U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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STATEMENT BY DEPUTY ASSISTANT SECRETARY FOR ASIA ROBERT DOHNER BEFORE THE U.S. - CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, DC—Chairman Wortzel, members of the Commission, thank you for the invitation to speak to you today about sovereign wealth funds and the activities of the Treasury.

History and Context

Sovereign wealth funds are not new. The oldest date from the 1950s. By the year 2000, there were about 20 sovereign wealth funds worldwide managing total assets of several hundred billion dollars.

Today, what is new is the rapid increase in both the number and size of sovereign wealth funds. Twenty new funds have been created since 2000, more than half of these since 2005, which brings the total number to nearly 40 funds that now manage total assets in a range of $1.9-2.9 trillion. Private analysts project that sovereign wealth fund assets could grow to $10-15 trillion by 2015. Two trends have contributed to this growth. The first is sustained high commodity prices. The second is the accumulation of official reserves and the transfers from official reserves to investment funds in non-commodity exporters. It should be noted, that within this latter group of countries, foreign exchange reserves are now sufficient by all standard metrics of reserve adequacy. For these countries, more flexible exchange rates are necessary, and Treasury actively pushes for increased flexibility.

To get a better perspective of the relative importance of sovereign wealth funds it is useful to consider how they measure up against private pools of global capital. Total sovereign wealth fund assets of $1.9-2.9 trillion are only a fraction of the $190 trillion stock of global financial assets or the roughly $53 trillion managed by private institutional investors. But sovereign wealth fund assets are currently larger than total assets under management by either hedge funds or private equity funds, and are set to grow at a much faster pace.

At the Department of the Treasury, we have defined sovereign wealth funds as government investment vehicles funded by foreign exchange assets, which manage those assets separately from official reserves. Sovereign wealth funds generally fall into two categories based on the source of the foreign exchange assets:

- Commodity funds are established through commodity exports, either owned or taxed by the government. They serve different purposes, including stabilization of fiscal revenues and the preservation of natural resource wealth for future generations.

- Non-commodity funds are typically established through transfers of assets from official foreign exchange reserves. Large balance of payments surpluses have enabled non-commodity exporting countries to transfer "excess" foreign exchange reserves to stand-alone funds. To prevent balance of payments surpluses from leading to inflationary growth in the money supply, countries often borrow domestically the currency they need to purchase foreign exchange inflows. The cost of this process of "sterilization" is the domestic interest rate, and non-commodity sovereign wealth funds often face pressure to generate returns that exceed the domestic borrowing cost.

Sovereign wealth funds are already large enough to be systemically important, and their growth clearly has implications for the international financial system. Sovereign wealth funds bring benefits to the system, but also raise potential concerns.

Benefits

A useful starting point in evaluating sovereign wealth funds is to recognize the benefits of foreign investment. On May 10, 2007, President Bush publicly reaffirmed the longstanding U.S. commitment to advancing open economies at home and abroad, including through open investment and trade. Lower trade and investment barriers benefit not only the United States, but also the global economy as a whole.

In 2006, there was a net increase of $1.9 trillion in foreign-owned assets in the United States. International investment in the United States fuels U.S. economic prosperity by creating well-paid jobs, importing new technology and business methods, and providing healthy competition that fosters innovation, productivity gains, lower prices, and greater variety for consumers. Over 5 million Americans – 4.6 percent of the U.S. private sector – are employed by foreign-owned firms' U.S. operations. These 5 million jobs pay 25 percent higher compensation on average than jobs at other U.S. firms. Additionally, foreign-owned firms contributed almost 6 percent of U.S. output and 14 percent of U.S. R&D spending in 2006.

Sovereign wealth funds are an additional source of foreign investment for the United States and many other economies. And, as many observers have pointed out, sovereign wealth funds have the potential to promote financial stability. They are, in principle, long term, stable investors that provide significant capital to the system. They are typically not highly leveraged and cannot be forced by capital requirements or investor withdrawals to liquidate positions rapidly. Sovereign wealth funds, as public sector entities, should have both an interest in and a responsibility for financial market stability.

Potential Concerns

However, sovereign wealth funds also raise potential concerns. Most importantly, there is a risk that the rise of sovereign wealth funds could provoke a new wave of investment protectionism, which would be very harmful to the global economy. Protectionist sentiment could be partially based on a lack of information and understanding of sovereign wealth funds, in part due to a general lack of transparency and clear communication on the part of the funds themselves. Better information and understanding on both sides of the investment relationship is needed.

