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Chairman Wortzel, Commissioner Mulloy, and to the other members of this commission, thank you for this opportunity to speak today at this important and timely hearing on the implications of sovereign wealth funds for national security.

Before I begin my formal testimony, I would like to clarify that the views and opinions that I present today are my own, and not those of the Congressional Research Service. However, the Congressional Research Service has granted me permission to submit my report on China's sovereign wealth fund as my written testimony for this hearing. In addition, I have submitted a formal copy of my oral presentation for the record.

On September 29, 2007, China formally established the China Investment Corporation, Limited – or CIC – six months after announcing its intention to start a sovereign wealth fund. With an initial injection of $200 billion in capital, the CIC became one of the largest sovereign wealth funds in the world. The CIC also became a focal point of widespread concern about the recent growth in sovereign wealth funds and their potential impact on global financial markets, international economic development, and national security.

However, it is interesting to note – according to the CIC's CEO, Lou Jiwei – that the creation of China's sovereign wealth fund was almost considered by China's leadership as a necessary byproduct of policy decisions made to remedy a couple of domestic economic problems. At a recent presentation at the World Bank, Lou explained that the CIC was created to solve two domestic economic issues. First, to find a way of soaking up perceived excess liquidity in China. Second, to find a way of transferring the holdings of China's commercial banks – the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China, and the China Development Bank – from the People's Bank of China to a central government agency. The fact that the resulting sovereign wealth fund would need to invest its capital seems to have been an afterthought.

Regardless of the circumstances surrounding its creation the CIC has begun to invest its initial capital. Approximately one-third of its capital was used to purchase the Central Huijin Investment Corporation – or CHIC – from the People's Bank of China. Prior its acquisition by the CIC, the CHIC had made investments in various financial entities, including several Chinese banks – the Bank of China (BOC), China Construction Bank (CCB), and the ICBC – and a U.S.

* References for specific figures or quotes in this testimony provided upon request.

private equity company, the Blackstone Group. In May 2007 – after China announced its plans to create the future CIC, but before the CIC was officially established, the CHIC invested $3 billion to purchase just under 10% of Blackstone in the form of non-voting shares. After the CHIC was acquired by the CIC, these investments were transferred to the new sovereign wealth fund.

Another third of the CIC's $200 billion in capital may have been invested during the last four months in two more Chinese banks – the Agricultural Bank of China (ABC) and the China Development Bank (CDB). In November 2007, the CIC supposedly decided it would purchase one third of ABC for $40 billion. However, since then there has been no confirmation of the investment. Just last week, there were reports that the CIC may be increasing its investment in the ABC to $45-50 billion, and that the investment may not occur until April 2008. The circumstances surrounding the CIC's reported investment in the CDB have similarly been rather vague, with the exact date, amount and terms of the alleged investment unreported.

Two of the CIC's investments have been reported extensively and in detail – $100 million in shares of the China Railway Group during its initial public offering in Hong Kong and $5 billion to purchase "around 9.9%" of Morgan Stanley. At the time of CIC's investment, Morgan Stanley stressed that the sovereign wealth fund would have "no special" rights of ownership and no role in the company's management.

The very fact that Morgan Stanley felt obliged to state that CIC would have "no special" rights or role in the company's management attests to the existing apprehension about the presence of China's sovereign wealth fund in international financial markets. Not that sovereign wealth funds are new to global markets; there have been sovereign wealth funds for over 50 years with an estimated $2-3 trillion already invested. However, for some reason, as Lou acknowledged during his presentation at the World Bank, China's creation of a sovereign wealth fund with $200 billion to invest caught everyone's attention – and raised some serious concerns about the impact of sovereign wealth funds on the global economy.

Edwin M Truman of the Peterson Institute for International Economics released a policy brief on sovereign wealth funds in August 2007 that provided an excellent summary of these concerns in the context of an international discussion about establishing "best practices" guidelines for sovereign wealth funds. He divided these concerns into four inter-related general categories – 1. Governance; 2. Transparency; 3. Behavior; and 4. Objectives and Investment Strategy. Truman also offered two criteria by which to assess policies targeted at the activities of sovereign wealth funds – 1. Accountability; and 2. Protection. For the next portion of my testimony, I would like to comment on these four concerns in the context of these two criteria as they pertain to the CIC.

Governance

Truman and others argue that there should be standards for sovereign wealth funds that clearly set out the role of the government and the fund managers, as well as clear accountability arrangements. In addition to underlying ethical issues raised by government officials investing in private companies, people have also expressed their apprehension about sovereign wealth funds being used by governments to advance a potential geopolitical agenda.

