SECTION 2: CHINA'S CAPITAL INVESTMENT VEHICLES AND IMPLICATIONS FOR THE U.S. ECONOMY AND NATIONAL SECURITY

> "The Commission shall investigate and report exclusively on—
> . . .
> "UNITED STATES CAPITAL MARKETS—The extent of access to and use of United States capital markets by the People's Republic of China, including whether or not existing disclosure and transparency rules are adequate to identify People's Republic of China companies engaged in harmful activities. . . ."

Introduction

The People's Republic of China (PRC) formally established the China Investment Corporation (CIC) on September 29, 2007, to manage and diversify its foreign exchange reserves beyond its traditional investments in U.S. government dollar-denominated bonds. With an initial loan of $200 billion from China's central bank, the People's Bank of China, CIC instantly became one of the largest sovereign wealth funds in the world.* [118] Most of the world's 40 other sovereign wealth funds have existed without much controversy for up to 50 years, but China's entry into the sovereign wealth fund market is remarkable for several reasons. For one, China appears far less likely than other nations to manage its sovereign wealth funds without regard to the political influence that it can gain by offering such sizable investments. With an estimated 40 percent of its domestic economy still under government ownership and control, China has long mixed economic and political goals and is likely to do so with its international investments, despite protestations to the contrary.[119]

Many experts share a concern about the phenomenal growth of other sovereign wealth fund assets and state capitalism generally. The Commission's charter limits its purview to specific matters related to the U.S.-China economic and security relationship; hence this chapter on China's sovereign wealth fund necessarily focuses on CIC and other Chinese state-owned entities. Our Report should be understood in this context. In light of the current crisis in credit markets and on Wall Street, the Commission also recognizes the

* 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* (Washington, DC: June 2007), appendix 3, p. 1. www.treas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007__Appendix-3.pdf.

difference between temporary, though massive, intervention undertaken by the U.S. government as a part of a rescue plan for the floundering economy, and the sustained control of China's economy by China's government.

China's sovereign wealth fund portfolio also is unusual because it is backed by the world's largest pool of foreign currency holdings—nearly $2 trillion and growing as much as $500 billion a year.* [120] This vast sum is managed by an arm of the central bank, the State Administration for Foreign Exchange (SAFE), that quietly has been making its own investments, in apparent competition with China's official sovereign wealth fund. In fact, both SAFE and CIC are just two parts of a complex web of state-owned banks, state-owned businesses, and government-run pension funds, all of which draw their money—and receive their directions—from the central government and which promote a state-led development agenda.

China's methods of raising such a large amount of foreign exchange also set its sovereign wealth fund apart from those of other nations. Rather than being derived from sales of commodities such as oil or minerals, the capital in China's fund is the result of its financial controls and its trade surplus in manufactured goods. CIC is a "by-product of efforts to manage exchange reserves more aggressively" and was established because the government's total holdings of foreign exchange "exceed what conceivably could be needed for prudent reasons," according to Brad Setser, a Council on Foreign Relations economist who testified at a February 2008 Commission hearing on CIC.[121] Ultimately, the enormous pool of money available for investment means CIC is likely to have "a major impact on the composition of global capital flows . . . and could have a particularly large impact on the United States." [122]

Controversy has continued to surround CIC and China's foreign reserves despite China's official insistence that it intends nothing more than to diversify its portfolio with sound investments devoid of political or strategic considerations. In early 2008, the *Financial Times* reported that SAFE, the official administrator of China's foreign exchange reserves, appeared to have surreptitiously made investments through a Hong Kong company that is its subsidiary.[123] In September 2008, the *Financial Times* revealed that SAFE money was used as part of an incentive package to persuade Costa Rica to shift its diplomatic recognition from Taiwan to China last year (see the portion of this section on SAFE for further discussion).[124] SAFE agreed to purchase Costa Rican government bonds at a low rate of interest despite Beijing's promises that it would not use sovereign wealth fund investments to further its political goals. It remains unclear whether SAFE created its own sovereign wealth fund to vie with CIC in a secretive, high-stakes bureaucratic squabble or whether the SAFE fund represents an effort to escape public notice while offering CIC up to scrutiny.

The participation of a large, nonmarket economy raises a broader issue: whether China's investment is formally transacted by CIC,

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*The People's Bank of China, the central bank, has reported that China's foreign exchange reserves grew from $1.0685 trillion in 2006 to $1.528 trillion in 2007. By September 2008, the reserves grew to $1.91 trillion and are expected to reach nearly $2 trillion by the end of 2008. www.pbc.gov.cn/english/.

SAFE, government-owned banks, or government-controlled industry, purchases by Chinese government-controlled entities ultimately may result in foreign authoritarian government ownership and control of important sectors of the world's free market economies. Chinese state-owned enterprises (SOEs) and state-owned banks have an historically large role in the Chinese economy, so the expansion of Chinese firms abroad likely will mean the expansion of Chinese state-owned firms abroad.[125] The "dramatic increase in the role of governments in the ownership and management of international assets" is "disquieting [since] it calls into question our most basic assumptions about the structure and functioning of economies and the international financial system," Edwin M. Truman, a former Clinton Administration Treasury Department official now at the Peterson Institute for International Economics, told the Senate Committee on Banking, Housing, and Urban Affairs in November 2007.[126] "In the United States, we favor a limited role for government in our economic and financial systems, [. . .] and we presume that most cross-border trade and financial transactions will involve the private sector on both ends of the transaction," Dr. Truman said.[127]

Growth of its foreign exchange reserves has made China the largest foreign investor in U.S. government securities; its holdings of this type totaled approximately $967 billion as of July 2008, according to officially disclosed U.S. figures.[128] So long as China confined its investment to bonds, few in the United States worried about China's potential to exert direct control over U.S. assets. Further, China's consistent willingness to buy newly issued Treasuries at auction allowed the U.S. government to finance its budget deficit at a lower cost than otherwise would have been the case. Judging from the very low returns China received in 2007, its purchase of U.S. Treasuries was motivated by a desire to manage its exchange rate and to boost its exports rather than to seek a high return.[129]

Recently, though, China's government has made a strategic decision to encourage outward investment by Chinese firms and to reorient the composition of the portfolio held by China's central government toward equities, raising new concerns. Chinese officials note that it makes little financial sense for China to invest the dollars it receives from foreign trade exclusively in safe but very low-yielding U.S. government bonds. However, as Dr. Setser testified before the Commission, China's desire to diversify its portfolio "runs squarely into the United States' historic aversion to government ownership of private firms" and may have engendered new misgivings about China's involvement in the international equity markets.[130] Specific proposed investments by CIC could raise national security concerns due to extensive involvement of the central government, which has a history of making strategic acquisitions to enable it to obtain advanced U.S. technology in such areas as automobiles, telecommunications, and aerospace. (See chap. 1, sec. 3, for more discussion on this issue.)

The Administrative Structure and Policies of the China Investment Corporation

Claims by Chinese officials that the establishment of CIC is intended to create an investment vehicle for strictly economic purposes are contradicted by many of the facts. While most other sovereign wealth funds have just one or two objectives, such as support of a country's pension system or reinvestment of oil revenues to ensure a sustained stream of income even after oil wells run dry (as is the case for Qatar's, Kuwait's, and Norway's funds), CIC's mandate reads like a composite of the mandates of several separate agencies with goals focused on monetary policy, foreign policy, bank regulatory policy, and industrial policy.[131] About a third of CIC's $200 billion has been dedicated so far to recapitalizing some of China's largest banks that have flirted with insolvency because of mismanagement and corruption. Bailing out poorly run banks is not likely to create high returns on CIC's investments.

