FP
Foreign Policy

Singing in the Rain

How China's fund of billions prospered during the financial crisis -- and what that means for the future of Asia's fast-growing economic superpower.

BY ASHBY MONK, GORDON L. CLARK | JANUARY 20, 2010

In the coming months, the Chinese government is **expected to inject** another $200 billion into its sovereign wealth fund, the China Investment Corporation (CIC), bringing the fund's total capital base up to half a trillion dollars. This massive infusion of cash would make the CIC, which was only launched in 2007, one of the largest sovereign wealth funds (SWFs) in the world -- potentially ahead of long-established funds from Abu Dhabi, Kuwait, Norway, and Singapore.

The rapid ascent of the CIC proves that, despite the global financial turmoil, China's economic power is intact. In 2009, China **may have supplanted Japan** as the world's second-largest economy and edged past Germany as the world's leading exporter. Meanwhile, the country's foreign exchange reserves have continued to set records, recently reaching $2.4 trillion, almost all of which has been accumulated during this millennium.

In fact, rather than stemming the CIC's growth, the global financial crisis has had a profoundly positive effect on China's SWF. Although the fund struggled to overcome a series of managerial, financial, and geopolitical hurdles upon its creation, the financial crisis set the stage for a remarkable transformation. Now, the fund has matured into perhaps the world's largest and most influential strategic investor.

The CIC was unprepared for its mission in 2007, losing money hand over fist in the first year of its existence. Its investments in financial institutions were particularly poorly timed. In 2007, the CIC made high-profile investments in Blackstone and Morgan Stanley that were quite embarrassing for the fund, highlighting to some their naiveté. By the end of 2008, these investments were down 80 percent and 67 percent, respectively. This loss, though only on paper, engendered domestic debates about whether the CIC should even exist.

The CIC, and sovereign wealth funds in general, were also facing increasing skepticism in the West due to fears that it blurred the line between finance and politics. At the time, many worried that these types of funds would be **used illegitimately** to advance political and nationalist, as opposed to commercial, agendas. For example, some policymakers in Washington worried that the CIC was concealing attempts by the Chinese government to obtain technology, resources, or expertise to benefit national strategic interests. In the words of one U.S. Senate staffer who we interviewed, "What happens when you unleash communists into free market capitalism?"

This skepticism led several countries to consider new protectionist policies. At the time, Australia, Canada, France, Germany, Italy, the European Union, and the United States were all mulling new policies to constrain SWFs' access to their markets. The stakes were, thus, very high, as any new protectionist policies in the West would have had a significant impact on these funds' ability to invest in these markets and fulfill their objectives.

Back in 2007, there was also considerable skepticism regarding the ability of the CIC, and SWFs more generally, to manage money effectively. Indeed, in **our survey of sovereign wealth funds' own asset managers**, we found that most of the respondents thought that the funds' internal resources were not up to the requirements o a global asset manager. Specifically, asset managers believed that the funds' investment capabilities could be greatly improved. There was also a widespread perception that SWFs were being taken advantage of by money managers and investment bankers; the CIC's 2007 investments are perhaps illustrative of this. Finally, many felt SWFs weren't able to attract the necessary talent to be successful. Our friend Keith Ambachtsheer, professor of finance and director of the Rotman International Centre for Pension Management at the University of Toronto, actually called these funds "accidental financial tourists." Simply put, 2007 was a difficult year for SWFs in general, and many viewed the CIC as the poster child of what went wrong.

But today, the situation has changed. While nearly all market participants have been struggling for survival during the financial crisis, the CIC has prospered. Part of this has been luck. Morgan Stanley and Blackstone, which the fund bet on heavily in 2007, have recovered some of the losses they incurred in 2008. Furthermore, these errant investments saved the CIC even larger losses; the fund appears to have been placed on a "time-out" for almost all of 2008, which meant that the CIC only invested $4.8 billion in the catastrophic market conditions of that year.

The good luck continued into 2009, as the CIC was apparently let out of the penalty box and, according to its annual report, planned to invest upwards of $50 billion. Again, the timing couldn't have been better: With fire-sale prices on assets around the world, the CIC could take big stakes in discounted companies. After playing it safe in a year when playing it safe was brilliant, the CIC invested a huge amount of assets in a year when investing huge amounts of assets was brilliant. Although it is likely that the CIC benefited from luck (not foresight), it looks set to have incredible profits in the future.

The financial crisis also helped alleviate some of the CIC's international political problems. With blue-chip investment banks like Lehman Brothers and Bear Stearns going bankrupt, bank runs reminiscent of the Great Depression, and the world's largest financial institutions requiring government bailouts, who had time to worry about the CIC's motives? Furthermore, due to expansionary monetary policies in the West, the CIC has been able to invest in resource and commodity firms without drawing geopolitical attention. Indeed, inflation is now the major concern among institutional investors, and real assets offer a good hedge; the CIC has clearly been taking advantage of this. In a sense, the recession provided the CIC with cover to invest in a way that met both the fund's commercial needs and China's strategic goals.

The CIC also benefited from being one of the few active and growing funds within a shrinking community of investors. For example, the CIC has been the world's largest "strategic" investor in a market that has seen mergers and acquisitions activity collapse. As with any monopsony -- one buyer, many sellers -- the sellers are going to have their prices dictated by the buyer. In the CIC's case, it gets to dictate the fees it is willing to pay mergers and acquisitions service providers. Whatever the fee level, the service providers will continue providing services, as they have no choice. Accordingly, there have been reports of the CIC's "stingy" advisory fees; one Reuters article actually referred to the fund as a "**cheapskate**." Another interpretation would be that the fund is getting great *value for money*; it is receiving world-class services at rock-bottom prices.

In addition, the CIC has bolstered its human resources. With many finance professionals losing their jobs over the past few years, the fund has been able to pick up some serious talent that it might not have been able to afford pre-crisis. Indeed, the fund has had major hiring drives in the last two years and has even launched a **dedicated website** just for recruitment, a rare step for an SWF. In 2009, we think the CIC looks far more capable and savvy than it did in 2007.

The CIC's rise has provided countries that previously were doubtful about the benefits of SWFs to think again; academics such as Robert C. Merton have even called for the establishment of an American fund to underwrite the liquidity and stability of financial markets. Furthermore, it is now unlikely that we will see a return of Western suspicion and political gamesmanship regarding the motives of Asian and Middle Eastern SWFs that existed before the global financial crisis. Perhaps the crisis illustrated to many the benefits of having a fund that can underwrite a public purpose and **facilitate long-term planning**, when compared to the apparent failure of our politicians and financial institutions to look beyond the present election or fiscal quarter.

As the stormy financial conditions of the past two years have laid low many other global investors, the CIC has been singing in the rain. Although the fund still has hurdles to overcome, it is far ahead of where it was in 2007 due in large part to factors that were beyond its control. The CIC can thank the global financial crisis for clearing the table and facilitating its rise to prominence. This development promises to have implications for China's rising influence, and the position of sovereign wealth funds in the global economy, for years to come.

China Photos/Getty Images

Gordon L. Clark and Ashby Monk are co-directors of the ***Oxford SWF Project*** *at the University of Oxford.*