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Development Of China's Sovereign Wealth Funds

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Abstract
Sovereign wealth funds (SWFs) have over $12.05 trillion in assets under management as of January 2024. Most of these 176 funds are sponsored by non-Western countries and their growth has made SWFs important international investors, particularly in private equity funding. We first define SWFs, then discuss their evolution into today's categories of stabilization, savings, and development/strategic funds. As the largest holder of foreign exchange reserves in the world, Mainland China established its first Sovereign Wealth Fund in 2007, which attracted considerable international attention immediately. On one hand, the scale of sovereign wealth funds had reached US 200 million $, which is the sixth highest in the world; on the other hand, China's sovereign wealth funds became active funds for investment under the global financial crisis occurred in 2008 when many countries were facing fund shortage. From the viewpoint of Independence Theory, this study investigated the positive political and economic benefits of China's sovereign wealth funds, as well as its problems, and proposed suggestions for its future development.

Keywords: Sovereign Wealth Funds (SWFs), Interdependence Theory, China Investment Corporation, International Political Economy, social and governance policies

Introduction

The emergence of sovereign wealth funds (SWFs) as global investors is one of the most significant financial developments of the past several decades. Two decades ago, SWFs held barely $1 trillion in assets, but that has grown more than 11-fold to $11.36 trillion at year-end 2022 (https://globalswf.com). The term 'sovereign wealth fund' was coined by Rozanov (2005) and SWFs entered mainstream Western news when they attempted to recapitalize much of the Western banking system immediately prior to the Global Financial Crisis of 2008–2010. Over the next dozen years, these funds expanded dramatically in number and aggregate size and emerged as true players in global institutional investing. After World War II, several new economic regions in East Asia and oil-producing countries in the Middle East have started to hold huge foreign exchange reserves. To pursue higher returns on investment of foreign exchange, the governments of these countries have established specialized foreign exchange investment institutions or public funds, which are known as Sovereign Wealth Funds. In recent years, the sharp rise of SWFs has attracted attention. With the largest foreign exchange reserves in the world, China established its first SWFs in 2007, and its operation has been widely concerned.

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Literature Review

"At the macroeconomic level, it is necessary to create a mechanism aimed at preventing sudden changes in the state budget revenues, which have a very high share of revenues depending on market conditions in the budget revenues, and tends to organize a system of effective management of surplus funds in the budget in certain periods of the fiscal year. Organization of sovereign funds is of particular importance in this regard" (Jumaniyazov, I. (2020)).

"Sovereign fund is a fund established for the purpose of realizing the basic constitutional rights of citizens, forming investment projects with important social aspects, based on experience and potential, with high financial and economic efficiency, and financing the budget deficit" (Jumaniyazov, I. T., & Abdurahmonov, Q. (2023)). Based on the research, it can be said that special attention is paid to the wider coverage of the stabilization of economic processes of sovereign funds.

"Sovereign funds are a financial and economic institution and one of the structures implementing the policy set by the government. Sovereign funds serve to implement social and economic functions of the country. Also, the term "sovereign funds" is used in relation to financial funds established by the state for the purpose of developing the economy over many years" (Jumaniyazov, I. T., & Islomov, A. (2023)).

"The operation of sovereign funds should be directed towards achieving the objectives and tasks of the anti-cyclical budget policy, in which the formation and use of funds is a monetary policy conducted by the state should be connected with it" (Asror, A., & Inomjon, J. (2023)). It can be said that the effective use of financial resources is important in the activity of sovereign funds.

E.H. Hansen considered sovereign funds as a tool for regulating the money supply in the country. According to the approach of this researcher, one of the important tasks of sovereign funds is to prevent the depreciation of the country's currency, thereby increasing the purchasing power of the national currency. By paying attention to these issues, there will be an opportunity to increase the income of the population. As a result, the initial and main influence of sovereign funds is the purchase price of the currency (Хансен, Э.Х. 2006).

According to I. Jumaniyazov, "sovereign fund is a centralized fund that is formed by the state and ensures its effective use by attracting a part of the income from the export of goods, budget surplus, gold currency and other reserves in order to ensure the development of the national economy and international competitiveness. is a fund" (I. T. Jumaniyazov, & A. Khaydarov. (2023)).