In addition, CIC's mandate tasks it to support the outward investment of Chinese firms in emerging markets and also to manage China's external investments in an equity-heavy portfolio.[132] Yet CIC also must function as part of China's capital control system whose purpose is to maintain a low value of the renminbi (RMB) relative to the dollar. This contradicts CIC's publicly stated goal of maximizing profits, because by investing in dollar assets, CIC is almost guaranteed to lose money. China is by no means unaware of its dollar-denominated predicament. SAFE has been making overtures to European private equity firms as part of a strategy to diversify its dollar holdings, but the extent to which it can manage that without triggering RMB appreciation or spooking the currency markets is uncertain.[133]

CIC's Capitalization and Working Capital

CIC is set apart from many older sovereign wealth funds, such as Norway's or those of the Gulf states, because it is "financed by issuance of debt, not from a fiscal surplus" derived from sales of commodities such as oil.[134] The working capital for CIC is backed by China's nearly $2 trillion in foreign exchange reserves. Until recently, most of those assets have been held as central bank reserves and invested conservatively in U.S. government securities. China's reserve growth has accelerated in recent years, adding at least $500 billion a year.[135] Currently, CIC manages just 10 percent of China's foreign exchange reserves, with the vast majority of foreign exchange remaining within the control of SAFE and the People's Bank of China. But that could change.

Under a plan approved by the Standing Committee of China's National People's Congress in June 2007, the Ministry of Finance issued 1.55 trillion RMB ($200 billion) in special Chinese government bonds to provide CIC with capital to purchase foreign exchange from the People's Bank of China.[136] Under the arrangement, CIC is to be responsible for paying the interest on the bonds, about 5 percent, at an estimated cost of $40 million per day.[137] CIC, after purchasing China's former state asset manager, Central Huijin Investment Company (Central Huijin), recapitalizing domestic banks, and making other domestic investments, reportedly had around $90 billion available for future investments as of April 2008. This is approximately equal to the cumulative total amount of China's outward direct investment as of the end of 2007.* [138]

Objectives and Investment Strategy

Since opening its economy to the world, China has maintained stringent controls over capital inflows and outflows and over its foreign exchange, the effect of which is to maintain low currency value that enhances China's trade competitiveness. Trade, foreign direct investment, and portfolio investment flows into China create a continuing stream of foreign exchange, mostly dollars. Conventional economics suggests that such an abundance of dollars is likely to push the value of the dollar down relative to the RMB, assuming a free market in currencies. Governments can use a variety of economic tools to influence the value of their currencies, such as raising or lowering short-term interest rates. China uses a different tool—controls on the dollars and other foreign exchange coming into the country. It is an expensive tool for China, and it provides more evidence that China's investment policies not only are aimed at maximizing financial returns but also are designed to satisfy broader political and economic ends, including obtaining advanced technology; gaining access to natural resources; and isolating Taiwan, which China regards as a renegade province.

Despite recent relaxation of rules for holders of foreign exchange, businessmen earning dollars and euros for exports still are required to exchange most of them for RMB in government-owned banks.† These dollars or euros then are spent by the banks to purchase foreign debt, much of it U.S. Treasury bills and other federal agency debt. But that leaves a lot of new RMB in circulation in China, a situation that would be expected to lead to inflation. Therefore, to absorb the excess RMB generated by the dollar swap, China offers government bonds with a relatively high rate of return to make them attractive to its citizens. The Chinese government also requires its banks to keep large amounts of cash on hand. This process is called "sterilization" and is intended to remove excess currency from circulation before it causes inflation. (See the detailed discussion of currency sterilization in chap. 1, sec. 1.)

However, because interest rates on Chinese government bonds are higher than the real interest rates the banks are receiving from their holdings of dollar-denominated bonds, the dollar reserves held by SAFE and the People's Bank of China are losing money. So, too, are the dollar investments made by CIC. China's accumulation of U.S. debt in 2007 was not very profitable, given the appreciation of the RMB against the U.S. dollar. The yield on 10-year U.S. Treasury bills fluctuated between 4.5 percent and 5.0 percent throughout 2007 and has been below 4.0 percent in 2008.[139] However, in 2007 the RMB appreciated nearly 7 percent relative to the

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*According to the United Nations Conference on Trade and Investment (UNCTAD), China's stock of outward foreign direct investment was $95.8 billion. UNCTAD, *World Investment Report 2008*. www.unctad.org/wir, or www.unctad.org/fdistatistics.

†To slow down the growth in its hard currency reserves and curtail inflows of speculative "hot money," the Chinese government removed the requirement in August 2008 that Chinese companies exchange all their foreign currency in the local banking system. Chinese businessmen can keep some foreign exchange abroad. See chapter 1, section 1, for more information.

U.S. dollar and has appreciated at about the same rate so far in 2008.[140] Thus, the real rate of return on U.S. Treasury bills held by China has been negative in 2007 and 2008.

CIC offers a new avenue for the government to invest accumulated foreign exchange holdings and potentially to earn a positive rate of return on its investments. In fact, CIC is responsible for paying the interest on the Chinese bonds issued to transfer the foreign exchange from the People's Bank of China to CIC. That means CIC must earn a real rate of return of slightly more than 5 percent (see the part of this section on capitalization for more detail). Lou Jiwei, CIC's chairman, has likened the fund to a Beijing taxi driver who knows he must make 300 RMB every day to cover his expenses. In CIC's case, it has to earn returns of about 300 million RMB ($40 million) each day to cover fully its debt service costs.[141] By this measure, CIC is not profitable.

One reason that CIC is losing money is the government's requirement that the fund take on an "exceptional level of exchange rate risk," Dr. Setser testified to the Commission.[142] The market currently expects the RMB to appreciate by about 8 percent a year against the dollar.[143] The RMB bonds issued to finance CIC carry an interest rate around 5 percent These two facts imply that CIC needs a nominal return of around 13 percent just to break even.[144] The target yield of CIC is important primarily because of the implications for its portfolio mix. Earning higher yields usually means investing in higher-risk investments such as equities and accepting more volatility in the value of the portfolio at any given time.

Prior to the creation of CIC, Chinese officials were making statements indicating that its investment strategy would be to maximize the rate of return on its investments. On the day CIC was created, Deputy General Manager Yang Qingwei said that CIC's "principal purpose is to make profits."[145] About a month after CIC's launch, CIC Chairman Lou Jiwei told a group of financial experts in Beijing that most of CIC's investments would be in publicly traded securities but that it also would make some direct investments.[146] In December 2007, on his first trip abroad as chairman of CIC, Mr. Lou said, "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."[147] On another occasion, Mr. Lou said that CIC was similar to "farmers—we want to farm our land well," suggesting a preference for investing in portfolios with relatively higher anticipated returns. But he also added that "when there is good market opportunity, we can also make some direct investment, such as the Morgan Stanley deal."[148] And more recently, CIC President Gao Xiqing noted that CIC is "looking at clean energy and environmentally-friendly investment."[149]

At the same time, China has been talking about the kinds of investments CIC will *not* be making. CIC President Gao said CIC will look at "everything cross-border except casinos, tobacco companies, or machine-gun companies."[150] CIC Chairman Lou has indicated that CIC will not invest in infrastructure.[151] Chinese officials reportedly told German Chancellor Angela Merkel during her visit to China in August 2007 that CIC "had no intention of buying strategic stakes in big western companies."[152] China's Vice Minister of

Finance Li Yong dismissed "rumors that China [will] try to buy out European and American companies in large numbers."[153] Vice Minister Li also has stated that CIC will not buy into overseas airlines, telecommunications, or oil companies.[154] An unnamed official at CIC indicated that the sovereign wealth fund 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."[155]

Sectors and Investment Activities CIC Has Stated it Will Avoid

- Tobacco companies
- Casinos
- Machine gun companies
- Controlling stakes in western companies
- Overseas airlines
- Telecommunications firms
- Oil companies
- Foreign technology companies as a means of obtaining advanced technology

Source: Statements by various CIC and Chinese officials in the press.

When Commissioners met with Gao Xiqing, CIC's president, during the Commission's March–April 2008 fact-finding trip to China, Mr. Gao stated that CIC is operating on a commercial basis and has to take responsibility for its decisions. Mr. Gao acknowledged that long-term financial interests sometimes have a political component, but he added that his interaction with government officials is mainly through informal channels. In response to concerns about CIC taking controlling stakes in its investments, Mr. Gao stated that CIC does not want board seats and has instructions to take passive roles in its investments. China, he underscored, is moving toward a free market, but in the interim, state enterprises will play a role in foreign trade and investment. In Mr. Gao's view, the more the United States engages with China, the more it promotes reform.

