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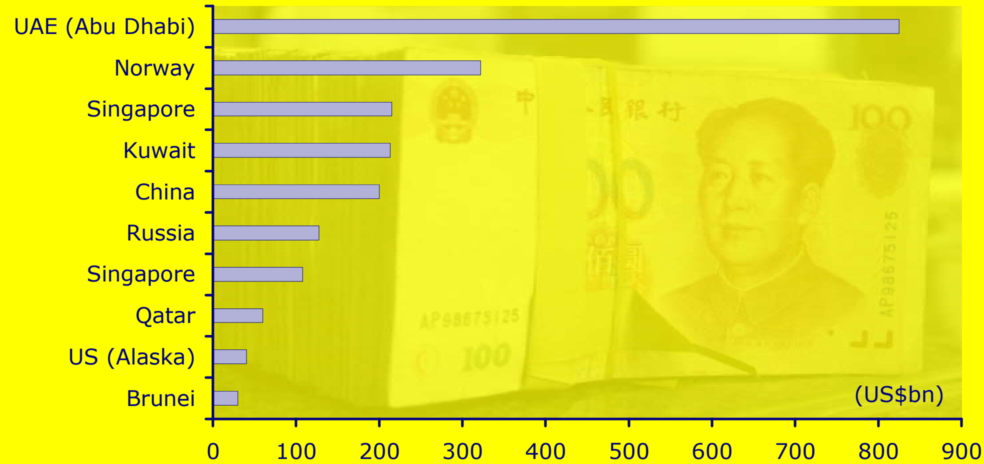
No reverse gear

China's sovereign wealth fund and overseas direct investment

In existence for just one year, China's sovereign wealth fund, Chinese Investment Corporation (CIC), is already the world's fifth largest and could become the biggest by as early as 2010. To examine the impact of this new global investment force, we turn to former British diplomat and author of books on China's economy and politics, Kerry Brown, who is now a Senior Fellow on the Asia Programme at Chatham House.

- China's appearance as an exporter of capital, an overseas investor and an owner of assets abroad is a new phenomenon.
- As at end-2006, Chinese investment abroad followed some clear patterns. But this preceded the establishment of CIC, which is likely to change things dramatically.
- The central government remains a key player in overseas direct investment, even though the rules have eased to allow non-state entities to operate abroad.
- CIC is managed by the Ministry of Commerce, the People's Bank of China, Ministry of Finance, the State Administration for Foreign Exchange and the National Development and Reform Commission, all keen to defend their territory.
- To clear up a misapprehension, the money in the US$200bn fund is not from the Central Foreign Exchange Reserves that sits in the PBOC and is managed by SAFE.
- CIC borrowed the fund money from the PBOC and, to service the debt, it must repay US$8bn a year. This would require a very ambitious - especially for a new and inexperienced fund - but not impossible, 14% annual return on investment.
- The key thing to remember is that, in the end, CIC reports to the State Council, and through that to the Politburo. The final responsibility for governance of the CIC is therefore the Communist Party.
- Through ODI, China can influence global economic trends far more than ever before, bringing it one step closer to becoming a global power.
- Now China has no choice but to communicate its purpose, and to show how it intends to operate, and what it intends to achieve.

The world's top-10 sovereign wealth funds



Source: *Thought Leadershp, the Rise of Sovereign Wealth Funds*, Gerard Lyons, August 2007

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Kerry Brown

Kerry Brown is a Senior Fellow on the Asia Programme, Chatham House, London. Previously, he worked for the British Foreign and Commonwealth Office, serving in London, and as First Secretary in Beijing. He is an Associate of the China Policy Institute, Nottingham, UK, and has written on China for the *Independent*, *Daily Mail, Guardian, Daily Telegraph, Far Eastern Economic Review,* and *Times*. His book, *Struggling Giant, China in the 21st Century* came out in 2007, followed by *The Rise of the Dragon, Chinese Inward and Outward Investment in the Reform Period* in 2008. He is currently working on a study of the Communist Party of China.

More expert views from CLSA U

No reverse gear

> The name of the truck was. . . "forever forward". I commented to the factory manager that [it] had a good name, indicating [a] willingness to march forward bravely. He replied that in fact the name literally meant what it said. The truck did not have a reverse gear: it could only move forward.[1]
>
> Former Chinese Vice Premier Li Lanqing,
> on a visit to a tractor factory in Chongqing, 1993

Chinese ODI is a new phenomenon in a world where everything has happened before

In the modern world, we may often feel that we have seen it all before. Most things that are happening have antecedents, roots, precedents. It is very rare that something just seems to come from nowhere. China's appearance as an exporter of capital, an overseas investor, an owner of assets abroad, however, is a genuinely new phenomenon. Those that look to understand China now are often best served by having a look over its recent, or even ancient, history. There they will find previous appearances of reform, revolution and change. But no matter under what dynastic guise it appeared, China has never been an exporter of capital, neither in the 20th Century, nor in the centuries before that.

Even in the tragic period of miscommunication and conflict in the late Qing dynasty, from 1840, China's accumulation of silver bullion from export sales was one of the main political grievances of powers like the UK, who were to force upon China the infamous "unequal treaties" in the 1840s and 1860s, prizing some of its markets open but leaving a deep and lasting residue of political anger. Qing China (1644-1911) did not figure as an operator overseas, except through exports. This stood in stark contrast to powers like Britain, who were, in the 1890s, to have almost 10% of gross national product (GNP) invested abroad.[2]

CIC - The new kid on the SWF block

The most startling aspect of this new dimension of Chinese economic and political activity is the foundation, on 29 September 2007, of the Chinese Investment Corporation (Zhongtou) (CIC) after almost two years of administrative preparation. As of September 2008, the CIC ranks fifth in the world's largest sovereign wealth funds (SWF).

I am grateful to Stephen Green, of Standard Chartered Bank and Friedrich Wu for their comments on China and SWFs. The opinions expressed in this paper, however, are entirely my own.

[1] Quoted in Yasheng Huang, *Selling China* Cambridge 2003, p 260.

[2] Niall Ferguson, *Empire* London 2002, p 369.

I am also grateful for the detailed comments, corrections and help of W John Hoffman

China's SWF is ranked fifth largest in the world from its beginning

Figure 1

The world's top-10 sovereign wealth funds

Country	Fund	Year established	Amount (US$bn)
UAE (Abu Dhabi)	ADIA	1976	625-825
Norway	Government Pension Fund	1990	322
Singapore	Government Investment Corporation	1981	215
Kuwait	Kuwait Investment Corporation	1953	213
China	CIC	2007	200
Russia	Stabilization Fund	2004	127.5
Singapore	Temasek	1974	108
Qatar	Qatar Investment Corporation	2005	60
US (Alaska)	Permanent Reserve Fund	1976	40.2
Brunei	Brunei Investment Authority	1983	30

Source: *Thought Leadership, the Rise of Sovereign Wealth Funds*, Gerard Lyons, August 2007, p 14

US$2 trillion of foreign reserves, and rising

But it's early days. Looming behind the US$200bn already committed, is the mighty and rapidly increasing foreign-exchange reserves China has accumulated over the past 30 years, sourced from foreign direct investment (China's FDI stockpile as of end-2006 was US$700bn) and export revenues. These stand at US$1.8tn, and are likely to increase to more than US$2tn by the end of 2008. China overtook Japan as the world's largest foreign-exchange holder in 2006. Since then, it has powered ahead. The CIC initial raft of money does not come from the foreign-exchange reserves. Details of how the fund was established and where the money comes from will be addressed further on in this report. But in principle, there is no reason why China would not be able to shift large amounts from its foreign reserves across to the fund. In such a case, it is well within the boundaries of possibility that China's SWF could eventually become not only the world's largest fund, but dwarf all others.

What this report aims to show

This report will look at the CIC within the context of China's moves to invest abroad and globalise its state and non-state companies. I'll look first at sovereign wealth funds in general, and then at the CIC in particular. I will also discuss China's latest overseas direct investment (ODI) data, and see what patterns can be discerned in that. I'll track the initial investments the CIC has made, and the policy pronouncements its main managers have come out with, along with some initial reactions from outside China. I'll look at the benefits, and the possible problems, that China's ODI in general, and the CIC in particular, might throw up. And then I'll give an assessment of where the CIC might have impact, and where we - potential foreign partners and governments - need to be careful.

A brief word about sovereign wealth funds

The history of the rise of SWFs and where they stand today

Sovereign wealth funds (SWFs) are not new. Kuwait's, as Figure 1 shows, has been around for over half a century. It is clear that some SWFs - Abu Dhabi's, Kuwait's, Qatar's - were created through the sale and export of energy products largely such as oil, and the accumulation of foreign reserves from this. Commodity- and non-commodity-led SWFs are now the key distinction between the types of wealth funds.

In the past few years, both types of funds have become more prominent, larger in size, more ambitious, and as a result, more problematic. There are a number of reasons for this. A look down the top-10 list in Figure 1 shows that they belong to countries which are, to put it mildly, a mixed bunch. China sits alongside the US, Singapore, Norway and Russia. The Middle-East states, for instance, are working alongside Norway with its squeaky clean reputation for transparency and good governance.

The sorts of money that they are in control of, because of the very mixed political backgrounds and environments that each of the SWFs comes from, have the potential to cause real conflict and opposition. This is best exemplified by the reaction to the Abu Dhabi Investment Fund's takeover of P&O in 2005-06. Political opposition in the US led to the divestment of the fund's port portfolio there on the grounds of worries over foreign ownership of key strategic national assets.

