ASIAN SWFS IN EUROPE: MUCH ADO ABOUT NOTHING?

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Introduction

Increased integration among the world's main regions – Europe, Asia and the US – the expansion of global markets and the coming to the fore of large economies have contributed significantly to global growth in the last decade. As a result the world economy is in its strongest state for thirty years.

The supply of cheap money, which is a source and a product of the current prosperity, brings to the global financial scene emerging-market countries with large surpluses. Global capital markets are clearly becoming larger while countries with large current account surpluses, such as China and the oil exporters, have been building up large official reserves holdings.

The size of these holdings has now surpassed precautionary motivations and liquidity objectives, moving the focus off currency stabilization and onto development strategies. It then makes sense to divert some of the new capital inflows to state-owned investment funds (Sovereign Wealth Funds, or SWFs) and switch to more 'aggressive' investment strategies. These funds, which so far have been a vehicle for the accumulation of low-risk and low-return securities, are likely to grow and become more like private mutual funds and even hedge funds.

SWFs are not new, especially in countries rich in natural resources, but have recently gained prominence in several emerging market countries, reflecting those countries' large balance of payments surpluses. SWFs already manage assets in excess of US$2 trillion; these are projected to grow to over US$5 trillion by 2015. Although the total size of SWF funds is still a fraction compared to funds in other investment categories, the dynamics of their growth and cross-border nature of their asset-holdings raise several operational, institutional and policy issues.

There are growing concerns that the limited publicly-available information on most SWFs, the multiplicity of their objectives and the lack of clarity regarding their institutional structures and investment management as well as the lack of specific regulations in home countries would make it difficult to assess their asset management activities and impact on capital markets and the wider global economy. Without more public accountability, funds could alter their governance structures which, in turn, could lead to sharp changes in their investment policies. The public ownership of SWFs also raises the possibility of recipient countries placing restrictions on their capital accounts to avoid certain types of foreign direct investment. Prior to the emergence of SWFs and other unregulated investment vehicles, we simply presumed that international capital was controlled by private investors and had near blind faith in their ability to make the right decisions.[1] However, the emergence of SWFs alerted us to the possibility that this presumption may not be correct, that how and where global capital is directed may require more regulatory attention than in the past.

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[1] In other words, we should not presume that pre-SWF the global economy was a pure free market, with public pension funds, especially in the US, accounting for a big chunk of investment there, Golden shares in Europe, several state-owned oil companies etc.

The aim of this paper is to look at the investments of Asian SWFs in Europe, assess their strategies and discuss the possible targets for acquisitions and strategic investments. Being among the biggest funds, with assets in excess of US$600 billion, Asian funds are set to become increasingly important players in Europe. Using published as well as original figures and information, the paper will identify the SWFs operating in Europe and look at their main objectives – for example, pursuing investment policies with higher returns or sharing wealth across generations.

The paper is organised as follows. Part 1 sets the scene and discusses the recent surge in capital flows and the coming to fore of emerging-markets countries with large surpluses in their current accounts. Part 2 looks at Asia's SWFs, assessing their size, growth prospects and strategies. Part 3 discusses possible targets in Europe. Part 4 concludes.

Part 1. Setting the scene

1.1. Surging capital flows

In the last three decades total global capital inflows have been rising faster than trade, initially benefiting from bilateral flows within the OECD (Table 1). They rose from under $1trillion a year in 1990 to over $4 trillion by 2000. Developing-country inflows also rose, from under $25 billion a year in the late 1980s to $150-250 billion in 2000. This is a major change compared to just twenty years ago, when the current phase of globalisation and fast financial integration started. As a result, total market activity is much larger.

TABLE 1 GLOBAL FLOWS: TRADE AND CAPITAL

US$trn	1970	1980	1990	2000	2010e
Goods Trade (exports)	0.4	1.9	3.4	6.3	16.5
Total Capital inflows	almost zero	0.1	0.5	4.0	10+

Sources: IMF, UNCTAD, Oxford Economics

Capital flows can be classified into three main groups: foreign direct investment (FDI), portfolio investment and banking operations and FX management. They reflect the complexity of the world economy as well as the international nature of big business, and are driven by increased economic integration. For instance, the surge in FDI is driven by cross-border activity to match 'assets and liabilities' or 'cost base-to-sales' and by market consolidation through mergers and acquisitions (M&A). The need to access new markets often fuels brownfield investment and the expansion in world trade mainly drives banking operations and trade finance. Foreign exchange reserves management, meanwhile, is a necessary tool for emerging market economies to maintain currency stability in the face of widening trade surpluses and capital inflows.

The emerging economies of Asia together with oil exporters – Russia and OPEC – are some of the main players in the world economy and on global markets, because of the size and dynamics of their capital flows. Net capital outflows from Asia, Russia and OPEC combined now amount to about $1trillion a year, reflecting the size of their aggregated current account surpluses. Most of these capital flows are directed towards the US market.[2]

In 2006 the US paid about US$604 billion on foreign-owned assets in the US, although the income receipts on US-owned assets abroad were higher, at US$647 billion (US Bureau of Economic Analysis). This means that the US, despite their large current account deficit, still earns more from investments abroad than what it has to pay to foreign investors for holding assets in the US. This is mainly because foreign investors tend to invest in low-risk debt securities whereas US investments abroad are mainly FDI and portfolio investments in equities.[3] IMF figures on the breakdown of capital account by type of transactions show that of the stock of the US assets abroad, about 22% are direct investment, 20% are portfolio investment and the rest is mostly banking operations and FX management. Of the stock of foreign assets in the US, almost 60% are portfolio investments compared with 10% in direct investments. Direct investments and portfolio investments in the equity market tend to have higher returns than debt securities.

The consequences of these surging capital flows are twofold. First, the US enjoys a surplus in the investment income account, and this somehow defuses concerns over the large current account deficit. However, such a position is sustainable – and it has been so over the last three decades – as long as foreign investors keep investing in low-return debt securities and do not switch their portfolio allocation to equities, or increase FDI flows in the US. Second, such large, and increasingly larger, capital flows require markets that are able to process large volumes and international transactions.

1.2 Global wealth is expanding

The background to the surge of global capital flows is the rise in global wealth which, in turn, is a consequence of almost uninterrupted expansion of the world economy. This has resulted in an increase in the proportion of this wealth that each country invests abroad. By cross-checking figures provided by Oxford Economics (Rossi, 2007) with 'quotes' from the IMF and Bank for International Settlements datasets – with the proviso, however, that available information on this kind of data is poor and only refers to financial activities[4] – we have estimated that world total financial wealth for 2005 stands at US$162 trillion (Figure 1). The distribution by activity is fairly balanced, with one-third in equity holdings, slightly more than one-third in the bond market (37%) and slightly less in cash (31%). The geographic distribution sees one-third of the global wealth in the hands of US companies and individuals. The Eurozone and Japan own about 22% and 20% respectively, and the rest of the world 26%.

