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China's Sovereign Wealth Funds: A path to sustained development?

SUMMARY: China's current considerable economic growth is the combined result of several factors. Among these undervaluation of the currency and the sustenance of currency restrictions play an important role. Until now the Asian giant has accumulated approximately 2,700 billion U. S. dollars of foreign exchange reserves; even the world financial crisis did not abate the pace of expansion. We assume China has more reserves than necessary; tapping into this surplus is an excellent tool for Chinese development policy. In our examination we analyse, on the basis of relevant economic theories, what proportion of foreign exchange reserves the country can freely manage. In order to answer the question of how the country's economic leadership wants to make use of these reserves, we analyse the practical policy of China's latest sovereign wealth fund. According to our conclusions China aims to spend a significant portion of its reserves on strategic objectives. By buying modern technologies and raw materials the country can create a firm basis for stable, long-term economic development.*

KEYWORDS: China, foreign exchange reserves, sovereign wealth fund
JEL CODES: E52, F30, G11, O11, O21

The Chinese economy has undergone tremendous changes in the past three decades. Through gradual integration into the global economy as well as by liberalising certain economic processes, China has set out on a path to becoming a developed country. The record foreign exchange reserves of the country provide a sound basis for the achievement of that goal. Our study seeks to answer the question of how the extent of the wealth accumulated as a result of Chinese economic policy should be interpreted. If, in fact, we find that these reserves are excessive, to what extent can this contribute to China's ability to catch up to developed countries in the long term? Can the obvious outcome of the development process also be considered an instrument to support China's unique development policies?

THE THEORY OF RESERVE ACCUMULATION

In the course of the history of the international monetary system nations have used different kinds of official reserves: gold and gold exchange standard based national currency, and the "fiduciary" – or trust-based – currency. Under the reign of the gold standard, which started in the 1870s and lasted until the beginning of World War I, parallel to the gradually increasing ratio of fiduciary currency, gold was the primary choice of reserve asset around the world. However, in the new world order created by the Bretton Woods Conference in the

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aftermath of World War II the US dollar replaced gold as the primary reserve asset. After the end of the gold standard currency, reserves were primarily accumulated in US dollars and other national currencies.[1] The ratio of SDR – a special basket currency created by the IMF in 1969 to protect the Bretton Woods monetary system – and gold reserves remained negligible. In the last decades of the twentieth century these reserve asset types have gradually lost their importance.[2]

Official reserves serve a variety of purposes in the economic policy of any country. The central bank or other governmental bodies in charge of managing the reserves can intervene on the foreign currency market to protect the country's foreign exchange system. Therefore, in case of pressure to devaluate the currency, it can strengthen the exchange rate by selling a portion of its reserves and buying domestic currency from the proceeds. In turn, it can also stop the appreciation of its currency by buying up the incoming foreign currency. The central bank can maintain the country's foreign currency liquidity, and, in case of of economic shocks, dampen the effects of the crisis by supplying the players of the economy with foreign money. Sufficiently high reserves can increase the credibility of economic policy and lessen country risk. That is because the country can demonstrate its ability to deliver on its financial obligations towards foreign players. By decreasing country risk – a factor closely observed and followed by money markets – the cost of loans can be mitigated, and high foreign exchange reserve levels also send a credible message to foreign investors that the country is able to uphold the exchange rate of its currency and will not be forced to devaluate it in the future, which, again drives down the cost of loans. Moreover, central bank reserves that are higher than those of the surrounding countries also improve the prestige of the country. It is also important that the government does not remain without funds if a natural disaster or emergency occurs. It can continue financing imports and foreign trade transactions. Monetary reserves are balancing items in the balance of payments and can be used to finance temporary deficits, whereas a surplus augments the official reserves of the central bank.

Earlier, the relevant literature considered foreign exchange reserves a buffer of sorts, which served as a cushion for implementing foreign exchange market interventions that became necessary in connection with the management of adjustable fixed and pegged float exchange rate regimes (Flood and Marion, 2002). *Feldstein* (1999) defines three instruments that mutually reinforce one another to reduce the exposure of countries to financial crises. First of all, debt denominated in short-term foreign assets must be kept at a low level; second of all, some sort of collateral supported loan arrangement must be created. Finally, the third option cited by the author is the accumulation of reserves. The latter, while undoubtedly costly, is the surest way of "self-defense". In a similar vein *Ocampo* (2007) recommends four instruments to protect against volatile capital flows experienced by emerging countries. On the one hand the author recommends administrative regulation of the capital balance – that is the introduction of capital restrictions – and the reduction, and efficient management of the external debt of the state on the other hand, which includes anti-cyclical fiscal and monetary policy. Finally, the author underscores the importance of the accumulation of foreign exchange reserves – as a means of "self-help" – as well as the necessarily related foreign exchange market interventions. In Ocampo's interpretation the main reasons underpinning the need for reserve accumulation are the procyclical nature of capital entering developing countries, and the lack of collective securities that would help avoid balance of payments crises.

Wyplosz (2007) mentions that a unique version of the Ricardian equivalence is present in the accumulation of reserves. This well-known economics theorem states that the surplus spending and saving of the government are counterba-lanced by the surplus savings and increasing spending of rational economic players, households and businesses. According to an approach to this theorem that is relevant for our purposes, in emerging countries the private sector has restricted access to foreign assets, therefore, it is rational for the national bank, in the interest of currency diversification, to accumulate foreign assets in their stead. Meaning that by accumula-ting reserves the national bank acts instead and in the interest of private sphere players whose economic opportunities are restricted.