SWFs: The good side and the bad. We are in the era of state capitalism

Figure 2

SWFs compared to market capitalisation of top global stock exchanges

	(US$bn)
New York Stock Exchange	15,421
Tokyo	4,614
Nasdaq	3,865
London	3,794
Euronext	3,708
Total SWFs	**2,070**
Hong Kong	1,715
TSX	1,701
Deutsche	16,838

Source: Oxford Analytica, in Gerard Lyons, *State Capitalist'* 2007, p 17

Gerard Lyons, Chief Economist of Standard Chartered Bank, has argued on the plus side that SWFs are a key aid in the process of globalisation and that the willingness of SWFs to put money into developing countries - and to go into sensitive areas like for instance China has done in certain countries in Africa - is not necessarily a bad thing. But the lower levels of transparency of SWFs, their form of governance, and, in the case of China and to a lesser extent Russia, the potential they have to carry an underlying political strategy that outside observers might only suspect but cannot clearly define, are all potential causes of conflict. The era of the SWF marks a shift in the world economy to what some commentators have called `state capitalism.' In China's case, this state capitalism is being practised by a country that still, ostensibly, subscribes to Marxism-Leninism and has one-party rule. In many ways, the questions of how we work with this new phenomenon reduces to that of how comfortable we are with China's political system, and how stable we feel that it is. That is a key issue this report hopes to address.

The global economic downturn - Time for the SWFs to take the stage

Another recent issue needs to be factored in. While the world's economy boomed, SWFs merely operated among other big investors and funds. But it is clear now that for the foreseeable future the good times are over. Suddenly, the SWFs' cheque books are viewed as particularly welcome. There are plenty of distressed assets about these days. Citibank welcomed an injection of cash from Dubai and other SWFs last year. Morgan Stanley has sanctioned a sale of 10% of its shares to the CIC, although this grants CIC no seats on Morgan Stanley's board or any management role. Even so, it is clear that SWFs are able to influence even without these formal roles being spelt out. In 2008, and for the short to medium term, it is going to be harder to turn potential source of funds such as the SWFs away.

China's overseas investment - The five phases

Chinese ODI since 1980 has gone through five phases, but it has never been big until now

The CIC, and China as an overseas investor, didn't just appear overnight. Their roots might be shallow, but almost from the moment the country

Foreign direct investment into China started first, but small amounts of outward investment were there, even early on

started implementing economic reforms and opening up its economy in the late 1970s, it was only a matter of time before it needed to look to working abroad, initially as a state actor, and then through the raft of newly created private (non-state) enterprises that were set up from the 1980s onwards. In the early days, during the first phase of "going out", China was very much a centralised, state-led economic entity. Investments were made abroad on a case by case basis, and frequently based on very little research or understanding. From the mid-1980s to the early 1990s, and the second phase, there was more standardisation. Some non-state and state actors were allowed to set up subsidiaries abroad. After Deng Xiaoping's southern tour in early 1992, in which he publicly recommitted China to continuing to open up and reform, there was a massive influx of foreign investment into China. Less noticed at the time was a much smaller but clear attempt by Chinese companies to "go out" (the official terminology used for Chinese companies trying to work abroad), which constitutes the third phase. As with the early years in the FDI story, however, some terrible mistakes were made. Former President Jiang Zemin, at the 15th Party Congress in 1997, continued to encourage Chinese companies to `go global.' Fifty national champions were selected in 2002 that were supported in becoming global brands in the years ahead. But this was to end up unsuccessful.

The most famous case of a Chinese company 'going global' and then going to the wall, was D'Long, which built up a property empire in northwestern China, and then went around the world acquiring assets in diverse sectors, only to see most of them collapse with massive losses in the early 2000s. From 1998 to 2002, during the fourth phase, the Chinese government started to support processing industries, particularly those in manufacturing light electronic goods, and machinery, in setting up plants abroad. From 2002, this has moved to the fifth and latest stage – the `stepping out' phase, in which both state and non-state actors have looked to make investments on commercial grounds abroad. This has culminated in the establishment of the CIC.[3]

[3] Yuen Pau Woo and Kenny Zhang, `China Goes Global, the Implication of China's Overseas Direct Investment for Canada.' (2005).

Figure 3

Deng Xiaoping in Shenzhen during his tour of southern China in 1992

Source: FOTOE

China's ODI is the latest stage of a long process of economic liberalisation

China's long march to becoming an overseas investor has occurred in a very particular way, and covered the period in which it has formulated its `socialism with Chinese characteristics,' liberalising its economy, entering the World Trade Organisation (WTO) in 2001, and practising `market socialism.' This has led to an economy where, according to the OECD in 2005, over half of the GDP growth rate is produced by the non-state sector. The political enfranchisement of the capitalist classes in 2001, after former President Jiang Zemin's `Three Representatives' campaign - in which he championed the `productive forces' of the entrepreneurial class - was highly significant. China's red capitalists could no longer be kept out of the tent. Even so, there were still very strict controls on their abilities to work abroad. They were given limited government support, needed political patronage and were often operating from a very low knowledge base – hardly surprising in view of the closed nature of the Chinese economy for most of their lives till the 1980s.

Chinese ODI in the 1980s and 1990s was very small in scale, and focussed on the clear objective of securing resources, mostly in minerals and energy. China had investments in Latin America, Canada and Australia. One of these, a copper mine in South America bought by the state-owned company Shougang in the early 1990s, serves as a good example of how problematic Chinese found these early moves. Shougang, a Chinese state steel company, made a US$118m purchase of a Peruvian iron mine between 1992-93. This was in one of the most deprived areas of Peru and warmly welcomed locally.

However, Shougang invested nothing in the apparatus and infrastructure of the mine. It ignored environmental rules, safety standards and the welfare of workers. It paid below minimal wages. Fines levelled by the Peruvian government didn't work in rectifying this. There seemed to be no sense of corporate governance or social responsibility on the part of the Chinese side, partly because, in the end, the Chinese company, being state owned, had no experience of such concepts. After a series of strikes in 2004 and 2005, Shougang, despite making handsome profits, simply sacked most of the local workers and imported labour from China.[4] This is a textbook case of how not to invest abroad. But this was in the days before CIC.

Chinese overseas investment to end-2006[5]

A statistical overview of how much China has invested abroad

According to the latest figures available from the Chinese Ministry of Foreign Commerce (MOFCOM), China invested US$20bn abroad in 2006. There were 5000 Chinese entities investing abroad, in over 10,000 separate investments in 172 countries and territories. The overall stock of Chinese outward investment up to the end of 2006 was US$90.63bn, of which US$75.02bn was in non-finance, and US$15.61bn in finance. Of the finance investment abroad, US$12.33bn was in banking and US$7.76bn in insurance. Chinese state banks had 47 branches abroad, in 19 countries, employing 20,000 staff. The figure for 2006 of US$20bn invested abroad during that year, divides into US$17.63 for non-finance, almost double the amount for the previous year. Chinese finance investment overseas in 2006 was US$3.52bn.[6]

These figures need to be put in context. According to UNCTAD's World Investment Report 2006, World FDI in 2005 was US$778.7bn, and the global stock of ODI to the end of 2005 US$10,671.9bn. On this accounting, China's ODI constituted 2.72% of the 2005 amount, and a mere 0.85% of the accumulated global amount, placing it 13th in the world. For now, China is tiny compared to the US, UK and other major players. But as with the story of FDI in China, it is starting from a low base and the only way it can go is up.

Which regions was this money going to?

Chinese investors are big in Asia, but only starting to register in other regions

Perhaps unsurprisingly, the key area for Chinese ODI in both the finance and non-finance sectors from 2003 onwards has been Asia, followed by Latin America and then Europe, Africa and North America. There are some anomalies in these figures, and some questions about how China calculates ODI, and how other countries do. Singapore, for instance, has a very different figure for Chinese investment into the territory than the Chinese figures here suggest. Even so, Chinese overseas investment figures are generally accepted as reflecting general trends well, even if there are specific issues which might need to be challenged. And the quality of Chinese investment date over the past decade has improved dramatically.

Big rises in Africa and Europe . . .

Figure 4

Chinese ODI stock in non-finance sector

(US$m)	2003	2004	2005	2006
Asia	26,603	33,479	40,954	47,978
Africa	491	899	1,595	2,556
Europe	487	676	1,272	2,269
Latin America	4,619	8,268	11,469	19,694
North America	548	909	1,263	1,587
Oceania	472	543	650	939
Total	33,222	44,777	57,205	75,085

Source: Chinese MOFCOM

[4] Ibid pp 168-169.

[5] Figures from this section are all from the 2006 Statistical Bulletin of China's Outward Foreign Direct Investment, issued by the Ministry of Commerce of the PRC, the State Administration for Foreign Exchange, and the National Bureau of Statistics of the PRC.

[6] Data for 2007 is incomplete. However, the overall amount for non financial investment abroad in 2007 was US$18.72 billion, a 6.2% rise on the year before. Of this, a third was made up of Mergers and Acquisitions.

. . . but a lot of these figures hide a hidden story, especially the Asian, European and Latin American ones

Figure 5

Chinese ODI stock in finance sector

(US$m)	2003	2004	2005	2006
Asia	1,505	3,013	4,484	7,663
Africa	74	317	391	519
Europe	145	157	395	597
Latin America	1,038	1,762	6,466	8,468
North America	57	129	320	258
Oceania	33	120	202	126
Total	2,854	5,497	12,261	17,633

Source: Chinese MOFCOM

These statistics contain three embedded stories. First, there is the increasing prominence of Hong Kong in China's outward investment. Of the non-finance total of FDI for Asia in 2006, which comes to US$47.9bn, a staggering US$42.26bn was attributed to Hong Kong - over 90%. Second, of the US$19.69bn for the non-finance sector marked down to Latin America, the Cayman Islands and the British Virgin Islands account for almost the entire total – US$14.20bn and US$4.75bn respectively. This raises issues about the round tripping of money through China via Hong Kong or offshore destinations and then back into China, in order to attract favourable tax breaks and better treatment accorded to investment classified as FDI rather than domestic.

Such preferential treatment has lessened since the National People's Congress passed laws in March 2007, which gave equal treatment to both domestic and foreign investment. Even so, the bias still remains to seek classification as foreign investment. This also means that both outward and inward bound investment figures are inflated, although it is difficult to assess by how much. Third, the Europe figure includes Russia, its 2007 total of US$2.26bn accounts for US$ 0.9bn. It is curious that investments into energy resources do not appear more clearly marked in these statistics. They are presumably subsumed into "mining". Even so, it is clear that one of China's main priorities in its outward investment, at least so far, has been to secure resources.

