Statement to the U.S.-China Economic and Security Review Commission

Investments by Sovereign Wealth Funds in the United States

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My name is Peter Morici. I am an economist and Professor of Business at the University of Maryland. Thank you for this opportunity to participate in these hearings. I will devote my remarks to the issues raised by the recent surge in investments by sovereign wealth funds in the United States.

What Is a Sovereign Wealth Fund?

In purest form, a sovereign wealth fund is a pool of resources, owned and/or controlled by a government, invested in public or private assets, including debt instruments, equities and direct investments in property.

Clearly, the China Investment Corporation (CIC) is an example of such an entity, but so too are national and subnational government interests in European industrial companies. In turn, the investments of CIC in Blackstone and European companies with part government ownership in U.S. companies would be examples of sovereign wealth investments in the United States.

Also, the California Pubic Employees' Retirement System (Calpers), which invests widely in equities, and similar foreign national and subnational government retirement systems around the world are sovereign investment funds. Those have holdings in U.S. companies.

My point is identifying sovereign wealth is usually easy, but identifying sovereign investments that should concern U.S. policymakers is difficult. Clearly, investments by the national government of China and its state controlled companies raise issues, but generalizing policy from those concerns is a tangle of string—pull one piece and you get more string than you anticipated.

U.S. and Foreign Government Policies

As a common law country and culture, much of U.S. policy must be deduced from piecemeal practice and by generalizing from fragments of legislation and policy directives. For example, the U.S. social security fund is not permitted to make private investments, in part, because Americans don't want the U.S. government engaged in allocating capital and influencing business decisions in the U.S. private enterprise system. However, U.S. state governments are permitted to do as they please—Calpers is a significant example, and it has not always been silent about the management of U.S. companies. The fact is, with its voting powers, it can't always be silent.

In contrast, in China and Europe, national and subnational governments make investments expressly for the purposes of promoting industries and affecting competitive international outcomes among businesses. Often, earning a decent return on capital is not a motivation;

rather, the objective is creating employment or establishing a national presence in an industry that the market would not otherwise support.

Sometimes the results have strong and lasting effects on the U.S. economy through international commerce and competition. For example, Airbus is a strong competitor today, but McDonnell Douglas no longer exists as an independent entity.

Sovereign wealth fund investments could have the capacity to influence important U.S. investment decisions—the choice of location of major production facilities in the United States or abroad; similarly, the location of R&D facilities; and the structure of investments by U.S. firms that may compete with companies domiciled in the home countries of sovereign wealth funds.

For example, how would a major CIC investment in a major U.S. automaker affect the location of facilities to produce small cars that could be made and exported from China? Or the location of an auto design facility? Chinese inward foreign investment policies have already had such effects. Given the size of Chinese sovereign holdings of U.S. dollars seeking investment opportunities, those issues will quickly move from the hypothetical to tangible.

The influence of sovereign wealth on the U.S. economy through the political process is another issue that will soon emerge. New York banks are busy selling significant minority interests to sovereign wealth funds. The employees of those banks are significant sources of campaign contributions for both political parties, because those banks have large numbers of employees that may contribute the maximum amounts permitted under campaign financing laws.

Through the Committee on Foreign Investment in the United States (CFIUS), the U.S. government has the means to review and screen sovereign investments; however, the recent rush to invest in U.S. banks by sovereign funds and the CFIUS response provides yet further indication that that agency is fairly passive. It seems great public controversy and Congressional out cry are necessary, as was the case in the proposed Dubai Ports investments in the United States, to spring CFIUS into meaningful action.

Nevertheless, with the massive overseas holdings of dollars created by U.S. trade deficits and the intervention in currency markets by foreign central banks, investments by sovereign funds in the U.S. economy will present troubling issues. After all, why would the U.S. government permit a foreign sovereign fund to invest in U.S. companies and wield influence when it does not permit the U.S. social security fund to do the same?

Yet, with all the dollars the United States has chosen to print and leave abroad, it can hardly deny completely sovereign investments in the United States.

Shaping U.S. Policy

Clearly, some sovereign investments are more troubling or benign than others, and I believe the answers to two sets of questions should help in identifying investments that should be the focus of concern and perhaps screened out.

First, does the sovereign entity share U.S. values about the role of markets and state intervention in managing its national economy and the global economy?

In China for example, sovereign investments have the purpose of creating a socialist market economy, with specific industrialization objectives. Investments by these Chinese entities in

U.S. companies pose much greater issues than, for example, investments by Canadian provincial government pension funds.

U.S. experience with large, direct sovereign investments, beyond pension funds, is limited. Investments by sovereign entities whose governments have announced specific goals to cultivate competitors to U.S. enterprises raise much more poignant issues than those whose purposes are to merely earn a profit to finance pensions.

Second, does the sovereign entity share U.S. political values or does it see itself in competition with the West?

China remains an autocratic state. The United States offers to the world democracy and markets, while China offers order and prosperity as justification for shunning democracy and controlling markets.

Large investments by such a government in the largest U.S. industrial financial institutions would create important concerns regarding the independent decision making of U.S. banks. The potential to compromise the allocation of large U.S. investments and the enduring independence of U.S. political figures should not be denied.

Investments could be denied in the United States by U.S. corporations or moved abroad to appease foreign minority interests, and U.S. banks could choose to allocate loans away from U.S. companies that compete with foreign companies favored by sovereign investors.

The United States has campaign finance laws, because Americans believe campaign money can influence legislation and public policy; hence, major holdings by sovereign funds in U.S. banks that are now emerging should be a focus of attention. It is hard to imagine that U.S. executives will not be sensitive to the political concerns of large shareholders when they choose candidates to support for public office.

An Awkward Corner

The United States is in a box.

By running up large trade deficits and tolerating foreign government intervention in currency markets, the United States has contributed to large dollar overhang abroad—much of it in the hands of sovereign funds. Investments by those funds in Treasury securities helped keep long-term interest rates artificially low, and helped facilitate the real estate bubble and subprime crisis now besetting U.S. banks.

U.S. banks, owing to questionable lending practices, need massive infusions of capital, which are difficult to find solely from domestic or private sources. We will likely hear from bankers in that foreign sovereign capital will not have any influences different from those of U.S. shareholders. However, we need ask why should foreign sovereign shareholders behave differently in the United States than they do at home? The Chinese government is not a neutral investor in China, and it should not be expect to be a neutral investor here.

Similarly, if the U.S. government wishes not to continue to have growing pressure from sovereign funds to invest in the United States, the U.S. government must finally address the massive U.S. trade deficit and foreign government intervention in currency markets that help finance sovereign investments. After all that is how these sovereign funds are amassing so many dollars to invest in the United States.