In Asian countries and primarily in China reserve accumulation is based on the undervalued currency exchange rate and the closely related balance of payments surplus. The national bank can counterbalance the appreciation pressure on the domestic currency by building up foreign currency reserves, i.e., by buying foreign assets, mainly US dollar assets, in exchange for domestic assets. Similarly, when capital outflows threaten the domestic currency and make it susceptible to weakening, the national bank can react by selling a part of its reserves. Since the turn of the millennium, with the intensifying global reach of free trade the current accounts of emerging Asian countries have been showing increasing surpluses. In the interest of preventing the appreciation of the national currency – a scenario that should be avoided if the price competitiveness of exports is to be maintained – central banks have been buying up incoming foreign currency, thereby significantly increasing the value of their official reserves in recent years.[3] In these countries the accumulation of reserves was a "by-product" of sorts, which was fuelled by an effort to maintain export-driven growth as a main goal (Wijnholds – Sondergaard, 2007). The purpose of this modern mercantilist economic policy is to create more and better jobs, absorb abundant forces of labour from traditional sectors, such as agriculture, and reallocate this labour force into companies specialising in exports. In the interest of maintaining the exchange rate China employs strict currency restrictions; the Yuan does not have an international market. Chinese exporters are required to change most of their foreign currency income to Yuan at a fixed exchange rate. Foreign companies can only obtain the currency within China. This rapid accumulation of reserves would be impossible without currency restrictions.

CHINA'S RESERVE PORTFOLIO

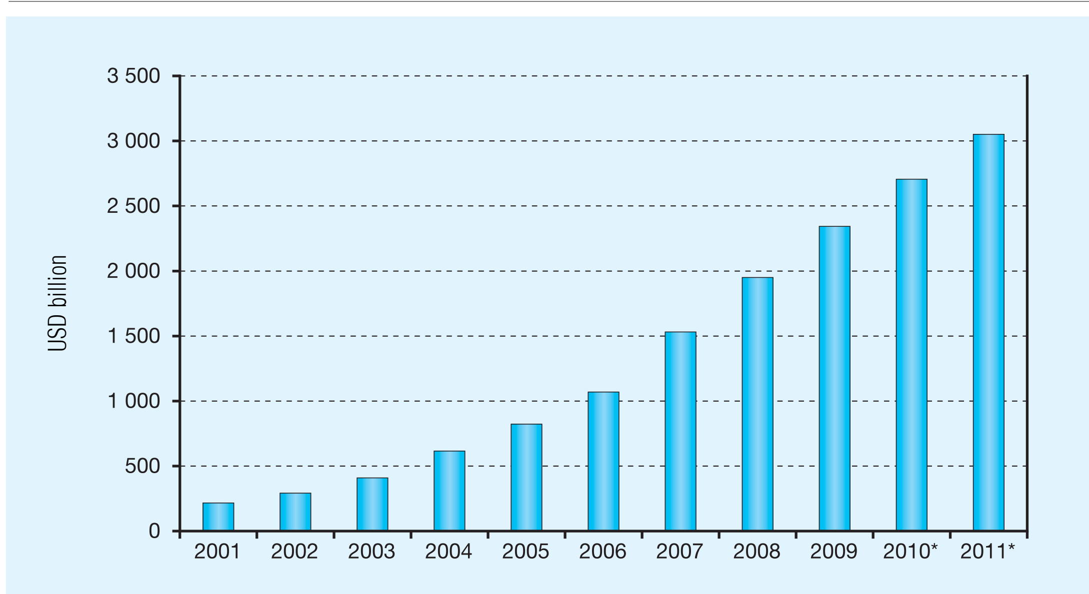
Over an eight-year period, from 2001 to 2009, China has multiplied the value of its monetary reserves tenfold. The reserve portfolio of China, which amounted to some USD 216.3 billion in 2001 reached USD 2,343.5 billion by the end of 2009, according to the data of the International Monetary Fund (IMF, 2010). In 2009, China held approximately 42% of the reserves of emerging countries. By 2011 this ratio is expected to reach 45%. The recent global financial and economic crisis was only able to interrupt this ascending tendency for a short period. *(See Chart 1)*

Between 2000 and 2008 the current account surplus was responsible for 78 per cent of the accumulation of reserves. Within that, the surplus generated on commodity exports was dominant, explaining the changes in official reserves in 64 per cent of cases in the examined period. The surplus of the capital balance accounts for another 21 per cent of the accumulation of reserves, while the remaining one per cent should be considered well within the range of a statistical error (Prasad – Sorkin, 2009). The period is characterised by the increasing role of

Chart 1

FOREIGN EXCHANGE RESERVES OF CHINA

(in USD billion)



* forecast
Source: IMF [2010]

the current account and conversely, the decreasing role of the capital balance.

In today's globalised world answering the question as to what can be considered an optimal reserve level for a given country is far from easy. There is a significant difference between the needs of developed industrialised countries and rapidly growing emerging countries that have already been integrated into the world economy. Developed states that more or less float their national currencies freely do not need reserve portfolios as extensive as those of developing, low-income countries that tend to fix their foreign exchange regimes and are much more exposed to crises.[4] This, of course, is exponentially true of countries whose national currencies are also used as reserve currencies.

