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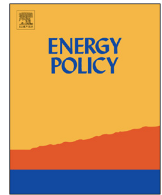

China's Sovereign Wealth Fund Investments in overseas energy: The energy security perspective

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HIGHLIGHTS

- Sovereign Wealth Funds (SWFs) are government-owned and may pursue geopolitical power.
- SWF investment in energy is necessary for commercial and strategic interests.
- China's SWFs are active in energy investment to support a "going global" strategy.
- Sovereign rights are inevitable to integrate the strategic property of energy.
- SWF investments in energy suffer negative impacts due to sovereign rights.

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ABSTRACT

Sovereign Wealth Funds (SWFs) are state-owned investment funds that invest in real and financial assets. Since the global financial crisis in 2008, SWFs' investments have resulted in national security concerns of host countries because SWFs continue to expand rapidly and have become increasingly active in real-time strategic transactions. Given this background, China, which has the biggest SWF in the world, is facing severe challenges of energy resources shortages while its plan is to accomplish social and economic development goals. Energy security is a key driving force of the energy investment policy of China's SWFs. This makes the SWF investments more complicated and more politically sensitive. The combination of sovereign rights and the strategic importance of energy also makes geopolitics more complicated and brings more uncertainty to SWF investments. This article explores the relationship between energy security and energy investments of China's SWFs. It is recognised that the energy investment of SWFs must follow a sustainable path to coordinate energy security, economic growth, return on investment and national security concerns. Government policymakers are urged to balance the financial and political returns on SWFs against potential negative effects. The conclusion presents insights for policymakers, energy scholars and SWF researchers.

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1. Introduction

Sovereign Wealth Funds (SWFs) have experienced a surge of growth because of imbalances in global trade as well as high commodity prices. However, the debate on policy issues arising from the growth of SWFs is a relatively new subject for academia (Dewenter et al., 2010; Nie et al., 2010; Nilsen, 2010; Raymond, 2010; Reiche, 2010; Kotter and Lel, 2011; You and Han, 2011; Knill et al., 2012a, 2012b). SWFs are largely motivated by the need for ensuring stability and security of a nation. Many SWFs incurred large losses during the current global financial crisis (2008–2013) and since then they have begun to seek long-term returns, externalities and societal benefits rather than short-term cost benefits (Clark, 2012). Energy has been a favourite sector for SWF investment because of limited supply and long-term profitability (Nilsen, 2010; Reiche, 2010; You and Han, 2011). China's SWF has also committed to improving its portfolio by increasing investment in energy resources, which offers an additional solution for concerns about China's energy security. Meanwhile, China's SWF has also triggered some international geopolitical concerns and thus China faces varying limitations in different countries. This makes investment in energy by China's SWF more complicated and very politically sensitive. Spontaneously, for China the questions that arise are how do SWF investments influence energy security and whether energy investments impact SWFs operations. And if so, how and what are these impacts both in China and in other nations?

Internationally, the rapid growth of SWFs and the sizes they have attained suggest that they are becoming an increasingly important class of investors. Globally, assets under the control of SWFs increased

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from $500 billion in 1990 to about $4.0 trillion in 2009. However, since then, they have risen even further to approximately $5.78 trillion (July 2013).[1] High oil revenues and trade surplus have resulted in several countries setting up SWFs and several others are contemplating establishing their own SWFs (Kotter and Lel, 2011). Thus, SWFs are expected to expand significantly in the near future (Johnson, 2007; Jen, 2007; Butt et al., 2008; Preqin, 2009; Kotter and Lel, 2011; and the Sovereign Wealth Fund Institute's statistics). At present, the operations of SWFs are highly concentrated in and are dominated by three types of countries: Arab oil-producing countries (Abu Dhabi, Algeria, Dubai, Kuwait, Libya, Qatar and Saudi Arabia), non-Arab oil-producing countries (Norway and Russia) and emerging East Asian economies (China, Hong Kong and Singapore). Within them, China has the biggest SWF and its operations attract special attention from host countries due to financial and political considerations.

Since SWFs are at the intersection of high finance and high politics, they signal a different kind of reassertion of state authority in the markets. SWFs have been identified as the most important new 'power brokers' in the world (Roy, 2007; Farrel et al. 2007, 2008; Drezner, 2008). Their striking growth and development in recent years have raised tricky challenges and potentially controversial questions of countries operating in the global capital markets. Individual countries' SWF operations are driven by the desire to promote economic prosperity by safeguarding opportunities for productive international investment since it is the responsibility of every government to ensure its economic security. Therefore, global capital governance has to experience the 'great trade-off' between sustaining the openness of capital markets and the legitimate national security concerns of individual host countries (Cohen, 2009). Meanwhile, the role played by the state in the capital market has made global capital governance a game between state interests, private corporations and geopolitical power, which will continue in all nations as the relationships between governments and businesses need to continue as they have historically in all nations. The public and private sectors need to collaborate for the benefit of each nation and others around the world (Clark and Li, 2010).

