MIZUHO RESEARCH PAPER

16

The launch of China's sovereign wealth fund ~ long-term implications upon the global monetary regime and economic order ~

Takamoto Suzuki
Senior Economist

Mizuho Research Institute

Takamoto Suzuki currently engages in macroeconomic and industrial research on China as senior economist at Mizuho Research Institute Ltd. (MHRI). Since the start of his career in 1992 at Hamagin Research Institute Ltd., he has held key positions including the Japan Center for Economic Research (JCER), the Institute of South East Asian Studies (ISEAS) and the Sanwa Research Institute (currently Mitsubishi UFJ Research and Consulting). Among his recent works co–authored are *Ajia no IT Kakumei* (Asia's IT Revolution) (Toyo Keizai Inc., 2001) and *BRICs* (Toyo Keizai Inc., 2006) and authored is *Tokusuru Chugoku Sonsuru Chugoku* (Facts and myths about the Chinese economy) (Aspect, 2004). He concurrently holds the position of lecturer at the National Institute for Defense Studies (NIDS) and adjunct lecturer at the Kanda University of International Studies (KUIS).

(The research division of the Industrial Bank of Japan was merged with the Dai–Ichi Kangyo Research Institute and the research division of the Fuji Research Institute Corporation to form MHRI.)

E–mail: takamoto.suzuki@mizuho–ri.co.jp
TEL: +81–3–3201–0515
FAX: +81–3–3240–8214

The launch of China's sovereign wealth fund

~ long-term implications upon the global monetary regime and economic order ~

Takamoto Suzuki
Senior Economist

Published by
Mizuho Research Institute
Tokyo, January 2008

Contents

Summary

1. China Investment Corporation (CIC), the first sovereign wealth fund (SWF) established by the People's Republic of China, commenced its operations on September 29, 2007. CIC rests upon a business model of purchasing the foreign currency reserves of the People's Bank of China (PBOC) and investing the reserves in both the domestic and global markets. Although CIC must focus upon the tasks of maintaining interest rate stability and quelling concerns among other countries, CIC will likley shift into full–fledged investment mode in 2008. The purpose of this paper is to provide a full view of CIC as well as an overview on its potential impact.
2. The Chinese government has been taking an increasingly positive stance toward the diversification of its investments of foreign currency reserves since the autumn season of 2006. Firstly, given China's ineffective measures for its trade surplus and the rise of foreign exchange reserves, adverse effects have started to emerge such as the destabilization of short–term interest rates, signs of an asset bubble and negative spreads on foreign currency investment, leading to the necessity for China to establish some sort of mechanism to channel back the foreign currency reserves to overseas markets. The second reason stems from the rising tide around the world to establish SWFs for the proactive investment of public funds. In the background are factors such as the rapid improvement of the current account balances and foreign reserves of emerging countries backed by the rise of crude oil and primary commodity prices, and the fading risk–averseness amid the ongoing global economic boom. Furthermore, given China's circumstances that direct investment in domestic corporations do not yield much promising returns, there was the need for a government–led structure to channel money overseas.
3. CIC is set to join the ranks of the Top Five global SWFs upon its inception. Models for the CIC are SWFs such as the Government of Singapore Investment Corporation (GIC) and Temasek

Holdings of Singapore. Even though the government of China has adhered to the three main principles of "stability", "returns" and "liquidity" in its management of foreign currency reserves, CIC's management policy will most likely shift gradually to an "proactive investment" stance in the medium term.

To provide for CIC's management assets (approximately $200 billion), China has established a framework in which the Ministry of Finance issues special treasury bonds and uses the proceeds of the issue to purchase the foreign currency reserves of the PBOC to be used for capitalization of the new company. The merit of this framework lies in the fact that the issuance of special treasury bonds is linked to the reinforcement of open market operations and the improvement of the bond market's interest rate formation functions. By issuing long–term special treasury bonds, the PBOC will be able to engage in open market operations using long–term government bonds, thereby curbing the rise of interest rates and improving its interest rate formation functions by adding depth to the bond market which is currently skewed to the short and medium–term zones.

4. Over the medium term, the first presumable impact is the rise of investment in non–dollar assets as a result of CIC serving as a potential seller. This would require the discipline of US government finances. Secondly, there is the possibility that CIC may serve to stimulate foreign direct investment by Chinese corporations. Thirdly, there is the possibility that frictions would arise with developed countries over the short term. In the event cash–rich SWFs acquire corporations related to national security such as those in the defense or petroleum industries, there are concerns that they may pose a threat to national security.
5. The establishment of CIC possesses a huge potential impact over the long run. For example, if CIC triggers a flight from the dollar, it may lead to a major shift in the current international monetary regime. Considering that the global economy has sought for and revolved around a single currency regime since the Industrial Revolution, it is yet unknown whether the global economy can

manage a currency regime without an anchor currency. The stabilization of the international monetary regime amid the absence of an anchor currency and the possible role of the emerging countries in the process will develop into a major issue. Furthermore, from a wider perspective, there is the possibility that the relationship between the emerging countries and the developed countries since the Industrial Revolution may change. This may be exemplified by the fact that the rise of crude oil prices – which have been kept low since the Industrial Revolution by means of colonialism and the existence of the so–called "oil majors" (large petroleum companies of the US and Europe) – has spread to various primary commodities, tipping the terms of trade largely in favor of the emerging countries. CIC may be triggering a silent but steady shift of the current global economic order and that its impact will start to emerge.