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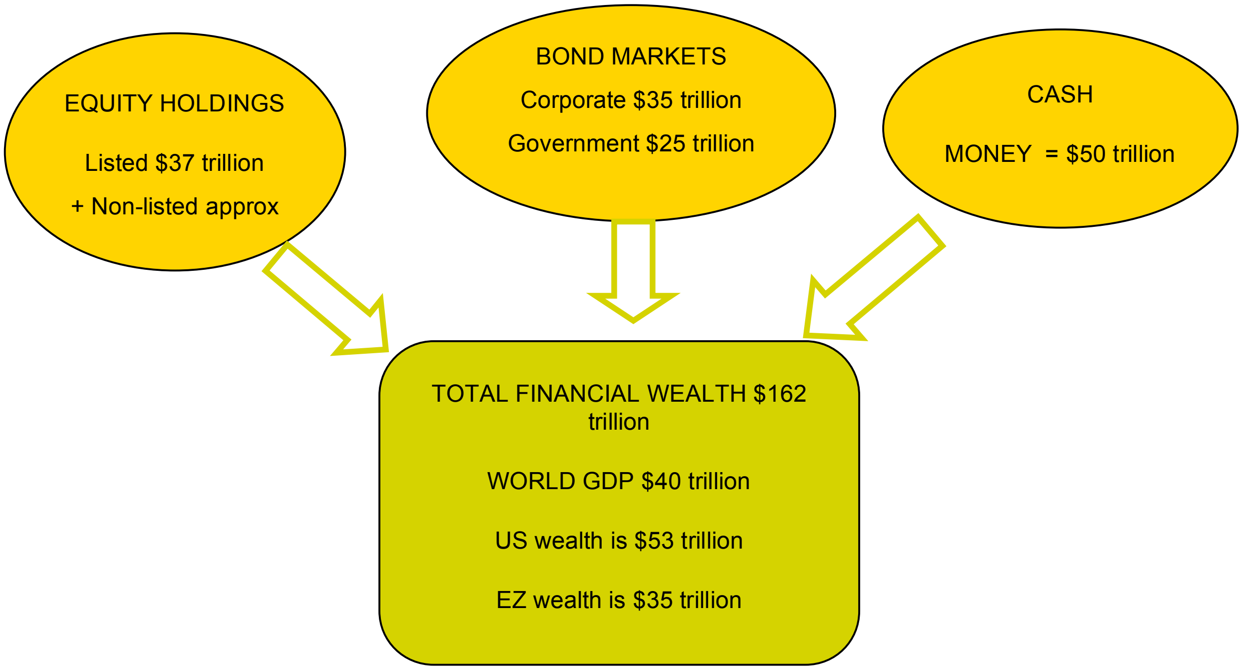
[2] Catherine Mann calculated that the US share of new portfolio investments rose from about 10% in 1993-95 to almost 80% in 1998-2000 (Mann, 2003). See also Gräf, 2007.

[3] These, of course, do not always pay a higher return, but have an expected higher return as they are riskier.

[4] Property holdings, for example, are excluded.

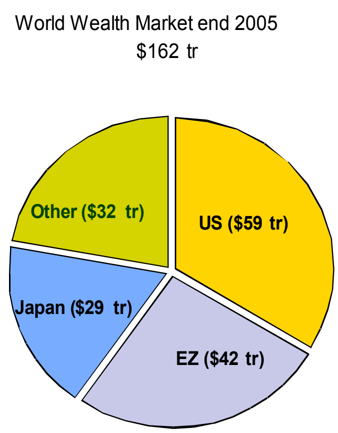
FIGURE 1 WORLD FINANCIAL WEALTH ESTIMATES, 2005



How is this global financial wealth allocated? Most of it goes to the US market, followed by the Eurozone (Figure 2). These two markets are larger than the total amount of wealth owned by Americans and Europeans. In a sketchy way this suggests that they absorb some of the global wealth which cannot be allocated in other markets. Without attempting to draw firm conclusions from patchy evidence, it is nevertheless worth stressing here the interplay of two distinct trends in the demand for investment instruments and the supply of such instruments. The former is driven by the existence of large pool of savings in some countries; the latter is constrained by underdeveloped and shallow financial markets in the same countries. As a result capital tends to flow where investment opportunities are available, i.e. the US and, to a lesser extent, Europe.[5]

[5] This seems consistent with the 'asset shortage' theory of Ricardo Caballero (Caballero, 2006).

FIGURE 2 WORLD WEALTH MARKET SIZE, END 2005



1.3 Reserve holdings and Sovereign Investment Funds

The obvious implications of this excess of savings in some parts of the world are low long-term interest rates – a "conundrum" for a country, like the US, with a large current account deficit – and abundant liquidity.[6] Less obvious are the structural changes that may be looming. Besides the fact that the world's biggest economy – and the only superpower – borrows from emerging economies to support household consumption and public spending, what are the implications of developing countries, especially China, controlling large chunks of global liquidity? With US$20-30 billion per month in trade surplus and FDI inflows, what kind of financial 'power' does this country – as well as others with substantial surpluses – wield, especially given the very low savings rate in some developed economies, notably the US?

FX reserves holdings and government investment funds are the main vehicles through which Asian economies and oil-exporting countries channel their external surpluses, with the result that these surpluses have been invested largely through the official rather than the private sector. Reserve accumulation, in particular, has been the main feature of the Asian economies since the financial crisis of 1997, providing a means to stabilise the exchange rate, to keep it at a level consistent with exports growth and to provide enough liquidity in case of a balance-of-payment crisis, as all these countries are softly pegged to the dollar and therefore potentially prey to speculative attacks.