If approached from the traditional angle, reserves should cover six months of imports at the most, in order to ensure that the country is prepared for a drastic change in external circumstances, such as the sudden crashing or complete stopping of incoming export revenues – which is a rather absurd, albeit theoretically acceptable assumption – or a natural disaster, i.e., to ensure that imports remain stable (Jeanne, 2007; Flood – Marion, 2002). Today this trade balance-oriented approach can only be applied to low-income emerging countries characterised by one-sided exports structure, often engaging in raw material production, with rather limited contact with international capital markets. It is not sufficient to explain the situation of rapidly growing emerging countries characterised by diversified exports structures (Wyplosz, 2007). This statement also holds true for China. Nevertheless, between 1990 and 2008 there were only three years – specifically 1992, 1993 and 1994 – when China's reserves were not sufficient to finance six months of import activity. Since 2002, China's reserves cover the entirety of the country's rapidly growing annual imports. Whereas in 2008, China

already had two years' worth of reserves. Thus, according to the simplest approach China's reserve portfolio can be classified as excessive. *(See Chart 2)*

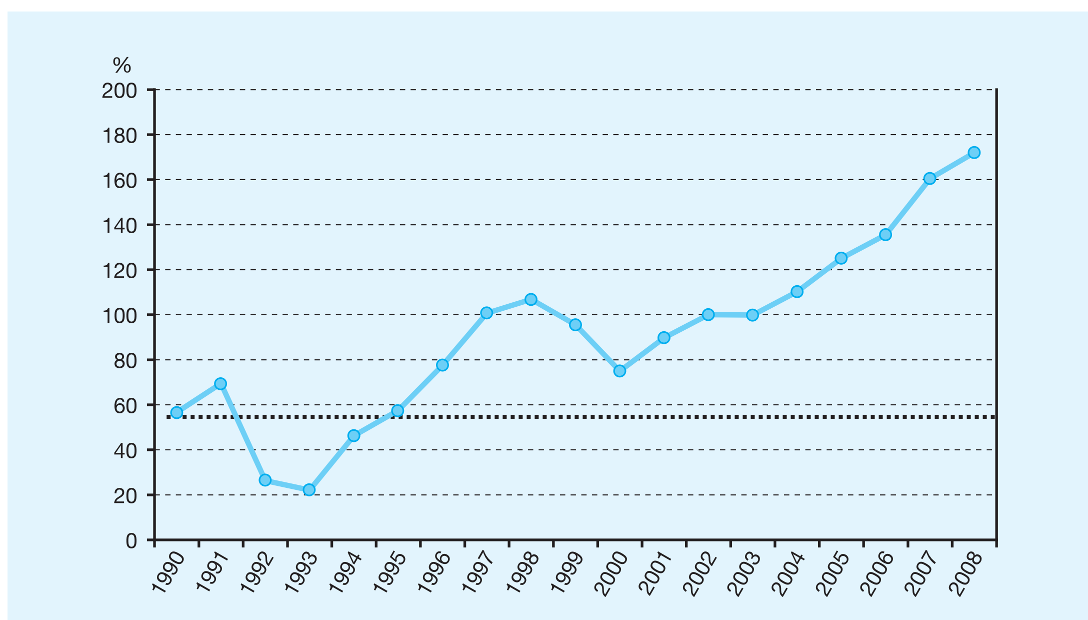
According to the Greenspan–Guidotti rule foreign exchange reserves should fully cover the entire short-term external debt of a country, in order to ensure that it is prepared under all circumstances to deal with a sudden massive withdrawal of foreign capital. Over the past few years, this capital balance-oriented approach has become the most widely applied rule of thumb (Green – Torgerson, 2007). This method provides us with an even clearer result than the one outlined in the preceding paragraph: China's official reserves are in considerable excess of necessary levels. Between 1990 and 2007 China had reserves portfolios that were in excess of its total short–term liabilities. The portfolio exceeded the country's external debt at least 1.5 times during the entire examined period and in some years reached 10 times the volume thereof. In 2001, the sharp drop in the values of the examined indicator were attributable to the drastic expansion of the country's short-term debt. Since 2001, indicator values have been slowly but steadily growing, and by 2007 China's reserves have amounted to almost eight times the value of the country's short-term liabilities. Self-help, as motivation, in this case does not seem to be supported by this method of calculation either. *(See Chart 3)*

The third rule that we shall examine here says that in order to improve confidence in a currency, foreign currency denominated reserves should cover a part of the money supply interpreted in the wider sense of the word. Starting out with a larger amount of money, reserves should cover a certain fraction of M2 depending on the foreign exchange regime in question. This ratio is between 5 and 10 per cent in a floating exchange rate system and between 10 and 20 per cent in combined and fixed exchange rate regimes (Wijnholds –

Chart 2

RATIO OF FOREIGN EXCHANGE RESERVES COMPARED TO COMMODITY IMPORTS

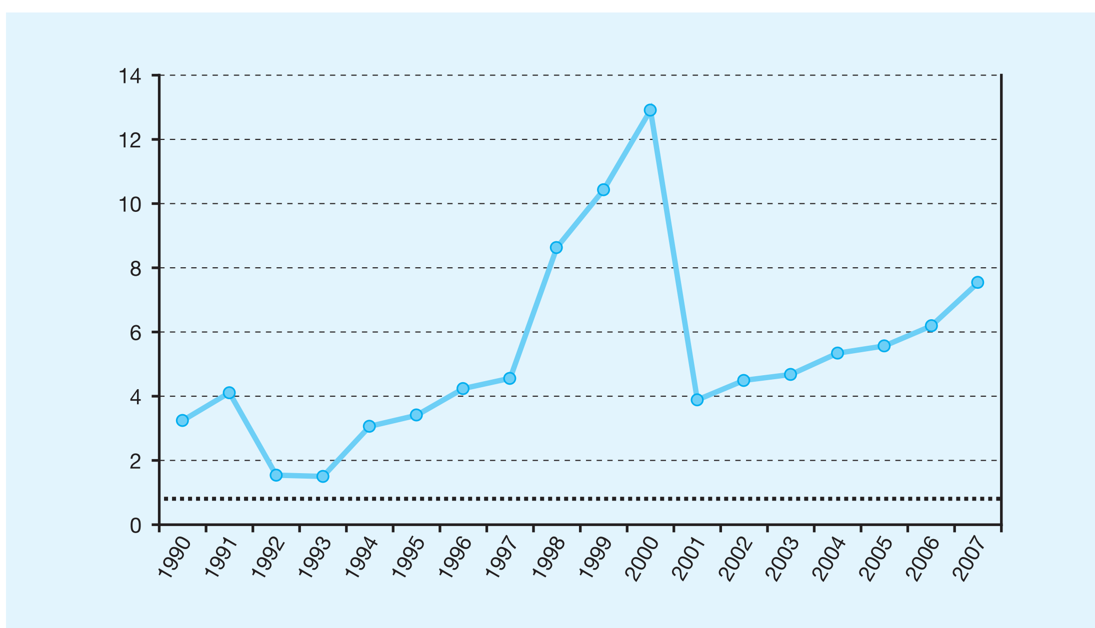
(percent)



