidies to bank loans paved the way for PBC to exert direct influence over the SOCBs over which MOF enjoyed ownership rights (Leong and Liping 2010, 28)."

The first attempt of the PBC was to recapitalize the banks by lowering the statutory reserve requirements (SRR) ratio from 13 to 9 percent in order to liquidify them. To build credibility in those banks and to prevent bankruptcy, the PBC ventured to transfer the NPLs worth US$ 173 billion to asset management companies (AMCs) in order to fend off the apparent NPLs (Shanker et al. 2008). This scheme enabled the SOCBs to restructure their space for more investment opportunities. The cost of saturating the NPLs of the SOCBs could be 30 percent of 2005 GDP (Ma 2006).

Although the MOF was the sole owner of the SOCBs, it is not empowered to recapitalize those banks. This was opportune to the PBC. In 2003, with aspiration to incorporate those SOCBs, the Third Plenum of the 16th Party Congress established the Central Leading Group on Reforming the Shareholding of SOCBs (CLGRSS). Most of the officials positioned in the CLGRSS were the former subordinates of the PBC. Thus the CLGRSS' color underneath was of the PBC (Leong and Liping 2010, 32). This indicated that the CLGRSS' bank restructuring agenda would be to situate the PBC as a major owner of the SOCBs. In other words, this was an attempt to contest for supremacy against the MOF. Nevertheless, Chinese law prohibits the PBC from owning any financial institutions. As a leeway, the Central Huijin Investment Corporation was formed as a state-owned investment company in terms of legality. It was, thus, subordinated within the State Administration of Foreign Exchange (SAFE). SAFE, accountable to the PBC, registered Huijin by pouring money from Chinese FERs for US$ 45 billion into Huijin. The newly molded entity, Huijin, bought stakes from the Bank of Commerce. In 2005, US$ 15 billion was invested in the other four SOCBs to alleviate the status of the PBC to be as equal as the MOF. In this light, Huijin operated under the behest of the PBC who controlled SAFE (Leong and Liping 2010, 32).

Huijin, according to the definition of SWFs employed in this essay, was technically a de facto SWF which served to effectuate political overwhelm of the PBC.

In international economics, when exports increase, the currency of a nation which gains stronghold in net exports will normally appreciate. China's trade surpluses with the US and other European nations sparked concerns of yuan appreciation which may encumber its booming exports in the long run. Yuan appreciation would raise real interest rates which might damage the SOEs which were financed by bank loans. Furthermore, the currency appreciation would aggravate the conditions of the AMCs which held debts transferred from the SOCBs when the PBC recapitalized banking sector. Moreover the SOCBs hold a considerable amount of assets denominated in dollar. Further appreciation would simply weaken the real values of those assets. As a repercussion, raising interest rates would further appreciate the value of yuan. On the contrary, lower interest rates would bar capital inflows which partly constitute China's economic growth. A major upshot in this circumstance was China's dilemma in controlling yuan appreciation on the one hand while avoiding the expense of China's domestic affairs.

Henceforth, it was of necessity to purchase assets abroad in order to assuage the pressure of yuan appreciation. China's surfeit FERs were bought into lime light as a solution. At a first glance, China acquired the US treasury bonds by using FERs. The US bonds' yield had low rates of return only 2.5 percent (Wu and Seah 2008). With yuan appreciation against the US dollar, it tacitly implied that the real value of yields from the US bonds would be decreased in value. These aforementioned factors propelled the Chinese government to search for alternatives.

By and large, the government unearthed a devise of spending its large FERs in the sources other than government bonds. Consequently, the Chinese Investment Corporation (CIC) was founded in 2007 in order to direct FERs to cushion the effects of yuan appreciation. However, there was an entailing problem with the establishment of the CIC, that is, which entity, the PBC and the MOF, should steer the CIC's investments. To pursue the policy of harmonious society announced by Hu Jintao, the State Council (government) harbored to direct the CIC to become accountable to it.

Although both the PBC and MOF seemed to be detached from the CIC, the MOF moved to swap 1.55 trillion yuan of bond with PBC's FERs for US$ 200 billion (CIC 2009, 10). The money in which the MOF swapped with the PBC was deployed to fund the newly founded CIC. And the very source of finance of CIC was utilized to purchase Huijin for US$ 67 billion. Another US$ 67 billion was pumped into two of the major SOCBs, that is, the China Development Bank and the Agricultural Bank of China, whereas another US$ 66 billion was aimed to invest overseas (Zhang 2008, 5). This strands of expense implied that the MOF technically owned the de jure and de facto SWFs of China.

The history of the origin of China's SWFs has clearly substantiated a view that the state could never extricate itself from political motives within any economic activities. The establishment of the de jure SWFs, CIC, served to gradually settle disputes between the two state vehicles of China, the PBC and the MOF.

China's SWFs Trends

After the emergence of the CIC, its overseas investments reaffirm Benjamin Cohen's assertion and the main argument of this essay that political objectives cannot be parted from economic activities. This section focuses on the CIC and SAFE investment to exemplify how these two political vehicles fulfill China's political objectives.

In May 2007, the CIC risked its investment by acquiring 10 percent stake (US$ 3 billion) in Blackstone Group. Before the end of the same year, the CIC projected another risk-adjusted investment by grabbing 9 percent of stake (US$ 5.6 billion) from Morgan Stanley. In spite of enormous losses in 2008 from global economic recession, those two corporations were selected to be key managers of China's assets (Carey and Strasbourg 2009).

In a nutshell, the CIC has acted as an agent provocateur to enthrall human capital in facilitating its own investment apparatus. Even with losses, in 2009 the CIC authorized Blackstone with US$ 500 million to invest in hedge fund (Carey and Strasbourg 2009).

Moreover, in regard to Morgan Stanley, the CIC was tempted to further channel US$ 800 million in Morgan Stanley's global real estate fund in 2009 (Miracky et al. 2009, 16). The losses did not discourage the CIC from those two Western corporations. In contrast, after the losses were publicized, some newspapers reported that the CIC even lodged a plan to buy as much as 49 percent of stake in Morgan Stanley (Quinn 2008). Loss-risking investment can hardly be dubbed as wise in financial calculation. However, with politically ulterior objectives, calculations have been placed in a different dimension.

Regarding SAFE, it invested in "global equities with the purchase of a US$ 2.8 billion stake in French oil company Total in April 2008 (Bremmer 2010, 74)." Before the end of August of the same year, SAFE diversified its investments throughout fifty British companies which were worth US$ 6.7 billion (Cao et al. 2008). Although the information of SAFE investment is quite limited, it can imply that part of its investment has been directed to energy sector for which China has been hunting.

Conclusion

This essay has demonstrated how the Chinese government has ratcheted its SWFs to function and serve political objectives. Throughout the essay, the origin of China's SWFs has depicted how the SWFs are intricately intertwined with the role of state and political processes within the country. Furthermore, China's SWFs investments have also been operated on the basis of fulfilling political objectives as exemplified though the cases of investments in Blackstone Group and Morgan Stanley.

The trend of orienting the SWFs will be booming every year. It is obvious that after the global economic crisis in 2008, the Western economic model has been challenged by the rise of state capitalism. The recent trend has indicated that the ecliptic marriage between the role of the state and capitalism could enhance economic capacities to self-propel in this century.

Inasmuch as jubilant successes, this new model is not without criticisms. Some have criticized that this new model is not sustainable. Whether this prediction is credible, what is certain is that the Western model has miserably failed to match with the very term of "sustainability" as well. This vacuum will be a gateway of the paradigm to emerge.

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