China's Sovereign Wealth Funds: Problem or Panacea?

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INTRODUCTION

With the balance of global economic power shifting from west to east, the current financial crisis has rendered sovereign wealth funds (SWFs) as one of the primary sources of capital, which may change the economic and political landscape. China has created a far more sophisticated instrument of SWFs, which appears to blend political and financial welfare maximisation within a private-public system of economic organisation. When the interplay between the ownership and governing organs is taken into consideration, growing common fears have been sparked as to SWFs’ potential use not only aiming at higher returns, but also pursuing geopolitical objectives. This might represent a potential threat to the national security of host countries. In this vein, the prominence of the state as an investor challenges legitimacy enshrined in the current international financial legal regimes. Regardless of multilateral approaches, such as the GAPP principles and OECD Guidelines made by international communities, there are key questions as to whether China’s SWFs investments can be adequately regulated under non-legal binding soft initiatives. The host countries’ response in the form of hard laws might trigger the danger of sliding into protectionism. On the other hand, there is another side of the coin for SWFs, given a lack of any solid evidence suggests that SWFs have been used to undermine financial stability and compromise national security. Instead, evidence from the recent global financial crisis suggests the contrary. The perceived threats posed to host countries’ national security seem to remain in the realm of the hypothetical. These tentative findings may enable the previous hypothesis to be challenged, in that the risks might have been overestimated. It is worth exploring these insights into the genuine potential problems related to the SWFs for the sake of stabilising global financial markets.

The paper starts with a general contextual setting where SWFs are conceived to be deployed strategically in pursuit of geopolitical goals, rather than based on purely commercial purposes. Part II ascertains that prerequisites to gaining insights into SWFs are clarification of the interweaving factors of state ownership, strategic investments and plausible resulting national security issues. Part III examines legal responses from both
regional and national perspectives, given the challenge posed by SWFs for global monetary governance. Since most SWFs flows are directed towards the U.S. market, the U.S. legal parameters are particularly highlighted. Part IV articulates IMF and OECD's endeavours and underlies the fact that compliance with international initiatives is conducive to alleviate Western concerns. Part V briefly looks at whether the concerns could be mitigated through conservative SWFs investments. The paper moves on to consider a few hypothetical issues in Part VI by explaining why the existing regulatory regimes in place could sufficiently screen out potentially threatening investments of SWFs, and considers whether the concerns remain in the realm of the hypothetical. In light of the lack of convincing empirical support for labelling the political dimension of SWFs, it is meaningful to examine what genuine risks are ahead in light of recipient countries' assessment of SWFs. A tentative conclusion would be that there is need to minimise the asymmetry of restrictions of SWFs investments and discretionary assessment criteria. It is advocated that sound corporate governance would be to the advantage of both SWFs holders and host countries, since it appears unrealistic to alter China's deep-rooted and combined model of integrating both political and commercial arenas. A most significant necessity appears to be to strike a proportionate balance between sustaining the openness of capital markets and efficiently reducing the implications of SWFs' political arenas. A well-framed corporate governance regime should underpin Chinese SWFs' efforts to gain trust and legitimacy in the global financial markets.

A CONTEXT

The SWFs has been one of the hottest topics in global financial markets. There is no universally accepted definition of a SWF. It was once defined as 'a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from official reserves of the monetary authorities.' The International Monetary Fund (IMF) provides SWFs as

"Government-owned investment funds set up for a variety of macroeconomic purposes. They are commonly funded by the transfer of foreign exchange assets that are invested long term overseas."

If properly used, the SWFs may produce a stabilising force in the world's financial system especially in the era of subprime and credit crisis.

Apart from the top priority for maintaining domestic stability and the survival of Chinese Community Party (CCP) regime, China has been investing heavily with its SWFs abroad to achieve both commercial and political aims. The soaring SWFs-based merger and acquisitions (M&As) as well as equity investment is causing some unease and

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2 U.S. Treasury Department, Remarks by Clay Lowery, Acting Under Secretary for International Affairs, on Sovereign Wealth Funds and the International Financial System (21 June 2007).