Source: Asian Development Bank

Chart 3

FOREIGN EXCHANGE RESERVES TO SHORT-TERM EXTERNAL DEBT RATIO



Source: Asian Development Bank

Sondergaard, 2007). The simple formula looks like this:

$$R^* = a * M$$

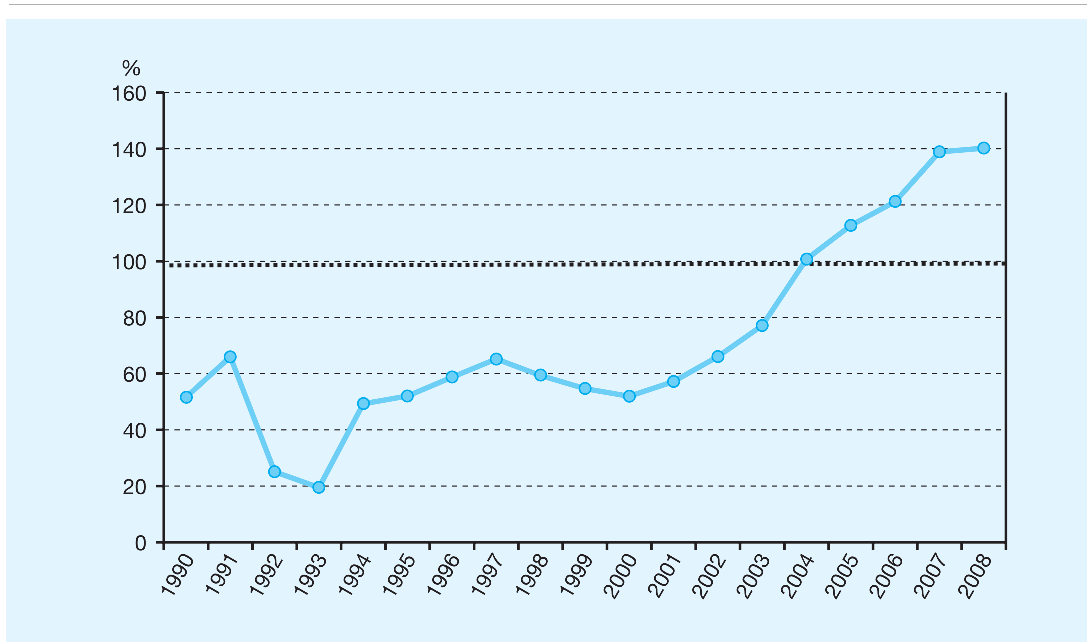
Where R^* is the sufficient, adequate amount of reserves, M represents a larger money supply (M2), and a denotes the fraction determined by the prevailing foreign exchange system. In our calculations a equalled 0.2, because the Chinese foreign exchange system is considered to be a strictly fixed regime. One of the strengths of this method is that it takes the quality of the foreign exchange system into account, which is of paramount importance in the case of China.

The results of the calculations, however, paint a somewhat different, perhaps not as clear-cut picture as in the first two instances. Until 2004, Chinese foreign exchange reserves did not comply with this criterion, i.e., accumulated reserves did not cover 20 per cent of M2. As a result of the rapid growth experienced since then, by 2007 reserves have expanded to cover almost 140 per cent of M2. Therefore, according to this particular criterion China has an adequate "protective buffer" against financial crises. *(See Chart 4)*

Based on the above it can be established that the reserves accumulated by China in recent years are well beyond amounts required for "self-help".[5] The emerging Asian power does not really have a reason to keep all of its accumulated foreign exchange reserves in high-liquidity, but low interest-bearing securities. The diversification of available funds would be a reasonable step. China's foreign exchange reserves should increasingly be considered part of the external wealth of the country.[6] Even according to the strictest M2-based rule, China had a "surplus" of USD 550 billion at its disposal in 2008. This amount is certainly going to increase in the future. According to the International Monetary Fund, the value of China's reserves will exceed USD 3,000 billion

Chart 4

RATIO OF FOREIGN EXCHANGE RESERVES COMPARED TO TWENTY PERCENT OF M2 (20%)



Source: Asian Development Bank

by 2011 (IMF, 2010). If the current trend continues uninterrupted China's reserves will come to close to USD 5,000 billion by 2020. It should be noted here, however, that China's policy imposes a significant burden on the world economy, by contributing to the formation of global disequilibriums and distorting international trade. Asia has had a considerable role to play in the formation of today's one-sided system of finance and trade – best exemplified by the rapid rate at which the United States is becoming increasingly indebted.[7]

