

Testimony before the U.S.–China Economic and Security Review Commission: Implications of Sovereign Wealth Fund Investments for U.S. National Security

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Overview

First conceived in the 1950s by foreign governments as a means to invest surplus foreign exchange earnings in the U.S. and markets elsewhere around the world, sovereign wealth funds (SWFs) are falling under growing scrutiny as their number and potential economic clout increase. Since 2000, the number of these state-owned funds has nearly doubled from 20 to almost 40 funds managing an estimated \$1.9 trillion–\$2.9 trillion of global assets.¹ Analysts forecast that sovereign wealth funds could grow along with the global market to about \$10 trillion–\$12 trillion by 2015.²

The size of these funds can be difficult to estimate because governments generally don't disclose information about the funds' assets, liabilities, or underlying investment strategy. While this makes it hard to assess the impact that such funds could have on the global economy, it is not likely that sovereign wealth funds have enough power to dictate the financial fate of the world's economy. Even the higher estimate of almost \$3 trillion of assets now being managed by these funds is but a fraction of all global investment, which is conservatively estimated at around \$165 trillion.³

However, there is mounting concern—fed by the lack of transparency—that these government-owned investment funds could be used to advance a political as well as economic agenda. If sovereign investors manage assets to promote more than a healthy return on investment, then asset prices in countries receiving sovereign capital may not reflect market fundamentals, and resources will not be allocated efficiently—exactng a real cost on the economies involved.⁴ Moreover, some fear that rather than use these funds as a means to hold a diversified asset portfolio and earn a solid return on investment, countries might instead use these funds to destabilize financial markets, protect industries and companies, or even expropriate technology.

With little public information available on most sovereign investors' financial objectives, countries—including the U.S.—are increasingly uncertain about the real benefits of receiving investment from these funds and worry that they instead represent a growing

¹ Simon Johnson, "The Rise of Sovereign Wealth Funds," International Monetary Fund, September 2007, at www.imf.org/external/pubs/ft/fandd/2007/09/straight.htm (January 30, 2008).

² *Ibid.*; Stephen Jen, "Currencies: How Big Can Sovereign Wealth Funds Be by 2015," Morgan Stanley Global Research, May 3, 2007.

³ Johnson, "The Rise of Sovereign Wealth Funds."

⁴ Christopher Cox, "The Rise of Sovereign Business," speech presented at the American Enterprise Institute Legal Center for the Public Interest, December 5, 2007, at www.sec.gov/news/speech/2007/spch120507cc.htm (January 30, 2008).

threat to their economic and national security. France and Germany have already declared their intention to block state-owned funds from investing in their economies.⁵

However, it is important to remember that such funds have been in operation for some time and that there is little evidence indicating that nations use their sovereign wealth funds to intentionally cause harm to the countries and firms they invest in. Furthermore, open and competitive markets are quick to punish any investor, sovereign or otherwise, that would mismanage their holdings. Few governments—even those with highly questionable free-market credentials—intentionally allocate scarce resources to gain control of an asset for the sole purpose of destroying the value of that asset and reducing their own wealth.

Of course, there is always the chance that a country could decide that political objectives outweigh the economic cost of using its sovereign wealth inappropriately. It is against this chance that policymakers are considering erecting costly protectionist barriers to sovereign investment flows. The predominance of the issue in the media has driven home the need for sovereign investors and countries that receive sovereign investment to engage in a meaningful debate about these funds and the role they play in financial markets—a debate that is now occurring both in the International Monetary Fund (IMF), World Bank, and Organization for Economic Cooperation and Development (OECD) and within governments. With greater understanding of the real issues surrounding sovereign wealth funds, policymakers can respond more effectively to the need to balance their economic security and open markets with national security concerns.

Sovereign Wealth Funds

The U.S. Department of the Treasury defines a sovereign wealth fund as a “government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities.”⁶ There are two general categories of sovereign wealth funds, based on the source of the foreign exchange assets.⁷

The first, often referred to as a *commodity sovereign wealth fund*, is financed by surplus foreign exchange earnings from commodity exports owned or taxed by the government.⁸ When commodity prices run high, as we are seeing most clearly in today’s oil market, exporters enjoy significant earnings gains that can stoke domestic inflation. When commodity prices collapse, the impact on countries that rely on export earnings as a primary source of government revenue can be very costly. Sovereign wealth funds are a mechanism that can be used to smooth the effects of volatile prices on revenue flows, as

⁵ Rick Carew, Marcus Walker, Chip Cummins, and Katharina Bart, “Barriers to Entry,” *The Wall Street Journal*, January 15, 2008, p. C1.

⁶ U.S. Department of the Treasury, *Semiannual Report on International Economic and Exchange Rate Policies*, June 2007.

⁷ Robert M. Kimmett, “Public Footprints in Private Markets,” *Foreign Affairs*, January/February 2008.