1. Introduction

China Investment Corporation (CIC), the first SWF launched by the People's Republic of China, commenced its operations on September 29, 2007. It initially targets the management of assets totaling $200 billion. CIC rests upon a business model where (1) the Ministry of Finance of the PRC issues special treasury bonds and uses the proceeds in renminbi to capitalize CIC, (2) CIC purchases the foreign currency reserves of the People's Bank of China (PBOC) and (3) CIC invests the reserves in both the domestic and global markets. Established in a flurry of developments in only nine months since the idea initially surfaced (**Chart 1**), CIC has already made significant achievements in investment such as its capital participation in the Blackstone Group L.P. of the US. Although CIC must focus upon tasks such as quelling concerns toward itself by, for example, raising its capital in renminbi paying due concern toward the stabilization of short–term interest rates, and setting forth a clear global investment stance toward the market, CIC is expected to shift into full–fledged investment mode in 2008. Judging from (1) the increase of foreign currency reserves held by the PBOC, (2) the rising needs for PBOC to release such foreign currency reserves, and (3) CIC's role as a leading and exemplary global investor for other Chinese corporations in the medium–term future, the size of CIC's investment asset portfolio should rise above the initial $200 billion and lead to a greater presence of CIC in the global financial markets and business arena (such as M&A). The purpose of this paper is to provide a full view of CIC as well as an overview on its potential impact.

Chart 1: Events leading to the establishment of China Investment Corporation (CIC)

Jan 2007	Central Financial Work Conference meeting	Prime Minister Wen Jiabao officially announces "the diversification of management routes for foreign currency reserves"
		Lou Jiwei, Vice-Minister of the Minister of Finance, assumes position as Vice-Chairman of the State Council
March 2007	National People's Congress	Jin Renqing, Minister of Finance, announces the government's approval of the establishment of an investment company capitalized by foreign exchange reserves
May 2007		Announcement of CIC's acquisition of a $3 billion stake in the Blackstone Group
June 2007		Announcement of a scheme involving the Ministry of Finance's issuance of special treasury bonds worth RMB1.55 trillion, its exchange for the foreign currency reserves of the PBOC and the establishment of CIC capitalized by such foreign currency reserves
September 2007		CIC commences its operations with Lou Jiwei, former Vice-Minister of the Ministry of Finance and Deputy Secretary-General of the State Council as Chairman of the Board of Directors and Gao Xiqing, Vice-Chairman of the National Council of the Social Security Fund as General Manager

Source: Press coverage on the matter

(Reference) CIC's Board of Directors and Management Committee

Board of Directors (11) (3 executive directors, 5 non-executive directors, 1 non-executive director (employee representative), 2 independent directors
Executive directors: Lou Jiwei, Gao Xiqing, Zhang Hongli Non-executive directors: Zhang Xiaoqiang (Vice Minister of the National Development and Reform Commission), Li Yong (Vice Minister of the Ministry of Finance), Fu Ziying (Assistant to Minister of Commerce), Liu Shiyu (Vice Governor of the PBOC), Hu Xiaolian (Assistant Governor of PBOC and Director of the State Administration of Foreign Exchange) Non-executive director (employee representative): pending as of establishment
Management Committee (7)
Chairman of the Board of Directors: Lou Jiwei General Manager: Gao Xiqing Deputy General Manager: Zhang Hongli, Yang Qingwei, Xie Ping, Wang Jiangxi Chairman of the Board of Supervisors: Hu Huaibang

Source: People's Daily.

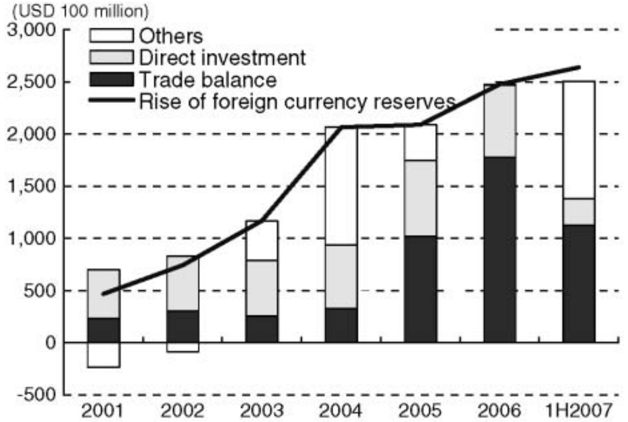
2. Background to CIC's establishment – the adverse effects of currency interventions and the global rise of SWFs

The Chinese government has been hinting from time to time in recent years, that it is considering a larger investment portfolio in euro and investments in strategic commodities such as crude oil in connection with the diversification of the investment tools for its foreign currency reserves – an issue closely linked to the establishment of CIC. The motives behind these hints were political in nature rather than mere efforts to stem the losses from a highly–likely fall in asset value of US dollar assets amid pressures toward the revaluation of the renminbi against the dollar or efforts to gain larger investment returns on foreign currency reserves to be used to resolve its domestic economic problems, as contended among certain academic circles. The real intent was to dampen the US requests toward renminbi revaluation by conjuring images of the plunge of US Treasury bonds (the rise of interest rates) by hinting that China would diversify its investment assets.

However, since the autumn season of 2006, the Chinese government has been taking a more positive stance toward the diversification of investment tools for its foreign currency reserves while showing due consideration toward the US (**Chart 1**).

There are two plausible reasons. The first reason stems from China's continuation of currency interventions in a bid to stabilize the renminbi exchange rate, which in turn has led to the acceleration of China's foreign currency reserves since mid–2006 amid an unabated rise of China's trade surplus due to its unsuccessful measures to reduce its trade surplus such as the revision of its tax system regarding exports (**Chart 2**) (Note 1) As a result, it has become necessary for China to establish some sort of mechanism to channel back its accumulated foreign currency reserves and incoming foreign currency in the future to overseas markets. Since it accession to the World Trade Organization (WTO), China's foreign currency reserves have soared from a rate of $100 billion/year during the period from 2002 to 2003 and $200 billion/year during 2004 to 2005, to $274.2 billion/year in 2006 and $363.6 billion during the nine months since January 2007 (foreign currency reserves outstanding as of the end of September 2007: $1.43 trillion)