Africa has been a big beneficiary of Chinese overseas direct investment

It is clear looking at these figures, though, that one of the real areas of growth has been Africa. This will be looked at further on. When surveyed Chinese investors, state and non-state, have both said that they regard Europe and North America as the most attractive areas to place their money. But by their investment actions it is clear they prefer, as Gerard Lyons rightly surmised in the report quoted above, more high risk territory.

What sectors are Chinese investing their money in?

Where are the Chinese putting their new found wealth?

From 2004 to 2006, Chinese investment abroad, year on year, went into a wide range of sectors. The real volume, however, accounting for a third of the total of US$21bn invested overseas in 2006, went into mining, followed by leasing and business services. This figure includes short and long-term leases on foreign premises and plants for overseas representative offices, etc, along with legal and professional service help for the operations of Chinese state and non-state entities abroad. In that sense, while creating better infrastructure for Chinese companies and investment abroad, it is not strictly direct investment in assets.

It does, however, indicate the number, and size, of Chinese corporate and state activity abroad, and could be interpreted as a clear sign of commitment and expansion of Chinese overseas. The greatest increase, however, was finance, which barely registered in 2004 and 2005, but shot up to US$3.5bn in 2006.

China continues its commitment to resources

Figure 6

Sectoral distribution of Chinese ODI

(US$m)	2004	2005	2006
Mining	1,800	1,675	8,539
Leasing, business services	749	4,941	4,521
Finance	-	-	3,529
Transport, warehouse and postal services	828	576	1,376
Wholesale and retail	799	2,260	1,113
Manufacturing	755	2,280	906
Real Estate	8.5	115	383
Science, research services	18	129	281
Agriculture	288	105	185
Power and other utilities	78	7	118
Residential and other	88	62	111
IT	30.5	14	48
Construction	47	81	33
Water and environment	1.2	0.13	8
Residential and catering	2	7.58	2.51
Education	-	-	2.28
Culture and sport	0.98	0.12	0.76
Public health	0.01	-	0.18
Public management	0.04	1.71	-
Total	5,497	12,261	21,163

Source: Chinese MOFCOM

Assets rule

Chinese investors are clearly putting their money into assets. Their investment in real estate has gone up dramatically in the past three years. But they are also diversifying into services and finance. Manufacturing peaked in 2005, and has now dipped back to levels similar to 2004.

Of China's ODI stock as of end-2006, leasing came top, accounting for over a fifth, with mining ranking second, and finance (because of a number of acquisitions during 2006) placed third.

Leasing, mining and finance make up over half of China's stock of ODI

Figure 7

Chinese ODI-stock breakdown

Sector	Total to end 2006 (US$bn)
Leasing	19.46
Mining	17.90
Finance	15.60
Wholesale and retail	12.95
Transport	7.56
Manufacturing	7.52
Real Estate	2.01
Construction	1.57
IT	1.44
Residential	1.17
Science	1.12
Water and environment	0.91
Agriculture	0.81
Power	0.44
Residential	0.06
Culture and Sport	0.02
Total	90,630

Source: Chinese MOFCOM

Down to the coalface: Where does the money come from?

China's ODI is predominantly from the state

Of China's US$17.63bn overseas non-finance investments in 2006, US$15.236 came from the central government, or its agents and subsidiaries.

Only US$2.397bn originated from provinces. Of these, the top 10 were led by Guangdong, with US$629m, of which two thirds can be traced to Shenzhen Special Economic Zone. Surprisingly, Heilongjiang in the northeast ranked third, above the traditionally outward looking, dynamic Zhejiang where the non-state sector has made the most profound impact (70% of Zhejiang's economy is in the hands of the non-state sector.) Beijing ranks tenth.

The figure for Liaoning, also in the north east, is almost wholly due to the coastal city of Dalian, which has become something of an economic rags-to-riches story since the leadership of former Minister for Finance and now Party Secretary of Chongqing, Bo Xilai, who was mayor of the city in the late 1990s and early 2000s.

The man who put Dalian on the map

Figure 8

Bo Xilai

Source: CNS

Of China's provinces, Guangdong is way ahead

Figure 9

Top-10 provinces for finance overseas direct investment, 2006

Province	Total (US$m)
Guangdong	629
Shanghai	448
Heilongjiang	217
Zhejiang	215
Shandong	126
Jiangsu	124
Liaoning	97
Fujian	95
Hunan	59
Beijing	56

Source: Chinese MOFCOM

It's the same for non-finance too

For the non-finance investment, the pattern is similar, with the Centre accounting for US$61bn of the US$74bn total, and the provinces US$13.397bn. Guangdong comes out top, again, and again Shenzhen contributes almost half of the province's figure. Once more, Heilongjiang performs well. Zhejiang, however, performs much better in these figures.

Figure 10

Top-10 Chinese provinces for non-finance ODI, 2006

Province	Amount (US$m)
Guangdong	4,173
Shanghai	2,612
Shandong	1,103
Beijing	918
Zhejiang	702
Heilongjiang	601
Jiangsu	588
Fujian	523
Hebei	327
Liaoning	279

Source: Chinese MOFCOM

And the companies that are investing abroad?

Chinese companies with assets abroad are almost all state-owned

China's economy may well have seen a process of company privatisation over the past two decades, but state owned enterprises (SOEs) are still dominant in key sectors such as energy, telecoms and logistics. Looking at the top asset holders among Chinese corporations and companies with interests abroad, it should come as no surprise that the list is dominated by these SOEs. For the telecoms and energy companies listed below, in particular, the state is the majority partner, even though they have subsidiary companies that may have been listed abroad (as it the case, also, with COSCO). As of the end of 2006, the top-10 Chinese firms with assets abroad – what can be called the real face of Chinese enterprise going global - were:

1. China Mobile
2. China Network
3. China Resource Holdings
4. China National Overseas Oil Company (CNOOC)
5. China National Petroleum
6. China Petrochemicals
7. China Ocean and Shipping Corporation (COSCO)
8. Unico
9. Shanghai Overseas United Investments
10. China State Construction Engineers

Only two from the non-state sector in the top 20, and even in these the state had stakes

From the non-state sector, Legend comes in at 13 and Huawei at 19. Even with these companies, the state was still a partner. Huawei, for instance, is 20% owned by the Chinese government, with the remainder in the hands of the 70,000 employees, who each have shares in the company. This means that of the top-30 companies going abroad now, none can be said to have any links with the state in terms of ownership or shareholdings.

In terms of whom the top investment enterprises were for 2006, the list looks as follows:

1. China Petrochemical Corporation
2. China National Petrol Corporation
3. CNOOC

4. China Resource Holdings
5. China Mobile Communications
6. COSCO
7. CITIC
8. China National Foods, Oils and Cereals Corporation
9. Chinese Merchants
10. Sinochem

Legend came 21st in this list, and Huawei 24th, with the electrical appliance manufacturer Haier coming in at 30.

How the figures add up

There were clear patterns for Chinese ODI until the end of 2006 - state led, in resources, and in Asia

At the end of 2006, Chinese investment abroad followed some clear patterns. It was predominantly in mining and leasing, with a big increase in finance. It was overwhelmingly directed from the centre, and through SOEs, some non-state players started to make a small splash. It was a small amount of the global proportion of stocks of ODI, but going up in huge jumps. Most of it went into the Asian region, with the bulk of this through Hong Kong. Significantly, the first Chinese investment (a mere US$2m) went to Taiwan in 2006. Africa saw the largest percentage increases over the 2003-06 period. Significant amounts also went into offshore areas.

But this was all before the establishment of the CIC. That looks likely to change things dramatically.

The policy debate leading up to the CIC founding

It's no secret that the Chinese government, in considering what to do with its foreign exchange reserves, looked very closely both at the Singapore Government Investment Fund and Temasek, a smaller government fund, also in Singapore. But in the years up to 2007 when the CIC was finally established, China learnt some hard lessons. The first, and possibly the one that has left the most profound marks, was the attempt by the state oil company CNOOC to buy the US energy company Unocal, a story which ran from 2004 into 2005, before CNOOC withdrew. Some of the comments made in the US at the time of this potential US$18bn deal haunt the CIC debate.

Failed CNOOC bid for Unocal left a bad taste

Perhaps CNOOC had become over-optimistic by the relatively smooth handling of the sale of the IBM Think Pad personal computer brand to China's Lenovo for US$1.6bn in 2004. The stipulations there had been largely commercial – that Lenovo had full use of the Think Pad name for five years and that it could not produce PCs carrying classified information for the State Department, one of IBM's biggest customers. Mary Ma, Vice President of Lenovo, underlined how commercial and strategic Lenovo's thinking was. The company wanted access to IBM's technology, market penetration and management skills. This deal fulfilled all of those requirements.[7]

But in size, and political impact, the CNOOC bid for Unocal was of a different order. Forty-one members of Congress wrote to the then US Treasury Secretary John Snow, who was also Head of the Committee on Foreign Investment. Their opposition focussed on two critical issues. Firstly, that CNOOC, which was 70% government owned, was using Chinese state funds

[7] McKinsey on Finance, Number 23, Spring 2007, p 18.

to make its bid. And secondly, if the deal went ahead, it would be acquiring sensitive technology – in this case, water drilling techniques. This was exacerbated by a sustained campaign by CNOOC's rivals in the potential deal, Texaco, for instance, highlighted these security issues.

