Asian SWFs in Europe: much ado about nothing?

Paola Subacchi - Chatham House

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Outline

- Setting the scene: global capital flows and new players
- SWFs: definition and size
- Europe’s target sectors: where are the “national champions”?
Section 1
Setting the scene: global capital flows
World economy strongest for 30 years

World: GDP growth

% year


Source: Oxford Economics

GDP at PPP exchange rates

Forecast

CHATHAM HOUSE
World: GDP and trade

Source: Oxford Economics

- World GDP at PPP exchange rates
- World trade
- World GDP at market exchange rates
- Forecast
Globalisation driving activity

- Global trade imbalances are one of the key drivers of capital flows
- Both trade and capital account flows are rising sharply - creating an ever greater need for financial market development around the world
- FDI, M&A and portfolio flows are all growing
- Asia and the Gulf are at the heart of the new boom
Capital flows and trade imbalances

- Global trade imbalances are one of the key drivers of capital flows.
- Net capital flows out of Asia, Russia and OPEC combined now amount to about $1 trillion per annum, reflecting their combined current account surplus - and the US current account deficit.
- In addition both in and outflows have increased - so total market activity is much higher.
- The US alone had a capital outflow of more than $1 trillion last year, although its inflow was larger at $1.7 trillion.
Global current account balances 2006

Source: Oxford Economics ($bn)
What capital flows?

- Capital account transactions are about a third portfolio flows, a third FDI with the rest mostly banking operations and FX management.

- The background to this is the rise in GLOBAL WEALTH and the increase in the proportion of this wealth that each country invests abroad.

- Major change from 20-30 years ago.
World financial wealth is growing (US$tr)
World financial wealth estimates for 2005

**EQUITY HOLDINGS**
- Listed $37 trillion
- Non-listed approx $15 trillion

**BOND MARKETS**
- Corporate $35 trillion
- Government $25 trillion

**CASH MONEY** = $50 trillion

**TOTAL FINANCIAL WEALTH** $162 trillion
- WORLD GDP $40 trillion
- US wealth is $53 trillion
- EZ is $35 trillion
- Japan is $32 trillion
- Rest of World is $42 trillion
Official reserves holdings

Source: Oxford Economics / Haver Analytics

Emerging Asia ex China
China
Japan
OPEC
Russia
Section 2
SWFs: definition and size
SWFs: a bit of history

- SWFs are not new: the first was established in 1953
- 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
- But only recently SFWs have become a big issue, particularly in policy circles
SWFs: a definition?

- There is no universally agreed definition of SWFs
- “A government investment vehicle which is funded by foreign exchange assets, and which manages these assets separately from official reserves”, Clay Lowery, Acting Under Secretary for International Affairs
- They need:
  - Sovereign; High foreign currency exposure; No explicit liabilities; High risk tolerance; Long investment horizon;
SWFs: growth rates and future size

- Over US$2 trillion currently held by SWFs
- Oil SWFs can easily grow by US$200-300 bn a year
- China’s SWF can grow by US$120-150 bn a year
- A total US$500 bn a year: SWFs bigger than the world’s total official reserves* in 5 years?

- * currently at US$6 tr
# Growing Government Investment Funds

<table>
<thead>
<tr>
<th>Country</th>
<th>Fund name</th>
<th>US$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td></td>
<td>2,279,866</td>
</tr>
<tr>
<td>UAE</td>
<td>ADIA</td>
<td>625,000</td>
</tr>
<tr>
<td>Norway</td>
<td>Gov Pension Fund - Global</td>
<td>322,000</td>
</tr>
<tr>
<td>Singapore</td>
<td>GIC</td>
<td>215,000</td>
</tr>
<tr>
<td>Kuwait</td>
<td>Kuwait Investment Authority</td>
<td>213,000</td>
</tr>
<tr>
<td>China</td>
<td>CIC</td>
<td>200,000</td>
</tr>
<tr>
<td>Russia</td>
<td>Stabilization Fund</td>
<td>127,500</td>
</tr>
<tr>
<td>Singapore</td>
<td>Temasek Holdings</td>
<td>108,000</td>
</tr>
<tr>
<td>Qatar</td>
<td>Qatar Investment Authority</td>
<td>60,000</td>
</tr>
</tbody>
</table>

Source: Morgan Stanley
SWFs: issues at stake

- Increasing strategic nature of these funds: a case of State Capitalism? (*Standard Chartered*)
- The surge in size and the likelihood that they will continue to grow
- Lack of transparency of most of them
- No ground rules regarding how SWFs should behave and what they can buy
- Risk of protectionism and market instability
SWFs: need for ground rules

- Level playing fields
- Best practice
  - Learn from Norway
- Avoiding collision between SWFs and host nations
- Code of conduct: western countries may need to accept the rise of SWFs as a further sign of a shift in the world economy and should seize this as an opportunity to work with economies such as China, Russia, the GCC etc
Section 3
Asia’s SWFs: targeting Europe?