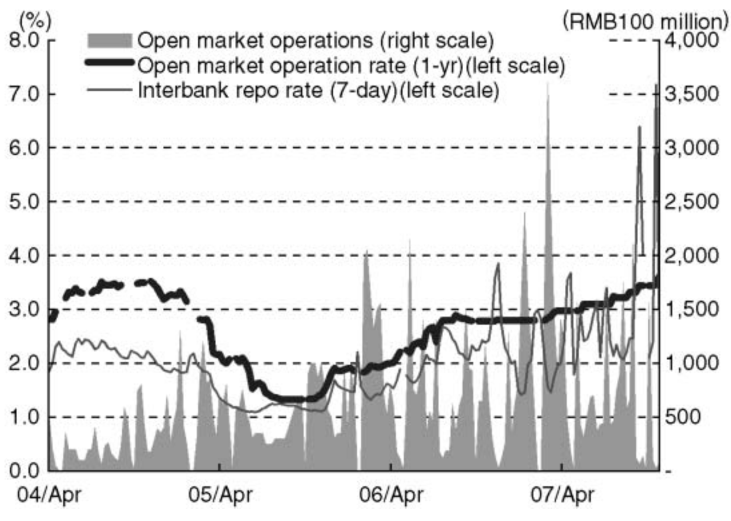
Chart 2: Rise of China's foreign currency reserves



Note: "Direct investment" and "Others" in 1H2007 = data from Jan to May.
Sources: Ministry of Commerce, CEIC.

Furthermore, the rise of foreign currency reserves as explained above has started to yield adverse effects. Firstly, the central bank's (PBOC) open market operations to absorb the renminbi channeled to the market through currency interventions (sterilized interventions) have grown astronomically , serving as a threat to interest rate stability which is the premise of China's current monetary policy (**Chart 3**). The amount of issued and outstanding central bank notes used for open market operations is growing at a faster pace as follows: RMB2.1 trillion as of the end of 2005, RMB3.2 trillion as of the end of 2006 and RMB4.0 trillion as of the end of June 2007. In tandem, the interest rate on central bank notes (1–yr) has climbed from 1.91% as of the end of 2005 and 2.80% as of the end of 2006 to 3.38% as of the end of September 2007. In renminbi terms, foreign currency reserves are currently rising at a pace of RMB4 trillion per annum, leading to the risks of higher interest rates depending upon the success or failure of monetary policy. In fact, the 7–day interbank rate momentarily jumped from 2.49% at the beginning of September to 7.19% at the time of listings by the Bank of Beijing and the China Construction Bank at the end of September 2007 just prior to China's National Day. Likewise, the 7–day interbank rate jumped from 2.525% as of October 19th to 10.31% as of October 26th (albeit a drop to 2.93% on October 31st) at the time of listings by China Petroleum & Chemical Corporation (Sinopec) at the end of October, undermining the premise of interest rate stability.

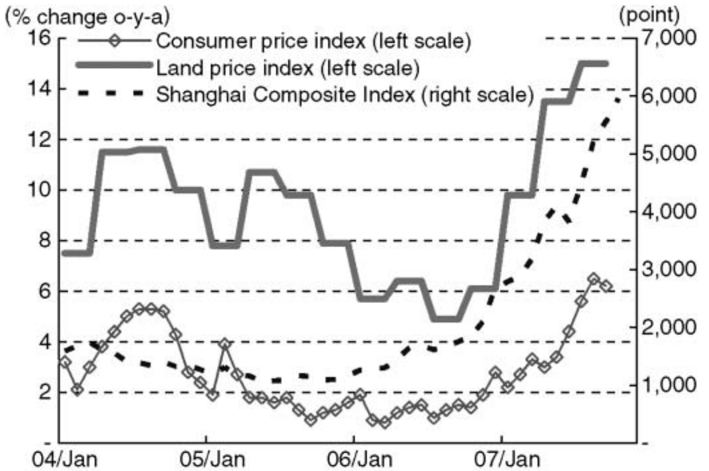
Chart 3: PBOC open market operations and interest rates



Secondly, the excessive liquidity stemming from money flowing into the market without being absorbed is starting to exert upward pressures upon the stock market, the CPI and real estate prices, eroding the foundations of China's high economic growth **(Chart 4)**. A look at stock prices at intervals of every three months from the end of September 2006 reveals the following trends: prices of stocks as of the end of December 2006 increased 1.5–fold from the end of September 2006, prices at the end of March 2007 increased 1.2–fold from the end of December 2006, prices at the end of June 2007 increased 1.2–fold from the end of March 2007 and that prices at the end of September 2007 increased 1.5–fold from the end of June 2007. In cumulative terms, stock prices rose 3.2–fold during the full year (Shanghai Composite Index as of the end of September: 5,552 points). As of the end of September 2007, the price–earnings ratio (P/E ratio) rose approximately 63–fold. Even though this may not be described exactly as an over–valuation in view of projected earnings growth at 30~40% per annum, approximately one–third of the recent rise of corporate earnings is comprised of earnings stemming from investment in stocks or real estate or financial revaluation, thus indicating bubble–like factors in the background.

Consumer prices have been rising at a faster pace since the end of 2006, rising 6.1% over a year ago (o–y–a) in the Jul–Sep quarter of 2007, the highest level during the past decade. Although the price rise was initially expected to be limited to the price of pork which was hit by supply–side concerns, inflationary pressures are spreading to a broader spectrum of goods such as fresh produce, milk and dairy products as of mid–2007. The rise of global crude oil prices also has had an impact, with the price of crude oil soaring close to $100/barrel stemming from the deterioration of political conditions in the Middle East. Given the vaunted “low inflation, high growth” economic policy, the rise of crude oil is posing difficulties for the government to implement appropriate policy decisions. For example, while the PBOC has implemented ten deposit reserve rate hikes and five interest rate hikes since the beginning of 2007, it has only raised the interest rate by a mere 1.17% point (1–yr rate, as of the beginning of December 2007) despite its rapid economic growth at the 11%–level, effectually lowering the real interest rate level.