Reserve accumulation has been growing at a fast pace in the last few years (Figure 3). Compared with the total official reserves of US$4.6 trillion that prevailed at end 2005, the

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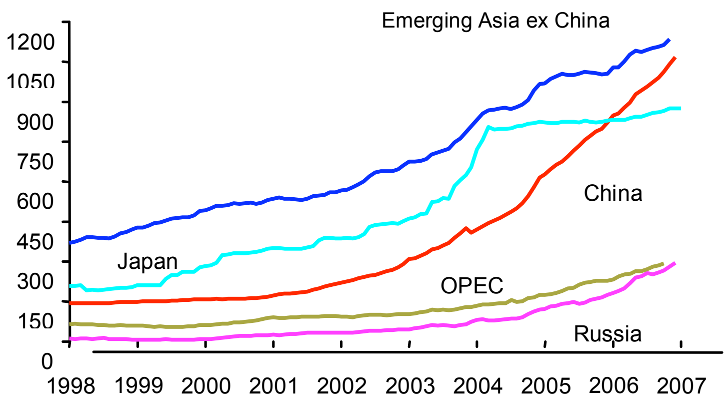
[6] The corollary to low nominal interest rates has been the increase in asset prices and the increased appetite for risk-taking.

world's official reserves have risen by over US$1 trillion in a little more than a year and were about US$5.7 trillion by the end of May 2007 (IMF figures). They have been growing at roughly US$60-65 billion a month, with China accounting for about 30% of these increases. China's foreign reserves – mostly in US dollars – now exceed US$1 trillion, bringing the total reserve holdings of emerging Asia to well over US$2 trillion. The central bank of Russia has had to buy up more than US$100 billion in foreign reserves so far this year on the back of the large trade surplus and capital inflows. Russia's official reserves are now a little more than US$400 billion – the third-largest in the world.

FIGURE 3 OFFICIAL RESERVES HOLDINGS



Sources: IMF

The seeming contradiction between the large external surpluses and the needs of domestic development highlights the problems inherent in a strategy of asset accumulation rather than investment, and, in the case of China, of 'mopping up' excess liquidity through sterilization – i.e. the central bank withdraws the excess liquidity generated by capital inflows by issuing notes and bonds. Not only there is an opportunity cost attached to reserves accumulation, but there is also a currency risk which becomes more relevant as the accumulation progresses. Given the size of their external surpluses, how plausible is it for China and other surplus countries to keep accumulating dollar reserves and low return dollar-denominated assets?[7] Moreover, with reserves now exceeding the level necessary to provide a safety net in case of a balance of payment crisis,[8] how long can these countries afford the costs and risks of such an exchange rate strategy? And what would be the implications of a portfolio diversification that reduces exchange risk exposure and better reflects country weighting?[9]

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[7] The Governor of the People's Bank of China, Zhou Xiaochuan, commented that China now has enough foreign currency reserves and that steps would be taken to contain the rate of their rise in future. *China Daily*, 21 March 2007.

[8] For the emerging markets FX reserves accumulation for precautionary reasons is typically about 4-6 months of imports.

[9] The acquisition of foreign companies in strategic industries is a sub-class of the broader policy of searching for higher risk-adjusted returns – in other words, SWFs invest overseas and sometimes, not always, they do it in strategic sectors. For infrastructure,

There are already clear signs of one form of stabiliser for the balance of payments – reserves management – being swapped for another – capital outflows. Indications of such a shift can be seen in the recent trend of FDI flows. While FDI inflows continue to outstrip FDI outflows (US$334 billion and US$117 billion respectively in 2005), the pace of growth of the latter has been stronger: inflows grew from about US$163 billion and outflows from about US$50 billion respectively in 2002. This trend is even more evident for China where FDI outflows grew from US$2 billion in 2002 to US$11 billion in 2005 while FDI inflows increased at a slower pace – from US$52 billion to US$72 billion over the same period.

These outflows will almost certainly rise markedly over the next couple of years. With deposits of some US$4 trillion – almost double China's GDP – bottled up in domestic banks and monthly surpluses of US$20-30 billion, assuming current exports growth rates and FDI inflows, China surely has the capacity to generate serious capital outflows. Indeed, assuming that half of the monthly surplus will continue to be channeled into FX reserves the rest can be used for direct investment or portfolio investments abroad. And US$10-15 billion per month could buy China several large US or EU companies as well as funding aid and various projects in Africa. Similarly, oil funds, which are currently around US$845 billion, could easily grow by US$200-300 billion a year over the medium term (Jen, 2007a).

1.4 Switching portfolio composition and investment strategies

Anecdotal evidence and recent trends in capital flows leave little doubt about the intention of countries with large external surpluses to switch to more 'aggressive' investment strategies – i.e. looking for a return, rather than being directed purely on the basis of liquidity considerations. As we discussed in the previous sections, the size of reserves holdings has now surpassed precautionary motivations and liquidity objectives, and is well above the level necessary to provide a safety net in the event of financial turbulence. Thus the focus has moved away from currency stabilization and onto development strategies. As managing reserves seems increasingly less appropriate to stabilize the balance of payments and to reduce domestic liquidity, diverting some of the new inflows of FX reserves to funds devised for long-term investment is becoming a plausible option for surplus countries.

SWFs epitomize the key changes underlying current trends in global capital flows. Their already considerable size (Table 2) is likely to grow in the years ahead. Drawing from Asia's large surpluses means that going forward, the portion of government funds derived from oil and gas export proceeds, which currently account for about two-thirds of the total, will drop to about 50% by 2015, with the other half derived from the proceeds from Asian manufacturing exports (Jen, 2007a). Stephen Jen estimates that diverting reserves into government funds would increase their total size from the current estimated total size of over US$2 trillion, by about US$500 billion a year, and that they would become as big as the world's total official reserve in about five years. As China is expected to play a key role in this process, the Chinese government investment fund is likely to become the second biggest fund in the world, surpassing Norway's GPF, GIC and KIA.

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in particular, the logic is dualistic: invest in strategic infrastructure at home, where the short-run returns by the way may not be very high, if positive at all, and in infrastructure that provides a good return overseas (in particular in regulated sectors).

TABLE 2 SOVEREIGN WEALTH FUNDS BY SIZE

Country	Fund name	US$ million
Total		*2,279,866*
UAE	Abu Dhabi Investment Authority (ADIA)	625,000
Norway	Government Pension Fund (GPF) - Global	322,000
Singapore	Government Investment Corporation (GIC)	215,000
Kuwait	Kuwait Investment Authority (KIA)	213,000
China	China Investment Corporation (CIC)	200,000
Russia	Oil Stabilization Fund	127,500
Singapore	Temasek Holdings	108,000
Qatar	Qatar Investment Authority	60,000
US (Alaska)	Permanent Reserve Fund	40,200
Brunei	Brunei Investment Authority	30,000

Source: Jen, 2007b, Lyons, 2007

Part 2. SWFs: definition and size

2.1 A tentative definition

Asia's SWFs are a relatively new story. Of the 20 largest SWFs, 7 were in existence before 1990, 6 started in the 1990s and 7 since 2000. A number of smaller funds have started in recent years; their success may encourage other countries to establish their own. Unlike commodity exporting countries that have been allocating their assets to SWFs for several decades – the first one, albeit not sovereign, was established by in Kuwait in 1953 – Asian countries have traditionally preferred to accumulate their surpluses in FX reserves.[10] Only recently have they been establishing non-commodity SWFs.