*Is “everything up for grabs?”*
Asia’s SWFs: source and scale

- All non-commodities funds
- Only the funds of Singapore (both GIC and Temasek) and China have assets in excess of US$100 bn
- As a proportion of domestic GDP, the most important funds are those of Brunei and Singapore (both GIC and Temasek)
- The total assets of SWFs exceed the market capitalization of Asia’s stock exchanges (exc. Tokyo SE)
- The assets of the two Singaporean funds exceed the market capitalization of their domestic stock exchange
- The assets of CIC are 23% of the market capitalization of the Shanghai stock exchange
Size of SWFs compared to the market capitalization of selected stock exchanges

NYSE: 15421
Tokyo SE: 4614
Nasdaq: 3865
London SE: 3794
Euronext: 3708
Total SWFs: 2070
Hong Kong Exchange: 1715
TSX Group: 1701
Deutsche Borse: 1638
Shanghai SE: 918
Korea Exchange: 834
Bombay SE: 819
Total Asia's SWFs: 606.1
Taiwan SE: 595
Singapore Exchange: 384
Bursa Malaysia: 236
GIC: 215
CIC: 200
Warsaw SE: 149
Temasek: 108
Brunei IA: 30
KIC: 20
Malaysia: 17.9
Taiwan: 15.2

Sources: Oxford Analytica, Standard Chartered
## Estimated size of Asia’s SWFs (US$ bn)*

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

* Non-commodities SWFs
Is China the problem?

- The two Singaporean funds have been around long enough: medium transparency (GIC), high (Temasek), known investment policy and asset allocation.
- CIC: New kid on the block, potential expansion of fund size, low transparency, guesses on investment policy and asset allocation.
The economics of CIC and GPF

CIC

- ‘hurdle rate’: 8-10%
- Investment policy and asset allocation not disclosed
- Aggressive approach
- Wider focus by country (G20), asset class (PE funds, hedge funds, infrastructure funds), strategic investment

GPF

- No ‘hurdle rate’
- “high return subject to moderate risk”
- Since 1997: 4.58% NRAR
- Conservative approach
- Focus on developed countries, 50-70% of overall portfolio in fixed-income securities, 30-50% in equities
### FDI inflows, 2007-11 average

<table>
<thead>
<tr>
<th>Region</th>
<th>US$ bn</th>
<th>Rank</th>
<th>% world total</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU27</td>
<td>570.1</td>
<td>1</td>
<td>38.06</td>
</tr>
<tr>
<td>US</td>
<td>250.9</td>
<td>2</td>
<td>16.75</td>
</tr>
<tr>
<td>Asia</td>
<td>244.3</td>
<td>3</td>
<td>16.31</td>
</tr>
<tr>
<td>UK</td>
<td>112.9</td>
<td>4</td>
<td>7.54</td>
</tr>
<tr>
<td>China</td>
<td>86.8</td>
<td>5</td>
<td>5.79</td>
</tr>
<tr>
<td>France</td>
<td>78.2</td>
<td>6</td>
<td>5.22</td>
</tr>
<tr>
<td>Belgium</td>
<td>71.6</td>
<td>7</td>
<td>4.78</td>
</tr>
<tr>
<td>Germany</td>
<td>66.0</td>
<td>8</td>
<td>4.41</td>
</tr>
</tbody>
</table>

Sources: EIU, author’s calculations
## New FDI projects, top recipient countries

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>% change yoy</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>% world total</td>
<td>No.</td>
</tr>
<tr>
<td>EU27</td>
<td>3237</td>
<td>30.98</td>
<td>3848</td>
</tr>
<tr>
<td>Asia</td>
<td>2611</td>
<td>24.99</td>
<td>3272</td>
</tr>
<tr>
<td>China</td>
<td>1237</td>
<td>11.84</td>
<td>1378</td>
</tr>
<tr>
<td>India</td>
<td>590</td>
<td>5.65</td>
<td>979</td>
</tr>
<tr>
<td>US</td>
<td>563</td>
<td>5.39</td>
<td>725</td>
</tr>
<tr>
<td>UK</td>
<td>633</td>
<td>6.06</td>
<td>668</td>
</tr>
<tr>
<td>France</td>
<td>489</td>
<td>4.68</td>
<td>582</td>
</tr>
</tbody>
</table>

Sources: EIU, author’s calculations
FDI and M&A (1)

- The growth in global FDI in 2006, as well as in 2004-05, was in large part the result of very strong M&A activity, including cross border deals (which are the main form of FDI in the developed world).
- The increase in FDI inflows in 2006 was especially strong in developed economies - by more than 50%.
- Growth in FDI flows to emerging markets was more modest - by 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 2006.
FDI and M&A (2)

- FDI inflows in 2007 should be sustained by a strong global economy and the continued boom in crossborder M&A that occurred in H1 2007
- However, growth in 2007 in the global FDI total will be modest - USD1.5tr, representing 10% growth on 2006
- M&A activity will slow from 2005-06 levels. There will also be fewer privatisation opportunities in emerging markets compared with recent years
FDI and M&A (3)