The Chinese government and the CIC apparently recognize these governance issues and have provided a fair amount of information about its administrative structure. Technically, the CIC is a separate corporate entity, owned by the Chinese government and reporting directly to China's State Council. The CIC has a board of directors with 11 members, including one selected by the employees of the CIC. None of the board members serve on China's State Council, providing some separation between the CIC and Chinese government.

However, some observers have pointed to the primary employment of the 10 appointed board members as an indication that the Chinese government wishes to maintain tight control over the CIC. Four of the board members come from the Ministry of Finance, two from the People's Bank of China, two from the National Development and Reform Commission, China's economic policy think-tank, one comes from the Ministry of Commerce, and the last one comes from China's national pension fund. To some analysts, the mix of board members represents a political compromise among the leadership of the Chinese Communist Party to obtain broad-based support for the creation of the CIC; to others, the board's links to China's key economic agencies will provide China's leadership with the necessary mechanisms to exert indirect control over the activities of the CIC.

The CIC has also begun to advertise internationally for external fund managers. According to Lou, the CIC plans on allocating some of its capital to external fund managers to invest – according to some general investment guidelines – as a both a method of administering its investment activities as well as to provide a second-layer of separation between the CIC's investments and China's central government. The external fund managers are to include not only well-known international funds, but also individual fund managers with a strong credentials.

However, the CIC appears to be planning on using its external fund managers primarily for overseas investments. At present, nearly two-thirds of the sovereign wealth fund's capital is targeted for domestic investments, such as the purchase of the CHIC or the planned capital outlays for China's commercial banks. As a result, the CIC could still be used as an instrument to advance the central government's domestic economic policies. In some cases, those domestic economic policies may have international implications.

Transparency

Truman's second category of concern focuses on the transparency of a sovereign wealth funds operations. Transparency covers a range of administrative issues, including publication of financial statements, independent auditing, and public disclosure of investment strategies. The underlying notion is that the more that is known about the investment activities of the sovereign wealth fund, the less likely that inappropriate activities will occur and the less likely that international financial markets will be "shocked" by the actions of sovereign wealth funds.

To date, the CIC has had a mixed record on its transparency. As previously stated, the CIC has provided quite a lot of information about its administration, and has quickly announced its planned investment decisions once they have been made. However, the CIC has not been particularly punctual or precise in announcing the details when and how the planned investments were made. As a result, there continues to be a stream of rumors about CIC's planned investments, and not surprisingly, a series of market fluctuations as investors react to those rumors.

According to the CIC, the issue of transparency cuts both ways. While a certain level of disclosure may provide reassurance to governments and international investors, too much disclosure may hurt the CIC's commercial interests. In the words of CIC's CEO, "If we are transparent on everything, the wolves will eat us up." Based on various comments made by senior officials of the CIC, it would appear that they plan on conforming to standard international accounting practices and forthcoming when investments decisions are made, but may not release financial statements or details of the CIC's investment strategy.

Behavior

To my mind, Truman's issue of behavior is intertwined with governance and transparency. Truman would like to see sovereign wealth funds establish behavioral guidelines for its investment management, covering both the scale and speed at which fund managers may alter their portfolios, but also consultative arrangements with countries that may be affected by investment decisions. The implicit notion is that these internal guidelines and policies will protect the sovereign wealth fund and the international financial markets from irresponsible behavior. However, as the recent experience of Credit Lyonnais would seem to indicate, such guidelines and policies are only as good as the commitment of senior management to abide by their self-established rules and regulations. In general, it is unclear if the behavioral risks of the CIC are significantly different from a privately-owned investment fund.

Objectives and Investment Strategy

The general presumption is that sovereign wealth funds should confirm to the alleged profit-maximizing behavior of other major investors operating in financial markets for two reasons. First, it supposedly makes the investment behavior of the sovereign wealth funds more predictable, and therefore, less likely to cause market disruptions. Second, it reduces or eliminates the possibility that a nation will use its sovereign wealth fund to advance geopolitical goals and/or pose a threat to the national security of another nation.

From the start, the Chinese government has issued a series of statements confirming that the CIC will be "purely investment-return driven." Lou gave a more nuanced explanation of the CIC's investment strategy to the press in December 2007, saying, "We will adopt a long-term and prudent investment principle and a safe, professional portfolio strategy that adapts to market changes, which will put emphasis on a rational match of returns and risks." More recently, Lou compared the CIC to a farmer who wants to farm the land well, but is able to take advantage if a "big, fat rabbit" runs by – a reference to CIC's investment in Morgan Stanley.