⁸ *Ibid.*

well as to spread the wealth generated by a country's natural resources across generations in an equitable manner.⁹

The second, known as a *noncommodity SWF*, is financed through excess foreign exchange assets accumulated as a consequence of running persistent current account surpluses.¹⁰ Of special concern to U.S. policymakers is China's recent creation of its own sovereign "noncommodity" wealth fund—the China Investment Corporation (CIC)—in September 2007. Prior to establishing the CIC, China generally invested its surplus foreign exchange holdings in U.S. government debt. This enabled China to earn a low but relatively risk-free return on its invested reserves and benefited the U.S. economy by pushing down interest rates and lowering the cost of borrowing for U.S. households and firms. With the CIC, China will have the opportunity to earn higher returns on a more diversified portfolio.

Allocated an initial \$200 billion of China's excess foreign exchange reserves, the CIC is one of the world's largest SWFs after the United Arab Emirates' Abu Dhabi Investment Authority, with an estimated \$875 billion in assets; Norway's Government Pension Fund—Global, which holds \$380 billion in assets; the Government of Singapore Investment Corporation, which holds an estimated \$330 billion in assets; and Kuwait's Reserve Fund for Future Generations, which holds an estimated \$250 billion in assets.¹¹

Of the \$200 billion allocated to the CIC, \$3 billion has so far been invested in non-voting shares in Blackstone Group LP, and another \$5 billion has been invested in Morgan Stanley.¹² Much of the rest of the initial financing has been used for domestic purposes, leaving about \$70 billion for future investments.¹³ While China has publicly committed to the transparent, commercially driven operation of the CIC, using the bulk of its financing to help restructure two state-owned banks (among other internal investments) raises legitimate questions about the role that government interests may play a role in how the fund functions.¹⁴ Even if the CIC's international investments are genuinely based on commercial considerations alone, using portions of the fund for politically

⁹ Deutsche Bank Research, "Sovereign Wealth Funds—State Investments on the Rise," *Current Issues*, September 10, 2007.

¹⁰ Kimmitt, "Public Footprints in Private Markets."

¹¹ Jen, "Currencies: How Big Can Sovereign Wealth Funds Be by 2015." Saudi Arabia also invests about \$300 billion in surplus foreign exchange reserves; however, the funds are not technically a sovereign wealth fund as they are managed by its central bank together with its reserves.

¹² Cathy Chan and Josephine Lau, "China's Blackstone Investment 'All About Returns,'" Bloomberg.com: Asia, at www.bloomberg.com/apps/news?pid=20601080&sid=a0cQhqkoUq3s&refer=asia (January 30, 2008), and David Wighton, "Morgan Stanley Taps China for \$5bn," *Financial Times*, December 19, 2007, at www.ft.com/cms/s/0/294ed78a-ae3a-11dc-97aa-0000779fd2ac.html (January 30, 2008).

¹³ Michael F. Martin, "China's Sovereign Wealth Fund," Congressional Research Service *Report to Congress* RL34337, January 22, 2008.

¹⁴ One-third of CIC's financing was used to purchase Central Huijin, which controls China's major state-owned commercial banks, and another one-third was used to recapitalize the Agricultural Bank of China and the China Development Bank, leaving the remaining one-third for investment in global financial markets. "China Investment Corporation Unveils Investment Plan," Xinhua News Agency, November 7, 2007, at www.china-embassy.org/eng/xw/t379014.htm (January 30, 2008).

driven domestic investments undermines China's claim that the CIC will be a passive global investor.

And that claim may not be far from the truth. China has stated that it would take a cautious approach to its sovereign investment, staying away from sensitive foreign transportation, energy, and telecommunications assets.¹⁵ Moreover, the CIC's investment in Blackstone Group has performed poorly, sparking public criticism of the CIC and potentially pushing China into a more risk-averse stance toward investment.¹⁶ The recent move by China to pull out of a planned investment in Citigroup seems to support the idea that China will not be investing its sovereign wealth in either the U.S. or world's markets aggressively any time soon.

Sovereign Wealth and U.S. National Security

Issues of corporate governance, transparency, and financial market openness plague many of the countries that rely most actively on sovereign wealth funds as a means to invest foreign exchange earnings. Uncertainty over the investment strategies underlying these funds and the concern that these funds could be manipulated to disrupt the U.S. economy or expropriate sensitive technologies increase with each new story about an American asset coming under foreign ownership. China's Blackstone and Morgan Stanley investments were no different.

However, the biggest threat to U.S. economic and national security is not foreign sovereign wealth investment from China or any other country; rather, it is the increasing threat that the U.S. will adopt protectionist investment policies. The notion that merely precluding foreign ownership of U.S. assets offers a measure of security is flawed. Erecting barriers to foreign investment would stifle innovation, reduce productivity, undermine economic growth, and cost jobs—all without making America any safer. The government's role is not to dictate how the marketplace operates, but to perform due diligence to ensure that vital national interests are preserved.