The US government issued a formal statement in August 2005, saying that it supported investment as long as it was according to US laws. Many argued that the Chinese involvement was easy to control, as all the relevant business was to be conducted in the US. CNOOC itself also made a commitment to open its books. On 2 August 2008, however, CNOOC abandoned its bid. Californian congressman Richard Rombo summed up the mood of the opposition in the US when he stated that had CNOOC's bid succeeded it would have had `disastrous consequences for our economy and national security.' [8]

CNOOC issued its own counterblast. Its withdrawal, it said, was a political decision. `The unprecedented political opposition that followed the announcement of our proposed formation was regrettable and unjustified. . . This political environment has made it very difficult for us to accurately assess our chance of success, creating a level of uncertainty that presents an unacceptable risk to our ability to secure this transaction.' The Chinese firm said its objectives had been `purely commercial' and that it would have been prepared to address `any legitimate concerns' held by US officials.[9]

Chinese ODI until 2006 had a mixed record abroad, with many failures

Looking at Chinese high-profile investment to 2006 (see Figure 11), the record is sobering. Partly government-owned electrical appliance manufacturer Haier's attempts to purchase US company Maytag in 2005 was ditched because of a counter-offer. The 2003 purchase of French TV manufacturer Thomson by TCL, headed by Li Dongsheng, is a case in point. The technology bought was not particularly robust and the management culture that TCL encountered in at least Thomson's European operations were utterly alien to those it had been used to. Imposing Chinese style management processes proved disastrous. Nor had TCL prepared itself for the union laws in France when it wanted to close down a factory there. TCL was more successful in Asia and the US. But as TCL President Li Dongsheng admitted at a conference held at Chatham House, London in June 2008, the journey had been a hard and rocky one.

Where the first big investments went and their success rate

Figure 11

Early Chinese high-profile investments

Date	Status	Name	Country	Bidder
May 05	Abandoned	Unocal	USA	CNOOC
Aug 05	Completed	PetroKazakhstan	Canada	PetroChina
Dec 04	Completed	IBM (PC division)	USA	Lenovo
Jan 01	Completed	Hyundai Display Technology	South Korea	BOE Technology
Jun 05	Abandoned	Maytag	USA	Hai'er
Jan 02	Completed	Repsol YDF	Indonesia	CNOOC
Nov 03	Completed	Sangyong Motors	South Korea	Nanjing Auto
July 05	Completed	MG Rover	UK	Nanjing Auto
Nov 03	Completed	Thomson SA	France	TCL

Source: Deutsche Bank

This offers background to policy formulation leading up to the CIC's establishment.

[8] Guardian, August 3rd 2005.

[9] Guardian, August 3rd 2005.

The rules: How Chinese ODI has been administered till now

The `Go Global' campaign and its attempts to focus on key sectors for Chinese to invest in abroad

China's `Go Global' aspirations were first announced in the 10th Five-Year Plan, running from 2001 to 2006. As with FDI, the government spelt out two broad areas where investment was to be focussed - securing resources, and `promoting the multinationalisation of Chinese companies.' [10] Outward investment was seen as a way to alleviate overliquidity in the Chinese economy and take pressure off appreciation of the Chinese yuan. MOFCOM opened an internet site for outward investments in 2005. The key sectors for investment were: 1) agriculture, cattle breeding and fisheries; 2) mining; 3) manufacturing; and 4) service industries.[11]

Rules about Chinese ODI abroad have been liberalised - in theory anyone can now place money outside China

The Chinese government is a major player and stakeholder in any form of Chinese ODI, even though, over the past two years the rules of Chinese ODI have been liberalised so that in theory non-state entities can operate abroad. In April 2003, the State Asset Supervision and Administration Committee was founded, partly to shape the top-50 Chinese SOEs into global companies. In 2003, MOFCOM and the State Administration of Foreign Exchange (SAFE) promulgated regulations saying that amounts under US$3m could be invested abroad without central-government approval. This meant that in the first 11 months of 2003, Chinese companies invested 92% more in offshore mergers and acquisitions than they had in 2002. [12] In February 2004, the State Council approved the National Social Fund to invest foreign currency in overseas markets.

In August that year, "Temporary Measures on Overseas Use of Foreign Exchanges Insurance Fund" allowed Chinese insurance companies to invest 80% of the balance of their funds in foreign exchanges from the previous year abroad. The central government has also allowed 22 cities and provinces to invest up to US$200m abroad without central approval. In December 2004, the Chinese Development Bank granted a loan of US$10bn to telecoms manufacturer Huawei, one of the main Chinese investors into the UK, to promote its international operations. And in 2005, China Exim Bank approved loans of US$20bn for overseas investment and trade. Most of theses loans have been allocated to Africa. The CIC has grown out of this background, but is the result of a separate articulation of policy goals and priorities.

The founding of the CIC

Behind the founding of the CIC was China's booming foreign currency reserves

Chinese leaders have been thinking about what to do about overseas investment and the burgeoning foreign-exchange reserve for the past few years. Premier Wen Jiabao has made it clear that having this huge amount of capital is no good. China of course wanted enough reserves to protect its currency, which is usually calculated as three months of costs of imports. In China, that runs at no more than US$250bn. In order to have US$1.8tn, as China currently does, is evidently excessive. The rate at which it is increasing (see Figure 12) is also a worry.

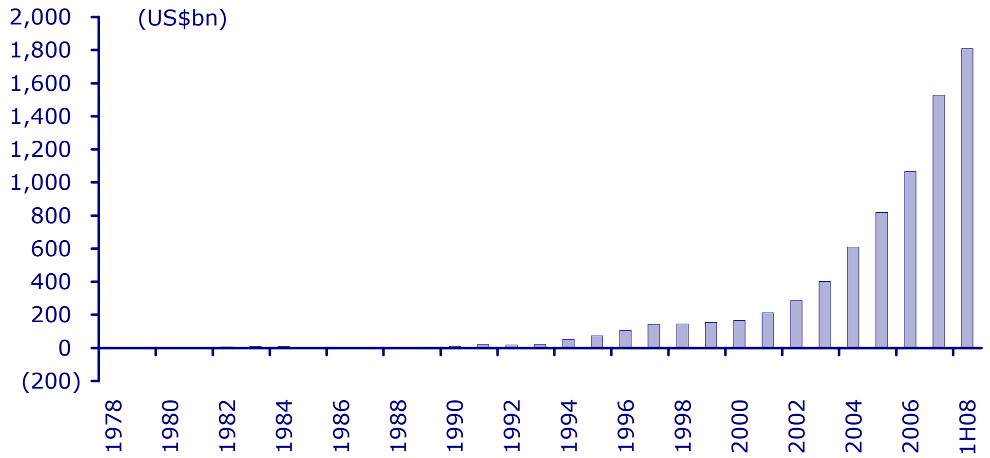
[10] Yoko Hagiwara, *Economic Review: Outward Investment Gathering Steam under the Go Global Strategy* Bank of Tokyo Mitsubishi, Vol 1, No 17, Nov 2006, p 1.

[11] Ibid, p 2.

[12] Dennis Pamlin and Long Baijin, *China's Outward Investment Flows*, World Wildlife Fund, April 2007, available at www.panda.com/invest p 19.

Figure 12

Chinese foreign-exchange-reserve accumulation



Source: SAFE

Where the reserves are and what they are being used for at the moment

It's not just the accumulation that is a problem. It is also the way in which the money is currently being put to use. According to Friedrich Wu, an academic and former Singapore government official, 70% of the foreign exchange reserves held by the People's Bank of China (PBOC) are in US dollars. That has depreciated 18% since 2005 as the US dollar has weakened against international currencies - 18% of more than a trillion dollars is a lot of money! Calculations made about the amount of US treasury bonds bought and sold in markets like London imply that China has as much as US$500bn of these bonds.

The perception in the US that China is funding its spending and buying its debt is an uncomfortable one. Politicians have publicly stated that there is an anomaly in the US government taking positions against the Chinese government on human rights and democracy, when its economy is underpinned by money from China. To others, though, this is the inevitable flip side of globalisation and China adopting liberal economic policies. To complain about it seems like trying to have your cake and eat it.

The first step into the unknown - Blackstone

China's first high profile state investment lost a lot of money

Faced with either keeping these reserves in low interest-rate accounts in China, or buying politically risky foreign-treasury bonds, the Chinese government looked carefully at other countries' sovereign wealth funds. Throughout 2006 and 2007, there were signs that Beijing was about to launch its own official wealth fund. A first big move came in May 2007, when Jianyin Investment[13] took a US$3bn stake (about 1% of the US$333bn for the whole fund) in US fund-and-asset-manager Blackstone, which owns British restaurant chain Café Rouge, Madam Tussauds, and Centre Parcs in France.

After the run around with CNOOC and Unocal in 2005, this seemed, at the time, a welcome sign that China was becoming more strategic in its investments. In a report on 22 May 2007 in *The Guardian*, Eli Tamir of the London Business School Private Equity programme said that the Chinese method this time had been a sign that `the Chinese are coming to terms with

[13] A Chinese government owned company set up as a precursor to the CIC.

the rest of the world. They're actually showing some restraint, some respect toward the West. If they really wanted to exercise muscle they could go for direct investment.'[14]

The Blackstone experience made Chinese believe their government could not be trusted to invest their money

These words were to prove to be tempting fate. Within a few months, the investment had lost US$1bn, a 30% fall in value. This was to provide plenty of firepower to critics within China who used it as an example of how the government couldn't be trusted with investment and was wasting hard earned money that it would be better placing in social welfare and public projects. One blogger complained on the popular Sina.com: "O senior officials of the Chinese government please do not be fooled by sweet-talking wolves dressed in human skin. The foreign reserves are the product of the sweat and blood of the people of China, please invest them with more care!"[15]

Outside consultants were asked to advise on the structure of the CIC management

Aware of this criticism, the Chinese government asked management consultants McKinsey and Booz Allen Hamilton to research the best management structure for the new fund. The final structure was to have an 11 member board and a seven strong management committee. The initial fund of US$200bn would be from three sources. The first would be from the already extant Central Huijin Investment Corporation, which had shares in banks, security firms and insurance companies. The second would be capital to hold shares in the Agricultural Bank and the China Development Bank. This would leave a residue of about US$90bn for overseas investment.

