Testimony of Business Professor Peter Navarro before the U.S.-China Economic and Security Review Commission, February 7, 2008

Mr. Chairman and members of the Commission. My name is Peter Navarro, and I want to extend my deepest thanks for providing me with this opportunity -- and high honor -- to speak before you today on the crucial issue of sovereign wealth funds. This Commission has consistently provided the highest level policy analysis of America's emerging "China Problem" of any government-sponsored or academic institution, and for that, I heartily applaud its efforts. As America's economic difficulties only deepen, I sincerely hope that at some point the U.S. Congress, the U.S. Treasury Department, the U.S. Trade Representative, and the White House will move swiftly to adopt the policy recommendations this Commission has put forth in its latest annual report.

As a biographical note, I am a business professor at the University of California-Irvine and hold a PhD in economics from Harvard University. My research has appeared in academic journals ranging from the Journal of Economic Perspectives, the Journal of Business, and the Rand Journal to the Harvard Business Review and China Perspectives. I am also the author of a number of books on economics and public policy, including *The Coming China Wars: Where They Will Be Fought, How They Can Be Won* (Prentice Hall, 2006). All of my publications can be accessed at www.peternavarro.com.

A. MAIN TESTIMONY

Sovereign wealth funds are government-run hedge funds financed by excess foreign reserves accumulated through a country's chronic trade surpluses. Commodity based funds common to the Middle East are financed largely by excess petrodollars generated by the cartel pricing of the OPEC cartel interacting with robust world petroleum demand. Asian SWFs are fueled by excess trade dollars generated by the sale of manufactured goods and, particularly with China, are accumulated to a very large extent through various unfair trade practices that allow the U.S.-Asian trade imbalance to persist.

As global financial investment vehicles, sovereign wealth funds are neither good nor bad, but governments make them so. While the SWFs of countries like Norway and Abu Dhabi may be cheered, those of China, Russia, and Saudi Arabia should rightly be feared.

As the poster child of a good citizen SWF, Norway's fund has two main goals. First, it provides countercyclical "fiscal stabilization." When oil prices are high, Norway adds to its SWF. If oil prices fall, Norway can draw down its SWF rather than slashing government expenditures on critical needs such as health care and education.

Second, Norway knows its declining oil reserves eventually will cease to be a major revenue source. By growing its SWF now, Norway will generate wealth for future generations to live on in the style that current oil revenues have made them accustomed to. For these reasons, Norway's SWF always seeks to maximize its risk-adjusted financial returns – a primary requirement of efficient global markets.

In sharp contrast, China has a clear historical pattern of strategically deploying its excess foreign reserves as a "loss leader" to achieve other economic goals other than to maximize its financial return. A perfect example of China's mercantilist misuse of foreign reserves is China's currency manipulation to boost its exports and create jobs – at the expense of workers in the U.S. and Europe.

In particular, to keep the Chinese yuan pegged and undervalued to the U.S. dollar, China first "sterilizes" vast sums of export dollars by issuing bonds to Chinese citizens at high interest rates. China's central bank then maintains the dollar-yuan peg by using those sterilized dollars to buy U.S. bonds at substantially lower interest rates. In this way, China earns a *negative* return on its foreign reserves. However, China is willing to take this loss on its foreign reserves investments because it boosts its exports and GDP. By doing so, China's "beggar thy neighbor" behavior completely violates the core principle of efficient capital markets, namely, that all investors in the financial markets seek to maximize returns.

Even more provocatively, China has also firmly established the use of its foreign reserves as a political weapon. Whenever pressure builds in the U.S. to curb China's currency manipulation or other unfair trade practices, Chinese government officials threaten what they themselves refer to as the "financial nuclear option." They warn – sometimes directly, sometimes more subtly – that China will stop using its vast dollar-denominated foreign reserves to buy U.S. government bonds and begin dumping dollars on the international market. Such a financial nuclear strike would cause interest and mortgage rates to soar and the U.S. stock market to drop sharply while triggering a U.S. recession.