Despite being in existence for a while, there is little anecdotal evidence and almost no statistical information to support a deep understanding of SWFs. We even lack a universally agreed definition of SWFs with the result that they are often confused with Sovereign Pension Funds and with official FX reserves. The US Acting Treasury Under Secretary for International Affairs, Clay Lowery, recently defined a SWF as: "A government investment vehicle which is funded by foreign exchange assets, and which manages these assets separately from official reserves" (US Treasury, 2007). SWFs, although similar in origin and composition to reserves holdings, are driven not so much by concerns over the stabilisation

[10] There are exceptions in both cases as Singapore created its Government Investment Corporation (GIC) in 1981 and Russia established its oil fund in 2003.

of the exchange rate and the prevention of financial crises. They rather respond to the needs of long-term development of countries that depend on natural resources, in particular oil, as their main source of revenue, or the need to preserve and enhance the international purchasing power of their reserves.

Oil-dependent economies need to smooth their revenues over a long period of time and use such revenues to diversify their economies.[11] External surpluses, therefore, are channelled into the government investment funds and held usually in the form of stocks, bonds or property. Non-commodity funds, such as Asia's SWFs, have the purpose of diversifying FX assets and earn a higher return by investing in a broad range of asset classes, including longer-term government bonds, agencies and asset-backed securities, corporate bonds, equities, commodities, real estates, derivatives, alternative investments and FDI. This means that the extent of their asset accumulation depends heavily on how successful these countries are in shifting to increased exchange rate flexibility.[12]

Throughout the paper I will look at SWFs in terms of their goals, investment horizon and risk tolerance and refer to them as having the following characteristics[13]:

- owned by a national sovereign state – as opposed to central banks or monetary authorities that in some countries perform roles typical of a central bank;

- investment funds rather than producers of goods or services, although they may invest in productive companies;

- high foreign exchange assets exposure – the source of which can either be commodity exports[14] ('commodity funds') or established through transfers of assets from official foreign exchange reserves[15] (non-commodity funds);

- no explicit liabilities – unlike sovereign pension funds;

- high risk tolerance;

- long investment horizon and low leverage.

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[11] For example, Russia's Oil Stabilisation Fund (OSF) was established in January 2004 with the aim of stabilizing the monetary impact of changes in oil prices. The tax proceeds above the threshold of US$27 a barrel were saved in the OSF. The OSF formed a part of the total official reserves of US$357 billion, which makes Russia the world's third-largest holder of official reserves. As of April 1, 2007, the OSF had US$109 billion invested in sovereign bonds of the US (45% of the total), euro (45% of the total) and the UK (10% of the total). In April the Duma approved the transformation of the OSF to split it into a Reserve Fund and a Future Generation Fund. This structural change will come into effect on February 1, 2008 (see Jen, 2007c).

[12] Unlike oil exporting countries that use their funds to replace a real asset in the ground with a financial asset in the account.

[13] For a discussion on how to define SWFs see Jen, 2007d.

[14] This, in turn, can be either owned or taxed by the government.

[15] Large balance of payments surpluses have enabled non-commodity exporters to transfer 'excess' FX reserves to stand-alone investment funds to be managed for higher returns.

2.2 Growing assets

As SWFs are often blended with a large amount of private capital, it is extremely difficult to monitor their currency and asset compositions, let alone their size. Guestimates, however, indicate that just over US$2 trillion may be currently held in these funds (Jen, 2007a, Lyons, 2007). The top ten funds (Table 2) include SWFs that have been around for some decades, such as UAE's Abu Dhabi Investment Authority (ADIA, 1976) and Singapore's Government Investment Corporation (GIC, 1981), as well as recent ones, such as China Investment Corporation (CIC, 2007) and Russia's Oil Stabilization Fund (2004).

So far, government wealth funds have been a vehicle for the accumulation of low-risk and low-return securities, mirroring, to some extent, the official reserves. As their size grows, these funds will become more like private mutual funds or even hedge funds. In Russia, for example, from February 2008, both the Reserve Fund and the Future Generation Fund (FGF) will be invested in a wider array of assets, including equities, oil options and other assets rather than almost exclusively in foreign currencies and sovereign bonds. China, in turn, recently established the State Foreign Exchange Investment Corporation (SFEIC) to manage China's FX reserves and merged the new company with the Central Huijing Holding Company, which it bought from the People's Bank of China for US$65 billion and made it the solely owned subsidiary of SFEIC. The new agency has ministerial level status and reports to the State Council.[16]

As a result investment strategies and attitude to risk will become more relevant, as will asset and currency diversifications. Intuitively speaking, such a shift bears huge implications – in terms of both economic and market dynamics and international and domestic politics – even if it is analytically difficult, at this stage, to track them all. Little is known about their investment policies, making it hard to formulate a detailed analysis of the likely implications. Not surprisingly, then, the sheer size of such funds and their prospective growth rates, their increasingly strategic nature[17], lack of transparency and poor governance have recently generated concerns that they could become a source of financial as well as geo-political instability. This is why SWFs have become a big issue, particularly in policy circles.

2.3 Asia's SWFs: size, strategies and transparency

Let's now focus on Asia's SWFs. Most of them are non-commodity funds. Only the funds of Singapore (both GIC and Temasek) and China have assets in excess of US$100 billion (Table 3). As a proportion of domestic GDP, the biggest funds are those of Brunei and Singapore (GIC and Temasek combined), respectively about 310% and 253% of GDP. CIC's assets are about 8% of China's GDP.

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[16] AsiaPulse via COMTEX News Network, August 8 2007, Beijing http://uk.quote.com/news/story.action?id=APU219u3672; *China Daily* March 2, 2007, http://www.china.org.cn/english/BAT/201272.htm

[17] Some commentators refer to them as 'state capitalism' (Lyons, 2007).