Second, transactions involving investment by sovereign wealth funds, as with other types of foreign investment, may raise legitimate national security concerns. The new Foreign Investment and National Security Act (FINSA) signed into law by President Bush last summer, and implemented through the Committee on Foreign Investment in the United States (CFIUS), ensures thorough reviews of investment transactions that pose genuine national security concerns, and requires heightened scrutiny of foreign government-controlled investments. CFIUS is able to review investments from sovereign wealth funds just as it would other foreign government-controlled investments, and it has and will continue to exercise this authority to ensure national security.

Treasury is also considering non-national security issues related to potential distortions from a larger role of foreign governments in markets, for example, through inefficient allocation of capital, perceived unfair competition with private firms, or the pursuit of broader strategic rather than strictly economic return-oriented investments. Clearly both sovereign wealth funds and the countries in which they invest will be best served if investment decisions are made on solely commercial grounds.

Finally, sovereign wealth funds may raise concerns related to financial stability. Sovereign wealth funds represent large, concentrated, and often non-transparent positions in certain markets and asset classes. Actual shifts in their asset allocations can cause market volatility. In fact, even perceived shifts or rumors can cause volatility as the market reacts to what it perceives sovereign wealth funds to be doing.

Treasury Activities

Treasury has taken a number of steps to help ensure that the United States can continue to benefit from open investment, including by sovereign wealth funds, while addressing these potential concerns.

First, Treasury and in other CFIUS agencies are aggressively implementing the Foreign Investment and National Security Act of 2007 (FINSA) to protect our national security.

Second, we have proposed that the international community collaborate on a multilateral framework for best practices for sovereign wealth funds. The International Monetary Fund, with support from the World Bank, should develop best practices for sovereign wealth funds, building on existing best practices for foreign exchange reserve management. These would provide guidance to new funds on how to structure themselves, reduce any potential systemic risk, and help demonstrate to critics that sovereign wealth funds can continue to be responsible, constructive participants in the international financial system.

Third, we have proposed that the Organization for Economic Cooperation and Development (OECD) should identify best practices for countries that receive foreign government-controlled investment, based on its extensive work on promoting open investment regimes. These should have a focus on avoiding protectionism, and should be guided by the well-established principles embraced by the OECD and its members for the treatment of foreign investment.

We have already seen meaningful progress along these lines. Following extensive Treasury discussions with government officials and individual sovereign wealth funds, Secretary Paulson hosted a G-7 outreach meeting on October 19 with Finance Ministers and heads of sovereign wealth funds from eight countries (China, Korea, Kuwait, Norway, Russia, Saudi Arabia, Singapore, and the United Arab Emirates) to build support for developing best practices. The next day, the IMFC – a ministerial level advisory committee to the IMF – issued a statement calling on the IMF to begin a dialogue to identify best practices for sovereign wealth funds. The IMF held a special session at a Sovereign Asset and Reserve Managers Roundtable on November 15-16 to begin this dialogue.

Fourth, Treasury has taken a number of steps internally and within the U.S. Government to enhance our understanding of SWFs. Treasury has created a working group on sovereign wealth funds that draws on the expertise of Treasury's offices of International Affairs and Domestic Finance. The President's Working Group on Financial Markets, chaired by Secretary Paulson, has initiated a review of sovereign wealth funds. We are cognizant that national authorities have an important role to play in understanding and addressing sovereign wealth fund issues. Securities regulators should treat these funds as they would any large institutional investor.

Treasury is also actively consulting with Congress through staff briefings and committee hearings. Under Secretary David McCormick testified in front of the Senate Banking Committee in November. We informed Congress in June of some of our initial thinking on sovereign wealth funds in an appendix to the Report on International Economic and Exchange Rate Policies, and provided an update in the December report.

The Treasury Department will continue its work on and engagement with sovereign wealth funds so that we effectively address legitimate areas of concern while ensuring that the United States and other nations remain open to foreign investment. We will also continue our work with multilateral institutions and directly with the major sovereign wealth funds to develop best practices applicable to sovereign wealth funds and foreign investment recipients.

China Investment Corporation

Since the particular interest of this Commission is China, let me say a few words about China's sovereign wealth fund.