Despite the reassurances provided by CIC, there is scant evidence that China has an investment strategy that is free from political influences. "Powerful forces within the state bureaucracy . . . [have their] own ideas on how the money can best be spent," notes the *Financial Times*.[156] At least some Chinese media outlets are discussing the broader geopolitical significance of sovereign wealth fund investment abroad and providing a message quite different from the statements made in public by CIC officials. An example is the following excerpt from a government-run Chinese newspaper article during the period just prior to the formal creation of CIC:

> *. . . [A]uthoritative sources . . . reveal that—although the leading cadres of the foreign exchange company preparatory committee have regarded the primary responsibility of [the company] as investing in financial products of the international financial market, and to make shareholding investments in financial institutions—the National*

Development Committee and other cognizant organs have always hoped that the investments of the foreign exchange company will give expression to the national will, and, other than investments in stocks and products of the financial system, that it should also make some strategic purchases, paying attention to some of the domestic 'Going Outward' enterprises, etc.[157]

This statement indicates that some Chinese officials are interested in seeing Chinese sovereign wealth fund investments achieve goals other than simply turning a profit. For example, when Chinese appliance maker Haier announced in June 2008 that it was considering a bid for General Electric's appliance business, executives at CIC said that one of its "mandates" is to help finance the foreign investments of Chinese companies.[158] The China Development Bank and other banks can be tapped to help finance such a bid and even take a slice of equity in any deal.[159] In another case, Aluminum Corporation of China (Chinalco) financed its stake in Australian mining giant Rio Tinto by borrowing from the China Development Bank, which recently was recapitalized with $20 billion from CIC. CIC, in turn, received a large equity stake in the China Development Bank.[160]

CIC's Governance

Technically, CIC is organized as a separate entity, owned by the PRC government and reporting directly to China's State Council. This gives it a political standing equivalent to that of a ministry, and a direct relationship with the State Council's leader, Premier Wen Jiabao.[161] CIC has a board of directors with 11 members, including three executive directors, five nonexecutive directors, two independent directors, and one director representing the employees. None of the members serves on China's State Council; however, all board members have strong ties with the government and the Chinese Communist Party.

CIC Board Chairman Lou, formerly deputy finance minister and State Council deputy secretary general, has been recently appointed as the chairman of CIC subsidiary Central Huijin, further strengthening the companies' merger.[162] CIC President Gao, a U.S.-educated and -trained lawyer, who formerly was vice chairman of the National Council for the Social Security Fund, China's national pension fund, also is CIC's chief investment officer. Other people serving in CIC's top management include the following:

- Zhang Hongli, CIC's executive director and chief operating officer, and former vice minister of finance;
- Zhang Xiaoqiang, vice minister of the National Development and Reform Commission;
- Li Yong, vice minister of finance;
- Fu Ziying, vice minister of commerce;
- Liu Shiyu, vice governor of the People's Bank of China;
- Hu Xiaolian, head of SAFE and vice governor of the People's Bank of China;
- Liu Zhongli, former minister of finance;

- Wang Chunzheng, former vice minister of the National Development and Reform Commission; and
- Yu Erhui, employee director and human resource director of CIC, and former board director and chairman of the Remuneration Committee of the Bank of China, Ltd.[163]

Many CIC workers came from its absorption of Central Huijin and its wholly owned subsidiary, China Jianyin Investment Company (China Jianyin).[164] CIC also has begun to advertise internationally for fund managers.[165] On the one hand, the mix of board members may represent a political compromise among the leadership of the Chinese Communist Party to obtain broad-based support for the creation of CIC; but on the other, the board's links to China's key economic agencies will provide China's leadership with the necessary mechanisms to exert control over the activities of CIC.[166]

During the Commission's March–April 2008 trip to China, CIC President Gao told the Commissioners that there are no regular contacts between CIC and the State Council regarding investment decisions. Major policy decisions are made by the seven-member Executive Committee that is comprised of the chairman, general manager, senior vice president, chairman of the supervisory board, chief investment officer, deputy chief investment officer, and chief risk and finance officer. Other organizational structures include an International Advisory Board whose membership has not been finalized and an investment committee that includes the chairman, general manager, chair of the committee, and mid-/front-line managers making specific investment decisions. However, CIC President Gao noted that board members who previously worked for ministries continue to report to their old offices.

CIC President Gao stressed to the Commission delegation that CIC is seeking passive investments and is subject to less government direction than western countries assume. In marked contrast with other reports, Mr. Gao insisted that the media erred when they reported the Chinese government was directly involved in CIC's investment in Morgan Stanley. According to Mr. Gao, CIC did not even tell the State Council about the deal until hours before it was announced. However, he acknowledged that CIC has to work within the Chinese government system while at the same time applying market principles.

CIC President Gao characterized CIC as being under significant pressure; its every move is closely scrutinized at home and abroad. Its autonomy is constrained, because large investments most likely need approval at the upper level of China's government and/or Communist Party. A decision by the State Council in early 2008 to block the China Development Bank's investment in Citibank is just one indication that China's top leadership is worried that CIC's portfolio is too concentrated in the financial sector or that Chinese investment is beginning to seem like "dumb money" in the eyes of the rest of the world.[167] Nearly two-thirds of CIC's capital is dedicated to domestic investments such as the purchase of Central Huijin or the recapitalization of China's commercial banks. As a result, CIC still can be used as an instrument to advance the central government's domestic economic policies. China, which has lost heavily on its strategic stakes in western banks, seems to have drawn some fairly conventional lessons. The State Council recently blocked a proposed takeover by China Development Bank of Germany's Dresdner Bank and, at the time this Report was completed, had not approved any large investment in a foreign bank in 2008.[168]

The rest of China's government is not necessarily vested in CIC's success. The bureaucratic rivalry between China's Ministry of Finance and the People's Bank of China apparently has spilled over into rivalry between CIC, which is linked to the Ministry of Finance, and SAFE, the People's Bank of China's manager of foreign currency.[169] The government agencies with links to the state firms want CIC to do more to support their overseas investments, "including the outward expansion of China's mining companies."[170] Overtly supporting Chinese state firms, however, would contradict the assurances that CIC is motivated solely by commercial considerations. Not supporting Chinese state firms, though, risks the creation of new bureaucratic rivals.[171]

China's SAFE as a Shadow Sovereign Wealth Fund

In 2008, a Chinese government agency promised to purchase Costa Rican government bonds in return for Costa Rica's severing of diplomatic ties with Taiwan. That same agency invested $2.5 billion with TPG Capital, a Texas private equity firm.[172] In addition, it bought approximately $2 billion in British Petroleum shares and approximately $2.5 billion in shares of France's oil and gas company, Total S.A.[173] Late in 2007, it made several small purchases of shares of three Australian banks.[174]

This government-owned investor, however, was not CIC, China's official sovereign fund, but a secretive offshoot of SAFE, the official manager of the nearly $2 trillion of foreign exchange reserves China has amassed. SAFE's investments traditionally have been in low-yielding U.S. Treasuries and other dollar-denominated, fixed-income securities such as Fannie Mae and Freddie Mac bonds and U.S. corporate bonds. But lately, SAFE has taken the bolder action of buying stocks. SAFE's foray into equity investments simply may be part of a coordinated government strategy to help diversify China's foreign exchange holdings while escaping notice. But available evidence points to bureaucratic turf wars as a more likely cause.

The bureaucratic origins of China's official sovereign wealth fund help explain this. CIC emerged from a dispute between the Ministry of Finance and China's central bank, the People's Bank of China. As China's top leaders considered how to divert some of China's growing foreign reserves into higher-yield investments, the People's Bank of China initially objected to the riskier move. But when those objections were overruled, the People's Bank of China argued that it would be a more suitable manager for the new fund than the Ministry of Finance.