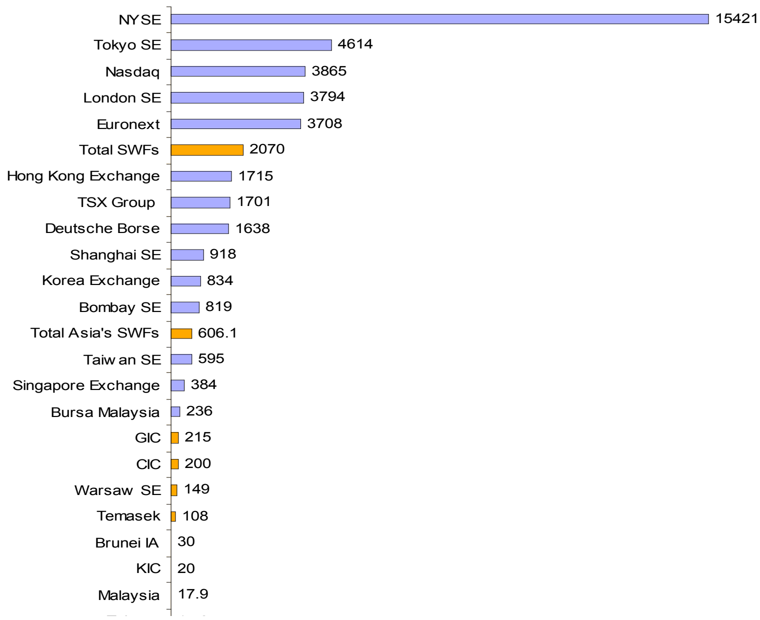
TABLE 3 ESTIMATED SIZE OF ASIA'S SWFS, US$ BN

Country	**Fund Name**	**Launch year**	**US$ bn**	**% of 2006 GDP**
Singapore	GIC	1981	215.0	169.0
China	China Investment Corporation (CIC)	2007	200.0	8.0
Singapore	Temasek	1974	108.0	84.9
Brunei	Brunei Investment Authority	1983	30.0	309.4
South Korea	Korea Investment Corporation (KIC)	2005	20.0	2.2
Malaysia	Khazanah Natsional BHD	1993	17.9	12.3
Taiwan	National Stabilization Fund	2001	15.2	4.0
Total		*606.1*		

Source: Lyons, 2007

The comparison between the size of SWFs and the market capitalisation of the main stock exchanges shows that the total assets of SWFs exceed the market capitalization of Asia's stock exchanges, with the exception of Tokyo SE (Figure 4). The assets of the two Singaporean funds almost equal the market capitalization of their domestic stock exchange. The assets of CIC are 23% of the market capitalization of the Shanghai stock exchange.

FIGURE 4 SIZE OF SWFS TO THE MARKET CAPITALIZATION OF SELECTED STOCK EXCHANGES



Source: Lyons, 2007

What do we know of Asia's SWFs? Singapore's GIC and Temasek have been in existence for a long time and show medium (GIC)[18] to high (Temasek) levels of transparency, so their investment policies and asset allocation are broadly known. GIC, for instance, invests in 40 markets, with a long-term focus through systematic diversification across equities, fixed income, foreign exchange, commodities, money markets, alternative investments, real estate and private equity. Temasek operates under commercial principles to maximise long-term returns. Its geographical asset mix is broadly as follows: 38% domestic, 40% rest of Asia, 40% OECD countries (except South Korea), 2% rest of the world.

With regard to Asia's SWFs with less than US$100 billion assets, they have been around for a long time (Brunei and Malaysia) or they belong to countries that are strongly in the US sphere of influence and are unlikely to trigger geo-political instability (South Korea and Taiwan). In any case, the size of such funds is relatively small, limiting investment ambitions.

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[18] Edwin Truman (2007) regards GIC and Temasek as quite secretive funds because of their lack of disclosure, but market practitioners, who have known and dealt with these two organisations for decades, look at both from a different view point. They feel perfectly comfortable with these SWFs, their modus operandi and their levels of competence and professionalism. They may have been extremely secretive and tight-lipped vis-à-vis the general public (e.g. they may not have a web-site or publish their assets under management), but they were relatively 'open' vis-à-vis their market counterparts and service providers, certainly enough for the latter to set up credit lines, trade with them and service them for decades. I am grateful to Andrew Rozanov for making this point.

2.4 Is China the problem? The economics of CIC

All this narrows the focus on China's CIC. This is the 'new kid on the block' and came into prominence in June 2007, when it was not yet in operation, with the US$3 billion acquisition of almost 10% of the initial public stock offering of Blackstone Group, one of the largest US private equity firms. The Fund was then established in September 2007 with US$200 billion drawn from the official FX reserves. It has the potential for rapid growth not only thanks to the Chinese economy's rate of expansion, but also because of the consolidation with other investment bodies. Indeed, an additional US$200 billion is expected to be added as a result of the merging of Central Huijin Company into CIC.[19] Tens of billions of dollars of CIC's funds will be ploughed into other government financial institutions. Moreover, CIC is expected to buy out the investments held by the People's Bank of China, the central bank, which has holdings in most state-run banks. On the whole, most of this additional US$200 billion will be used to acquire the government's stakes in Chinese banks. As a result CIC's start-up funds are accounted for although there is scope for drawing from China's FX reserves if necessary.

The decision to separate the new fund from the People's Bank of China bears important implications not only in terms of governance – the removal of the potential conflict of interest between low-risk reserves and the higher-risk management fund – but also in terms of balance sheet. In accounting terms it is like the new funds borrowing from the central bank's assets, issuing short-term yuan-denominated bonds. This has two important consequences. First, the new fund is debt-based.[20] Second, there is a currency mismatch between US$ denominated assets and CNY denominated liabilities.

These two factors combined have huge implications for the economics of CIC and for its investment strategies. The US$ denominated assets are a depreciating stock because of the strength of the exchange rate vis-à-vis the US$, reflecting, in its turn, the strength of the Chinese economy. In the last three years the yuan has appreciated in broad real terms by an annual average rate of 5%. This is the kind of return that CIC has to guarantee in order to retain the value of its assets. To this we need to add another 3-5% which is the money-market rate and the yield on the short-term papers. On the whole the fund needs to generate an 8-10% return to just break even. What does this mean for investment strategies?[21]

CIC's investment policy and asset allocation are not disclosed, but it looks like it has a larger mandate than Central Huijin Company, including a large array of assets and not only shares from a few major financial institutions. China's leadership has debated the right strategy for the government investment fund. Vice Premier Zeng Peiyan has suggested that China should invest in natural resources to increase its strategic reserves. Other high-ranking party officials

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[19] Central Huijin Company is a People's Bank of China-controlled investment company that controls three of China's biggest state banks.

[20] The fund borrows because of the government's credit standing, rather than of specific collaterals.

[21] China recently announced that they wont be making any big investments for about a year – so to can weigh up the size of losses in banking sector. It looks like some of the funds can be used to bail out state banks, which leaves no much scope for big acquisitions in Western companies – but perhaps only minority stakes.

would rather see the country acquire shares in high-tech companies to help China more rapidly close the gap with leading industrialized nations. Moreover, Lou Jiwei, a former vice minister of finance and now the company's chairman said CIC will operate on the principle of "commercial operation", and will abide by local laws of countries where it invests.