U.S. policymakers need to remember that America already has the banking, investment, export controls, and other regulatory mechanisms in place to help reduce the risk associated with foreign ownership of critical assets while still promoting the economic benefits that come from foreign investment. Additionally, the President's Working Group on Financial Markets discusses sovereign wealth issues, and the U.S. Department of the Treasury has established a working group to discuss and monitor sovereign wealth fund activity. With such a heightened sense of awareness concerning SWFs, it is unlikely that risky transactions will fail to attract scrutiny.

The U.S. Committee on Foreign Investments in the United States (CFIUS) provides an objective, nonpartisan mechanism to review and, if necessary, block risky foreign government investments that may have security implications for the United States. Updating CFIUS to strengthen the evaluation of foreign government investment in the U.S. is Public Law 110-49, the Foreign Investment and National Security Act of 2007

¹⁵ *Ibid.*

¹⁶ Carew *et al.*, "Barriers to Entry."

(FINSAs), which mandates additional CFIUS scrutiny of potential transactions where a foreign government, or an entity controlled by a foreign government, seeks to acquire a U.S. asset. Additionally, the President or CFIUS may consider the potential for transshipment or diversion of sensitive military technologies as a factor in determining the national security impact of a proposed transaction, as well as the effect of a transaction on critical U.S. infrastructure that is essential to national security and major U.S. energy assets.

FINSAs codifies CFIUS's authority to re-open approved transactions if any party has omitted or submitted false or misleading material information or if any party intentionally and materially breaches a national security agreement aimed at mitigating the risk of the transaction. CFIUS is also mandated to conduct post-approval monitoring of mitigation agreements to ensure the foreign agent's compliance. CFIUS/FINSAs ensures a rigorous evaluation of foreign government acquisitions of U.S. assets.

On January 23, President Bush issued an Executive Order amending Executive Order 11858, concerning foreign investment in the United States. The Order provides guidance concerning the implementation of the Foreign Investment and National Security Act (FINSAs). The Order carefully reiterates the Bush Administration's policy, stating that the United States "unequivocally supports" international investment, which "promotes economic growth, productivity, competitiveness, and job creation," while stressing that such investment must be "consistent with the protection of the national security." The Order also directs the Department of Commerce to monitor and report on foreign investment trends and significant developments, to include sovereign wealth funds.

It is true that not every sovereign wealth investment may be large enough to trigger a CFIUS/FINSAs, Securities and Exchange Commission, or other U.S. government investigation before a transaction occurs. However, scrutinizing every potential sovereign wealth investment would only add to the cost and time associated with each potential transaction, driving away perfectly safe foreign investment. Moreover, sovereign wealth funds will be no more transparent, better governed, or more likely to follow investment strategies based on purely financial criteria if America erects additional barriers to these funds.

The U.S. should instead:

- Engage sovereign investors to promote sound macroeconomic policies, financial development, and liberalization in their own economies. With regard to China, the U.S. should continue to push for a more aggressive pace of financial and economic reform through the U.S.–China Strategic Economic Dialogue (SED), the U.S.–China Joint Commission on Commerce and Trade (JCCT), and other channels.
- Support IMF and World Bank efforts to establish a voluntary set of best practices for sovereign wealth funds. While market pressures are already working to prompt improved transparency from some sovereign investors, guidance that

clearly describes methods of implementing good governance practices, greater measures of accountability, and sound financial investment strategies would help countries to structure and operate their funds more effectively and responsibly.

- Promote meaningful debate and research about sovereign wealth funds to better understand their impact on both U.S. and world markets and on sovereign investors themselves. The U.S. Treasury has already been active on this front, hosting multilateral and bilateral discussions on sovereign wealth funds and a G-7 meeting in October 2007 that brought sovereign wealth investors—including China—together with finance ministers to discuss the creation of best practices for these funds.¹⁷
- Stand firm against implementing protectionist barriers against foreign investment and ensure that U.S. national security and financial reviews of foreign investments remain non-discriminatory and fair. Not all sovereign wealth funds are structured and managed the same way, and the potential threat to U.S. national security interests by foreign governments is not the same around the world. Care should be taken to ensure that the administration of CFIUS/FINSA rules does not impose undue delay or scrutiny of transactions that do not affect national security.

Conclusion

The rise of sovereign wealth funds carries implications for global financial market stability and U.S. national interests. There is no question that America must ensure that the laws and procedures governing foreign investment are robust, up-to-date, and functioning effectively to achieve the purposes for which they are designed, especially with regard to U.S. national security.

However, the relatively small share these funds represent in U.S. and global financial markets, financial and other market dynamics, the CFIUS/FINSA process, and other U.S. securities and financial regulations all work together to reduce the likelihood that foreign investment will bring more harm than good to the U.S. economy. The growing trade and investment ties that bind the economies of the world together are more likely to promote responsible economic behavior than to provide enticement to cause mayhem; investment is more about creating wealth than destroying it. Properly monitored and regulated, sovereign wealth funds are not a threat to America's national and economic security.

¹⁷ U.S. Department of the Treasury, *Semiannual Report on International Economic and Exchange Rate Policies*, Appendix II: Sovereign Wealth Funds, December 2007.