Chart 4: Stock market and price developments

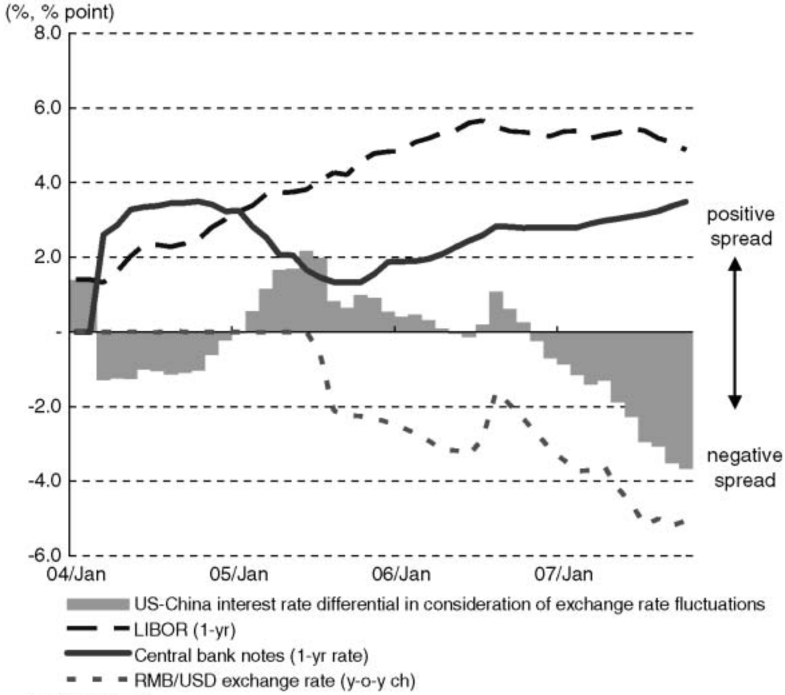


Sources: National Bureau of Statistics of China, CEIC.

Given a significant rise of real estate prices since the beginning of 2007, the inflow of overseas funds to Shenzhen and Shanghai is leading to a second round of speculative investment. Since 2004, the government has shifted economic policy in the direction of restraints upon investment, tightening restraints upon speculative investment both from supply and demand such as the reinforcement of the real estate tax system and the implementation of stricter conditions for construction licenses. However, despite these efforts, it has become difficult to curb speculative investment in high–grade property because of the fundamental perception that there are strong needs to upgrade the quality of residences as well as strong needs among foreigners.

Lastly, given the contraction of the interest rate differential between the US and China and the appreciation of the renminbi, the negative spread on foreign currency investments (mainly US Treasury bonds) is widening (**Chart 5**). A look at the LIBOR (USD 1–yr), the rate on central bank notes (1–yr) and the percentage change of the renminbi exchange rate to the dollar reveals that subsequent to a pause in the rise of the LIBOR in mid–2006, the central bank note rate and RMB/USD exchange rate have continued to rise, leading to the expansion of unrealized losses (negative spread) on RMB–denominated foreign currency investments. Given the US monetary policy shift from tight to accommodative with the emergence of the subprime loan crisis in August 2007, the contraction of the US–China interest rate differential and the appreciation of the renminbi is picking up. Amid these conditions, there are stronger incentives to dissolve the negative spread.

Chart 5: The interest rate differential between the US and China



Source: CEIC.

The second reason stems from the rising tide around the world to establish SWFs for the proactive investment of public funds.

According to estimations by Morgan Stanley, the total amount of investment by SWFs reached $2.5 trillion as of May 2007 (Note 2), surpassing the amount of investment by hedge funds ($1.4 trillion as of the end of 2006) which are viewed as entities embodying speculative activity.

In the background to the rising tide to establish SWFs are factors such as the the rapid improvement of the current account balances and foreign reserves of emerging countries backed by the rise of crude oil and primary commodity prices, and the fading risk–averseness amid the ongoing global economic boom. **Chart 6**, showing the foreign currency reserves by geographic area, reveals that foreign currency reserves are not increasing much among the developed countries with the exception of Japan and Northern European countries. In contrast, note a sharp rise among the emerging countries, led by the countries of Asia. The establishment of SWFs is gaining momentum among these emerging countries. In the case of China, foreign currency reserves totaled $1.43 trillion as of the end of September 2007. Assuming that the amount of foreign currency reserves necessary in times of emergencies is equivalent to six months worth of imports, or $600~700 billion, more than half of the foreign currency reserves would be unnecessary. As a result, there has been a rising need for a more effective utilization of the excessive foreign currency reserves. Moreover, while 70~80% of China's foreign currency reserves are said to be invested in the US (of which half are investments in US government bonds), there are rising needs for investment in euro and the pound which are rising against the dollar and investments in corporate bonds and securitized products having higher yields than government bonds (US government bond–holdings has been falling since April 2007).

Chart 6: Trends in foreign currency reserves (ex gold) by geographic areas

(Upper half: actual amount, USD 100 million, lower half: change, actual amount)

	Worldwide	Developed countries	Japan	US	Eurozone	Northern Europe	Other developed countries
1995	14,736	7,249	1,833	748	–	576	–
2000	20,221	8,506	3,549	566	2,423	750	1,218
2005	42,343	13,350	8,343	541	1,847	1,020	1,600
2000/95	5,485	1,257	1,717	-182	–	174	–
2005/00	22,122	4,845	4,794	-25	-576	270	382
	Emerging countries	Africa	Asia	China	Europe	Middle East	Latin America
1995	7,484	264	4,328	754	857	744	1,292
2000	11,715	549	7,135	1,683	1,267	1,200	1,565
2005	28,993	1,617	18,644	8,215	4,248	1,930	2,554
2000/95	4,231	286	2,807	929	410	456	272
2005/00	17,277	1,067	11,509	6,532	2,981	730	989

Source: International Monetary Fund, *IFS*.

To begin with, the Chinese government has taken measures to cope with its rising foreign currency reserves amid its rising trade surplus, such as the adoption of a more proactive stance toward direct investment, the alleviation of restrictions upon foreign currency holdings and investment in foreign securities by corporations and individuals. However, given the underdeveloped management capabilities of domestic Chinese corporations including state–owned corporations, circumstances were not conducive for a more proactive stance toward direct investment. As for the alleviation of restrictions upon foreign currency holdings and investment in foreign securities by corporations and individuals, it was necessary to build a framework which may be controlled by the government because of the possibility that money inflows and outflows could intensify depending upon domestic and overseas business trends. Thus, there was a greater need to build a framework enabling more inflows and outflows of money while maintaining government control. One of the answers was the SWF.