Given that very little is known about CIC, we can draw some insights into its strategy by comparing its economics to that of other SWFs, in particular Norway's Government Pension Fund (GPF), which is the most transparent of all. GPF's objective is to gain 'high return subject to moderate risk'. In practice this means that since 1997, the return on the Fund, once adjusted for inflation, has been 4.67% while the net real annual return – i.e. without management costs – has been 4.58%.[22] Clearly this annual return is too low given CIC's 'hurdle' rate.

Since 1998, GPF has mainly invested in fixed income securities (50-70% of the overall portfolio) and 30-50% in equities – before it was only government securities. 40-60% of the equity portfolio is invested in currencies and markets in Europe, 25-45% in Americas/Africa and 5-25% in Asia and Oceania. Where fixed income securities are concerned, 50-70% has been invested in currencies and markets in Europe, 25-45% in the Americas/Africa and 0-15% in Asia and Oceania. The portfolio's country distribution within the respective regions is based on market size in the individual countries. The Fund tends to hold less than a 1% stake in individual companies.

It is clearly the case that to gain higher returns CIC cannot structure its portfolio like GPF and has to embrace a more 'aggressive' style, rather than Norway's conservative and risk-averse approach.[23] This means a fully diversified portfolio which includes higher risk-higher return assets – along with more liquid, less volatile and lower return assets. CIC, therefore, is likely to include a relatively larger proportion of emerging markets equities, private equity funds, hedge funds, infrastructure funds, etc. Indeed, following the acquisition of a stake in Blackstone it was disclosed that CIC would continue to invest in private equity funds and hedge funds and to provide financial support to state-owned enterprises in overseas investment and financing. It is also likely that CIC will make some strategic investments – i.e. 5-10% stake in a company – or try to achieve corporate control.

This is the thorniest issue arising from the establishment of China's SWF. Looking at the economics of CIC it would make sense for the Fund to follow the same value-creation model as private equity funds. This means turning around and creating value in under-performing companies. Would this work for CIC? Perhaps it would work in the region, but it seems a hardly viable and efficient model to be applied to investments in more remote countries. Moreover, CIC would have to rely on foreign professionals with the relevant skills as Chinese institutions tend to lack global experience, both in investing overseas and in running enterprises in foreign countries. Finally, and more importantly, would this strategy be consistent with China's overall development targets?

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[22] The average nominal annual returns on the equity and fixed income portfolios for the years 1998-2006 have been 5.37% and 7.02% respectively.

[23] It is an equity-based, net wealth fund.

China needs energy, commodities and knowledge, so acquiring these assets through investments in key companies makes a lot of sense. This means that rather than following the 'classic' private equity model of value creation, CIC's acquisition strategy would be directed by goals of technology transfer, skill acquisition and access to commodities. This does not mean that the majority of the Fund will be absorbed by strategic investments. The Fund is likely to be structured to reflect optimum portfolio diversification with a bias toward high return assets – i.e. emerging markets and alternative asset classes. However, like all sovereign funds, CIC will have to gain and retain political support. Reporting to the State Council and ultimately to the Premier Wen Jia Bao, the Fund would have to be consistent with China's long-term economic policy goals, with the likely result that a small portion of its assets would be held in strategic investments. This would also be a way to make sense of the existence of a fund which is not entirely justified in purely economic terms.

Looking at the governance of CIC, the little we know seems to support the existence of financial and non-financial reasons behind its operation. For instance, CIC is likely to 'subcontract' a large portion of its assets to external, professional managers, and this is probably the portion of the fund managed according to portfolio allocation theory and which is expected to deliver a return consistent with the 'hurdle' rate.

CIC's board is made of eleven members, representatives from half a dozen agencies, including the finance ministry, the central bank, the commerce ministry, and National Development and Reform Commission, China's powerful economic-planning agency. Disagreements between the committee members – drawn from diverse backgrounds – could significantly hamper decision making. This means that economically efficient choices could be shunned by politically driven decisions. This is the share of portfolio which will be invested in strategic stakes.

Part 3: Asia's SWFs in Europe

3.1 'Is everything up for grabs?'

In summer 2007 China Development Bank (CDB) and Singapore's Temasek acquired a 3.1% and 2.1% stake respectively in Barclays, one of the biggest banks in Europe by market capitalisation, ranking 27 by market value in the FT Europe 500.[24] Investing US$3 billion – and US$2 billion respectively, CDB and Temasek also acquired a seat on Barclays's board. This was to provide Barclays with extra cash to buy ABN Amro, the Dutch financial institution that was the target of a bidding war between Barclays and a consortium led by the Royal Bank of Scotland. The two Asian funds also made a conditional offer to increase their investment to a combined total of US$19 billion in case the planned merger with ABN Amro succeeds.

This kind of deal could not go unnoticed and indeed sparked an intense debate and generated concern that an open economy such as the UK – and, more broadly, Europe – could become prey to the financial ambitions of companies and investment funds controlled

[24] Market values and share prices at 30 March 2007.

by foreign governments. As Britain's *The Observer* wrote on 29 July, quoting Gerard Lyons, chief economist at Standard Chartered Bank: "… everything is up for grabs in Britain. It's open season for those who want a chunk of UK plc." Is this a correct assessment of the situation? Which are the possible targets of Asia's SWFs in Europe?

Figures seem to confirm such an impression. In recent years low long-term interest rates have boosted global asset prices, leading to resurgent financial markets and fuelling a new surge in M&A activity. This has been supporting global FDI since 2004. The increase in FDI inflows in 2006 was especially strong in developed economies – more than 50%. Growth in FDI flows to emerging markets was more modest – 20% in 2006, similar to the growth rate in 2005. The share of emerging markets in global FDI inflows declined to 38% in 2006 from a peak of 48% in 2005. In terms of FDI outflows, developed countries remain by far the main players. However, outflows from Asia are the fastest growing, especially in the last decade (Table 4).

TABLE 4 OUTFLOWS OF FDI BY REGION, AS % OF GLOBAL TOTAL

	1978-1980	**1988-1990**	**1998-2000**	**2003-2005**
Developed economies	97	93	90	85
Africa	1	0.4	0.2	0.2
Latin America and the Caribbean	1.1	1	4.1	3.5
Asia and Oceania	0.9	5.6	5.1	8.6
South East Europe and CIS		0.01	0.2	1.8

Source: UNCTAD

Europe features prominently at the top of the list of recipients of capital flows, ahead of the US and Asia (Table 5). Among the European countries, the UK is at the top of the list, followed by France and Belgium. On the global scale and at the country level the UK is second of the US and ahead of China.