"According to the approach of the Institute of Sovereign Funds, the main criteria for evaluating the activity of sovereign funds are the level of openness, the level of profitability of the investment portfolio and the size of assets" (Jumaniyazov, I. T. (2019)).

It can be noted according to the above-mentioned approaches, features and issues of the sovereign funds should be learnt to understand real functions and importance of them.

Analysis and results

According to the U.S. Department of Treasury, a sovereign wealth fund is a "government investment vehicle", and is managed separately from the official reserves of the monetary authorities. International Monetary Fund (IMF) defines it as special purpose investment funds or arrangements owned by the government1. In general, SWFs refers to the continuous accumulation of government surplus and foreign exchange reserve from the improvement of economy, trade, government revenue and expenditure, and renewable natural resources, as well as the governmental implementation of long-term budget planning and fiscal expenditure restriction policy. The funds resulted from excessive fiscal revenue and foreign exchange reserve surplus are managed and operated by special investment institution, so that they can be separated from exchange rate or monetary policy to pursue higher rate of return on investment. At present, 28 countries have established their SWFs, which are mainly East Asian countries and oil-producing countries in the Middle East. Among them, the largest sovereign wealth funds is Abu Dhabi Investment Authority (ADIA), estimated to be US 875 billion $. Among the SWFs for trade development, the most famous one is Temasek Holdings Pte Ltd. According to the data from IMF, the current global SWFs had increased from US 500 billion $ in 1990 to US 2.5 trillion $ in 2007, and will reach US 10 trillion $ in 2012

In 1992, the 14th National Congress of the Communist Party (CCP) firstly proposed the policy of "active expansion in corporate foreign investment and transnational operations". Hu Jintao stressed the foreign investment in the 17th National Congress of CCP held in 2007. China's direct foreign investment was only US 900 million $ in 1990, and increased to US 18.72 billion $ in 2006. Therefore, oversea expansion of Chinese corporations is the beginning of SWF establishment.

After reform and opening in 1978, China actively attracted foreign investment and adopted export-oriented policy to accumulate a huge sum of foreign exchange reserves. The foreign exchange surplus was transformed into foreign exchange reserves, and active foreign exchange investment was carried out.

China issued special national debt through the Ministry of Finance to establish SWFs totaling US 200 billion $. The foreign exchange reserves were transferred from Peoples Bank of China (PBC) to the Ministry of Finance, and the foreign exchange reserves held by the PBC reduced.

The U.S. and other Western countries believe that the Chinese government controls the foreign exchange market by administrative power, and underrate the value of RMB deliberately for a long time, so that Chinese products can be undersold in world market. As a result, a large amount of foreign exchange reserves was created. Facing the criticism, China has appreciated RMB, and tried to reduce the holding of huge foreign exchange reserves. However, its foreign exchange reserves topped US 1 trillion $ in February of 2006, and surpassed Japan to rank the first in the world As shown in Table 1, China's first SWFs! China Investment Corporation (CIC) was founded on September 29, 2007, after less than two years of preparation, but it has become the world's sixth largest SWF.

After the establishment of CIC, Central Huijin Investment Ltd. (Huijin Ltd.) retired on December 16, 2003, and became the sole subsidiary of CIC. Basically, CIC founded the national foreign exchange investment based on the operational model of the Government of Singapore Investment Corporation (GIC)12; on the other hand, it adopted the investment model of Temasek Holdings Pte Ltd. The direct capital management is conducted for strategic industry, and the level of profits and international competition can be enhanced.

Superficially, enhancing investment returns of foreign exchange assets is the main purpose of CIC, indeed, it has two purposes in the political and economic aspects!