3. Establishment of the framework

(1) Overview – the Top Five in terms of size, taking a proactive investment stance

Having initial capital of $200 billion, CIC – China's SWF – is set to join the ranks of the Top Five global SWFs upon its inception (**Chart 7**).

SWFs may be classified broadly into the two following types: (1) "commodity type" SWFs (such as the UAE) funded by petroleum exports, and (2) "non–commodity type" SWFs (such as Singapore) funded by accumulated foreign currency reserves and budget surpluses. A different classification would be: (1) "stable investment" SWFs (Saudi Arabian Monetary Authority (SAMA)) placing emphasis upon stable investment in, for example, government bonds, and (2) "proactive investment type" SWFs (Government of Singapore Investment Corporation (GIC), Temasek Holdings also of Singapore, Kuwait Investment Authority (KIA), Abu Dhabi Investment Authority (ADIA) of UAE) with a wide array of investments. GIC and Temasek Holdings, which are said to have served as models for China, invest in a wide range of products such as overseas stocks and securities, real estate and venture capital, and industries such as communications (Thailand, Indonesia and Japan), finance (Hong Kong and Pakistan), education (Australia) and physical distribution (Japan). The foregoing provides us with reason to believe that CIC will also invest in a wide range of products and industries. Furthermore, in view of the fact that GIC has achieved average investment returns of 9.5% during the past 25 years, CIC will likely aim at this level considering that the RMB/dollar exchange rate is rising by 5~6% per annum and that the interest rate on bond operations (1–yr) is rising to the 3%–level. That said, note that the Chinese government has traditionally aspired for the three main principles of "stability", "returns" and "liquidity" in its management of foreign currency reserves. Therefore, we expect that CIC's management policy will gradually shift from "stable investment" in its initial phase to “proactive investment” in the medium term.

In fact, on May 20, 2007, CIC made a $3 billion investment in the Blackstone Goup. The Blackstone Group is a private equity fund (managing total assets of $80 billion with Antony Leung, former with Secretary of Hong Kong, as Greater China Chairman) covering a wide range of business from real estate funds and M&A advisory services. Considering the average record of 25% returns on investment, CIC is already taking an aggressive investment stance while placing emphasis upon stability.

Chart 7: Major SWFs of the world (March 2007)

(USD100 million)

Country	Fund	Assets
United Arab Emirates (UAE)	Abu Dhabi Investment Authority (ADIA)	8,750
Singapore	Government of Singapore Investment Corporation (GIC)	3,300
Norway	The Government Pension Fund of Norway (GPF)	3,000
Saudi Arabia	various	3,000
China	China Investment Co., Ltd. (CIC)	2,000
Russia	Stabilization Fund of the Russian Federation (SFRF)	1,000
Kuwait	Kuwait Investment Authority (KIA)	700
Australia	Australian Government Future Fund	400
US (Alaska)	Alaska Permanent Fund	370
Brunei	Brunei Investment Agency	300
South Korea	Korea Investment Corporation (KIC)	200

Note: Estimates by Morgan Stanley. Assets regarding CIC are projections.
Source: The Nikkei Financial Daily (July 9, 2007) (with minor alterations).

(2) Method of establishment and characteristics – capitalization by special treasury bonds, mechanism to upgrade investment efficiency and the reduction of the adverse effect of currency intervention

On June 29, 2007, the Standing Committee of the National People’s Congress adopted a “resolution on the purchase of foreign currency reserves by the issuance of special treasury bonds and the adjustment of the limit on government bond issues in 2007”. The resolution, in effect, decided upon a framework whereby the Ministry of Finance issues special treasury bonds totaling RMB1.55 trillion (approximately $200 billion), uses the proceeds of the issue to purchase the foreign currency reserves of the PBOC and uses the reserves for capitalization of the new company. The issuance of the special treasury bonds was completed by the end of December 2007, with bonds worth total RMB1,350 billion issued to the PBOC via the Agricultural Bank of China in August and December 2007 and bonds worth total RMB200 billion to be issued in the financial market in September November and December 2007.

Despite the initial prognosis that CIC would be established under the same method (direct investment of foreign currency reserves by the PBOC) as the Central Huijin Investment Company Limited under the strong influence of the PBOC, it appears that the current framework was adopted since “safety” is not necessary guaranteed under the CIC and is not compatible with the character of PBOC.

The merit of the current framework lies in the fact that the issuance of special treasury bonds is linked to the reinforcement of open market operations and the improvement of the bond market’s interest rate formation functions. China’s bond market is currently comprised mainly of government bonds, policy–related bank securities and central bank notes. While there has been a sharp rise in issuance of government bonds in recent years, they are only issued in maturities of 3 months, 6 months, 1 year and 3 years (the issuance of 6–month securities was suspended during the period from September 2006 to July 2007). The issuance of 10–yr special treasury bonds will enable the PBOC to engage in open market operations using 10–yr bonds, thereby curbing the rise of interest rates and improving its interest rate formation functions by adding depth to the bond market which is currently skewed to the short and medium–term zones.

(3) The market’s response and the government’s explanations – a long and winding road ahead as a tool for monetary tightening

The establishment of CIC by the issuance of special treasury bonds is aimed at the improvement of both open market operations and investment of foreign currency reserves. Given the recent focus of attention upon the government’s concerns regarding the overheated state of the stock market, the announcement of the issuance of special treasury bonds worth RMB1.55 trillion gave the impression of a major monetary tightening effort by absorbing liquidity equivalent to 10 deposit reserve rate hikes. Subsequent to the announcement, on both June 28th and 29th of 2007, the Shanghai Composite Index plunged 6.4%, creating a near–panic in the stock market.