More importantly, SWFs have given rise to national security concerns from the very beginning since they have been viewed as inseparable from the interests of the state. Naturally, these funds have accumulated much power and influence in the financial and political world (Backer, 2009; Nilsen, 2010). Meanwhile, fears of strategic and political usage of SWFs can provoke 'financial protectionism' in recipient economies as they can prove to be detrimental to host countries in some ways (Cohen, 2009; Pekkanen and Tsai, 2011). Some observers agree with Drezner (2008) that fears of SWF investments were initially overstated. However, most studies accept that SWFs are managed by state-affiliated entities with geostrategic motives and they might be deployed for the pursuit of geopolitical objectives and cause shifts in geopolitical power distribution (Gerard, 2007).

Fears of industrial espionage and geopolitical threats originate from commercial considerations or are driven by political or foreign policy considerations (Reisen, 2008). This gives rise to some legitimate national security concerns, which finally convert into policy motives in practice. The policy responses on foreign investments affecting national interests are summarised in Cohen (2009); this covers the USA, European Commission, Canada, Australia, Japan and France. The number of countries that feel concerned about SWF investments is rising and some countries have issued specific regulations to supervise or restrict operations of and investments by such government-linked entities. Additionally, investments of China's SWF in energy highlight the fears that they would become a vehicle to realise China's geopolitical purposes.

[1] Statistics of Sovereign Wealth Fund Institute, http://www.swfinstitute.org.

Energy security is viewed by some leaders as a bottleneck for the economic and socially sustainable development in China. According to British Petroleum (BP) statistics, import dependence in oil was more than 55% in 2011 and about 58% in 2012.[2] In order to secure energy supplies, China's overseas investments in energy have been increasing. It may be said that every investment or co-operation in energy suffers from geopolitical considerations due to the strategic nature of energy. As a new powerful investment, China's SWF has increased overseas investments in energy and the investment projects were almost completely related to energy in 2010, 2011 and 2012.[3]

For China, the SWF is a tool to be used in the energy field, in addition to investments by state-owned enterprises (SOEs), and it should play a more active role in the future. However, there are some debates and even fears have been expressed because of rising investments by China's SWF. In this article, we do not judge these debates or fears, but attempt to investigate SWF overseas investments in energy and its possible influence on energy security.

Centring on the questions and issues outlined above, the rest of the article is organised as follows. In Section 2, the historic bond between energy and SWFs is examined, which offers a logical foundation for the follow-on analysis and discussion. Next, the development of China's SWF in the energy field is investigated in Section 3; and then the authors reflect on 'China's SWFs influences on energy security' and 'Energy investments' impact on China's SWFs operations' in Sections 4 and 5. Finally, in the last Section (6), some policy implications are provided.

2. Energy and SWFs

Due to the diversity of sources, objectives and management structure of the SWFs, there is no widely accepted definition of SWFs to date (Rozanov, 2005; OECD, 2008; International Monetary Fund (IMF), 2008). After the term 'Sovereign Wealth Funds' was first coined by Rozanov (2005), the International Monetary Fund (IMF) (2008) defined the SWFs as "government investment vehicles funded by foreign exchange assets, which manage those assets separately from official reserves," and similar definitions are subsequently given. As the most controversial players, SWFs are widely diversified, without a uniform pattern. Each one is unique and the difference lies in its capital size, complexity, risk preferences, as well as transparency in management and operations, in addition to the impact of the state system and national interests.

After the first oil crisis in the 1970s, major oil-exporting countries set up their own SWFs because of concerns on depletion of oil resources. In the 1990s, emerging Asian nations quickly followed with their economic development, mainly on the back of exports and accumulated abundant surplus of foreign exchange reserves (FERs). The SWFs of Norway, Russia, Saudi Arabia, Kuwait, Abu Dhabi, Qatar, Alaska and elsewhere derive their investment capital mainly from petroleum revenues. Other countries, such as China and Singapore, have amassed substantial foreign currency reserves by running persistent current account trade surpluses that are unrelated to oil exports. Nevertheless, SWFs share at least three elements in common: (1) SWFs are state-owned, (2) they have no significant liabilities and (3) they are managed separately from the rest of the central bank's reserves (Beck and Fidora, 2008). Generally speaking, SWFs, in nature, are government-owned or controlled funds operated as the government's investment tools, in order to achieve a series of economic and political objectives.

[2] Calculated by the authors based on Statistical Review of World Energy 2011 and 2012, which were published by British Petroleum (BP).

[3] Listed in Table 2.

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