UTILISATION OF SURPLUSES

Since the turn of the millennium global foreign exchange reserves have been growing at an extraordinary rate. In addition, the value of reserves accumulated by certain countries is well in excess of the accepted and necessary reference values. This process has prompted many states to create their own sovereign wealth funds (SWFs).[8] What does this expression mean exactly? Many interpretations have come to light, but the authors of this paper shall use the definition of the International Monetary Fund for the purposes of this study. According to this definition, sovereign wealth funds are special purpose investment funds controlled and owned by the general government. Management of these assets is also the responsibility of the governments; the funds are invested in accordance with their medium and long-term macroeconomic and financial purposes. These investments are typically financed with foreign currency assets (IMF, 2008). The concept itself is rather new, first used by *Andrew Rozanov* (2005). Today, however, the term is generally used as a core indicator of which countries are lagging behind and which are considered the richest. SWFs are usually established out of surpluses, because in many cases it is not desirable or possible to

keep these surpluses in monetary assets. Every SWF has its own special purpose defined in accordance with the characteristics of the country in question. These include, the reduction of the volatility of governmental revenues, increasing the yields of foreign currency reserves, or savings for the welfare of future generations, etc. It should be noted here, however, that these funds should not be seen as the wealth of any given country, rather these are surpluses which have been appropriated to be used for a specific set of goals (Ferber, 2009). The realisation of these goals is the responsibility of a team of experts delegated by the government. Today, the largest sovereign wealth funds are operated mainly by Asian and Middle Eastern countries. By European standards, Norway should also be considered among the leading states in this respect. *(See Table 1)*

The table clearly shows that China is rapidly catching up, since among the largest funds, with the exception of the Russian fund, Chinese funds are the youngest. This begs the question of why China decided to establish another fund in 2007 in addition to the two already active funds. In the next part of this study, based on the characteristics of the new fund we shall examine whether these proven surpluses have been spent for strategic purposes.

The Road to the New Chinese Sovereign Wealth Fund

Over the last few years a special relationship characterised by interdependence has developed between China and the United States. At the same time as China became the world's "producer", the world's "consumer", the United States, has become more and more indebted. China has begun to serve the demand of the United States with its rapidly expanding exports that also carried comparative advantages. The USA, however, was unable to finance its own demand and bought from China partly on credit. The Chinese–American relationship is embodied in a record deficit of

Table 1

THE LARGEST SOVEREIGN WEALTH FUNDS, IN ORDER OF THEIR OVERALL ASSET VALUES JANUARY 2011

Country	Fund	Assets in USD billion	Year of establishment	Origin
Abu Dhabi	Abu Dhabi Investment Authority	627.0	1976	Oil
Norway	Government Pension Fund – Global	512.0	1990	Oil
Saudi Arabia	SAMA Foreign Holdings	439.1	n/a	Oil
China	SAFE Investment Company *	347.1	1997	Non-raw material
China	China Investment Corporation	332.4	2007	Non-raw material
Hong Kong	Hong Kong Monetary Authority Investment Portfolio	259.3	1993	Non-raw material
Singapore	Government of Singapore Investment Corporation	247.5	1981	Non-raw material
Kuwait	National Welfare Fund	202.8	1953	Oil
China	National Social Security Fund	146.5	2000	Non-raw material
Russia	National Welfare Fund **	142.5	2008	Oil
Singapore	Temasek Holdings	133.0	1974	Non-raw material

* Asset value based on estimation.

** Including the value of the Russian Oil Stabilization Fund.

Source: SWF Institute, http://www.swfinstitute.org/fund-rankings/ Download: 09. 01 2011

the current account of the United States. The other side of the deficit, in turn, manifests itself in China's surplus.[9]

American economic policy contributed largely to the divergence of the trade balances. The deficit-financed consumption boom and the inadequate regulation of the American financial system escalated the situation. As the United States cut down on its savings, the two regions have become mirror images of each other in terms of economic cycles and capital movements (Yoshitomi – Liu – Thorbecke, 2007).

Chinese economic policy further reinforced this mutual interdependence. The export-oriented economic model used by the other Asian countries was a prime example for emerging China.[10] China's currency exchange rate policy – geared towards reinforcing the low-cost nature of Chinese products – is closely linked to the accumulation of its foreign exchange reserves. China's official currency, the Yuan was devalued several times in the 1990's, then the country used a 8.27 CNY/USD exchange rate – which was rather high compared to the previous rate – for seven years starting in 1998. The first objections of the United States came as late as 2003, until then enjoying the advantages of its position as importer. Acting in its own interest China gave way to outside pressure and made a statement in 2005 declaring that it was going to peg the exchange rate of the Yuan to a basket currency, i.e., it was abandoning its policy of pegging its currency to the US dollar alone.[11] Despite the fact that the currencies of China's main trade partners were included in the basket, the strong correlation between the USD and CNY remained, while the weight of the other currencies is marginal at best. (Frankel – Wei, 2007)

The overheatedness of the Chinese economy has been on the agenda ever since the country's initial boom.[12] Since 2005 China has registered GDP growth of over 10 per cent per annum every year – calculating with fixed prices – accompanied by app. 6 per cent inflation in 2008.[13] China was well aware of the fact that its economic policy was bordering on dangerous, but since 2004 the annual increment of its foreign exchange reserves has exceeded USD 200 billion, which, in turn, created an excellent opportunity for the country[14] *(see Table 1)*. This peak performance inspired Chinese decision-makers, so in the years leading up to the 2008/2009 financial crisis China was forced to employ economic policies that continued to stimulate its booming exports, but also managed to curtail the adverse effects thereof. In the spirit of restrictive monetary measures the country continued to hike its base rate and the mandatory reserve rate in order to curb inflation. In addition, the Chinese central bank also set the objective of keeping the Yuan exchange rate fixed. In order to neutralise the appreciation pressure generated by these measures, China intervened on the open market. It bought US government bonds and pumped Yuan into to the Chinese economy, so – in line with *Mundell's* thesis[15] – as the amount of money present in the economy grew, so did the US dollar reserves of the central bank.