Based on China's own bad behavior to date and the enormous economic and political power that its burgeoning foreign reserves bring, it should be clear that America has much to fear from the rapidly growing ability of Chinese SWFs to acquire controlling interests in U.S. corporations. In buying up American corporate assets, Chinese SWFs will be able to heavily influence decisions about the offshoring of jobs, managerial best practices, research and development, and technology transfer. Offshoring jobs hits America's economy immediately. Moving America's R&D, managerial elite, and technologies to China significantly reduces future American productivity and growth.

China's SWFs also pose strategic dangers as they may seek to gain control of critical sectors of the U.S. economy -- from ports and telecommunications to energy and defense. A big problem here is that many U.S. companies generate "dual use" technologies with both civilian and military applications. Keeping China away from these technologies is particularly problematic, as the U.S.-China Commission well knows..

Most broadly, China's SWFs threaten a loss of American sovereignty. This danger lies in the aforementioned ability of China to use its vast foreign reserves to destabilize the international financial system in times of conflict – and thereby bully American politicians into submission. In this sense, if China's central bank represents the atomic bomb in China's "financial nuclear option," its rapidly growing SWFs will eventually represent a much higher megaton yielding hydrogen bomb. Any one of a number of future conflicts with China could trigger the use of these financial nukes – from skirmishes over fair trade to the perennial open sore in U.S.-China relations, Taiwan.

While China poses the most direct SWF threat, Russia poses its own set of problems. Russia's SWF is flush with petroleum and commodity revenues, and like China, it is no stranger either to state capitalism or brass knuckled trade policies. Exhibit A is Russia's bullying of Europe and the Ukraine over access to Russian natural gas reserves at reasonable prices while Russia's veiled seizure of the oil company Yukos likewise casts a shadow over its commitment to free markets.

As for Saudi Arabia, its corrupt monarchy stands as a perennial target for Islamic extremists. Should Saudi Arabia suffer an Iranian-style fundamentalist revolution, its SWF holdings, together with its vast oil reserves, would provide America's Islamic enemies with substantial firepower.

It follows that the rapid emergence of SWFs cries out for a coherent U.S. policy. One major obstacle to swift action is the constructive role SWFs appear to be playing in the current global financial crisis. They are providing critical liquidity to strapped global markets while serving as White Knights for distressed companies like Citi, Merrill Lynch, and UBS. However, these short run benefits should not lull us into a false sense of long term security.

In considering America's policy options, it is critical to note that SWFs invariably represent the fruit of the poisoned free market tree. Indeed, the SWFs of the Middle East and Russia exist largely because oil is priced according to monopoly principles by the OPEC cartel. The Asian SWFs, particularly China, likewise exist largely because of mercantilist trade practices now generating chronic current account surpluses with the U.S. and Europe.

In this regard, China's mercantilist trade practices are well-known by this Commission and include: blatant currency manipulation that acts as a tariff on U.S. exports to China and a subsidy to Chinese exports to the U.S.; a wide range of WTO violations, including the widespread use of export subsidies and import barriers; rampant counterfeiting and piracy that provide Chinese manufacturers with real cost advantages; and lax health and safety regulations far below international norms that likewise provide production cost advantages.

These observations suggest three broad SWF policy responses. First, the U.S. needs a comprehensive energy policy that will dramatically cut its reliance on foreign oil and thereby choke off the flow of excess petrodollars to Middle East and Russian treasuries. Second, the U.S. urgently needs to crack down on Chinese mercantilism while boosting the fortunes of its own manufacturing base. Third, the U.S. must end an era of easy money and deficit spending that has helped artificially stimulate U.S. consumption of both Middle East oil and subsidized Chinese goods.

America also needs a targeted SWF policy. Here, the U.S. should certainly lend its support to the International Monetary Fund. At the urging of the G-7, the IMF is exploring the establishment of a set of guidelines, a code of conduct, and a menu of best practices for SWFs. However, given the IMF's political constraints, unilateral U.S. action will also be an absolute necessity.