However, a number of commentators – including my fellow panelist Brad Setser – have questioned whether the CIC has developed a "coherent investment strategy." While Lou implied at a presentation in Washington that the Morgan Stanley investment decision came after a long courtship and much consideration, various unnamed sources inside the CIC claim that the decision was made rather suddenly, catching some of CIC's top officials by surprise. There are also reports that there continues to be discussion and debate between key Chinese government agencies on the proper role and purpose for the CIC.

In response to a question about possible models for CIC among the existing sovereign wealth funds, Lou stated that the CIC will probably be more like the Government of Singapore Investment Corporation (GIC) than Temasek Holdings, Singapore's other sovereign wealth fund. It is interesting to note that last year Truman ranked 32 sovereign wealth funds according to a set of criteria he had developed and determined that GIC was one of the worst sovereign wealth funds (ranking 30th) while Temasek one of the better funds (ranking 11th). Lou did not elaborate upon his comment.

There has also been much speculation on the CIC's goal for the rate of return on its investments. Because few sovereign wealth funds publish financial reports, it is hard to determine their overall profitability. On several occasions, the CIC has made it known that the it will have to establish a record of profitability if it is to receive additional capital from the Chinese government. As Lou put it, "If I am making losses every day, how can I face asking the government for more money?"

There is a fairly clear floor on the CIC's rate of return goal. Under its agreement with the Chinese government, the CIC is responsible for servicing the cost of bonds issued to transfer the foreign exchange from the People's Bank of China over to the CIC. That means the CIC must earn at least a rate of return of about 5% in order to cover the cost of the bonds.

Currently, a significant portion of China's $1.5 trillion in foreign exchange reserves is invested in U.S. government debt, earning approximately 4-5% interest. So, it seems reasonable to assume that the CIC will have to outperform the relatively low risk rate of return that can be earned from U.S. government debt. In addition, the Chinese renminbi is expected to continue its gradual appreciation against the U.S. dollar and other major currencies over the next few years, which could place pressure on the CIC to preserve the real value of its capital fund over time by earning an additional 5-8% in its overall rate of return. Finally, China's domestic inflation rate is rising, and is expected to exceed 5% in 2008. If the Chinese government should evaluate the CIC's performance in its domestic currency, China's rising rate of inflation will place more pressure on the CIC to obtain higher yields, possibly as high at 15-20%. However, according to Lou, the Chinese government only expects the CIC to cover the nominal cost of its debt, or about 5%.

The target yield of the CIC is important primarily because of its implications for its portfolio mix. Earning higher yields usually means investing in higher risk investments and accepting more volatility in the value of the portfolio at any given time. This raises concerns for international markets for two reasons. First, given the CIC's comparatively large current and potential capital fund, higher target yields could translate into riskier investments and more market volatility. Second, it is uncertain how comfortable the Chinese government will be if and when the CIC's portfolio undergoes a sharp correction due to a poor investment decision. There is a risk that China will respond to a short-term loss by making sudden dramatic shifts in its investments, and possibly causing tumult in international financial markets. Similarly, a particular good patch of CIC investments may persuade the Chinese government to sell off much of its U.S. government debt and hand the capital over to the CIC to invest. Under some circumstances, such a sharp shift in China's ownership of U.S. government debt could cause problems for the future issuance of U.S. government debt.

Market Effects

Setting aside for a moment the potential political ramifications of China's sovereign wealth fund, the entry of the CIC into global financial markets ***in theory*** could have a significant economic impact on both a macroeconomic and microeconomic level. On a macroeconomic level, the key issue appears to be the possible shift of China's holdings of U.S. government debt – either in a sudden move or gradually over time – into other forms of investments. On a microeconomic level, there are two separate issues of greater concern. First, some people are apprehensive about China using the CIC to secure significant market power over key commodity or financial markets. Second, regardless of the intentions of the CIC, there is concern that rumors and speculations about possible CIC investments may contribute to market instability.

According to a recent Congressional Research Service report, China possesses over $600 billion in U.S. government securities, making China one of the largest overseas holders of U.S. debt. As previously mentioned, the creation of the CIC provides China with an alternative investment vehicle for its accumulating foreign exchange reserves. Rather than buying more U.S. governmental debt, the CIC can invest in higher-yield, higher-risk investments. Analysts have raised concern about two alternative scenarios involving shifts in China's holdings of U.S. government debt.