It is estimated that almost two thirds of the aggregate portfolio of China consisted of American assets when the value of its foreign exchange reserves suddenly soared. Among them, US treasuries were the most heavily represented, but they also held US corporate and agency bonds and shares which provided various interest and yield rates. Moreover, US dollar denominated assets issued by other institutions of the international banking system and other countries were also represented in the portfolio (Setser – Pandey, 2009). Due to a lack of suitable alternatives, for a long time it seemed an obvious choice for China to keep its surpluses denominated in the leading currency of the world, the US dollar.[16] However, compared to the beginning of the 2000s, the US

dollar has become substantially weaker. Because the weakening of the US dollar created a state of emergency for China, it started to gradually diversify its portfolio. China admitted that it was no longer worth keeping its accumulated official reserves in American bonds. Massive unloading of the US dollar denominated securities onto the market was not really a viable option either, because that would have sparked a major financial crisis. Moreover, having the equilibrium price of the US dollar determined solely by market forces would not have been beneficial for China either; this fact forced the country to maintain its demand for the greenback. Therewith a new era of foreign exchange reserves management was ushered in for China.

What do we know?

As the most significant step of the new era, China established the Chinese Investment Corporation (CIC) with the purpose of improving the rate of return of foreign exchange reserves. This allowed China to establish the conditions necessary for the gradual reallocation of a part of its foreign exchange reserves, in essence, to channel the wealth that was tied up in American securities into other foreign investments. Naturally, China's dependence on the United States factored in heavily in the decision to put the measure into place. The change was justified by the fact that by this time China's wealth had grown to such a colossal extent that the country could afford to turn to relatively riskier investments. In addition, more lucrative investment opportunities with much higher potential yields than those offered by US government bonds impelled China to make a change.

It can be inferred from the above that China disposes over a vast amount of cash in addition to its necessary foreign exchange reserves, therefore, the country had sufficient resources to capitalise the new fund. A new semi-independent investment institution was created, which reports to the Chinese State Council. The adjective semi-independent was used, because there are certain persons on the Standing Committee of the State Council, who used to be in positions of power and have strong networks of contact in place. The working capital for the fund comes indirectly from China's foreign exchange reserves, i.e., the required sums are practically being pumped out of those reserves. In 2007, the Chinese government instructed its Ministry of Finance to issue USD 200 billion worth of Yuan in special bonds. These were purchased by the People's Bank of China, thereby providing capital for the new fund. Since it is illegal for the central bank to buy bonds from the Ministry of Finance, the Agricultural Bank of China was used as an intermediary (Ziemba, 2007).

Originally, the fund had three functions and special departments were assigned to each of those functions (Martin, 2008):

- capital injections for domestic financial institutions,
- management of domestic financial assets and the disposal of non-performing loans, and the
- management of overseas investments.

If approached from a conventional point of view, foreign exchange reserves can only be used to purchase foreign assets – that is assets that originate from outside the country. That is to say that, in principal, China can use those funds to purchase foreign commodities, raw materials, foreign debt securities, and to implement foreign capital investments. Theoretically, therefore, these foreign exchange reserves should not be used to re-capitalise China's own indebted, defaulting domestic banks; however this is exactly what is happening. At the start of its operation, the fund committed large amounts to domestic banks, albeit often indi-

rectly. For instance, the CIC bought another state investment firm (Central Huijin Investment – CHIC), which usually invests in the main state-owned banks.

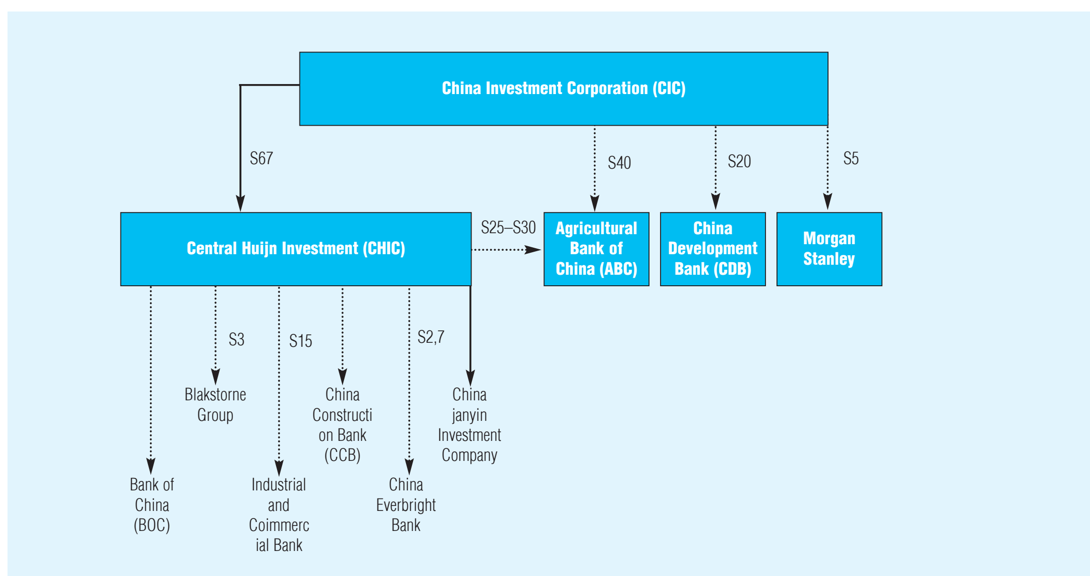
According to the 2008 annual report of the fund[17], one half of the original subscribed capital was used for global investments, while the other half was used to settle the balances of domestic institutions. It is the opinion of the authors of this paper that the practice whereby China rescues non-efficient banks from the appropriated wealth of the state vis-à-vis a subsidiary is not a lucrative endeavour in the long run. On the other hand, it would be much more promising if the sums pumped into the banking sector were used to mitigate the current weaknesses of society, and to establish a solid foundation for a sustainable future as it were. *(See Chart 5)*