First, the U.S. should demand full transparency for any SWF purchasing U.S. assets. This means quarterly and annual reporting requirements like those filed by corporations that summarize the SWF's financial returns, major holdings, and objectives.

A second option would limit SWFs to investments in broad-based index fund like the S&P 500 and Russell 2000 rather than allowing SWFs flush with cash to cherry pick America's finest corporations.

Still a third, less restrictive, option, would limit the percentage of equity shares held in any given company. This limit should be set low enough to prevent an SWF from gaining a controlling interest and thereby influencing managerial decisions related to offshoring, R&D, and tech transfer. In this vein, SWFs should also be completely prohibited from investing in any sector, industry, or asset deemed to be strategic for U.S. economic or military purposes.

As a final cautionary note, corporations themselves need to be very careful when fielding inquiries from SWFs. Opening their company's books and operations to such prospective investors is often an open invitation to industrial espionage and other abuses.

B. Q&A PORTION OF NAVARRO TESTIMONY

Business Professor Peter Navarro responds to the following set of questions provided by the U.S.-China Commission for his February 7, 2008 testimony.

1. How do SWF investments differ from other foreign investment?

The two key differences between SWFs and other foreign investment relate to source of funding and investment objectives.

Foreign investments undertaken by entities other than SWFs are typically funded by individuals or institutions through vehicles ranging from mutual funds and pension funds to corporations and other private entities. What each of these forms of foreign investment share in common is the singular desire to simply maximize their rate of financial return on the foreign investment for a given level of risk. This desire is consistent with the requirements of efficient capital markets and helps ensure an efficient allocation of capital.

In contrast, government-owned SWFs are funded by excess foreign reserves earned when countries run chronic trade surpluses. Because SWFs are owned by governments, they have the potential to pursue investment objectives that may not directly maximize the financial returns of their investments but provide other types of economic and/or strategic benefits. In pursuing strategic goals beyond that of maximizing their financial returns in their particular investments, SWFs violate the principles of free market efficiency.

As an example, an SWF may acquire a controlling interest in an American corporation and effectively gut that corporation by offshoring jobs, R&D, technology, and management talent to the homeland. While shareholders in the American corporation – including the SWF -- suffer a loss of financial return, the gains to the homeland would more than offset the SWF's financial loss and provide a net benefit to the homeland. In this way, SWFs may act as strategic "loss leaders" for the achievement of other policy goals.

2. Is there a difference between funds derived from commodity sales and funds that derive from running large trade surpluses?

No, not when it comes to the critical global welfare test of an SWF. The critical global welfare test of an SWF is whether it seeks to maximize its financial returns or, alternatively, is the SWF willing to sacrifice return in pursuit of other policy goals. As argued in my testimony, SWFs that sacrifice financial returns for other policy goals present very significant dangers both to the U.S. and global economy.

In principle, both commodity-financed or trade-financed SWFs are capable of failing this global welfare test by using their excess reserves to promote broader strategic goals. As I indicate in my testimony, SWFs are neither good nor bad but governments make them so.

For example, a Norwegian commodity-financed SWF may simply seek to maximize its financial returns to meet the goals of fiscal countercyclical stabilization and intergenerational wealth transfer. In contrast, a Russian SWF financed by petrodollars and other commodity-derived revenues can be every bit as dangerous as a Chinese SWF financed by trade dollars if they both use their SWFs to pursue goals other than the maximization of their financial returns.

3. How do other G-7 countries deal with foreign investment and sovereign wealth funds? Do other G-7 nations limit investment for national security or other reasons?

While political rhetoric against SWFs is becoming more heated, SWF policy formulation continues to lag behind in both Europe and the United States. At present, at the urging of the G-7, the IMF is seeking to develop a voluntary code of conduct for SWFs. Such a voluntary code is likely to do little to stem the growing influence of SWFs. <u>Direct action by the U.S. Congress is critical</u>.