China's sovereign wealth fund, the China Investment Corporation (CIC), is an example of a non-commodity fund. CIC was created to diversify management of a portion of China's rapidly growing foreign exchange reserves, which have grown to $1.5 trillion.

China's reserve accumulation is the result of a pattern of growth that depends heavily on exports and investment. This model has produced economic growth to date, but has led to large internal imbalances, a large and growing current account surplus, and this model is not sustainable in the future. Consumption has been restrained by a falling share of household income in GDP, and by households' high needs for precautionary saving.

The imbalances that have been created and the need to rebalance the sources of Chinese economic growth have been a key part of the discussions of the Strategic Economic Dialogue with China. We have argued strongly, and the Chinese recognize, that they must shift to a model of growth that depends more on domestic consumption. This will lead to smaller current account surpluses and to more sustainable growth. It is important that China take effective steps to strengthen the social safety net, provide a greater range of financial services to households, and increase the payment of dividends by state-owned companies to bring this rebalancing about. A more flexible currency will play a key role in facilitating this adjustment. It is important that China move more rapidly to increase renminbi (RMB) flexibility. China should not use the earnings of its sovereign wealth fund to delay the continued increase in the flexibility of China's currency.

The Chinese government decided in January 2007 to create a sovereign wealth fund, and the China Investment Corporation, Ltd. (CIC) was officially launched on September 29, 2007 with $200 billion in registered capital. Former Vice Minister of Finance Lou Jiwei was appointed Chairman. In his inaugural speech, Chairman Lou announced two goals for the CIC -- improving investment returns on foreign exchange reserves and managing reform and recapitalization of domestic financial institutions.

Two thirds of the assets of the CIC – about $133 billion – have been dedicated to the recapitalization of Chinese domestic financial institutions. In October 2007, the People's Bank of China (China's central bank) transferred ownership of Central Huijin Investment to CIC in exchange for $67 billion. Central Huijin is the holding company that manages the government's stakes in commercial banks and securities firms. In addition, CIC is reportedly planning to spend an additional $67 billion to recapitalize domestic banks, and announced a $20 billion capital injection into China Development Bank and $3 billion into China Everbright Bank in late 2007. The Agricultural Bank of China has been identified as a future candidate for capital injection.

According to public comments by Chinese officials, the remaining one-third of CIC's assets, or $67 billion, has been allocated for overseas investment. CIC has so far made three offshore investments, and is reportedly recruiting external asset managers to help manage its offshore portfolio.

CIC's first overseas investment was a $3 billion stake, of less than 10 percent of outstanding shares, in U.S. private equity firm Blackstone Group LP in May 2007. Second, CIC bought $100 million in shares of China Railway Group at their Hong Kong IPO in November 2007, amounting to a 4 percent stake. Third, on December 20, 2007, CIC announced its plan to invest $5 billion in Morgan Stanley, for an ownership stake of no more than 9.9 percent of Morgan Stanley's total outstanding shares.

Chinese official statements have characterized the objectives of CIC as commercial. Chairman Lou said that CIC's investments "will be focused on financial portfolios, aiming to improve long-term investment returns while keeping risks in an acceptable range." China's Premier Wen said in January that CIC's investments abroad will be "entirely commercial" and that CIC will be "open and transparent". Chairman Lou has also acknowledged that CIC is expected to earn returns sufficient to cover the costs of the RMB bonds issued by China's Ministry of Finance to capitalize the CIC, bonds whose yields are between 4.3 and 4.6 percent.   It is important that CIC be organized and that it operate on a commercial basis, as China's leaders have claimed. We will continue to work with CIC and other SWFs and watch their activities vigilantly.

Treasury has been actively engaged with China's leadership on the issues of sovereign wealth funds and investment since the announcement of CIC. We have maintained close contact with CIC's leadership and China's economic policy makers on these issues. We have encouraged China to participate in the drafting of voluntary international best practices for sovereign wealth funds that is being coordinated by the International Monetary Fund. Particularly important is China's commitment to pursuing a high level of transparency for CIC.

The rapid growth in size and number of sovereign wealth funds presents important issues. Treasury has led the international effort to deal with the concerns posed by sovereign wealth funds. We believe the development of best practices for SWFs, coupled with existing CFIUS authority and the authority that our financial regulators have to protect market integrity provide the most effective way of addressing these concerns while maintaining the benefits of open investment in the United States and globally.

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