The CIC belongs to the opaque group of sovereign wealth funds. The CIC is a member of the International Working Group of Sovereign Wealth Funds (IWG) which cooperates with the International Monetary Fund, and has adopted the internationally accepted relevant rules and practices (GAPP-Principles). It is also a party to the International Forum of Sovereign Wealth Funds (IFWSF) created by the Kuwait Declaration for the purpose of discussing common interest issues. At the same time it makes very little specific information available publically, and according to the survey of the Sovereign Wealth Fund Institute (SWFI), the CIC is an opaque fund engaged in strategic investments. Since 2009, the CIC has received a rating of 7 on the 0–10 scale of the quarterly published Linaburg–Maduell Transparency Index[18]. That is, out of ten transparency related statements only three do not hold true for the CIC. It is, however, notable that in the first quarter of 2008 it only received a rating of 2. This underscores a statement of the spokesperson of the CIC made earlier: "We will increase transparency without harming the

Chart 5

MAJOR INVESTMENTS OF THE CIC

(in USD billion)



Source: MARTIN, 2008; China's Sovereign Wealth Fund, CRS Report for Congress, page 11 http://www.fas.org/sgp/crs/row/RL34337.pdf. Download: 12.03.2010

commercial interests of CIC. That is to say, it will be a gradual process... If we are transparent on everything, the wolves will eat us up."[19]

The published mission of the fund is to select long-term investments and to maximise return. The CIC strives to contribute to the prosperity and development of local economies. The set of four principles[20] formulated at the inception of the fund are as follows:

- the CIC selects investments based on economic and financial objectives,
- the CIC allocates capital and assets to maximise shareholder value,
- the CIC does not seek an active role in the companies in which it invests,
- the CIC seeks long-term, stable, sustainable, and risk-adjusted return.

It remains to be seen whether the CIC will strive to achieve these ostensibly commendable objectives in reality as well. *(See Table 2)*

Criticisms and opportunities related to the Fund

There are a number of concerns regarding the investments made by the CIC. Firstly, certain investments made by the fund go against the spirit of trade, as the restructuring of the capital portfolio of state-owned banks certainly cannot be considered a profitable investment. As a result, the CIC does not always make investments based on market considerations. Secondly, many people think that its overseas investments are motivated by political considerations as opposed to economic ones. This is supported by the fact that China is seeking more and more companies that could serve a strategic interest, companies that can help satisfy its appetite for raw materials. Thirdly, China is acquiring increasingly larger shares in the corporations it invests in for strategic purposes. Specifically, the CIC has a more than 10 per cent share in many crude oil extraction and raw material trade companies of fundamental importance. These figures lead us to believe that China's bargaining position will increase over time and that it will more easily be able to secure products and raw materials necessary for further economic growth. Fourthly, the American public disapproves of the that fact that in 2009 China obtained USD 9 billion in shares in a number of large American corporations, and now has a stake – albeit a small one at that – in most renowned American brands (Coca-Cola, Apple, Goodyear, Motorola, etc.).[21]

The current capital of the fund (roughly USD 300 billion) is rather small compared to

Table 2

MAIN DIRECT FOREIGN INVESTMENTS OF THE CIC, MARCH 2010

Corporation	Country	Region	Share (%)
GCL-Poly Energy Holdings Limited	Hong Kong	Energy services	20
Teck Resources Limited	Canada	Raw materials trade	17
AES	United States	Energy services	15
The Noble Group	Hong Kong	Raw materials trade	15
SouthGobi Energy Resources	n/a	Raw materials trade	13
JSC KazMunaiGas Exploration Production	Kazakhstan	Raw materials trade	11
Blackstone Group	United States	Financial services	10
Morgan Stanley	United States	Financial services	10
Visa	United States	Financial services	n/a

Source: Based on the data provided by the SWF Institute http://www.swfinstitute.org/fund/cic.php Download: 15.03.2010

global capital flows. The conditions, however, are in place to reallocate additional resources into the fund, if the practice proves to be a success. As mentioned earlier China can afford to release additional funds from its foreign exchange reserves. For reallocations of this sort there are certain checks in place, making it mandatory, in principle, to show a specified amount of profit from previous investments. On the other hand it is apparent that long-term goals are China's priority, therefore, even if some of its investments do not turn out to be as successful as intended, China will not be deterred from allocating additional "spending" money for these purposes.

Opinions vary about the effects of this process on the world. According to *Rogoff* SWFs will do "more good than bad" in an increasingly globalised world economy, that is, liquid Chinese capital was often the much needed antidote of recession.[22] Nonetheless, others are apprehensive about a developing country gaining global power and becoming a stakeholder in corporations worldwide. In addition, as a completely new development, the Chinese state is acquiring influence in privately-held companies, which enhances its prestige even further.

ACTUAL PURPOSE OF THE UTILISATION OF RESERVES

From China's perspective, the new era can definitely be classified as a success. After analysing the management of the CIC it is obvious that we are witnessing the roll-over of China's outputs to date. A successful strategy like this will make the restructuring of the Chinese economy possible as well as put it on a well-established growth path. If the country manages to enhance its international role further, it could acquire influence in several international corporations in exchange for capital. What this means is that China can continue implementing a strategy that it has been purporting so far, it can acquire developed technologies and information, import them and have them adopted by its own companies. Moreover, after a while China will also be in the position to dictate certain terms for these companies. In addition, Chinese companies will have a better bargaining position in the international arena. Different types of cooperation will take shape and Chinese suppliers will reach more and more markets. Areas of focus are very important in terms of global penetration. Profits can be magnified by concentrating on investing in more sensitive markets and sectors. This way China can even protect itself in terms of price explosion-prone energy carriers, which are nevertheless a necessary component of production. With the help of its foreign exchange reserves it can also indirectly correct the shortcomings of the domestic economy. China can continue to invest in infrastructure development as it has done up to now.