In a bid to stem the panic, the government adhered to its explanation (**Chart 8**) that the issuance of special treasury bonds is part of the “reform of the foreign currency reserve control system”. On June 30, 2007, the government announced that Central Huijin Investment Company Limited will be merged into the CIC. Of its funds totaling $200 billion, RMB70 billion will be used not for the acquisition of overseas assets but for the acquisition of foreign currency–denominate assets within China. Despite initial explanations that CIC would be established as a means to improve the tools for open market operations, it has become difficult to make sweeping changes. Thus, all in all, CIC started out on a decidedly muted tone. (In October 2007, CIC announced its capital injection into the Agricultural Bank of China and the China Development Bank. For the time being, acquisitions of assets overseas would start out with one–third of $200 billion.)

Chart 8: Explanations on the issuance of special treasury bonds by the Ministry of Finance of China (July 4, 2007)

1. The issuance of special treasury bonds will not serve as a shock upon the domestic financial market. Domestic liquidity will not decline much because the special treasury bonds issued will replace the notes issued by the central bank. The issuance is not intended for the purpose of cooling the stock market or influencing funds in the securities market.
2. The issue will not be underwritten directly by the central bank (later interpretations reveal that the central bank's underwriting is possible). However, the central bank's government bondholdings will be increased through appropriate methods.
3. Special treasury bonds differ fundamentally from conventional bonds. They are not intended for the supplementation of fiscal deficits. However, they will be recorded as part of government debt. There is the need to change the allocation of the outstanding government bonds.
4. The issuance will upgrade and expand the range of the central bank's open market operation tools. This stems from the increase of the central bank's government bondholdings in order to control domestic liquidity.
5. The foreign currency purchased by the state investment corporation (China Investment Corporation) will not be recorded as official foreign currency reserves.
6. The foreign currency purchased will be used for the capitalization of the state investment corporation. The state investment corporation is a state-owned corporation with reporting obligations toward the State Council.

Source: People's Daily.

4. Impact upon global financial markets

(1) The direct impact – growth of investment in non–dollar assets, significant impact upon emerging countries

In comparison to foreign currency reserves, SWFs take an aggressive investment stance. Considering this characteristic, the conceivable direct impacts of CIC are as follows.

The first presumable impact is the rise of investment in non–dollar assets. On average, 65% of foreign currency reserves of countries around the world are constituted of dollar–denominated assets in order to ensure safety and liquidity (member countries of the IMF as of the end of 2006, 26% in euro). In contrast, the dollar–denominated component is small in the case of SWFs. The dollar–denominated asset component of the Government Pension Fund of Norway is said to be approximately 30% and less than 50% among SWFs of the Middle East. Since 70~80% of China's foreign currency reserves are denominated in US dollar (meaning that China's non–dollar currency–denominated foreign currency reserves total approximately $300 billion), if CIC decides to invest half of its assets in non–dollar investments, this would serve as a dollar–selling factor totaling a maximum $100 billion.

In August 2007, dollar–denominated assets held by the central banks and government institutions of the world fell by 3.8% when the subprime loan problem came to light. Fortunately, a "flight to quality" occurred within the US and the purchase of US government bonds more or less offset the sell–off of dollar–denominated securities and stocks, avoiding the worst–case scenario of "the fall of US government bonds → rise of long–term interest rates". Even though a massive dollar–selling spree is unlikely going forward, a gradual rise of dollar–selling pressures may trigger dollar–selling pressures in other countries and regions, leading to the destabilization of the dollar. China's possession of the "dollar–selling card", regardless of whether it is in the best interests of China to play the card, will serve as a trigger for dollar–selling pressures as long as there are frictions in Sino–US relations.

Secondly, the size of CIC's investment assets ($200 billion) is not necessarily large in terms of the global financial market as a whole. As of the end of 2006, the aggregate market value of listed stocks totaled $54 trillion ($200 billion is 0.4% of this amount) and foreign currency–denominated assets (including foreign currency reserves) of the countries of the world totaled $26 trillion (likewise, $200 billion is 0.8%) (**Chart 9**). If CIC chooses to invest in a wide range of assets such as stocks, securities and real estate, its impact upon each of these markets would be small. However, since China's investment in US securities are concentrated in government bonds and government agency securities (**Chart 10**), its shift to the stock market will have large repercussions. Moreover, if CIC invests in commodity futures with a market size of only several hundreds of billion dollars or in emerging countries which are considerably smaller than developed countries, such investments would have a massive impact upon the economies of such countries.

Chart 9: The size of the global financial market (2006)

(USD 100 million)

	Worldwide					Percentage of USD200 billion	
		Worldwide (ex US)		US		Worldwide	ex US
Common stock issuance market	5,948	4,564	76.7%	1,384	23.3%	33.6%	43.8%
M&A market	36,000	20,890	58.0%	15,110	42.0%	5.6%	9.6%
Syndication loan market	39,855	22,547	56.6%	17,308	43.4%	5.0%	8.9%
Foreign currency-denominated external assets of the countries of the world (year end)	260,950	106,990	41.0%	153,961	59.0%	0.8%	1.9%
Aggregate market value of listed stocks (year end)	543,253	389,512	71.7%	153,740	28.3%	0.4%	0.5%
Foreign exchange market trading (1-day average)	16,400	11,790	71.9%	4,610	28.1%	12.2%	17.0%

Notes: 1. The "foreign currency-denominated external assets of the countries of the world" in the "US" column refers to foreign currency-denominated assets which are denominated in US dollar. "Worldwide (ex US)" refers to non-US dollar-denominated assets converted into US dollar.
2. The "aggregate market value of listed stocks" regarding the US includes only the New York Stock Exchange.
3. "Foreign exchange market trading" includes only London, New York, Tokyo, Singapore and Hong Kong. April 2004

Sources: Thomson Financial, World Federation of Exchanges, BIS.