Instead, CIC was created and placed under the control of the State Council, out of the bureaucratic reach of either the Finance Ministry or the central bank, but was staffed primarily with personnel tied to the Ministry of Finance. In addition, the People's Bank of China's holdings of shares of China's state-owned banks were sold to the newly created CIC at below-market prices.[175]

Both the bank holdings and the relative shares of costs borne by the People's Bank of China and the Ministry of Finance in recapitalizing the state-owned banks long had been a point of contention between the two ministries. In the aftermath of CIC's creation, the new sovereign wealth fund controlled all the People's Bank of China's shares in China's state-owned banks and other investment companies organized under China Jianyin.[176]

The Ministry of Finance fared considerably better in this first period of the contest than the People's Bank of China. Nevertheless, SAFE is determined to prove it is the more astute and capable institution and, in particular, that it can obtain the same or better returns than CIC.

SAFE now is competing with CIC for investments and brings some significant advantages to this second phase of the contest. SAFE has far deeper pockets than CIC, which at the moment has only about $90 billion in remaining cash to invest abroad. SAFE's head sits on CIC's board, with access to sensitive information about its planned investments.

When SAFE's Hong Kong-based subsidiary acquired stakes of less than 1 percent (about $176 million) each in three Australian banks, the investments went unannounced. However, even after the news was broken by the *Financial Times*, SAFE continued to deny knowledge of the Australian bank investments while privately asking the *Financial Times* not to publish any of the details SAFE was publicly denying.[177] The *Financial Times* nonetheless exposed the deal, and the details were later confirmed by nonofficial Chinese media. According to Thomson Financial, SAFE also has used its Hong Kong subsidiary to buy stakes of less than 1 percent in Barclays, the Royal Bank of Scotland, British Gas, Cadbury, Tesco, Unilever, and others.[178]

In the clearest case yet of using its foreign exchange reserves as a tool to advance China's foreign policy goals, in January 2008 SAFE bought $150 million in U.S. dollar-denominated bonds from the government of Costa Rica as part of an agreement signed the previous year under which the Central American nation cut diplomatic ties with Taiwan (after 63 years) and instead established relations with the People's Republic of China.[179] The agreement explicitly links the foreign policy switch to China's purchase of government bonds and a grant of $130 million, reading in part that "Once diplomatic relations are established [China] will buy in two equal parts, in January 2008 and January 2009, the sum of US$300m in Costa Rican bonds [. . .]."[180]

In an exchange of letters from January 2008 between SAFE's deputy administrator and Costa Rica's finance minister, SAFE promised to buy government bonds under the terms of the 2007 agreement but included a clause requiring Costa Rica to take "necessary measures to prevent the disclosure of the financial terms of this operation and of SAFE as a purchaser of these bonds to the public."[181] The details came to light only after *La Nación*, Costa Rica's largest newspaper, won a court case, and a judge ordered the government to release the information to the public.[182] Both Taipei and Beijing have used "checkbook diplomacy" in the past, but this is the first confirmed time that China has used its foreign exchange funds as a means of directly applying political pressure. It also demonstrates the great length to which SAFE is willing to go in order to hide its objectives and investment positions.

It is not yet clear if SAFE will continue to act as a second de facto sovereign wealth fund for China or if the PRC government will decide that SAFE has overstepped its authority and force it to sell its equity holdings. A story in *Caijing*, China's premier economics and business magazine, quoted an anonymous Chinese official as claiming that the State Council had authorized SAFE to invest 5 percent, or about $50 billion, of China's foreign exchange reserves in non-fixed-income investments.[183] Whether SAFE has done so is uncertain, but the bureaucratic conflict driving SAFE's actions may have far-reaching consequences for CIC and for the foreign recipients of sovereign wealth. Of these two pools of sovereign wealth, only one, CIC, is under any pressure to disclose its dealings and operations, while SAFE's activities are veiled in secrecy.

CIC's Record on Transparency

CIC has a mixed record on revealing details of its investment timing and strategy. The fund has provided a considerable amount of information about its administration and has quickly announced its investment decisions after they have been made but not the precise details of when and how the investments will be or have been made.[184] This is not wholly unexpected, however, as most fund managers and the International Monetary Fund (IMF), which has drawn up general guidelines for the operation of sovereign wealth funds, agree that premature disclosure can be harmful. Markets already fluctuate in response to rumors of CIC's planned investments, and too much information before the fact could lead to mispricing and volatility. For example, if CIC announces that it will invest a large sum of money in a particular sector, many other investors will try to move immediately to profit from any resulting rise in value.

CIC officials and other leading economic figures in China have been making reassuring statements about the transparency of CIC's operations and management, but often with caveats. For example, on the day 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."[185] CIC's pledge of transparency was reiterated by Vice Minister Li in November 2007 during an international investment forum.[186]

In a meeting with Commissioners during the March–April 2008 trip to China, CIC President Gao said that when CIC was founded, Premier Wen established three principles for the organization: be transparent and responsible for shareholders, be responsible to markets, and obey the laws of recipient countries. This, Mr. Gao said, is consistent with draft IMF principles on sovereign wealth funds. CIC, he mentioned, frequently consults with representatives of Norway's sovereign wealth fund, who noted that CIC was on the right path and that criticism would wane once other countries are more familiar with CIC's leadership and operations. In a sentiment he would frequently echo in later statements, Mr. Gao suggested that U.S. officials should be patient with CIC as it evolves relative to sovereign wealth fund best practices. Other sovereign wealth funds have had many years to improve their operations, while CIC is only six months old, he emphasized. Criticizing CIC's executives, all of whom are proponents of reform, too soon and too hard would be counterproductive. "If you push too hard, it will backfire," he added. Mr. Gao sees no problem if sovereign wealth funds, including CIC, are treated like other large institutional investors. However, there is a big concern in China that CIC is being held to a separate standard.

During an April 2008 interview with CBS correspondent Lesley Stahl on the television show "60 Minutes," CIC President Gao said that it would be CIC's policy "not to control anything," because "we don't want to go in and say, 'OK, I think you should change this person or I think you should change this product line.' That's not our business."[187] Mr. Gao said the reason he agreed to the interview, a first for a high-ranking manager of China's foreign exchange reserves, was to dispel fears that CIC will try to gain control of the market, steal government secrets, or trigger a U.S. economic collapse by withdrawing financing. Such actions would "hurt the company [CIC], hurt China," Mr. Gao explained.[188] He again reiterated CIC's commitment to transparency, saying that, at the time, CIC was only five months old but that it would produce annual reports and would be "like the Norwegian sovereign wealth fund," which is considered a paragon of best practices.[189] However, in his testimony before the Commission, Peter Navarro, a business professor at the University of California-Irvine, argued that China's and Norway's sovereign wealth funds are fundamentally different, because China has a history of using its financial resources to achieve political goals.[190]

The degree and speed at which China will make CIC more transparent is uncertain. Speaking at a dinner hosted by the mayor of London in December 2007, CIC Chairman Lou gave a more nuanced view. "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," said the chairman.[191] Moreover, China does not disclose the pace at which it is transferring additional funds to CIC or the extent to which the state banks have been forced to hold dollars, which obfuscates CIC's endowment and its investment capacity.

Dr. Truman has developed a scale for ranking the world's sovereign wealth funds on structure, governance, accountability and transparency, and behavior. In Dr. Truman's scorecard, CIC's score—29 out of 100—gives it a relatively low ranking compared to Norway (score of 94), South Korea (51), Kuwait (48), and Singapore's Tamasek Holdings (45).[192] The funds of Gulf oil-exporting nations, on the other hand, score significantly worse, with scores of 18 for Brunei, 15 for Abu Dhabi, 14 for Dubai, 9 for Qatar, and 9 for the United Arab Emirates.

Investment Vehicles Outside CIC

Chinese government and CIC officials steadfastly have maintained that their only motivation for investing the country's sovereign wealth in the United States or other western countries is to seek profitable returns. Whether such assurances are sincere, recent revelations of the activities of other Chinese government-affiliated investment entities raise questions about the transparency of and motivations for Chinese state-affiliated investments. These entities are not formally designated sovereign wealth funds but they nonetheless manage China's state-controlled financial resources. In early January 2008, articles appearing in the *Financial Times* revealed the existence of at least one investment vehicle still controlled by SAFE. This entity, Safe Investment Company Limited, was involved in an apparent effort to make secret purchases of stock in three Australian banks (see the portion of this section on SAFE).