That is to say that Chinese economic development could fulfil the objectives of the five-year plan. Naturally, the process is not so clear-cut and simple. There are a number of factors that could undercut it, regardless, however, the conditions necessary for success are in place and China is much closer to reaching its stated objectives than ever before.

CONCLUSION

The official reserves of the Asian giant, China have been rapidly expanding since 2000. At the end of 2010 these reserves exceeded USD 2,700 billion. None of the three rules generally used to describe adequate reserve levels examined in this paper account for the rate of reserve accumulation of the Chinese government. The reserves accumulated by China should be considered exorbitant and in excess of the levels

necessary for self-help. Even according to the strictest rule applied, in 2008 the country held USD 550 billion, in excess of the minimum amounts generally used by countries for purposes of "self-protection". This ascending trend seems to be escalating unabated.

In the opinion of the authors of this paper efficient investment of reserves provides China with an excellent opportunity to accelerate its development. The analysis of the state-owned investment corporation created in 2007 leads us to believe that decision-makers are striving to put China on a well-established path to growth by strategically exploiting the reserves of the country. By reallocating and consciously investing increasing amounts of foreign exchange reserves worldwide, China could be able to provide for part of its raw material needs, achieve better bargaining positions in many sectors, obtain influence in sensitive industries, and – as a result of its global reach – may provide Chinese corporations with competitive advantages. Utilising spare reserves in this manner helps China break with its current, unsubstantiated, unstable development policy and diminish its dependence on other nations.

Notes

[1] Based on the size of the economies and their role in international trade, the single European currency – the Euro – grew to become a rival of the US dollar. Its function improved slowly but surely over the last few years. According to the COFER database of the International Monetary Fund, in the first quarter of 2010 almost 62 per cent of the world's total foreign exchange reserves were held in US dollars and 28 percent in Euros. This piece of information, however, refers to the reserves on which accurate data are available, which account for less than 60 per cent of overall reserves worldwide.

[2] In 2007, gold accounted for only some 0.3 per cent of China's monetary reserves; also a negligible portion – approximately 0.077 per cent – of those reserves were held in SDR. (Source: Asian Development Bank)

[3] China is often faced with charges of exchange rate manipulation in connection with the undervalued Yuan. Although China came out with another symbolic statement to make its foreign exchange regime more flexible just before the 2010 G-20 Summit in Toronto, no substantial headway has been made until the summer of 2010. The Chinese currency appreciated modestly during the whole of 2010. As a result of intensifying inflation pressure and the threat of asset bubbles forming, greater movement is anticipated in 2011.

[4] For instance, in 2005 Canada only had monetary reserves equalling 10 per cent of the value of its annual imports, compared to the world average of 40 per cent at this time (Wijnholds – Sondergaard, 2007).

[5] Jeanne and Ranciére (2006) arrived at a similar conclusion with regard to the Asian region as a whole, and Wijnholds and Sondergaard (2007) have also detected excessive reserve accumulation in the case of many other countries.

[6] Jeanne (2007) stresses this notion in the case of emerging Asian countries.

[7] The issue of global disequilibriums is a rather complex one, and the authors of this paper shall not engage in providing an opinion on the matter due to the scope constraints of this article, for additional reference see Blanchard – Milesi-Ferretti (2009).

[8] The term "separate national wealth fund" is also used quite often.

[9] It should be noted that Europe is also in danger of becoming dependent on China, as China is also the main supplier of the European Union. Similarly, the EU's trade balance is the weakest in its relation to China. (Data sources: WTO, Eurostat, BEA database)

[10] Although it must be noted here that opinions differ in terms of whether China's growth is attributable to its exports. According to authors Goldstein – Xie (2009), the fact that the rate of exports compared to GDP is outstanding does not necessarily mean that the growth is export based. In their opinion, in order to detect export-driven growth one has to compare net exports to GDP first and then compare this value to the domestic component of growth (consumption and investment). However, from the

perspective of our topic what is important is that continually expanding Chinese exports have generated tremendous amounts as profit.

[11] The global economic crisis has overwritten the original script, forcing China to abandon its policy of strictly controlled, gradual currency appreciation and keep the Yuan exchange rate fixed between 2008 and June 2010.

[12] The period of downturn during the 2008/2009 crisis was an exception.

[13] Source of data: IMF database

[14] Source of data: ADB database

[15] "Monetary expansion is ineffective under a fixed foreign exchange rate regime, and can only be a means of changing reserve levels" (Mundell, 1998)

[16] Recently, China has brought up the issue of the need to transform the international monetary system on multiple occasions (see Zhou, 2009). Nevertheless, it is the opinion of the authors of this paper that the current regime is not likely to undergo transformation in the near future.

[17] Download: http://www.china-inv.cn/cicen/annals/aboutcic_annals.html

[18] For more information about how the index is calculated please refer to: http://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index/

[19] The quote was cited from the following publication: Forbes 12/10/2007: "China Investment Corp warns western governments against protectionism"

[20] http://www.china-inv.cn/cicen/investment/investment_investment.html

[21] The United States made the exact list of corporations public in February of 2010.

[22] Writes David R. Francis in his article entitled "Will Sovereign Wealth Funds rule the world?" (11/26/2007, *The CSMonitor*) http://www.csmonitor.com/2007/1126/p16s01-wmgn.html

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