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A principal–agent analysis of China's sovereign wealth system: Byzantine by design

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ABSTRACT

The paper provides an explanation for a puzzling aspect of China's nascent sovereign wealth system, namely the ever-more obvious competition between China's officially designated sovereign wealth fund (SWF), the China Investment Corporation (CIC), and the foreign exchange reserve management agency, the State Administration of Foreign Exchange (SAFE). We outline an analytical framework which illuminates the various pathways by which state leaders seek to address a principal–agent problem common to all sovereign wealth funds. We suggest that state leaders select corporate governance regimes that mesh with what we call the state's 'governance endowments'. We then substantiate the claim that China's particular governance endowments have led China's leaders to embrace a corporate governance model premised on competition among the state's sovereign wealth investors. We trace the intense bureaucratic conflicts that shaped the creation of CIC and then show how SAFE was subsequently drawn into

competition with CIC in the area of high risk, high yield investment. Although China's SWF tournament emerged as a quite unintended consequence of bureaucratic politics, China's leadership has since tacitly endorsed this rivalry because it has supplied the government with valuable carrot and stick mechanisms with which to discipline fund managers.

KEYWORDS:

China Investment Corporation | State Administration of Foreign Exchange | sovereign wealth funds | principal–agent problem | corporate governance

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Notes

1 Kaufmann et al.'s (2008) governance measures cover 212 countries and aggregate data from 33 separate sources. The 'voice and accountability' score 'measure[s] perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media' (Kaufmann et al., 2008: 7)

2 This point is made well in a Wall Street Journal (2007) editorial which argues that CIC would have a hard time replicating Temasek's successes. The author argues that the insular Singaporean model would not take root in China: '[It'] may work ok in Singapore, where the civil service has a reputation for clean management. But China's bureaucracy has proved to be riddled with corruption. Party leaders are probably attracted to the Temasek model because their power rests on keeping a tight grip on information and capital. How profitably, and properly, will an opaque Chinese agency reporting to the State Council manage billions of dollars without public supervision.'

3 Our measures of Abu Dhabi transparency/accountability are not as strong as the others. In all the data sources we consulted, data sources for Abu Dhabi specifically (i.e. as separate from United Arab Emirates) were not available so we have used the UAE measures. We think this is reasonable especially considering that Abu Dhabi is the most powerful emirate in the UAE. Unfortunately, the Institutional Profiles Database data, the only data source we found that includes direct measures of government transparency, did not collect data from UAE.

4 The EIU Democracy Index is based on five categories: electoral process and pluralism; civil liberties; the functioning of government; political participation; and political culture. The index categorizes countries in terms of four types: full democracies; flawed democracies; hybrid regimes; and authoritarian regimes. The CHECKS variable counts "the number of veto players in a political system, adjusting for whether these veto players are independent of each other, as determined by the level of electoral competitiveness in a system, their respective party affiliations, and the electoral rules" (Beck et al., 2001: 170). Since countries that do not hold competitive legislative elections are assigned the minimal score of one, the CHECKS variable does not capture contestation in authoritarian systems. For political systems with competitive elections, the CHECKS variable increases by the number of veto players in the system and adjusts for differences between presidential and parliamentary systems.

5 Conceived during the turmoil of the Asian financial crisis in 1997, these special meetings of the State Council are held every five years and are occasions for setting the framework of broad financial policy reforms.

6 Bank recapitalization, it is worth noting, was yet another source of discord between the MoF and PBoC. Due to concern about loss of influence to PBoC (via Huijin), the MoF which had been sole shareholder in the Big Four commercial banks prior to the creation of Huijin, is reported to have successfully lobbied for much smaller Huijin capital injections into the Industrial and Commercial Bank of China (ICBC) and Agricultural Bank of China (ABC) (Green, 2007). (The tab for Huijin's recapitalization of ICBC came to only US $15 billion and left MoF and Huijin each with 50 per cent of the bank's equity prior to listing.)