CIC management is a combination of Chinese ministries and government institutions

The management of the CIC consists of the Ministry of Finance, Ministry of Commerce (MOFCOM), the People's Bank of China (PBOC), the State Administration for Foreign Exchange (SAFE), and the National Development and Reform Commission (NDRC), all powerful entities, and all with a keen interest to defend their territory. It is headed by Lou Jiwei, China's former deputy-finance minister and State Council deputy-secretary general, who now serves as chairman of its board. The CIC's President is Gao Xiqing, vice chairman of China's national pension fund and one of CIC's executive directors. Other members of the board are:

- Zhang Hongli, CIC's executive director and vice-minister of finance
- Fu Ziying, assistant minister of commerce
- Hu Xiaolian, deputy governor of the People's Bank of China and administrator of SAFE
- Li Yong, vice minister of finance
- Liu Shiyu, deputy governor of the People's Bank of China
- Wang Chunzheng, ex-vice minister of the National Development and Reform Commission (NDRC)
- Liu Zhongli, former minister of finance
- Zhang Xiaoqiang, vice minister of NDRC[16]

A final member will be voted by the CIC staff.

[14] Guardian, 22 May 2007.

[15] *International Herald Tribune*, 2 August 2007.

[16] *China's Trillion-dollar Kitty is Ready, Asia Times*, 2 October 2007.

The two CIC leaders

Figure 13

Lou Jiwei

Figure 14

Gao Xiqing

Source: FOTOE

The ultimate power still lies with the State Council

The board reports finally to the State Council and to the Premier Wen Jiabao. Since the fallout from Blackstone, there have been clearer stipulations for China's State Council to approve all major overseas investments and give them greater attention and scrutiny. This makes it clear that any money of any significance China places abroad now will have political coverage.

Despite such a wide ranging board, there is still potential for conflict between stakeholders

Such a management board is inclusive. However, it is clear that there are stark divisions within it, and in classic Chinese high politics fashion, there are turf wars going on. SAFE, in particular, feels that it is better placed to make investment decisions, and has used Blackstone as an opportunity to point out that the CIC simply lacks the experience and structure to be entrusted with so much money. Pointedly, it was SAFE that was behind the Chinese investments earlier in 2008 into BP (1% of its equity) and Total (1.6%).

How the CIC is funded

CIC funds: how they have been raised

First of all, to clear up a misapprehension, the US$200bn is not from the Central Foreign Exchange Reserves, which sit in the PBOC and are still managed by SAFE. The CIC fund money has been borrowed from the PBOC. The NPC was authorised by the Ministry of Finance to issue RMB1.55tn to buy foreign exchange reserves to make up the US$200bn of CIC's first tranche of funding in mid-2008.

This fundraising is shown in Figure 15. Rmb1.35tn (about US$181bn) was channelled through the Agricultural Bank of China (ABC), in August and December 2007. The remainder (about US$ 20bn) was sold in six separate occasions on the inter-bank market, on special bonds with a maturity range of 10 to 15 years, and rates of 4.3% to 4.68%, from September to December 2007. So far, because of rising inflation, the PBOC has kept these special bonds on its books, rather than sold on to the public, which was the original plan.[17]

CIC's current funds are not from the foreign reserves

Figure 15

CIC fundraising sources to date

Date	(Rmbbn)	(US$bn)	Sale method
29/08/2007	600.0	79.4	To PBOC, via ABC
17/09/2007	32.0	4.3	Market issue
21/09/2007	35.1	4.7	Market issue
28/09/2007	36.3	4.9	Market issue
02/11/2007	35.0	4.7	Market issue
19/11/2007	35.7	4.8	Market issue
14/12/2007	26.4	3.6	Market issue
11/12/2007	750.0	101.6	To PBOC, via ABC
Total	1,550.0	208.0	

Source: Standard Chartered Bank Global Research, Bloomberg, media reports.

And because the CIC is using borrowed money, it has to make good returns

In order to service this debt, the CIC has to repay US$8bn a year. This means a 14% annual return on its investments, a not impossible target (some SWF investments reach 16%) but a very ambitious one, especially for a new and inexperienced fund. On 28 February 2008, CIC ominously missed its first interest payment. Jesse Wang, the CIC's risk director, has said that the CIC needs `a 5% return per year [on investments].'[18] But this doesn't cover costs of bond issue on the interest payments mentioned above.

What has the CIC said about its policy framework and Investment Strategy?

Chairman of the Board Lou Jiwei has publicly said that the CIC will focus on three areas:

1. IPO cornerstone investments
2. Outsourcing to external asset managers
3. Investment in firms hit by the subprime crisis.

According to public statements at least, the CIC invests solely on commercial grounds

He has also said that they will avoid investments in energy, and telecommunications. This is possibly on the back of the Unocal experience, and the attempts by Huawei in 2005-6 to purchase with the US private equity firm Bain Capital the US telecom company 3com, which failed due to national security issues.

Jesse Wang has stated that the motives behind the CIC, and the way in which it will be run, will be purely commercial: `The mission for this company [CIC] is purely investment driven.'[19] One of the CIC fund managers, Yang Qingwei, has echoed this, saying that the CIC's principle purpose is `to make profits.'[20] Even so, since the bad experience of Blackstone on its current record CIC seems risk averse. Offsetting concerns about the transparency and openness of China's SWF, both Chairman Lou and the General Manager Gao have said that the fund will be run according to `ethical standards for investment.' Chairman Lou has also said, in very typical Chinese official fashion (betraying his government background) that `We will adopt a prudent accounting

[17] I am grateful for the information in Wu and Seah, *World Economics*, Volume 9, No 2, April-June 2007, pp 7-8 for the explanation of this.

[18] Friedrich Wu and Arifin Seah in *World Economy*, vol 9, No 2, April-June 2008, p 20.

[19] Quoted in Michael F Martin, *CRS Report for Congress: China's Sovereign Wealth Fund'*, 22 January 2008, p 10.

[20] Ibid, Martin, p 14.

system, adhere to commercial lines and improve the transparent [sic] on the condition that company interests will not be jeopardised.'[21] However, he continues, this needs to be a `gradual process. If we are transparent on everything, the wolves will eat us up.'

The CIC needs outside help

The fund has made it clear that it needs a great deal of external help. There is a shortage of qualified investment professionals in China. According to an estimate made by Accenture in 2005, China will need 75,000 professionals in the next decade, with international experience. At the moment, it has only 5,000.[22] The CIC currently has 200 analysts, many of them returnees from overseas. But the levels of remuneration that the fund offers mean that it is simply not internationally competitive. It has therefore looked at outsourcing advice on potential investments, and has placed a figure of US$30bn of its initial fund for this external use. Applicants to manage its money must have at least six years experience, and a minimum of US$6bn under their management. The CIC in return has set targets for them for investment returns. Morgan Stanley, JP Morgan, Goldman Sachs and Merrill Lynch all have their Chinese SWF teams in place. CIC has set a limit to the number of external advisors at 30. Any more, and its management of these would become a massive task in its own right.

The funds performance so far

Setting out initial policy frameworks is one thing. But now that the fund has existed for almost a year, where has it actually put its money? Of course, the investments so far are only the ones we know. There may be others that have not, as yet, become public.

When it was set up, over half the funds were already committed to existing investments

In August 2007, the CIC just before being formally set up allocated US$67bn to the Central Huijin Investments, which had equity stakes in BoC, China Construction Bank, Industrial and Commerce Bank of China, China Galaxy, Shenyin Wanguo, Guotai Junan, China Securities, China, Jianyin Investment, Hongyuan, Southwest, Beijing and Qilu securities companies. These were bought at book value from the PBOC. In December 2007 the CIC put in US$20bn to the China Development Bank for recapitalisation, for an equity stake. In the same month, it put in US$3bn for similar recapitalisation for Everbright Bank on the same terms. In December 2007, it also bought US$5bn of convertible bonds for a 9.9% equity stake in Morgan Stanley after three years. It invested US$100m in China Railway in November 2007. In March 2008, it announced a US$3.2bn-US$4bn injection of funds into J C Flowers, for investments to be run by Flowers in US banks and brokers. There were also rumours in 2007 that a 0.45% stake in BG Group for US$250m last Autumn by the PBOC was on behalf of the yet to be set up CIC.

The role of SAFE

These investments should be kept distinct from the ones by SAFE, who, to many people's surprise, took a 1% share in BP, a 1.7% share in Total, and 1% of the IPO of Visa earlier in 2008. SAFE sits on the CIC's board, but it is well known that, even though they are the administrator of China's Foreign Exchange Reserves, they had reservations about the setting up of the CIC, and have been seeking a chance to show, since the Blackstone debacle, that they are better placed to make sensible investments abroad. The existence of two competing entities within the Chinese government hierarchy is common (look at the division between the Aviation Industries of China (AVIC) which

[21] Ibid Martin, p 16.

[22] *China Spreads its Wings: Chinese Companies Going Global* Accenture 2005.

was split into AVIC1 and 2 in 1999) and sometimes serves political and economic purposes. But it is also often the result of brokered compromise, and shows the surprisingly fragmented nature of the Chinese body politic. Whether tension between SAFE and CIC leads to healthy competition, or corrosive conflict, remains to be seen. But for observers, it adds yet a further important state actor as China starts to operate more abroad.

It is still far too early to define any set patterns. And the CIC must be put in the broader context of China's whole investments abroad. Africa offers a good example of how state and non-state, financial and non-financial investment from China can be mixed up, and how it can be seen as in many ways more than the sum of its parts. This will be covered below.

Should we have a problem with this?

Investing abroad - A major step in the internationalisation of the Chinese economy

China's becoming an outward investor, and having assets abroad should surely be welcome. After all, the thrust of the last three decades after the years of Maoist economic darkness from 1949 to 1976 has been to see China liberalise its economy. Entry to WTO, along with a host of other reforms and changes, has seen this happen. China is now one of the world's most open economies, with something like 9% of its GDP from foreign trade, 7 percentage points higher than Japan. Surely China should be embraced as a global investor? We do not want to return to the period where it operated as an almost autarkic isolated entity. And its working abroad as an investor should, in the long term, see it adopting some of the governance standards that will help Chinese corporations back in China.