China's primary state-owned holding company is the CITIC Group, formerly the China International Trust and Investment Company, established in 1979 with the approval of then-PRC President Deng Xiaoping.[193] Its initial aim was to "[attract and utilize] foreign capital, [introduce] advanced technologies, and [adopt] advanced and scientific international practice in operation and management."[194] The CITIC conglomerate oversees the government's international investments as well as some domestic ones and answers directly to the State Council. CITIC now owns 44 subsidiaries, including China CITIC Bank; CITIC Holdings; CITIC Trust Co.; CITIC Merchant Co., Ltd.; CITIC Securities (China's biggest brokerage); CITIC Pacific; CITIC Capital; CITIC Resources Holdings; and CITIC International Financial Holdings. Its areas of investment include the financial services industry, telecommunications, construction, manufacturing, specialty steel manufacturing, iron ore mining, property development, media, and industries providing other products and services.[195] In November 2007, CITIC Securities announced that it planned to buy about 6 percent of Bear Stearns for about $1 billion in a deal that would have involved Bear Stearns taking an equity stake in CITIC at a later date. Chinese regulatory approval was delayed, and the deal was abandoned in March 2008 amid Bear Stearns' collapse. JPMorgan Chase agreed to buy Bear Stearns for $236.2 million, saving CITIC from a huge financial loss and embarrassment.[196]

In addition to the PRC central government's sovereign wealth funds, various regional governments have their own investment funds, such as the planned $2.9 billion (20 billion RMB) Shanghai Financial Industry Investment Fund. Shanghai International Group, an arm of the municipal government, and investment bank China International Capital Corp (CICC), will hold equal stakes of either 40 percent or 50 percent in a company that will manage the fund.[197]

According to a report in *Caijing*, "The Shanghai government obtained approval last year from the State Council to launch the fund. If launched, it will be the second RMB-denominated, city-backed fund in China following the Bohai Industrial Investment Fund in the northern Chinese port of Tianjin that has 20 billion RMB (about $2.9 billion)."[198] The provinces of Shanxi, Guangdong, and Sichuan also have won approval in principle to establish similar funds focused on energy, nuclear power, and high technology, respectively.[199]

There also are vehicles created specifically to invest in emerging markets such as the China-Africa Development Fund (CADFund).

CADFund was launched in June 2007 with an initial $1 billion provided by the China Development Bank; it plans to grow eventually to $5 billion, the fund's Vice President Hu Zhirong said.[200] The fund plans to spend about $300 million on projects in 2008 and already has invested $60 million in the first glass factory in Ethiopia, a power station in Ghana, and a chrome plant in Zimbabwe.[201] According to Mr. Hu, CADFund also is working with several Chinese firms to form a holding company that will manufacture construction materials in all African countries.[202]

These multiple investment vehicles are in a special position to rely on the Chinese central government's financing, insight, and strategic planning. Time will tell if they choose to do so, and, if they do, how that will affect their activities.

Activities of China's Investment Funds

Several investments now under CIC's jurisdiction were made before CIC was formally launched and named. In May 2007, China Jianyin, a subsidiary of Central Huijin, purchased a 9.9 percent stake in Blackstone Group nonvoting shares worth $3 billion.[203] According to Blackstone's Chief Executive Officer and Chairman Stephen A. Schwarzman, the deal was "purely commercial" and did not need U.S. government approval "as the stake is less than 10 percent."[204] The deal, moreover, was struck "without any discount or influence, while it barred CIC from selling the stake for four years or making similar investments for a year."[205] The investment, now criticized in China for losing some three-quarters of its value following Blackstone's subsequent public listing, made the Chinese acutely aware of the danger of financial loss and the potential for loss of face. This may be reflected in the more cautious approach that has been taken regarding later foreign investments. In October 2008, however, reports emerged that CIC is intending to raise its stake in Blackstone from 9.9 percent to 12.5 percent by buying Blackstone shares in the open market at a significant discount (CIC paid $29 a share for the original 9.9 percent stake, while the price in mid-October is between $9 and $10).[206] While the original investment with Blackstone prevents CIC from selling its shares for four years, the new purchase will not have such restrictions.[207]

In November 2007, Central Huijin announced it intended to purchase a 70.92 percent stake in China Everbright Bank, a Beijing-based joint-equity commercial bank.[208] Later the same month, the bank's shareholders agreed to accept 200 billion RMB ($29 billion) from CIC.[209] While China Everbright Bank's shareholders were reaching their decision, the newly formed CIC assumed responsibility for the assets and liabilities of Central Huijin, which previously was owned by the People's Bank of China. The People's Bank of China received about $67 billion from CIC in compensation for Central Huijin, approximately one-third of CIC's working capital.[210] As a result, CIC became the parent company for Central Huijin and its subsidiary China Jianyin, plus owner of $3 billion in Blackstone Group stock that had been purchased by China Jianyin. In addition, CIC indirectly became a major stockholder in China Construction Bank and the Industrial and Commercial Bank of China by way of the investments of Central Huijin and China Jianyin in those two banks.[211]

Also in November 2007, CIC decided to recapitalize two of China's state-owned banks, the Agricultural Bank of China and the China Development Bank.[212] After its investment in the Agricultural Bank of China, CIC supposedly was to own one-third of the bank, with another third owned by China's Ministry of Finance.[213] According to an August 2008 report from *China Business News*, the Agricultural Bank of China's reform proposal has been approved by the State Council, and the bank will receive a $20 billion injection from Central Huijin.[214] In December 2007, Central Huijin signed an agreement to invest $20 billion in the China Development Bank.[215]

Responding to the current global economic turmoil, CIC's Central Huijin unit announced in September 2008 that it will buy stakes in three major Chinese lenders, the Industrial and Commercial Bank of China, the Bank of China, and the China Construction Bank, to fortify their share prices amid the stock market slump.[216] The state-owned newspaper *Xinhua* reported that the move was aimed to support the steady operation of these major state-owned financial institutions, stabilize their share prices, and ensure "the government's interest in the three lenders."[217] Through Central Huijin, CIC holds 67.5 percent of the Bank of China, 59.1 percent of the China Construction Bank, and 35.3 percent of the Industrial and Commercial Bank of China. China's Ministry of Finance also owns 35.3 percent of the Industrial and Commercial Bank of China, giving the government absolute control over the principal arms of the nation's financial industry.[218] All these banks were state owned before their respective public offerings, but the purchase of the additional shares will only strengthen the government's grip.

CIC has made several other major investments since its establishment. In November 2007, CIC announced plans to purchase $100 million in shares of a Hong Kong initial public offering for the China Railway Group (CRG), a state-owned company that reportedly is one of the largest construction companies in the world.[219] Then in December 2007, CIC paid $5 billion for a 9.9 percent stake in Morgan Stanley, one of the largest U.S. investment banks.[220] Morgan Stanley stressed that CIC will have "no special" rights of ownership and no role in corporate management.[221] As in the Blackstone deal, the Morgan Stanley investment resulted in a loss, with the shares falling some 80 percent this year (as of October 2008).[222]

In 2008, CIC invested $100 million in Visa's initial public offering and signed a deal with J.C. Flowers & Co., a U.S. private equity firm, to launch a $4 billion private equity fund focusing on investments in U.S. financial assets.[223] It will be the first private equity fund to be launched by CIC since it was established and likely will help mollify some of those complaining about CIC's investments, because the investment will be managed indirectly.[224] Press accounts citing unnamed sources report that eight overseas asset managers are in final talks about contracting with CIC to run $250 million to $600 million of fixed income funds focused on emerging markets.[225] Also indicative of CIC's intention to diversify its portfolio is the report in the state-controlled *China Securities Journal* that it will "make international equity investments focusing on actively managed funds, shares in emerging market companies, and Asia Pacific stocks excluding Japan, [and] also plans to invest in a portfolio of blue-chip stocks." [226]