Expected objectives in economy:

a Develop asset allocation and diversification and internationalization of investment by expanding the foreign exchange channels and ways.

b Input funds into China's domestic financial institutions, resolve issues between the nationalized banks and securities dealers, avoid chained financial crisis, preserve and increase the value of national financial assets.

c. Increase long-term returns of foreign exchange assets

Expected objectives in politics:

a CIC obtains profits by engaging in overseas investment. It can provide supports promptly if major economic crisis or financial events take place in China, so to effectively stabilize domestic economy and maintain the stability of domination.
b For investment of other countries and investment sum, it serves as the political bargaining chip in Chinese diplomacy.
c Raise influences on international politics and economy, as well as China's position in the international community.
d Get to know political and economic situations of host country through overseas investment, collect information, and influence the relevant policies of the host country.
Based on the above political and economic objectives, CIC is consisted of three parts! 1) CIC parent company, which is responsible for investment of overseas financial assets! 2) Huijin Ltd. acquired by CIC, which continuous to input funds into state- owned commercial banks and obtain the right of controlling interests! 3) China Jianyin Investment Securities (CJIS) under Huijin Ltd., and it takes charge of funds injection and transformation of Chinese problem securities traders and handling non-performing assets.
In fact, Huijin Ltd. and CJIS belong to "policy-oriented investment", and undertake the task of official reformation of commercial banks and securities traders, while the CIC parent company is responsible for "strategic investment", and actively expands its market oversea. According to Li Yong, the Vice Minister of the Ministry of Finance of China and non-executive director of CIC, CIC plans to invest 1/3 of its asset in Huijin Ltd., another 1/3 in Agricultural Bank of China and China Development Bank, and the remaining 1/3 in the global financial market. The funds for overseas investment will total US 60 ~70 billion $.
This paper aims to discuss the current development of China's SWFs through interdependence theory, where interdependence refers to situations characterized by reciprocal effects among countries or among actors in different countries. These effects often result from international transactions, including transnational flows of money, goods, and information15. When China's SWFs have impacts on circulation across international boundaries, for example, CIC invested in the U.S. financial sectors after the subprime mortgage crisis of 2008 in the U.S., and was called the "Wall Street Savior".
Robert 0. Keohane and Joseph S. Nye analyzed international politics and economy based on the realism in international relations theory, but did not reach any comprehensive conclusion. Thus, they criticized the hypothesis of realism proposed by Hans J. Morgenthau. The realism dominated the research of international relations from 1940s to 1960s. The differences between interdependence theory and realism are described as follows In realism theory, countries are the most important actors and decisive factors in international politics. In interdependence theory, social ties have many kinds of channels, which can be divided into three kinds! relation between countries, intergovernmental relation, and transnational relation. In addition, non-state actors will replace the actor of national sovereignty gradually, and play important roles in international system and actual international political manipulation. The non-state actors include International Governmental Organization (IGO), International Non-Governmental Organization (NGO), transnational corporation, civilian interest groups, and unofficial individuals. Mainly, SWFs operate based on transnational business model, and invest in transnational corporations of other countries. For instance, CIC invested in the world's second largest private equity— Black Stone and Morgan Stanley, in 2007[18]. On the other hand, IGOs have involved in SWFs operation. As SWFs of China and other countries have expanded abroad

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continuously, IMF and Organization for Economic cooperation and Development (OECD) have planned to formulate relevant SWFs regulations.
Realism suggests that international field is in a nongovernmental state which lacks sovereign power, as in domestic politics, so military force is the most effective means. However, interdependence theory indicates that the role of military force is rather limited, and solving economic issues is the most important focus. Registered capital of CIC is US 200 billion $, and in 2009, half of it was invested in the state-owned commercial banks and 90% of the remaining US 100 billion $ was in cash. The cash drew international attention when the world face global financial crisis
Realism suggests that issues of global politics have hierarchy, and military security ranks the first. However, interdependence theory argues that issue hierarchy has disappeared, military security is no longer the global priority. Internal polices can also affect international society. China entered the international markets with national political force and huge foreign exchange reserves, and raised the alert and anxiety of European and American countries. They worried that China may intervene into the normal operation of free markets of other countries via financial manipulation, or control other countries by economic means, thereby resulting in threats of economic security, which are more significant than the military security.
With change of situations in global politics and economy, Keohane and Nye made adjustments and proposed the following four points
Firstly, not all transactions between nations are interdependent, the interdependence only exists when the transactions have costs; secondly, interdependence implies neither mutual benefits nor international conflicts. Contrarily, international conflicts will appear in new form or even increase. In fact, current SWFs for investment of other countries have no mutual benefits or may result in conflicts with recipient country (host country). Joshua Aizenman and Reuven Glick suggested that SWFs should adopt "basis of reciprocity"; in other words, the free investment should be opened between countries. However, this is not feasible23. For the situation that "self-benefit" dominates over "mutual benefit and reciprocity", as described by Lou Ji-wei, Chairman of CIC in December 2008 that, CIC "dare not" to invest in any foreign financial institution when facing global financial crisis and negative news of European and America financial institutions24. He even pointed out that, the greatest contribution China can make to the world economy is to maintain its own economy.