- Completed crossborder global M&A surged by more than 50% yoy in the first half of 2007
- PE funds were willing to inject capital into all kinds of deals
- However, volatile financial markets will have a dampening impact on M&A activity in the second half of 2007 and into 2008
- Much of the M&A activity continues to be undertaken by strategic investors with healthy balance sheets and strong cash flows
Who invests in Europe

- Mainly US and Japan
- Significant increase in investment originated from the BRICs (from 102 in 2005 to 153 in 2006, +50%), *Ernst & Young*
- India: among the top 10 investors into Europe for the first time in 2006 (78 projects), most in UK
- China more beneficiary of FDI than investor
- Brazil and Russia: irrelevant
- Chinese investors set to increase their investment in Europe in 2008-09 (*InterLink Survey of 200 investors from Asia-Pacific*)
## FDI: Europe’s top destinations (1)

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

Source: Ernst & Young
FDI: Europe’s top destinations (2)

- UK and France at the top of the list
- Investment in other countries fell behind these market leaders
- Decline of the relative position of CEE because of (1) shift in importance between manufacturing and service sector investment; (2) limited appeal of CEE for service sector investment to date
- Western Europe features a large number of less labour-intensive projects
China outbound M&A, by sector in 2005

Source: Deutsche Bank/EIU
## Chinese investment in Europe

<table>
<thead>
<tr>
<th>Date</th>
<th>Target</th>
<th>Acquirer</th>
<th>Deal value (US$ml)</th>
<th>Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 2007</td>
<td>Barclays (2.64%, UK)</td>
<td>China Development Bank (CDB)</td>
<td>3000</td>
<td>Banking and finance</td>
</tr>
<tr>
<td>July 2007</td>
<td>British Gas (0.46%, UK)</td>
<td>CIC-PBOC</td>
<td>110</td>
<td>Energy</td>
</tr>
<tr>
<td>July 2007</td>
<td>Schwerin-Parchim Airport (100%, Germany)</td>
<td>Link Global Logistics</td>
<td>130</td>
<td>Infrastructure</td>
</tr>
<tr>
<td>March 2007</td>
<td>Mon terrico Metals (89.9%, UK)</td>
<td>Zijin Mining Group Co</td>
<td>94.6</td>
<td>Minerals</td>
</tr>
<tr>
<td>2007</td>
<td>Ridge Mining (29.9%, UK)</td>
<td>Zijin Mining Group Co</td>
<td>15.93</td>
<td>Minerals</td>
</tr>
<tr>
<td>July 2005</td>
<td>MG Rover (100%, UK)</td>
<td>Nanjing Automobile group</td>
<td>93</td>
<td>Automotives</td>
</tr>
<tr>
<td>2005</td>
<td>Thomson SA (joint-venture, France)</td>
<td>TCL Corporation</td>
<td></td>
<td>Consumer electronics</td>
</tr>
</tbody>
</table>
## Chinese banks targeting foreign banks

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

* Pending  

Source: Dealogic
# Major European banks

<table>
<thead>
<tr>
<th>Bank</th>
<th>Country</th>
<th>Market value US$bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>HSBC</td>
<td>UK</td>
<td>202.0</td>
</tr>
<tr>
<td>UBS</td>
<td>Switzerland</td>
<td>124.4</td>
</tr>
<tr>
<td>Royal Bank of Scotland</td>
<td>UK</td>
<td>122.5</td>
</tr>
<tr>
<td>Santander Central Hispano</td>
<td>Spain</td>
<td>111.2</td>
</tr>
<tr>
<td>Unicredito Italiano</td>
<td>Italy</td>
<td>99.0</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>France</td>
<td>97.0</td>
</tr>
<tr>
<td>Intesa SanPaolo</td>
<td>Italy</td>
<td>96.6</td>
</tr>
<tr>
<td>BBVA</td>
<td>Spain</td>
<td>86.9</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>Switzerland</td>
<td>86.7</td>
</tr>
<tr>
<td>ABN Amro</td>
<td>Netherlands</td>
<td>83.0</td>
</tr>
<tr>
<td>Societe Generale</td>
<td>France</td>
<td>79.4</td>
</tr>
<tr>
<td>HBOS</td>
<td>UK</td>
<td>77.1</td>
</tr>
</tbody>
</table>
Possible targets: countries

- Germany: manufactures and location, SMEs
- France: good, but obsession with ‘national champions’
- Italy: difficult, mainly financial sector, SMEs
- Netherlands: critical mass of firms in a number of sectors - notably telecoms, media, IT - resulting in ‘positive externalities’ that are likely to attract more investment in the sectors concerned
- Sweden: some key companies in key sectors, strong potential including competitive corporation tax
- UK: one of the world’s most attractive location
- CEE: not really attractive for Asia’s SWFs - too small mkts, no much technology transfer etc - but some exceptions like Poland
Concluding remarks

- SWFs are not a homogenous group
- Concerns in Europe and the US triggered by China’s activities
- CIC: ‘aggressive’ approach, most of assets in portfolio holdings, 10-15% in strategic stakes
- Limited targets for strategic investment in Europe: banking and finance, mining and metal, and the UK