In early October 2008, amid Wall Street turmoil, news reports indicated that CIC, which already has made a series of losing investments in western financial institutions, had $5.4 billion frozen in a failed U.S. money market fund, Reserve Primary Fund.[227] The investment, an 11.1 percent stake, was made through Stable Investment Corporation, a wholly owned CIC subsidiary registered at the same Beijing address as CIC and sharing employees with it.[228] Reserve Primary Fund is in crisis, because in September 2008 it had to value $785 million worth of Lehman Brothers debt securities at zero in the wake of the investment bank's bankruptcy filing.[229] As a result, Reserve Primary Fund was inundated with requests for withdrawal and after the value of its shares dropped to 97 cents, it froze all redemptions.[230] The news of yet another disastrous investment and possible loss triggered enough public outrage to induce CIC to release a statement on its Web site "to clarify" the situation. In the press release, CIC said that although CIC "had invested in the [Reserve Primary Fund], [CIC] filed a redemption order before the Fund announced the suspension of redemption; in addition the Fund has confirmed in writing that CIC's investment will be redeemed at par. [. . .] CIC is confident of its position with regard to the full recovery of its money." [231] Though CIC seems assured that its investment will be recovered fully, this event will provide more fuel to those within the Chinese government and public who believe China should not invest in western financial markets. According to documents filed with the U.S. Securities and Exchange Commission (SEC), Stable Investment Corporation also has invested about $5.9 billion in three other U.S. money market funds: $2.1 billion in the Invesco Aim Liquid Portfolio; $2.3 billion in the JPMorgan Prime Money Market Fund; and $1.5 billion in Deutsche Asset Management's DWS Money Market Trust.[232]

So far, most CIC investments appear to have been made based on noncommercial criteria. For example, there are indications that the State Council, the People's Bank of China, and China's National Development and Reform Commission insisted that CIC help to restructure the two state-owned banks (Agricultural Bank of China and China Development Bank) as a condition of CIC's establishment.[233] Li Yang, director of the Finance Research Institute of the Chinese Academy of Social Sciences, said that "as a state investment institution, the company [CIC] will work to ease the pressure of rising forex [foreign exchange] reserves and absorb market liquidity," a goal which, while important for the Chinese state, certainly is not predicated solely on anticipated return on investment.[234]

Each of CIC's foreign investments to date has acquired less than a 10 percent share of the company in which the investment was made—a level below which U.S. regulatory authorities consider the stake to be noncontrolling and thus exempt from investigation and oversight. This suggests that the Chinese are becoming more sophisticated in their investment activities and are learning from past experiences, such as when the Chinese oil company CNOOC

Ltd. attempted to acquire the U.S. oil firm Unocal Corp. in 2005 and encountered heavy U.S. opposition on the grounds that such a takeover would threaten U.S. national and economic security interests.

Possible Implications of CIC Investments for Global Markets and the U.S. Economy

While there has been little controversy over the behavior of most sovereign wealth funds, the potential financial clout of the 40 largest sovereign wealth funds, their opportunistic investing, and their linkages with nondemocratic regimes are sources of concern. In the case of China, its sovereign wealth funds are even more controversial because of their size and potential market effects. As of July 2008, the Chinese government held about $967 billion in U.S. government securities, which made it the largest holder in the world and endows it with the ability to sway markets.[235]

According to the testimony before the Commission of Michael F. Martin, an analyst at the Congressional Research Service, one major worry is that "China [would use] CIC to secure significant market power over an important commodity market or financial sector."[236] Using its enormous wealth and government connections, CIC has the capacity to buttress China's national energy security by, for example, purchasing vast natural gas and oil reserves or strategic minerals and ores. Such activities not only would grant China control over resources whose price normally is determined by the markets but also would harm other economies by restricting their access to these resources.

Another concern is that rumors or speculation about the investment activities of CIC may instigate increases in market volatility. Since CIC's establishment, there have been cases in which stock prices of companies rumored to be possible targets of CIC investment have jumped as much as 10 percent in one day. In February 2008, a rumor that CIC, along with China Shenhua Energy, might invest in Australia's iron ore company Fortescue, pushed up its stock price by 10.5 percent.[237] Similarly, in late 2007, rumors that CIC was going to invest in Australian mining company Rio Tinto contributed to a 7.5 percent rise in Rio Tinto's stock despite CIC's repeated assertions that there was no truth to the rumor.[238]

The creation of CIC and, implicit in it, China's desire to diversify its portfolio pose a host of other issues for the U.S. economy. As Dr. Setser, an expert on this issue, said in his testimony before the Commission, as long as "China manages its currency against the dollar, it is likely to face pressure to keep the majority of its foreign assets in dollars, which in turn implies it could soon be a large presence in the U.S. equity market."[239] Further, "so long as China's government has an effective monopoly on outward Chinese investment flows, the growth of Chinese investment in the U.S. implies the growth of Chinese government investment in the [United States]—and the prospect that a foreign government will own sizeable stakes in a number of U.S. firms."[240]

The recent investments by sovereign wealth funds, including CIC, in financial firms harmed by the subprime mortgage crisis were widely perceived as providing market stability at a time when major financial firms like Morgan Stanley, Citigroup, and UBS were in trouble. In addition, because sovereign wealth funds typically are not highly leveraged and are seeking long-term returns from their investments, they are under less pressure to liquidate investments during times of major market volatility.[241]

In his testimony before the Commission, Robert Dohner, deputy assistant secretary of the Treasury for Asia, said that the most pressing concern raised by sovereign wealth funds is the risk that their proliferation "could provoke a new wave of investment protectionism, which would be very harmful to the global economy."[*][242] However, according to the testimony of Linda Chatman Thomsen, director of the Division of Enforcement at the Securities and Exchange Commission (SEC), the Treasury also is concerned that "through inefficient allocation of capital, perceived unfair competition with private firms, or the pursuit of broader strategic rather than strictly economic return-oriented investments," sovereign wealth funds may contribute to market volatility and distortions.[243]

There are also worries about the potential for abuse or corruption created by the greater role sovereign wealth funds carve out for governments in the private sector. As the existing investments of CIC reveal, there is a growing network of interlinked investments among banks and other financial firms within China and overseas. Some U.S. financial analysts are concerned that CIC could seek to increase its market share in important industries via targeted acquisitions or takeovers.[244] Others have warned that CIC's investments in financial firms will provide those firms with unfair preferential access to China's domestic financial markets.[245]

According to a July 2008 account in the *Sunday Telegraph*, HSBC Holdings, a banking group, is hoping for exactly such an outcome.[246] The newspaper reported that Stephen Green, group chairman of HSBC Holdings, has met with officials from CIC several times in recent months to discuss the possibility of the Chinese sovereign wealth fund buying shares in HSBC on the open market, since the bank has no need to raise additional capital—a move, some analysts have suggested, that may facilitate HSBC's listing on the Shanghai stock exchange and "reduce political barriers to its expansion into the Chinese market."[247] Another persistent worry is 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.[248]

An additional crucial issue is the conflicts of interest that arise when government is both the regulator and the regulated. Rules that might be applied rigorously to private sector competitors may

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* "Investment protectionism" refers to the practice of countries erecting barriers to international investment, regardless of whether the investor holds a controlling interest in national firms, by, among other things, reducing the transparency of investment policies and processes, increasing regulatory obstacles, treating investors unequally through tax and regulatory policies that discriminate between foreign and domestic entities, or dictating to foreign investors how to allocate their investments. See Assistant Secretary of the Treasury for International Affairs Clay Lowery, *Remarks at Barclays Capital's 12th Annual Global Inflation-Linked Conference*, Key Biscayne, FL, February 25, 2008. www.ustreas.gov/press/releases/hp836.htm; Secretary of the Treasury Henry M. Paulson, Jr., *Opening Statement at the Meeting of the U.S.-China Strategic Economic Dialogue*, Beijing, China, December 12, 2007. www.ustreas.gov/press/releases/hp727.htm.

not be applied necessarily in the same way to organizations that are a part of the government that makes the rules, and the opportunity for political corruption increases.[249]