Conclusions

China joined the wave of SWFs in the 21st century. With continuous development of Chinese economy and active roles in the international society, it will become the world's largest SWFs country in 2012. Under the catchword of free-market economy, capital globalization and internationalization, China stresses legitimacy and necessity of its SWFs. It is undeniable that the doubts are internationally cast over China being not a democratic country, and its investment has obvious political purposes. According to report from Financial Times in September 2008, Administration of Foreign Exchange (SAFE) of the State Council is responsible for operation and management of foreign exchanges, but actions of SAFE are rather secret and lower-key. Until now, only a small part of stock options of many East Asian countries has been acquired, and no investment of highly sensitive or strategic assets, so the investment is not regarded as SWFs. In fact, these are real underground SWFs. The controlled funds exceeded CIC. Since 2007, SAFE acquired minority holdings of British Petroleum (BP), French Total, three Australian banks and other listed companies through Hong Kong branch institution. According to Ted Truman, a researcher in Peterson Institute for International Economics, "When a country wants to elude review, it will operate funds through SAFE, not SWFs"54. Although the international image of China's SWFs has been improved via CIC, and transparence has been enhanced, the funds managed by SAFE raise doubts over political purposes of China. Therefore, IMF, OECD, and WTO believe that the government of the SWFs countries should play a transparent role, and compromise mechanism should be constructed internationally.

Particularly, in July 2007, through the Ministry of Foreign Affairs and SAFE, China invested US 300 million $ in government bonds of Costa Rica, and bestowed US 130 million $, but under the condition that Costa Rica must terminate the 63-year diplomatic relation with Taiwan, and establish diplomatic relation with China. Thus, Kerry Brown, the senior researcher at Chatham House, expressed that "It raises questions about some of SAFE's other investments, and will worry politicians and business people in places where Safe is taking stakes in high-profile companies"56. As a result, China displays the open and transparent image of SWFs operation by the right of CIC, and on the other hand, SAFE is its "underground SWFs", which shows its political roles. Joshua Aizenman and Reuven Glick indicated that, many countries will have to carry out capital control and financial protectionism if SWFs result in ill political influence, and this will obstruct development of financial globalization57. As Robert M. Kimmitt described, the benefits of receiving countries by means of SWFs depend on economic purpose of investment and cannot be achieved by political purpose58.

China's SWFs has become the rather sensitive topic, so CIC should insist on commercialized operation, the political tinge should be avoided in laws, systems, culture, team and management to reduce the unnecessary international attention. Currently, CIC should devote to construction of internal mechanism not active investment, so as to determine investment strategy, risk tolerance, internal control and to attract professorial talents to join it. Furthermore, the bureaucracy can be eliminated by professional operation.

On the other hand, when China's SWFs is operated actively, SWFs of other countries hope to enter China. In recent years, some make investment in China such as Norway's Government Pension Fund, Dubai Investment Group, Qatar Investment Authority, Kuwait Investment Authority, and Temase, and they have established representative office in China. Thus, China begins to defend the actions of foreign SWFs. It is paradoxical that China hopes to effectively defend the political, diplomatic and economic purposes of foreign SWFs, but it carries out overseas expansions by means of SWFs. This is the inevitable phenomenon under development of economic globalization, and indicates interdependence and mutual defense among countries in the interdependence theory.

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