TABLE 5 FDI INFLOWS, 2007-11 AVERAGE

	US$ BN	RANK	% WORLD
EU27	570.1	1	38.06
US	250.9	2	16.75
ASIA	244.3	3	16.31
UK	112.9	4	7.54
CHINA	86.8	5	5.79
FRANCE	78.2	6	5.22
BELGIUM	71.6	7	4.78
GERMANY	66.0	8	4.41

Sources: EIU, author's calculations

The list of leading destination countries for FDI projects in 2006 differs somewhat from the list of leading recipients by FDI values because FDI values are heavily influenced by cross border M&A, rather than greenfield investments. However, here too EU27 is ahead of Asia, with 3848 projects in 2006 – an increment of 19% from the previous year. In terms of individual countries China, with 1,378 projects in 2006, is ranked first by the number of new FDI projects, while it was fourth by FDI inflows. The UK and France are some of the main recipients after China, India and the US (Table 6).

TABLE 6 NEW FDI PROJECTS, TOP RECIPIENT COUNTRIES

	2005		2006		
	No. projects	*% world total*	*No. projects*	*% world total*	*% change yoy*
EU27	3237	30.98	3848	32.56	18.9
Asia	2611	24.99	3272	27.68	25.3
China	1237	11.84	1378	11.66	11.4
India	590	5.65	979	8.29	65.9
US	563	5.39	725	6.14	28.8
UK	633	6.06	668	5.65	5.5
France	489	4.68	582	4.93	19.0

Sources: EIU, 2007, author's calculations

Breaking down the EU figures by country, the UK, France and Germany are Europe's top destinations for FDI projects (Table 7). Investment in other countries fell behind these market leaders. The decline of the relative position of Central and Eastern Europe is notable and is a result of (1) the shift in importance between manufacturing and service sector investment; (2) the limited appeal of these regions for service sector investment to date. Western Europe, on the other hand, features a large number of less labour-intensive projects.

TABLE 7 FDI: EUROPE'S TOP DESTINATIONS

	Destination	No FDI, 2006	Market share, 2006	No FDI, 2005	change, 2005-06
1	UK	686	19.4%	559	+22.7%
2	France	565	16.0%	538	+5.0%
3	Germany	286	8.1%	182	+57.1%
4	Spain	212	6.0%	147	+44.2%
5	Belgium	185	5.2%	179	+3.4%
6	Poland	152	4.3%	180	-15.6%
7	Romania	140	4.0%	86	+62.8%
8	Switzerland	136	3.9%	93	+46.2%
9	Czech Republic	113	3.2%	116	-2.6%
9	Sweden	113	3.2%	95	+18.9%

Source: Ernst & Young, 2007

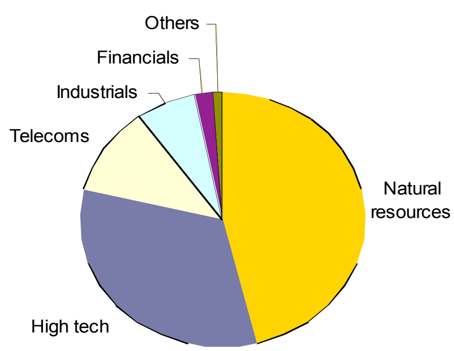
3.2 Who invests in Europe?

Recent figures published by Ernst and Young show that non-EU investments in Europe are mainly from the US and Japan. In the last couple of years there has been a significant increase in investment originating from the Brics – from 102 projects in 2005 to 153 in 2006, a 50% increase (Ernst and Young, 2007: 4). These are mainly investments from Indian investors (78 projects, most in the UK). For the first time in 2006 India was among the top ten investors into Europe. China, on the other hand, is more a beneficiary of EU FDI than an investor in Europe while the role played by Brazil and Russia is so small as to be irrelevant (Ernst and Young, 2007: 4)

However, a survey that Interlink, a secure data provider, published last September, based on responses from 200 dealmakers across the Asia Pacific region shows that Chinese companies are set to be Asia's most acquisitive in Europe and US in 2008. 59% of respondents see Chinese companies as the most acquisitive, followed by Indian corporates (27%). As much of the M&A activity seen in 2005-2007 – and in the first half of 2007 – is expected to slow down through the end of the current year and into 2008[25] (EIU, 2007), deals will continue to be undertaken by strategic investors with healthy balance sheets and strong cash flows. Asian companies and funds are good candidates for this.

Outbound acquisitions by Chinese companies have in recent years focused on investment in the resources sector in Africa and Latin America, while its leading financial services companies have stepped up overseas activity in recent months. In 2005 investments in natural resources and high tech sectors were 46% and 33% share of total M&A deals respectively, while deals in the financial sector were a mere 1% in 2005 (Figure 5). This is part of China's strategy of developing 'global champions' and therefore expanding the biggest banks' global reach.

FIGURE 5 CHINA OUTBOUND M&A BY SECTOR IN 2005



Most Chinese FDI is commodity-driven and goes to Latin America, Australia, the Middle East and Africa. However, IntraLink's findings suggest Chinese companies from across a broader range of sectors are actively considering M&A activity in the US and Europe, even if, according to some respondents, outbound deal flows might be tempered by the inability of some Chinese companies either to identify M&A targets or to manage acquisitions. These investments are market-based,[26] with ownership advantages bringing capital, technology, information, organisational and administrative skills, R&D, scale economies, trademarks and goodwill (Goldstein, 2007:80). In the banking and finance sector in particular, acquisitions are driven by the need to gain access to new products and a wide range of skills.

3.3 Possible targets in Europe: countries and sectors

Past investments by Asian SWFs and companies – in particular Chinese – indicate a preference for investing in institutions with exposure to emerging markets, the securities

[25] This is because of volatile financial markets and fewer privatisation opportunities in emerging markets compared with recent years.

[26] Unlike Africa where they are resource-based.

business or the private equity and the hedge fund industries. SWFs have invested an estimated US$35 billion in the shares of banks, securities houses and asset management companies since the beginning of 2006 (Morgan Stanley, 2006). Of that figure, about US$26 billion has been invested in the past six months alone by SWFs such as Singapore's Temasek, in particular, in financial-sector companies including Barclays, Blackstone, Carlyle, Deutsche Bank, London Stock Exchange, NASDAQ and HSBC. Temasek has 38% of its portfolio in financial stocks in the belief that the growth of these companies will be linked to the emerging middle class in Asia.

Chinese banks are likely to expand internationally in response to existing corporate customers' own moves (Table 8). Chinese resources companies, such as CNOOC, Simopec and Petrochina, have already expanded aggressively overseas, often through M&A, as have China's global technology companies, such as Lenovo, TCL and Huawei. These businesses have increasingly sophisticated international banking requirements and China's banks have been forced to upgrade their overseas services as a result. This mostly entails overseas branch openings but it is increasingly likely that Chinese banks will consider strategic acquisitions to accelerate the development of branch networks abroad, especially in Latin America, Middle East and Africa. Acquiring a relevant branch network across these jurisdictions is quicker and more effective than trying to build such a network from scratch, which would take years.