For the SEC, which is charged with investor protection, sovereign wealth funds raise a number of problems, chief among them "the fact that the ability of U.S. supervisors to govern sovereign wealth funds is mostly unclear."[250] Like other participants in the U.S. capital markets, sovereign wealth funds are subject to federal securities laws, including a variety of disclosure requirements and antifraud provisions, generally found in sections 13 (Periodic and Other Reports) and 16 (Directors, Officers, and Principal Shareholders) of the Securities Exchange Act of 1934.[251] Neither international law nor the Foreign Sovereign Immunities Act renders these funds immune from the jurisdiction of U.S. courts in connection with their commercial activity conducted in the United States. These provisions include requirements that

Owners of more than 5 percent of a registered class of securities disclose their share ownership and any plans for influencing or taking over the issuer;

Institutional investment managers with discretion over accounts holding more than $100 million of SEC-registered securities file quarterly reports on all SEC-registered securities in the accounts; and

Owners of more than 10 percent of a class of equity securities registered with the SEC report on the size and composition of their holding and on changes to that ownership.[252]

There are serious enforcement issues associated with sovereign wealth funds, however. They are relatively opaque and, "by virtue of their substantial assets," have "substantial power in our financial markets," which makes them similar to hedge funds that also are opaque.[253]

Hedge and private equity funds are virtually unregulated in the United States. They provide vehicles for CIC and other Chinese state-controlled entities legally to hide their investments from public view. CIC's investment of a reported $4 billion with J.C. Flowers & Co., a New York-based private equity firm, provides an illustration of how this can work. CIC's investment reportedly represents 80 percent of the newly created Flowers fund. If this fund in turn purchases 10 percent of a publicly traded entity in the United States, the only disclosure precipitated by the transaction will be various filings with the SEC requiring information about the J.C. Flowers entity to be revealed, but not the underlying fact that CIC is an 80 percent investor in the vehicle that purchased 10 percent of the firm. Nor, for that matter, is there any disclosure requirement if the other 20 percent of the Flowers fund were held by other Chinese state-owned entities, if that were in fact the case. Disclosure of material information is the underpinning of the U.S. securities markets. But current disclosure rules do not appear uniformly to force the revelation of the routine investments (after the fact) by CIC or other sovereign wealth funds in the U.S. public securities market. Yet thousands of U.S. institutional investment managers are legally required to disclose their holdings on a quarterly basis with the SEC.

In addition, unlike hedge and private equity funds, sovereign wealth funds have power derived from being governmental entities, which may give them access to government officials and information that is not available to other investors. SEC Enforcement Division Director Thomsen, testified before the Commission that there is "the potential for these powerful market participants to obtain material non-public information, either by virtue of their financial and governmental powers or by use of those powers, and to engage in illegal insider trading using that information."[254] The magnitude of any such conduct could be quite large, given the assets these funds have at their disposal.

Another series of issues associated with sovereign wealth funds relates to the need for law enforcement authorities to work together in order to police global markets effectively. According to Ms. Thomsen, each year the SEC "makes hundreds of requests to foreign regulators for enforcement assistance, and responds to hundreds of requests from other nations."[255] In the case of sovereign wealth funds, however, the SEC is concerned that if the government from which it seeks "assistance is also controlling the entity under investigation, the nature and extent of cooperation could be compromised."[256]

National Security Considerations and Policy Responses

In many respects, the security concerns raised by sovereign wealth funds are an extension of the economic concerns, but they are not necessarily the same. Potential CIC investments in companies that possess important dual-use technology or intellectual property are one example. In theory, the review process of the Committee on Foreign Investment in the United States (CFIUS) checks proposed foreign investments in U.S. companies to ensure that sensitive technology will not be diverted to foreign actors in such a way as to threaten U.S. interests.[257] In some ways, CIC's portfolio investment abroad is "likely to produce less controversy than the outward expansion of China's cash-rich state firms," Dr. Setser said. That is because, if its public statements to that effect are any indication, the CIC lacks the capacity to manage controlling stakes in a large number of firms, whereas Chinese state-owned firms may want controlling stakes.[258]

In his testimony before the Commission, Dr. Navarro points to China's historical record of "strategically deploying its excess foreign reserves as a 'loss leader' to achieve economic goals other than to maximize its financial return" and cites China's persistent undervaluation of its currency.[*] [259] By purchasing corporate assets, the argument goes, "Chinese sovereign wealth funds will be able to heavily influence decisions about the offshoring of jobs, managerial best practices, research and development, and technology transfer," as well as to "seek to gain control of critical sectors of the U.S.

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* "Loss leader" is a commodity offered by the seller at cost or below cost of production to attract customers. The price can even be so low that the product is sold at a loss. In other words, the seller is wiling to accept a short-term loss of profit in exchange for some long-term benefits, like a future increase in sales.

economy—from ports and telecommunications to energy and defense, [and especially] 'dual use' technologies with both civilian and military applications."[260]

In July 2007, Congress passed and the president signed into law the Foreign Investment and National Security Act of 2007 (FINSA). The law grants CFIUS the authority to investigate any foreign investment transaction (including mergers, acquisitions, or takeovers) if the transaction "threatens to impair the national security of the United States and that threat has not been mitigated during or prior to the review of a covered transaction"; if it "is a foreign government-controlled transaction"; or if it results in "control of any critical infrastructure of or within the United States by or on behalf of any foreign person."[261] The new law also expands criteria for CFIUS to use when determining if an investigation of possible deleterious effects of a proposed transaction is warranted, including whether the transaction is a "foreign government-controlled transaction."[262] FINSA codifies CFIUS' authority to reopen an approved transaction if any party has omitted or submitted false or misleading material information or if any party intentionally and materially breaches a national security agreement aimed at mitigating the risk of the transaction.[263] In addition, FINSA increases Congressional oversight of CFIUS by requiring more detailed reports to Congress on CFIUS actions and the results of its investigations. However, the authority to suspend or prohibit foreign investments in the United States remains with the president.[264]

Also, it remains unclear if purchases by CIC in concert with other state-controlled entities in increments of less than 10 percent over, for instance, several months or years would trigger a national security review under current CFIUS laws and regulations.

There are critics who do not believe the new law sufficiently protects the United States from the risks posed by the emerging sovereign wealth funds. Some maintain that while FINSA effectively deals with the national security risks posed by foreign investments, it does not adequately address the economic security risks.[265] In his November 2007 testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Dr. Truman mentioned that "some observers" are concerned about the stability implications for the U.S. economy and financial systems of sovereign wealth fund investments in "private equity firms, hedge funds, and regulated financial institutions."[266]

Cognizant of the concerns raised by sovereign wealth funds in general and CIC in particular, the Treasury Department "has taken a number of steps to help ensure that the United States can continue to benefit from open investment, including by sovereign wealth funds, while addressing these potential concerns."[267] In addition to strengthening and aggressively implementing the CFIUS process, the Treasury has "proposed that the international community collaborate on a multilateral framework for best practices for sovereign wealth funds."[268]

The IMF, with support from the World Bank and input from sovereign wealth funds, has developed a voluntary code of best practices for sovereign wealth funds that will "provide guidance to new funds on how to structure themselves, reduce any potential systemic risk, and help demonstrate to critics that sovereign wealth funds can continue to be responsible, constructive participants in the international financial system."[269] The IMF's International Working Group of Sovereign Wealth Funds (IWG), whose members include nations such as China and Abu Dhabi that operate sovereign wealth funds as well as countries such as the United Sates that have received funds, reached broad agreement on the Generally Accepted Principles and Practices (GAPP) after September 2008 negotiations in Santiago.[270] The 24 voluntary principles and practices, the so-called "Santiago Principles," have been hailed by Deputy Secretary of the Treasury Robert Kimmitt as "a milestone in enhancing the openness and transparency of the global financial system and in promoting open investment worldwide."[271] The IWG members will implement the principles on a voluntary basis, "*each of which is subject to* [sic] home country laws, regulations, requirements and obligations"; the IMF will not play a monitoring role.[272]