The first theoretical scenario involves a decision by China to gradually divest its holdings of U.S. government debt and moving the proceeds over to other international investments. In some respects, the speed of such a move may be unimportant; what matters more is the overall decline on global demand for U.S. government debt. As demand declines, the U.S. government will be under market pressure to increase the rate of return on U.S. government debt in order to sell out its new issuances. This will have two possibly important macroeconomic effects. First, the cost of serving the national debt will rise, which will increase the overall federal deficit. Second, the higher yields on U.S. government debt will put upward pressure on interest rates, which could hinder private investment and overall economic growth. Various economists have examined the possible impact of a shift in China's investment portfolio and have generally concluded that the overall economic impact on the United States would be small.

The second theoretical macroeconomic scenario involves a rapid divestment of U.S. government debt by China. In this case, the concern is that the sudden flood of existing U.S. debt on the market will cause a sharp drop in price and precipitate dramatic shifts in assets as investors move from stocks to bonds to capture the short-term high return on U.S. government debt. As capital leaves other financial markets, stock prices may quickly fall and possibly lead to wide fluctuations in financial markets around the world. While most analysts have stated this scenario is unlikely – principally because China would more than likely suffer a significant loss as it sells off its holdings of U.S. government debt – the fact that China holds over $600 billion in U.S. government debt means that rational investors will need to factor in this risk in their investment decisions.

Many analysts consider it highly unlikely that China would undertake a rapid divestment of its holdings of U.S. governmental debt for several reasons. First, China would incur a significant loss in the process. Second, there is no clear economic benefit to China in placing economic pressure in the U.S. federal deficit, interest rates and overall economic growth. Third, China would risk slowing its own economic growth by possibly precipitating a recession in one of its most important export markets. Fourth, China would also be risking economic retaliation from the United States.

Turning to the microeconomic concerns, the first situation being discussed is the possible impact of China using the CIC to secure significant market power over an important commodity market or financial sector. For example, there has been some discussion about China using the CIC to purchase natural gas companies around the world in order to secure enough natural gas to supply its growing energy needs. Some market watchers are anxious that China could purchase enough of the global supply of natural gas to influence the market price and acquire monopolistic profits on their investments. Meanwhile, other economies around the world would be harmed due to the higher cost of natural gas.

The second microeconomic situation is not predicated on monopolistic intentions by the CIC, but possible market volatility instigated by rumors or speculation about the investment activities of the China's sovereign wealth fund. Since the establishment of the CIC, there have already been cases where the stock market prices of companies rumored to be possible targets of CIC investments have jumped over 10% in the course of one day. Just this week, a rumor that CIC along with China Shenhua Energy were going to invest in Australia's iron ore company, Fortescue, pushed up its stock market price by 10.5% in one day. Similarly, in late 2007, rumors that CIC was going to invest in Australian mining company Rio Tinto contributed to a 7.5% rise in the stock, despite CIC's repeated assertions that there was no truth to the rumor.

In many respects, whether looking at the macroeconomic or microeconomic concerns about sovereign wealth funds, the underlying issue primarily involves the uncertainty of international markets in adjusting to the recent growth in sovereign wealth funds. Although sovereign wealth funds have been around for decades, their overall capital holdings have been small and their involvement in global investment markets even smaller. However, with new sovereign wealth funds like China's CIC entering into the market, and projections of more growth in the future, private investors and governments around the world are unsure how CIC and other sovereign wealth funds will affect the global economy.

The recent experience with sovereign wealth funds providing welcome capital to financial firms harmed by the so-called sub-prime financial crisis may provide some reassurance. The investments of the CIC and other sovereign wealth funds were widely perceived as providing market stability at a time when several major financial firms were in trouble. In addition, as the U.S. Treasury noted, because sovereign wealth funds are typically not highly leveraged and are seeking long-term returns in their investments, they are under less pressure to liquidate investments during times of major market volatility.

Security Concerns

In some respects, the security concerns raised by sovereign wealth funds are an extension of the economic concerns. The key difference lies in the motivation of the behavior of the sovereign wealth fund, not in the mechanism by which the goal is achieved. For example, whether a potential CIC's investment in natural gas companies is motivated by a desire to earn a higher rate of return or starve the U.S., Japan and Western Europe of energy makes no difference to the manner by which the CIC obtains such market power. In both cases, the CIC will have to purchase natural gas companies.

Cases where the security concerns may be distinct from the economic concerns involve possible CIC investments in companies that possess important dual-use technology or intellectual property. If the CIC – or any other sovereign wealth fund – were able to obtain critical technology or intellectual property by investing in particular companies, it could raise security concerns independent of the economic impact of the investment.