Chart 10: Securities trading by foreigners in the US (2006)

(USD100 million, share)

	Total	Stocks	Government agency securities	Corporate bonds	Government bonds
Buy	101,423	69,041	15,722	16,660	–
Sell	92,019	67,539	12,827	11,653	–
Net	11,382	1,503	2,896	5,007	1,977
of which are European	5,907	969	887	3,058	992
of which are Chinese	1,099	5	375	313	407
of which are Japanese	733	−7	451	127	163
of which are European	52%	65%	31%	61%	50%
of which are Chinese	10%	0%	13%	6%	21%
of which are Japanese	6%	0%	16%	3%	8%

Source: FRB, *Federal Reserve Bulletin*.

(2) The indirect impact – acceleration of China's foreign direct investment, momentary aggravation of frictions

We believe that the establishment of CIC will affect the global economy and politics through the foregoing direct impacts.

Firstly, there is the possibility that foreign direct investment by Chinese corporations will gain momentum as a result of CIC serving as a leading drive. China's foreign direct investment has been picking up since 2005, totaling $16.13 billion in 2006 and ranking 13th place in the world (17th in 2005). Even so, considering that 30~40% are investments seeking tax haven merits, foreign direct investments have not increased as much as the superficial data. As mentioned before, this stems from the fact that the managerial capacities of local corporations including state–owned corporations are not up to global standards. That said, there are rising incentives toward foreign direct investment in the mining industry (such as petroleum and iron ore) and the manufacturing industry (such as telecommunication equipment, electric and electronic devices, apparel and general merchandise) as a result of the resource and energy crisis and revaluation of the renminbi in recent years. In terms of geographic regions, South Asia, Central Asia, Africa and Central and South America are viewed as promising areas. CIC would be able to gain knowhow on overseas investment on behalf of each individual corporation and pass on such knowhow to Chinese corporations and to supplement the creditworthiness of Chinese corporations helped by China's credibility as a state. This alone would serve as adequate drivers of overseas investment.

Considering that Temasek Holdings of Singapore serves as a model for CIC, the chances of CIC advancing into infrastructure and resource & energy development are not negligible. On November 6th, the China Development Bank, scheduled for capital injection by CIC, and the government of Venezuela decided upon the establishment of a $6 billion investment fund for the purpose of investment in Venezuela. The government of Venezuela will likely use the funds mainly for fuel oil toward China, providing a glimpse of its contribution to China's energy strategy.

Secondly, there is the possibility that frictions would arise with developed countries over the short term. There are concerns regarding SWFs due to their lack of transparency and the possibility that they may create a black box in global money flows. Furthermore, in the event cash–rich SWFs acquire corporations related to national security such as companies in the defense or petroleum industries, there are concerns that they may pose a threat to national security. While not a case involving SWFs, the acquisition of Unocal Corporation of the US by China National Offshore Oil Corporation (CNOOC) in 2005 raised alarms among the US public toward China. At the time of CIC's announcement of its investment in the Blackstone Group in May 2007, US Senator Jim Webb raised concerns regarding the possible leakage of classified technological information on defense and satellite companies in which Blackstone has a stake and requested the US government to examine whether the acquisition poses problems regarding national security. Subsequently in July, the US Congress reinforced the powers of the Committee on Foreign Investment in the United States (CFIUS), an inter–agency committee of the US government that reviews the national security implications of foreign acquisitions of US companies. In October of the same year, the Group of Seven (G–7) meeting of finance ministers and central bank governors called for greater vigilance toward state–owned funds including SWFs. Amid these turn of events, the Chinese government told Robert M. Kimmitt, Deputy Secretary of the US Department of the Treasury upon his visit to China that "it will engage in portfolio investment such as corporate bonds and stocks for the time being". With respect to corporate acquisitions, the Chinese government said that "it is not considering such matters at the moment" and that "even if the opportunity arises, it will limit its acquisitions to areas which do not pose problems" (The Nikkei, June 23, 2007), showing consideration toward the US. Upon the launch of CIC's business operations on September 29, 2007, Lou Jiwei, Chairman of the Board of Directors commented that "(CIC) would invest mainly in overseas financial products for the time being" and that it "will seek to maximize profits through long–term investments within the limits of acceptable risks". On November 7th, one month after CIC's launch, Li Yong, Vice–Minister of the Ministry of Finance and non–executive director of CIC sought to improve global perceptions on the transparency of CIC and quell concerns among the countries of Europe and the US that it would embark on a corporate acquisition campaign by a string of comments that "(CIC) would use one–third of its funds for investment in overseas financial markets, another one–third for asset injections into the Agricultural Bank of China and the China Development Bank and another one–third for the merger of Central Huijin Investment Company Limited", "(CIC) would conduct global investments in a careful and gradual manner", and that "CIC is a separate entity from the government and that its management will be based upon a commercial basis". In fact, in its investment in the Blackstone Group, CIC indicated that it would act as a passive and stable shareholder by, for example, limiting its stake to up to 10% of issued stocks, refraining from selling its stockholdings for a period of four years from its acquisition and limiting the sale of stocks per year to one–third its stockholdings even after the initial four–year period.

Even so, note that there are increasingly protectionist tendencies among the developed countries of the world such as the reinforcement of measures against foreign acquisitions (**Chart 11**).

(3) Concluding comments

The establishment of CIC possesses a huge potential impact over the long run. For example, if CIC triggers a flight from the dollar, it may lead to a major change in the current international monetary regime. In the event of a flight from the dollar, there is the possibility of a multipolar currency regime with the euro (since the creation of an Asian common currency is unlikely anytime soon, a multipolar currency regime with Asia is inconceivable). Even so, considering that the global economy has sought for and revolved around a single currency regime since the Industrial Revolution, evolving from the gold standard to the dollar standard regime, it is yet unknown whether the global economy can accept a new regime in the short run. During the period between World War I and World War II, the absence of an anchor currency served as an obstacle to currency stability and led to a sharp contraction of global trade. While it would be unrealistic to predict that global trade would shrink since the creation of CIC itself stems from the expansion of trade, the question of how to build a framework for the stabilization of the international monetary regime amid the absence of an anchor currency and the possible role of the emerging countries in the process will be a major issue.