But the Chinese CIC will cause political issues

Even so, the issue generic to almost all SWFs – their opaqueness and lack of accountability - haunts discussions of the Chinese funds, magnified by the fact that, of the world's top ten economies, China alone remains a one-party state. There is evidence for it aplenty, but any subject, when it touches China, becomes highly political very quickly. As the Bush administration is fond of saying, the US and Europe in particular may have some shared strategic goals – economic stability, prosperity, protection of the environment, etc – but in terms of values, they often speak from different planets. The government of the People's Republic of China is, as of 2008, autocratic, the legal system highly vulnerable to political influence, and the bottom line still the strong feeling that, in the end, the Communist Party of China, with its particular ideological and strategic objectives, will always do what it takes to look after its own interests.

China's official entry into the global economic system

Figure 16

Signing ceremony of China's agreement to enter the WTO in 2001

Source: CNS

However this is articulated, this is what lurks behind suspicions and fears of what Chinese money might be doing and what strategies are guiding it. That becomes clear in statements like that by Brad Setzer, of the US Council For Foreign Relations interviewed in November 2007: `The rise of sovereign wealth funds represents a shift in power from the US to a group of countries that aren't transparent, aren't democracies and aren't necessarily allies.'[23] Among the SWFs, the CIC presents particular problems. It is big, it has low transparency, and it appears highly strategic. There are also fundamental problems about what China wants from these funds, beyond sound returns.

The five strategic objectives of Chinese ODI are resources, brands, market access, soft power influence and technology

Chinese ODI generally has been focussed on the following key areas. ODI from state and non-state players has been sanctioned when it meets these general objectives:

1. Resources: China is the world's main user of zinc, copper, aluminium, and other metals, and is now the world's second largest user of oil. For both of these, therefore, it has become reliant on external sources of supply. It has invested in major mining projects in Latin America, and in energy projects in the Middle East (45% of its imported oil comes from this region, making up 21% of its oil consumption), and Africa.

2. Brands: The Chinese government understands that its indigenous companies, state or non-state, need to internationalise. Many of the more successful (Huawei, Lenovo and Haier) have reach the limits of what they can achieve within China, and need to now engage more deeply with the global economy. For China's economy overall, as with Japan's in the 1960s and 1970s, and the United States over a century before, there is a desire to create internationally competitive, credible companies. China is aware of its lack of globally recognised brands. Acquisition of foreign brands (Lenovo's of IBM, TCLs of the French TV manufacturer Thompsons, Nanjing Auto's of MG Rover in the UK in 2005) is seen as the quickest, and easiest, way to deliver brand value.

Outward investment to gain technology and skills

3. Technology and management know-how: One of the key motivators for the government at the beginning of the reform process in 1980s was not so much to attract FDI because it brought capital into China, but as a

[23] Martin, `CRS Report in Congress' quoted p 5.

means to gain access to foreign management know-how and intellectual property (IP). Joint ventures were set up from the first Joint Venture Law in 1979 to achieve this delivery of IP. As of 2005, however, 88% of China's hi-tech exports are made by Foreign Invested Enterprises in China. There is a clear knowledge deficit, and a lack of technical capacity. Having tried accessing this through FDI, the Chinese are clearly now using ODI as a quick means to acquire IP. This was partially behind the purchase of IBM Think Pad in the US, and MG Rover in the UK.

Outward investment to gain entry to markets

4. Market access: Purchase of foreign companies by Chinese ones is seen as a quick way to acquire an already extant and available sales network. The purchase, for instance, by Shenzhen based TV manufacturer TCL of Thomson in France was seen as delivering not technology (Thomson TV technology was already available in China) but a ready network in Europe and America. Due to their relative lack of experience internationally, Chinese companies are aware of their lack of local knowledge, and the difficulties of gaining access to the different, complex markets both in Europe and North America. Mergers and acquisitions with foreign companies are seen as the best way to achieve this quickly.

5. Soft power: A final, more illusive and more ambitious motivator behind Chinese overseas investment is to enhance and increase China's influence. Its efforts to increase the country's soft power, especially in Asia, have been described by, among others, Joshua Kurlantzick in *Charm Offensive*. China's investment, in Africa, sometimes takes the form of soft or preferential loans, or aid, seemingly untied. China has also supported projects that showcase its pretensions to economic great power status.

China's weakness is in corporate governance, lack of knowledge and transparency

These are the areas China wants to work in to meet its national goals. But then there are the well documents weaknesses of China's corporations:

1. Corporate governance: The key issue is the skills Chinese corporations have in terms of governing and accounting for their actions. All Chinese companies have come from a background in which, from 1956 to 1978, 99% of the Chinese economy was in the hands of the state, with central planning the norm, and micromanagement of all areas of activity, from production, to sales, to budget. In the space of just two decades, therefore, China has had to first create a credible company law (it did not even have a proper bankruptcy law till the 1990s), then a workable legal infrastructure within which semi-privatised companies could start to exist, and then preside over a wholly new private economy. Issues of corporate governance and corporate social responsibility, of labour rights, environmental impact, etc, which either the state had previously taken responsibility for, if they factored at all, suddenly became important for a company's functioning in China, and even more important if it wanted to work outside of China. It is often not so much that Chinese corporations are acting improperly abroad, but more that there is the lack of experience, knowledge and skills to perform corporate governance to the standards expected.

Chinese entities abroad need a lot of help

2. The need for help: According to one senior executive with many years experience of heading a multinational energy company in Beijing, and working with Chinese counterparts, a major issue connected with the poor corporate governance record of Chinese companies so far, is the fact that as they internationalise they need a great deal of help. The political, environmental, and labour problems that these companies experienced in some African countries, and the shocked response by the Chinese to the

criticisms this brought them, only highlights this. For many mainland corporations, it seems like they are running before they can walk, but such is the pressure on them, this is the only option. Those working in partnership with Chinese corporations abroad have found the responsibilities of telling their Chinese counterparts the fundamental things was much greater than originally expected.

Lack of transparency is a problem

3. Transparency: Both as a discipline, and for reasons of lack of legal and political protection, transparency has not been viewed as a desirable practice in China. Chinese corporations have famously kept various forms of their accounts, and dislike the air of publicity or disclosure. The general atmosphere of secrecy from the Maoist period still lingers and has migrated from government into the operations of both state and non-state enterprises. There is a lack of clarity about the decision making structures in companies, their accountability, their relationship with other enterprises, and with, crucially, the government, both local and national. Rumours that, despite being forced out of commercial work by the government in 1998, the People's Liberation Army, and other arms of the intelligence and security services are still linked to companies like Huawei through the 20% government stake in it still remain common. In order to avoid accountability, Chinese companies often create highly complicated structures, many with offshore arms, in order to shield themselves from too much scrutiny.

The buck stops with the Communist Party

The CIC in many ways distils all these problems of strategy; Chinese corporate weakness, and how China is trying to take its economy further into globalisation without conflict with the rest of the world. The key thing to remember is that in the end, the CIC reports to the State Council, and through that to the Politburo. The final responsibility for CIC governance is therefore the Communist Party. The CIC, in the words of Standard Chartered Bank Chief China Researcher Stephen Green, is `a state owned bureaucracy but needs to act commercially.' This is very contradictory, and offers challenges, threats as well as great opportunities. What observers have to understand is that, however benign the CIC's activities have been so far, the very fact that it makes investments is by its nature highly political.

Market response

So much money from a system like China's is already causing unease

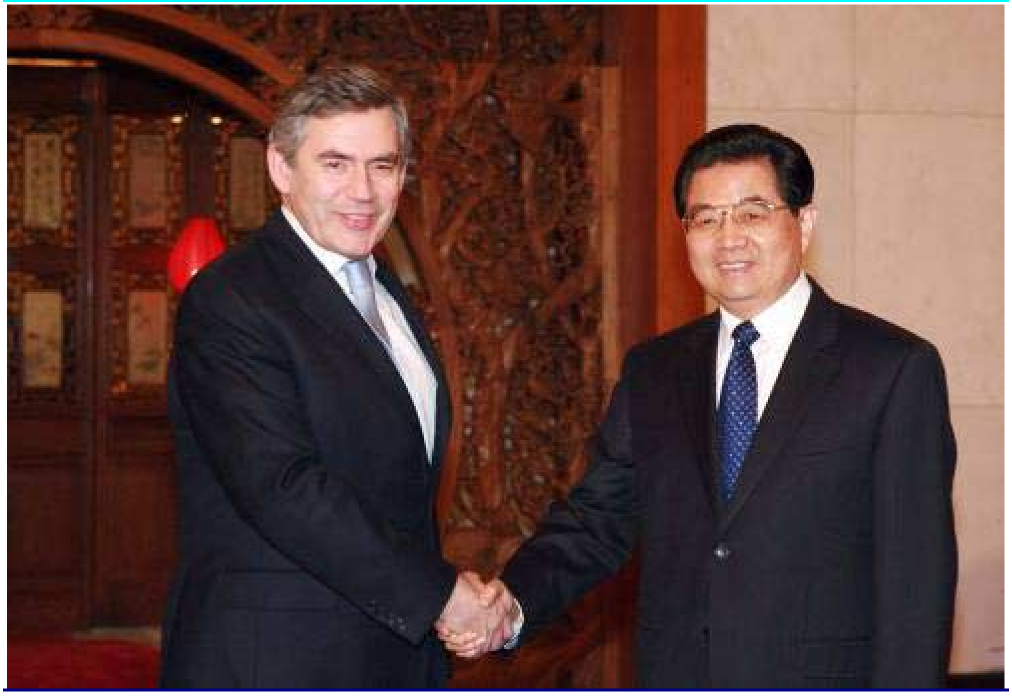
So far, in the CIC's young history, a moment of crisis coming from strong external opposition has not happened. But there are signs of a potential political backlash, and politicians in Europe and the US starting to question what, and how much, SWFs, and in particular, the CIC, can own of foreign entities. The purchase of 3% of Barclays Bank by China Development Bank last summer in the UK offers a hint of this. The deal had to be politically cleared by the British Finance Minister, Alistair Darling. Even so, press comment at the time made clear there was unease. Journalist John Kampfner in *The Guardian* stated: `Ever since the events of 9/11 the [British] government has seen radical Islamism . . . as the greatest threat facing the country . . . And yet a new threat is emerging which neither Britain nor other western states have prepared for – the spread of Chinese and Russian power and influence. The theatre of battle is the City of London. . . . The question is not which countries are acquiring wealth and power but which value systems.' And China represents `rapid development, unencumbered by lectures about human rights and democracy.''[24] Beyond values, however, was the simpler issue of just how open an economy should be.