TABLE 8 CHINESE BANKS TARGETING FOREIGN BANKS

Date	Target	Acquirer	Deal value (US$bn)
23 July 07	Barclays (2.64%, UK)	China Development Bank (CDB)	3.0
24 August 07	Bank of America (Asian business Hong Kong)	China Construction Bank (CCB)	1.2
29 August 07	Seng Heng Bank (79.93%, Macau)*	ICBC	0.6
8 October 07	UCBH (9.9%, US)*	China Minsheng Banking (CMB)	0.3
19 April 00	Union Bank of Hong Kong	ICBC	0.3

* pending

Source: Dealogic

A sensible acquisition strategy in Europe would entail deals targeting institutions that can offer a widespread branch network through Africa, the Middle East and Latin America and can also bring technology, new products, expertise in areas such as project finance and even management skills. Looking at Europe's 20 biggest banks by market value (Table 9), which are the possible targets?

TABLE 9 MAJOR EUROPEAN BANKS

Bank	Country	Market value US$bn*
HSBC	UK	202.0
UBS	Switzerland	124.4
Royal Bank of Scotland	UK	122.5
Santander Central Hispano	Spain	111.2
Unicredit	Italy	99.0
BNP Paribas	France	97.0
Intesa SanPaolo	Italy	96.6
BBVA	Spain	86.9
Credit Suisse	Switzerland	86.7
ABN Amro	Netherlands	83.0
Societe Generale	France	79.4
HBOS	UK	77.1
Deutsche Bank	Germany	72.8
Credit Agricole	France	63.9
Lloyds TSB	UK	61.9
Fortis	Belgium/Netherlands	59.3
KBC Group	Belgium	45.0
Nordea Bank	Sweden	41.2
Standard Chartered	UK	39.7
Dexia	Belgium	34.5

* Market value at 30 March 2007
Source: Author's calculation based on FT Europe 500 2007

HSBC, Santander Central Hispano, BBVA, BNP Paribas, Standard Chartered are the European banks with extensive networks in Latin America, Asia and the Middle East. Some of them have already established links with counterparts in Asia. For instance, at the beginning of 2007 Spain's BBVA acquired a 5% stake in China CITIC Bank (CNCB) and a 15% stake in CITIC International Financial Holdings (CIFH), the CITIC Group's Hong

Kong-based financial flagship. BBVA's combined interest across the two Chinese banks stands at €1 billion, and it is likely to double as the chairman Francisco González recently announced. BBVA and CNCB's partnership extends to retail banking, wholesale banking, global markets, treasury, risk management and human resources. The strategic alliance with CIFH also covers asset management, global markets, treasury and corporate banking.

Of course national governments' attitudes towards acquisitions by SWFs – or by state-owned companies – need to be taken into account in the investment strategy. Given the rather hard stance expressed by some European governments and, on the other hand, the 'open market' stance shown by Britain, it is likely that most acquisitions would converge on the UK market.[27]

The next possible Chinese acquisition in the banking sector is rumoured to be Standard Chartered Bank.[28] This acquisition would offer a Chinese bank not only a network to enable it to follow its clients into the Middle East and Africa, the deal would also bring a coveted Asian presence, including Hong Kong and Singapore as well as Indonesia, Malaysia and Thailand, all countries with a significant Chinese diaspora.

Are there lessons and strategies from other sectors? Recent Chinese investment in Europe has been concentrated on infrastructure and mining (Table 10). Most companies with strategic investment from China are based in the UK.

TABLE 10 CHINESE INVESTMENT IN EUROPE

Date	Target	Acquirer	Deal value (US$ml)	Sector
July 2007	Barclays (2.64%, UK)	China Development Bank (CDB)	3000	Banking and finance
July 2007	British Gas (0.46%, UK)	CIC-PBOC		Energy
July 2007	Schwerin-Parchim Airport (100%, Germany)	Link Global Logistics	130	Infrastructure
March 2007	Monterrico Metals (89.9%, UK)	Zijin Mining Group Co	94.6	Minerals
2007	Ridge Mining (29.9%, UK)	Zijin Mining Group Co	15.93	Minerals
July 2005	MG Rover (100%, UK)	Nanjing Automobile group	93	Automotives
2005	Thomson SA (J-V, France)	TCL Corporation		Consumer electronics

[27] On 10 December 2007 Lou Jiwei, CIC's chairman, said that his fund would boycott countries which displayed protectionism on pretext of "national security", FT, 10 December 2007.

[28] Possibly through the acquisition of 17% currently held by Temasek.

The UK is likely to remain the preferred destination of Chinese investment in Europe. Acquisitions in other European countries may be more difficult given their governments' less open policy stance (Table 11).

TABLE 11 KEY LOCATIONS IN EUROPE

Country	Advantages	Disadvantages
Germany	Manufacturing, infrastructure and logistics SMEs	SMEs
France	Banking and energy Good size companies	Politics Obsession with 'national champions'
Italy	Manufacturing and defense (Finmeccanica)	Politics 'Golden share' in key companies Too many SMEs
Netherlands	Critical mass of firms in a number of sectors (telecoms, media, IT) 'Positive externalities'	
Sweden	High concentration of MNCs Key companies in key sectors Strong potential including competitive corporation tax	
UK	Open economy Large companies in key sectors One of the world's most attractive locations	'Tabloid' pressure
CEE	A few opportunities for market penetration	Too small markets Not much technology transfer Brain drain in some countries

Part 4. Provisional conclusion

SWFs are not a homogenous group, but they can be segmented by countries, long-term goals, strategies, liabilities, etc. Bundling all them together does not help to foster a deep understanding nor does it favour a balanced debate.

Looking specifically at Asia's SWFs, it was the creation of CIC that raised concerns in the US and Europe. Singapore's SWFs have been around for decades without generating headlines outside the specialist press.

There is a clear case for CIC to pursue a rather 'aggressive' investment strategy given its 'hurdle' rate. However, available evidence seems to suggest that most assets will be allocated according to the standard portfolio diversification theory, with a smaller potion (10-15%) to be invested in 'strategic stakes'.

Looking at Europe, the possible targets for strategic investment are rather limited. The banking sector, companies with interests in resource-rich developing countries, mining and energy sector, are the obvious targets. Given the current political climate, it is not clear how many of these targets are a concrete possibility. The UK is likely to remain the preferred destination, at least until the government remains committed to its open-market policy.

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