Furthermore, from a wider perspective, there is the possibility that the relationship between the emerging countries and the developed countries since the Industrial Revolution and the global economic regime built by the developed countries on the basis of such relationship may change. Ever since the Industrial Revolution, the low price of petroleum, maintained through colonialism and the existence of the oil majors (large petroleum companies of the US and Europe), has increased by four to five times. Furthermore, the rise of crude oil prices has spread to various primary commodities, tipping the terms of trade largely in favor of the emerging countries.

While it might be slightly premature to make such conjectures, CIC may be triggering a silent but steady shift of the current global economic order and that its impact will start to emerge.

Chart 11: Protectionist policies taken by major countries toward foreign acquisitions

Japan	Range of industries requiring prior notification for acquisitions widened to include such industries as special steel and machine tools
US	Reinforcement of the powers of the Committee on Foreign Investment. Congressional request to the Secretary of the Treasury to examine matters related to national security
Canada	Amendment of laws regarding investment and fair trade in 2008
Germany	Rising debate on the regulation of foreign government funds. Regulations to be drafted by a team of experts
China	Acquisitions related to "priority industries" and "prominent brands" require government screening
Russia	Considering the restriction of foreign capital in 39 strategic areas

Source: Nikkei (July 14, 2007)

(Reference) The Big 4 SWFs of the world

United Arab Emirates (UAE) Abu Dhabi Investment Authority (ADIA) ・Established in 1976. Manages the government's surplus funds of the Abu Dhabi Emirate which possesses a leading position in the UAE. Its purpose is to prepare for the future depletion of its oil reserves. ・ Its investments are said to include stocks and bonds as well as real estate. According to a report by the Institute of International Finance (IIF), ADIA's investment portfolio is said to be constituted of stocks (50~60%), bonds (20~25%), real estate (5~8%), private equity (5~8%) and alternative investments (5~10%). ADIA is also purported to have an even distribution of investments without a concentration or bias upon a specific country ・ Having offices in Washington DC and London, it recruits fund managers from US and European financial institutions
Singapore Government Investment Company (GIC) ・Established in 1981. Given the surge of Singapore's foreign currency reserves, GIC's purpose is to invest the foreign currency reserves in long-term and high-yielding assets ・Invests in diverse assets such as stocks, bonds, commodities, alternative investments, real estate and private equity. An example of its real estate investment is the Shiodome City Center and its private equity investments include the Texas Pacific Group, the Carlyle Group and the Blackstone Group ・Possesses eight offices around the world **Temasek Holdings** ・Established in 1974. Invests in domestic corporations in key industries including private equity ・As of the end of March 2006, its investment assets totaled S$129 billion (approximately $80 billion). Its geographic distribution of investments is as follows: Singapore (44%), other areas of Asia excluding Japan (34%) and the members of the OECD excluding South Korea (20%)
Norway Government Pension Fund-Global ・Established in 1991. Its purpose is to pool the government's petroleum-related income and to prepare for the forthcoming decline of petroleum-related income. ・Its aggregate market value of NOK1.787 trillion(approximately JPY6 trillion as of the end of 2006), increased by NOK380 billion from the previous year (one-third of the increase stems from investments). 59% of its investment portfolio is invested in bonds and 41% in stocks. It invests in stocks of 42 developed countries and emerging markets and bonds denominated in 31 currencies. Since January 2006, it has widened its investment portfolio to include commodities and basket funds. It invests in approximately 3,500 companies. ・Its investment returns during the past decade is 6.5%. ・Its shareholding ratio is limited to 5%. Having an Ethical Council, it has a high degree of transparency
Saudi Arabia Saudi Arabian Monetary Agency (SAMA) ・Manages the government's surplus funds and the government agency pension fund. ・Its investment portfolio includes the following: foreign securities investment (approximately 56%), domestic securities investment (approximately 33%) and foreign bank deposits (7%). Considering its purported emphasis upon liquidity and stability, a major part of its foreign securities investments are said to be comprised of US Treasury bonds.

Source: Japan Center for International Finance, "SWF – chuugoku roshia mo kuwawari shijo no kanshin ga takamaru kokka fanndo" (SWF – Mounting concerns regarding state funds with the entry of China and Russia), June 2007 (with partial alterations).

＊＊＊＊＊＊＊＊＊＊

Notes:

1 The first reason may be separated further into two parts. Firstly, it means that the foreign currency would be channeled overseas under the control of the government (thereby slowing the rise of foreign currency reserves), improving the mechanism which enables the compatibility of both the controls upon foreign currency and the controls upon the renminbi exchange rate. Secondly, part of the foreign currency reserves in the central bank's balance sheet (foreign currency reserves now comprise 60% of the central bank's total assets) are separated from the central bank's balance

sheet and replaced with the special treasury bonds to be issued for the capitalization of CIC. By curbing the issuance of central bank notes by engaging in selling operations using the special treasury bonds amid efforts to absorb the foreign currency and excess liquidity, it will disperse the upward pressures upon interest rates. That said, the initial purpose of absorbing liquidity ended in a self–inflicted failure since the decision on the issuance of special treasury bonds led immediately to a sharp fall of stock prices. As a result the government will still be faced with the problem of excess liquidity.

2 US Securities and Exchange Commission (SEC) Chairman Christopher Cox said in his testimony at the hearing of the US Senate Committee on Banking, Housing and Urban Affairs on July 31, 2007 that total investments of SWFs would increase from the current $2.5 trillion to an estimated $12 trillion in 2015. In October 2007, the International Monetary Fund (IMF) also revealed its estimate that the size of SWFs would grow from $500 billion in 1990 to $2~3 trillion at present to $10 trillion in 2012.

Mizuho Research Institute

5-5, Otemachi 1-chome, Chiyoda-ku,
Tokyo 100-0004, Japan
TEL: (03) 3201-0519
FAX: (03) 3240-8223
http://www.mizuho-ri.co.jp/english/