Chancellor Angela Merkel of Germany has made clear that her government has reservations about certain types of investment, and the operations of SWFs, as has President Sarkowsky of France. But on his visit to China in January 2008, British Prime Minister Gordon Brown stated that `Britain was open for business,' and that as one of the world's most liberal economies, it would embrace Chinese investment as long as it fulfilled the rules and regulations of the UK.

Gordon Brown says Britain is open for business to Chinese investment

Figure 17

Gordon Brown meeting Hu Jintao in Beijing, January 2008



Source: CNS

Ironically, this happened at the same time as the Northern Rock bank was about to be nationalised in the UK because of faults in the country's banking and financial services regulations. This has dampened the confidence of those who feel that the legal system alone can make sure that investments and investors remain well behaved.

Chinese state investment is a challenge to our confidence in our legal and regulatory systems

Crunch time has not yet come. Many commentators scotch the concerns over SWFs in general, and China's SWFs in particular, by saying that there is no evidence as yet that SWFs cause problems of governance when they invest in something. They abide by the rules of the lands and entities that they put their money into. As one Chinese journalist based in London told me, foreigners should not fear Chinese investment, either from the SWFs or other state sources. It will abide by the rules of the lands in which it is domiciled. But maybe a more realistic assessment is that firstly, we need to be pretty confident in the robustness of our laws when potentially up against such a massive raft of capital. And secondly, we might be being a little naïve about the ways in which behind the scenes lobbying and political pressure could start to subtly influence these rules, and cause their reformulation,

[24] John Kamfner, `The West's Great New Threat is Right at Home in the City' Guardian, 26 July 2007.

modification or change. It wouldn't be unprecedented for a bit of dextrous agitating by a business entity to end up with a set up more in line with their own advantages and gain.

And sometimes, no matter how good the deal looks commercially, we will have to say no for political reasons

Despite Gordon Brown's confident assertion about the UK being `open for business', it is clear that a Chinese investment in, for instance, BAe systems, or even a sizeable equity in a UK bank, would cause major problems, firstly for the relationship with the US, and secondly, with a sizeable constituency in the UK and Europe. That moment has not arrived - yet. But when it does, and we see a tempting offer for perhaps a distressed asset in economic lean times, governments need to have thought through beforehand what their response should be, and how they tie up their long-term goals in national interests, and maybe shorter term gains.

Understanding China's goals

Like it or not, Chinese sovereign wealth funds are finally to accrue wealth and benefit for a state that, in certain areas, has very different goals to Western liberal democracies. The Chinese state - and the financial and other institutions within that state - have markedly different levels of transparency than most European or North American states. We have no control over where China disburses its money once it has made a return from its overseas investments and decides to repatriate its profits back to the PRC. Are we really that comfortable with the thought that some of this money could, in theory, go to supporting the 17% annual increase in China's military budget each year? And how relaxed do we really feel about China's strategic goals as the country becomes more influential and powerful?

We need to have a pretty clear definition of our own strategic goals and our sense of national interest to match the Chinese who have a similarly clear understanding of what they are after in the middle to long term - a stable international system, for them to continue to develop and prosper, but no threats to unity, no moves from de-facto to de jure independence for Taiwan, and a strong influence in the Asian region.

Thickening the plot - The Chinese stake in Rio Tinto

Rio Tinto and Chinese investment

For those who say that China's overseas investments are not strategic, the largest of them stands as a stark contrast. On 1 February 2008, in a 'dawn raid', the US aluminium giant Alcoa and the state-owned Aluminium Corporation of China (Chalco) bought a 12% share of Anglo-Australian mining giant Rio Tinto for US$14.05bn. The deal, done through Singapore, gave US$1.2bn to Alocoa and the rest to Chalco, making it the largest Chinese investment abroad to date. As early as November 2007, reports had surfaced of CIC itself, along with Shougang Baosteel, making a bid for Rio Tinto, of up to US$200bn. This caused a surge in Rio's shares. The news however proved unfounded. Even so, it was to prove itself a precursor of what was to happen only a few weeks later. Xiao Yaqing, chairman of Chalco, said of the deal: 'For us to make such a strategic investment overseas, we would have to get the support of the Chinese government'. But he went on to play down the state's role, saying the decision was purely commercially driven.

China's stake in Rio Tinto could show how Chinese investors wish to influence commercial events for their national strategic purposes

Even so, China had made its opposition to the discussions of a merge between BHP Billiton and Rio Tinto clear in 2007 when discussions started. This was not in the interests of Chinese companies, meaning that 70% of the world's iron ore would be in the hands of two entities, Rio Tinto/BHP and the Brazilian CVRD. On 3 August 2008, Luo Bingshen the Head of the China Iron and Steel Association, according to a report on *Xinhua*, stated that China was opposed to the deal.[25] It is clear at least here that, far from being a passive player, China is using its minority stake to control events it feels are in its interests, though there has been considerable debate about what its real intentions and aims are.

Not an easy bedfellow

Increasing investment in Africa shows the good and bad side of Chinese operating abroad

A look at China's investments in Africa draws out some of the complexity of the issues that China's involvement raise. This is not a straightforward story. Chinese state and non-state players are all involved in Africa, with some countries getting real benefits, and others suffering.

As of early 2007, there were about 800 officially recorded Chinese investments across the African region, 700 of these run by non-state companies, and the rest by SOEs.[26] However, the investment size of the 700 was relatively small, most dealing with import and export.[27] The real bulk of the dollar investment was in the 100 SOE companies. The largest number of investments was in South Africa (83), with 33 in Nigeria. These were mainly focussed on light engineering. 750,000 Chinese work in Africa,[28] with two-way trade reaching US$66bn (split almost equally each side) by the end of 2006. This is expected to reach US$100bn by the end of the decade.[29]

China is Africa's third-largest trading partner after the US and France.[30] Figures about the actual levels of Chinese investment in Africa, however, are variable. According to the UN, as of the end of 2005, there was US$1.6bn in Africa. The Chinese Ministry of Foreign Commerce figure puts this at US$520m. In 2007, Christopher Burk, in a study issued by the centre for Chinese Studies at Stellenbosch University, suggested it was in the vicinity of US$15 to US$20bn, including the US$5.5bn in the Standard Bank in South Africa.[31]

What the Chinese really want from Africa

While China might be interested in the Africa market of one billion consumers, spread among the 54 countries there, and is, of course, keen for the political support from these various nations at the UN (only five now recognise Taiwan over the PRC), and despite the long history of friendships with specific African states spreading back to the period in the 1960s when China regarded itself as the leader of the `Third World' (a term which China coined), there is little doubt now that China's greatest interest in Africa is because of the resources and energy supplies that can be located there. This underlies China's investments. Africa has 85% of the world's new oil reserves. At the moment, however, only 7% of the world's total output is sourced in Africa. This was something noted in China's first comprehensive Africa Report produced in January 2006.[32]

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[25] Report on http://news.xinhuanet.com/english/2008-08/03/content_8923258.htm, accessed 3 August 2008.

[26] There are probably many thousands more smaller trading operations, involving Chinese merchants on their own, or a small group of Chinese. These however have had no official tabulation, and will not figure in discussions here.

[27] Deborah Brautigan (forthcoming): *Flying Geese of Hidden Dragon: Chinese Business and African Industrial Development,* in Daniel Large, J, Christopher Alden, and M S Soeres De Oliveira, *China Returns to Africa: A Rising Power and a Continent Embrace*; London, Hurst, p 2.

[28] Waging Peace *China in Africa, the Human Rights Impact*, London, p 10.

[29] Rockefeller Foundation (2007): *China's Engagement with Africa: Preliminary Scoping of Africa Case Studies*, Centre for Chinese Studies, Stellenbosch University, p 4.

[30] Ian Taylor (2007): *China's Relations With Nigeria; The Round Table;* Volume 96, No 392, 631-645, October 2007, p 1.

[31] Christopher Burke (2008): *Emerging Economic Links Between China and Africa*, Centre for Chinese Studies, Stellenbosch University. p 5.

[32] *Waging Peace*, p 10.

The potential for Africa as a source of energy for China is, therefore, very great. In order to help Africa, China has cancelled debt to African states of US$1.36bn and put tangible investments in places like the Democratic People's Republic of the Congo, where it has helped build 3,200kms of railway. China has given US$314m to 14 projects in eight countries through the African Development Bank.[33] The Meowe Damn in the Nile has had a US$680m investment. In 2007, the Chinese government through the State Council authorised a US$5bn China Africa Development Fund loan, administered by the China Development Bank.

Africans and many outside observers see big benefits in Chinese investment

The benefits of Chinese involvement in Africa are numerous, and should not be forgotten. China has supplied affordable drugs commodities. The competition for resources because of the involvement of Chinese companies in Africa has created a more beneficial market for separate African companies. Chinese enterprises have used Africa as a commercial launchpad.[34] Chinese investment and aid in many African countries is seen as less bureaucratically restricted, and easier to access and deploy.