The principles are intended to allay concerns that sovereign wealth fund investments are politically motivated by emphasizing that their policy purpose should be clearly defined and publicly disclosed, and based on economic and financial objectives (GAPP Principle 2).[273] If a fund chooses to pursue any other objectives, they should be narrowly defined and mandated explicitly, while ensuring that investments are undertaken without "any intention or obligation to fulfill, directly or indirectly, any geopolitical agenda of the government."[274] GAPP Principle 19 goes further, calling for investment decisions that "are subject to other than economic and financial considerations [to] be clearly set out in the investment policy and be publicly disclosed."[275] GAPP Principle 9, discussing sovereign wealth funds' operational management, suggests that to "enhance confidence in recipient countries, it is important that managers' individual investment decisions to implement the [sovereign wealth fund's] defined strategy be protected from undue and direct political interference and influence. As owner, the role of the government is to determine the broad policy objectives of the [sovereign wealth fund], but not to intervene in decisions relating to particular investments."[276] On the issue of a fund's access to market-sensitive information through its government connections, GAPP Principle 20 suggests that sovereign wealth funds "should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities."[277] The principles also call for sovereign wealth funds to establish a clear division of roles between owners and managers (GAPP Principle 6) and, if a sovereign wealth fund chooses to exercise ownership rights, publicly to disclose its approach to voting and other factors guiding its exercise of ownership rights (GAPP Principle 21).[278]

According to Dr. Truman, an expert on sovereign wealth funds, the weakest areas of the Santiago Principles are those related to transparency and accountability. "Disturbingly, many of the principles are silent about disclosure to the general public or only call for disclosure to the fund's owner. That approach does not promote the needed accountability to citizens of the country with the SWF [sovereign wealth fund] or of other countries," Dr. Truman wrote.[279] GAPP Principle 11 calls for publication of an annual report, while GAPP Principle 17 suggests public disclosure of funds' asset allocations, benchmarks, and rates of return.[280] At the same time, however, the principles "[are silent] on each fund's revealing its size even while endorsing full annual reports where that information would be redacted," according to Dr. Truman.[281] During the press briefing at the launch of the Santiago Principles, David Murray of the Australia Future Fund, chair of the IWG's Drafting Group, stated that "we [the IWG] believe that size is not necessarily indicative of trust in terms of economic intent, whereas a demonstration of strategic asset allocation, benchmarks, investment policy, and those things which give rise to the real risk appetite and decision making of the sovereign wealth fund are more likely to build trust than just an exposition of size."[282]

A plethora of other government and quasi-government organizations, both within individual nations and multilateral institutions, is scrutinizing sovereign wealth funds and formulating the best ways to coexist with them. The Organization for Economic Cooperation and Development (OECD) is working to identify best practices for countries that receive foreign government-controlled investment, which will focus on avoiding protectionism.[283] In April 2008, as an initial step, the OECD Investment Committee published a report on "Sovereign Wealth Funds and Recipient Country Policies," which provides guidance for recipient country policies toward sovereign wealth fund investment, drawing on key OECD investment policy principles of transparency, liberalization, nondiscrimination, predictability, and accountability.[284]

The U.S. Treasury Department has created a working group on sovereign wealth funds that draws on the expertise of Treasury's offices of International Affairs and Domestic Finance. The President's Working Group on Financial Markets, chaired by Treasury Secretary Henry Paulson, has initiated a review of sovereign wealth funds.[285] In September 2008, the United States and China launched the negotiation of a bilateral investment treaty. The negotiations are still in the very early stages but could have an impact on the regulation of investments by China's sovereign wealth fund and other entities in the United States. (See chap. 1, sec. 1, for additional discussion on the investment treaty.)

The U.S. policy response to sovereign wealth funds in general is especially constrained, because much existing financial regulatory law, particularly pertaining to banking and taxation, was not written with sovereign wealth funds in mind and must be adapted. A June 2008 report by the Congressional Joint Committee on Taxation discussed the application to sovereign wealth fund investments of existing tax law that pertains to commercial endeavors of foreign governments. Under the current U.S. tax code, passive portfolio investments by foreign governments are not deemed to be commercial and therefore are exempt from taxation. This exemption is not specifically directed at sovereign wealth funds and, in fact, "first became part of the U.S. income tax laws in 1917, long before the first sovereign wealth funds were created."[286] While a controlling stake would mean that the sovereign investor would be liable for taxes like a private investor, the Joint Committee on Taxation report states that

> *[. . .] some of the most important statutory U.S. income tax advantages that a foreign sovereign investor enjoys over a*

> *foreign private investor are: exemption from U.S. withholding tax on all U.S. source dividends paid by noncontrolled corporations; exemption from U.S. withholding tax on interest paid by a corporation where the foreign sovereign owns at least 10 percent (so the general 'portfolio interest' exemption is not available) but less than 50 percent (so the payor is not 'controlled' by the foreign sovereign) of the payor; and exemption from U.S. tax on certain gains from real estate transactions.*[287]

Existing banking law was not written with sovereign funds in mind, but the experiences of applying it to transactions of foreign government investors in the United States, including those pertaining to state banks, provide precedents worth considering. In any event, moving through these uncharted waters to devise and tailor new applications of the old laws is challenging.

These difficulties have contributed initially to delays in a decision on whether to allow two Chinese state banks, Industrial and Commercial Bank of China and China Construction Bank, to open branches in the United States. Since CIC was established and given control of Central Huijin, the state bank holding company, CIC, has held responsibility for managing the controlling stakes in Chinese state banks. Therefore the U.S. Federal Reserve had to decide "whether CIC should itself, as the ultimate controlling shareholder in the banks, be treated as a bank holding company" and subject to the same obligations as Central Huijin.[288]

The U.S. Federal Reserve Bank approved Industrial and Commercial Bank of China's application in August 2008 (China Construction Bank's application is still under consideration) but with a warning that CIC "cannot subsidize loans for its companies" through the New York branch of the Industrial and Commercial Bank of China.[289] Transactions with companies controlled by CIC will be limited to 20 percent of the Industrial and Commercial Bank of China branch's lending base, the Federal Reserve said.[290] In a legal interpretation letter issued concurrently with the Industrial and Commercial Bank of China's approval order, the Federal Reserve granted to CIC and Central Huijin exemptions under the Bank Holding Company Act from the nonbanking restrictions of the act.[291] The Fed granted the exemptions based on CIC's and Central Huijin's status as wholly state-owned vehicles and on the conditions that they conduct "the greater part of [their] business . . . outside the United States" and obey several other ownership and holding restrictions pertaining to financial holding companies, banks, and bank holding companies.[292]

Conclusions

- The significant expansion of the Chinese government's involvement in the international economy in general and in the U.S. economy in particular has concerned many economists and government officials due to uncertainty about the Chinese government's and the Chinese Communist Party's motivations, strategies, and possible impacts on market stability and national security. At the same time, cash-strapped U.S. firms have welcomed the investments, viewing them as stable and secure sources of financing in the wake of the credit crunch.

- China's government uses a number of state-controlled investment vehicles among which it chooses depending on its particular investment purposes and strategies; most widely known among such vehicles are China Investment Corporation (CIC), the State Administration for Foreign Exchange (SAFE), and China International Trust and Investment Corporation (CITIC).

- Some aspects of China Investment Corporation's mandate follow China's industrial policy planning and promotion of domestic industries by, for example, investing in natural resources and emerging markets that are relevant for the advancement of China's value-added industries. CIC and SAFE form just one part of a complex web of state-owned banks, state-owned companies and industries, and pension funds, all of which receive financing and instructions from the central government, promote a state-led development agenda, and have varying levels of transparency. Many of their investment activities contravene official assurances that they are not being managed to wield political influence.

- Regulations governing investments by sovereign wealth funds, especially disclosure requirements pertaining to their transactions and ownership stakes, are still in development, both in the multilateral arena and in the United States. There is concern that the Chinese government can hide its ownership of U.S. companies by using stakes in private equity vehicles like hedge or investment funds.

- China's foreign exchange reserves continue to grow, while its management of the exchange rate has given it monopoly control on outward flows of investment. This strongly suggests that China will have a very substantial and long-term presence in the U.S. economy through equity stakes; loans; mergers and acquisitions; ownership of land, factories, and companies; and other forms of investment.