Such a scenario is one reason why Congress passed P.L. 110-49, tightening the review process of the Committee on Foreign Investment in the United States, or CFIUS, and heightening congressional oversight of the activities of CFIUS. In theory, CFIUS monitors foreign investments in U.S. companies to insure that entities such as the CIC are not allowed to invest in U.S. companies that possess sensitive technology or intellectual property.

Reciprocity

There is one more area of concern that I wish to raise with respect to the CIC – the general issue of reciprocity. Over many years, regardless of which political party has been in power in Congress or in residence in the White House, it has been U.S. policy to promote the liberalization of trade and international financial markets. There has been a general consensus that the lowering of barriers to the trade in goods and services, as well as the open international flow of capital, is good for the U.S. economy and for nations around the world. As part of that general policy, the United States has pushed China – and other nations – to lower trade barriers and open up their financial markets to the inflow of U.S. capital.

It would seem that the creation of the CIC and China's accumulation of over $1.5 trillion in foreign exchange reserves may be changing attitudes about the merits of trade and investment liberalization. There is apparently little concern about Caterpillar purchasing China's Shandong SEM Machinery Co., Ltd., but greater concern about the pending acquisition of 3Com Corporation by Huawei Technologies of China and its U.S. partner, Bain Capital, LLC. While there may be merit in the distinction, it may be lost on other governments and foreign investors who perceive the United States as having a double standard with respect to foreign investment.

Alternatives

The preceding analysis of China's sovereign wealth fund logically leads to consideration of what – if anything – should be done. There are already a variety of laws and regulations governing aspects of foreign investments in the United States, involving CFIUS, the Security and Exchange Commission and other government agencies. In addition, the U.S. government is supporting efforts by the International Monetary Fund and the Organization for Economic Cooperation and Development to create guidelines or best practices for sovereign wealth funds.

Whether or not these existing policies, laws, regulations and actions are sufficient to protect the U.S. national security and economic prosperity is the subject of much discussion of late. Rather than trying to offer yet another proposal for an ideal U.S. policy on sovereign wealth funds, I prefer to raise a few questions or ideas that I think are critical in decided what – if anything – the U.S. government should to do at this time.

First, how important is the apparent lack of transparency of sovereign wealth funds? If the key issues revolve around the opaqueness of the CIC's investment portfolio and managerial practices, one possible response would be to require sovereign wealth funds investing in the United States to publicly release audited financial statements along the lines required of publicly traded companies. However, such a policy would raise criticism from overseas that such disclosure is not required of other entities investing in the United States, such as hedge funds.

Second, how important are concerns about foreign ownership over key companies or sectors of the economy? If ownership is a major issue, then one option would be to place limits on the percentage of a U.S. company that may be owned by a foreign entity. Such restrictions already exist in U.S. law for some types of companies. However, if the United States were to broaden the scope of foreign-ownership restrictions, it is reasonable to expect other nations to act in kind.

Third, if the real issue is not one of foreign ownership, but of foreign control, then rather than limiting the percentage of ownership, limits could be placed on the type of investment foreign entities could make in U.S. companies. For example, sovereign wealth funds may be limited to only non-voting shares of publicly-traded companies and barred from having a seat on the company's board of directors. However, it is likely that other countries could place similar restrictions on U.S. investments in their domestic companies.

Finally, I would be remiss as an economist if I did not point out the role the federal deficit and the U.S. trade deficit play in any discussion of sovereign wealth funds and their potential impact on the United States. The rising federal debt and the continuing U.S. global trade deficit can only be financed by a continual flow of foreign funds into the United States. Foreign governments such as China have accumulated large holdings of U.S. government debt in part because the United States does not have adequate savings to finance the federal deficit. Similarly, foreign governments are accumulating foreign reserves at unprecedented rates in part because the United States continues to import more goods and services than it exports. Until these twin deficits are closed in some fashion, the United States will continue to face an inward capital flow that has to be accommodated in some manner. If new laws and regulations block or limit foreign direct investment in U.S. companies, the foreign capital will either have to flow to an alternative investment instrument in the United States, or the United States will be forced to reduce its twin deficits by rather harsh and painful adjustments, such as a serious depreciation of the U.S. dollar, significantly higher interest rates and possibly high rates of inflation, or a potentially severe economic recession.

Chairman Wortzel, Commissioner Mulloy, and to the other members of this commission, this concludes my testimony. I thank you for the opportunity to testify before this commission. I will be more than happy to answer your questions in the time remaining.