As the Sierra Leone Ambassador to Beijing said, `Chinese investment is succeeding because they don't set high benchmarks.'[35] Horror stories abound of World Bank or other aid donors taking years to deliver, and then being deployed in the wrong areas, or incorrectly. It could be argued that Chinese investment in the last decade in Africa has brought more prosperity and economic development to the continent that many decades of western aid.

The President of Senegal in a recent interview with the *Financial Times* stated that `I achieved more in my one hour meeting with President Hu Jintao in an executive suite at my hotel in Berlin during the recent G8 meeting in Heiligendamm than I did during the entire, orchestrated meeting of world leaders at the summit – where African leaders were told little more than that G8 nations would respect existing commitments.'[36] Even in the highly controversial territory of the Sudan, China has supplied Aid and peacekeepers over the past two years.

But there are a range of problems, from lack of concern for human rights, to low labour standards

There are, however, a number of areas where the impact of Chinese companies and investments in Africa is problematic. These include:

- The low labour standards of some Chinese companies. An explosion in a Zambian factory in 2005 killed 46 people.
- Resentments caused locally by Chinese workers being brought in for Chinese projects, with little localisation either of management, or work groups. Some estimates show that Africa has in fact lost 250,000 jobs in the past few years because of Chinese workers and cheap Chinese goods.[37]
- Support for regimes with major human rights issues like Zimbabwe or Sudan. For the latter, China has been accused of sourcing one tenth of its oil from Sudan, taking 82% of Sudanese oil production, and cancelling US$80m of Sudanese debt, granting a US$77m interest free loan to the

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[33] Ibid, p 20.

[34] Rockefeller report, p 7.

[35] *Waging Peace*, p 21.

[36] Quoted in FT, Africa China Trade special supplement, 23 January 2008. See http://www.ft.com/cms/s/5d347f88-c897-11dc-94a6-0000779fd2ac,dwp_uuid=8735dcb2-be8a-11dc-8c61-0000779fd2ac.html.

[37] *Waging Peace,* p 14.

regime there in February last year. It has also granted US$500m to a new refinery there. This has offered major financial support to the government in Khartoum, breaking sanctions imposed by the developed world. However, although China has taken much of the flack for this, it should be remembered that India, though the India Oil and Natural Gas Corporation, owns 25% of the Greater Nile Project in the Sudan, an involvement that is sometimes conveniently forgotten in the criticisms of China.[38]

- China has been accused of also sending over US$200m of small arms, the main cause of loss of life in conflicts in Africa.
- The environmental impact of its investments has been criticised,

Many of these problems stem from weak standards of the government in the host country

According to Professor Ian Taylor of St Andrews University in the UK, the problems above are worst where local standards of government in the target country are weakest. In that sense, looking to see improvements in the performance of Chinese state and non-state enterprises is a two way bridge.[39] Governance in Africa is important, with countries like Botswana, Ghana, and South Africa really getting what Singapore based expert in Chinese ODI Friedrick Wu called ` a win-win situation.'

These countries are proactive in their engagement with Chinese investment, and defend their national interests. Modes of government in many other Africa states are highly personalised, with elites frequently using Chinese, and other, investments to look after their main power constituencies, with no transparency or accountability. This is a problem compounded by the lack of knowledge of Chinese companies about the terrains within which they are operating. The weak social and institutional capital of African states, as Waging Peace argues, compounds the problems of Chinese companies negative impacts on employment, labour rights and human development.[40]

Chinese investment in Africa is symptomatic of the best and worst of Chinese ODI anywhere

Chinese investment in Africa, because of its volume, and because of the very complex political terrain into which it goes, raises many of the issues associated with Chinese investment globally. The Chinese themselves point to the fact that the benefits of their involvement have not been adequately noted. This is a fair point. They are also able to point out many examples of very poor Western corporate behaviour in different African territories, and a history, as they present it, of exploitation and colonialism. China presents itself as an equal partner, working to get mutual benefit. This complex balance of positive and negative needs to be considered carefully when commenting on the human-rights impact of any specific Chinese investment.

A partial solution - Global governance for all SWFs

The IMF proposal on SWF principles

The US' unease at the role of SWFs resulted in the Committee on Foreign Investment (under the Department of the Treasury) passing rules that mean all investments can be vetted, regardless of their size, if they raise concerns about foreign control of `critical infrastructure that could impair the national security.' Demands are made for board members of any investor to disclose military and government links, even when this involves less than 10% equity stake in a US company. Such bilateral treatments have now led to calls, over the past two years, to draft and then implement an international code, through both the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD).

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[38] Bill Emmett, `Rivals,' London, 2008, p 154

[39] Interview with author, 12 March 2008.

[40] P 17.

The IMF has established a 25-member country-drafting committee in order to establish a `set of SWF principles that properly reflects their investment practices and objectives.' The draft is expected ahead of the annual meeting in October, and a full report in 2009. The outcome is not expected to be rules, but at least a guide to best practice. China is on the 25-member drafting group. They have made it clear that they do not wish to subscribe to another developed-country dominated international mechanism where they have no real substantive input or voting rights (the IMF itself, on which China has only 6% voting rights, comes to mind here, along with the G8 which China and India, despite their economic clout, are not even members of).

The OECD is planning a *Freedom of Investment Report,* also in 2009.[41] This may well be an opportunity for everyone – creating an international mechanism in which everyone has proper input, and which offers an example of how multilaterally countries can work with each other, and produce something meaningful and enforceable. This is, however, still a work in progress.

Conclusion

As a World Wildlife Fund report on Chinese outward investment puts it:

> `The manner in which Chinese outward investments are guided and promoted will have significant implications for the development of the global governance system. The global quest for natural resources is closely linked to the question of poverty alleviation, corruption, transparency, regulation of transnational corporations and human rights. The degree to which the Chinese government and corporate sectors are supported by foreign governments and businesses as they engaged in these issues will be of great importance.'[42]

Like many of China's major reforms before, Chinese ODI will have planned and unplanned consequences

Chinese ODI is a new phenomenon and the CIC, even newer. It will take a while to assess its likely impact and any clear underlying strategy. To those that subscribe to the idea that China has a unified, and clear long-term view, which we are only able to see obscurely, it is worth quoting the words of Deng Xiaoping, about an earlier period of the reform process, in the early 1980s: `In the rural reform our greatest success - and it is one we had no means anticipated - has been the emergences of a large number of enterprises run by villages and townships. They were like a new force that just came into being spontaneously.'[43] Town and village enterprises have been one of the great engines of the Chinese economy over the past three decades and still employ hundreds of millions of people. To discover that they were largely unplanned, gives the lie to the idea that now China has a clear vision over its use of its massive foreign reserves.

We need a strategy to engage with Chinese ODI

The Chinese government talks of a `win-win' situation, in the use that the CIC and other money, can be put to. They are, invariably, very optimistic. Observers feel that the CIC, along with other SWFs can play a positive role in helping China modernise and open its economy further. They feel that the safeguards are in place to make sure that China is saved from both its own inexperience and some of its endemic faults - lack of transparency

[41] See report on SWFs by Norton Rose, http://www.nortonrose.com/knowledge/publications/2008/pub15287.aspx?page=080512110224&lang=en-gb, accessed 3 August 2008.

[42] Dennis Pamlin and Long Baijin, *China's Outward Investment Flows*, World Wildlife Fund, April 2007, available at www.panda.com/invest, pp 5-6.

[43] Quoted in Yasheng Huang, *Selling China* 2003, CUP, p 308.

being the most prominent. Chinese ODI generally, the CIC in particular, offer an opportunity to influence China, and to engage with its reforms even more profoundly.

Chinese views of outward investment - their chance to influence the globalisation agenda

To others, however, we are in a game of high-risk poker. China has seemingly accepted the urge to liberalise its economy, and this has caused great economic, social and cultural change in China. Political change will happen, given time. After having heeded the urge of much of the developed world to reform its economy, it seems churlish and contradictory to oppose China takings its development to a new level by proactively investing abroad. Is it that we want things all our own way? The moment China moves from being a passive taker of foreign investment to being a giver of it, and turns up with a cheque book and a desire to have some of our assets in return, suddenly we throw up dozens of conditions and questions.

Chinese intellectuals are right to feel that there is something rather one-sided about this modernisation and globalisation that many outside China want to see it signed up to. The offer of Chinese money sincerely, and with clear commercial goals, is an interesting moment to test people's real commitment to China's role in the world. Why this fear and anxiety about what China is `really up to' and what its hidden purpose might be?

China working abroad is a chance for China, and the rest of the world, to learn

Of course, China's increased assets abroad, as with the US almost a century before, will see it want stability and transparency in how it invests, and the governance of the countries it invests in. And it offers an opportunity for China to look long and hard at some ways of continue to modernise and improve its own enterprises. Even so, the fact that China, with US$90bn of state funds to add to the US$90bn it already has abroad, and the immense financial pressure these funds are under to perform, is moving very fast, and needing to learn some difficult lessons in a very short time. It is certainly not able to control this process – thus the admission, already, that it needs outside help, with the formal invitation to international fund managers and consultants to work with it in identifying investment opportunities and then structuring these (just prior to the foundation of the CIC, for instance, Blackstone was the state-owned China Development Bank's advisor for its acquisition of a 3% share in Barclays Bank). But the intrinsic instability of its own economic system is also evident in the way it has set up, and is starting to conduct, its own funds, and overseas investments. It needs a lot of help. And it needs to adapt quickly. This is not to say it can't do this but it is a very, very big challenge.

Chinese ODI: Part of a continuing process of the country's internationalisation

Chinese ODI is politically highly significant. Through it, China has the opportunity to shape the global economic and political infrastructure far more than ever before. Through this, it comes one step closer to becoming a global power. Now the country has no choice but to communicate its purpose and to show how it intends to operate and achieve. This promises to be a dynamic process, where those outside China, and those within China, will interact in profoundly new ways. It promises to be a bare-knuckle ride. But it is already clear that this is not a process China can simply step outside off. Like the truck that Vice Premier Li Lanqing saw in the factory in Chongqing in 1993, this one truly has no reverse gear.

Notes