C. RESPONSE TO ARGUMENTS IN FAVOR OF UNREGULATED SWFS

The U.S.-China Commission has also asked hearing participants to respond to a set of arguments offered in favor of SWFs by proponents of an unregulated SWF market. Professor Navarro explains why each of the identified claims is spurious.

Spurious Claim #1 *"[T]the [SWF] funds merely invest for financial gain and are not involved in politics and that they are not interested in technology transfer or obtaining proprietary information from their investment targets.*

The claim itself is not spurious but rather what we are supposed to infer from it. Unregulated SWF proponents would have us infer that SWFs will continue to exhibit this benign behavior. Nothing in the current economic and regulatory environment can possibly guarantee that.

Spurious Claim #2: *SWFs provide capital to the U.S. economy and help create jobs*

SWFs also destroy jobs and diminish the availability of capital within the U.S. Consider China's SWFs. These are financed by China running chronic trade deficits with the U.S. The U.S.-China chronic trade imbalances are, in turn, the result of a well-documented and highly destructive set of unfair trade practices. These practices include blatant currency manipulation, massive illegal export subsidies, import barriers, flagrant counterfeiting and piracy, and health, safety and environmental regulations far below international norms.

The broader point is that the dollars in China's SWF literally have a mirror image in the destruction of jobs and the slowing of economic growth in the U.S. because they are being accumulated and invested through the application of mercantilist trade practices that violate the norms of free trade.

Prospectively, if left unregulated, the "mercantilist SWFs" of countries like China will accumulate more and more funds and therefore more and more power to directly harm America's industrial base. Such harm may be inflicted in any number of the ways outlined in this testimony.

Spurious Claim #3: *In the current subprime mortgage and credit crisis, they are helping to bail out the U.S. financial services industry.*

As with Claim #1, it is not the claim itself that is spurious here but rather what unregulated SWF proponents would have us infer from it. The faulty inference is that just because SWFs represent an important source of liquidity in the present global financial crisis, they must therefore be benign in the future. In fact, the SWFs could just as easily be looked upon as vultures than White Knights.

In this regard, one should not forget the critical and critically destructive role that China's currency manipulation has played in the creation of the mortgage crisis and real estate asset bubble to begin with. To maintain, its fixed peg to the dollar, China has recycled over a *trillion* dollars of its foreign reserves back into the U.S. bond market over the last six years. This currency manipulation contributed materially to the era of low mortgage rates and easy credit that created the asset bubble to begin with.

Spurious Claim #4A: *SWFs are just … like private equity firms.*

This claim is just plain stupid. Private equity firms have only one goal – to maximize the value of their shares for their owners. In this way, private equity firms fulfill the most critical requirement of efficient capital markets.

In contrast, SWFs may or may not seek to maximize their financial returns. Instead, as this testimony has illustrated in the case of China's currency manipulation, a country like China may purposely lose money on its foreign reserves to promote other goals related to its economic and trade policies. In this way, unlike private equity firms, SWFs fail to meet the most critical requirement of efficient capital markets.

Spurious Claim #4B: *SWFs are just a manifestation of the free market system.*

This claim is equally stupid. Almost all of the world's SWFs derive their funding by <u>crippling</u> the free market in one or more ways.

As every economics student learns, the free market leads to an efficient allocation of resources if and only if certain conditions are met. These conditions include the lack of monopoly elements, the lack of subsidies that distort true price signals, and the absence of any "negative externalities. When any one of these conditions are not met, the free market is said to be afflicted with "market failure" and an efficient allocation of resources is not obtained.

In fact, the world of SWFs is riddled with market failures so the virtues of the free market do not apply. For example, commodity-based, petrodollar SWFs owe their very existence to the monopoly pricing and production constraints of the OPEC cartel. If such a cartel were to try to operate on U.S. soil, it would be ruled *per se* illegal under our antitrust laws and its managers and owners would be fined and jailed.

The trade dollar SWFs likewise represent the poisonous fruit of a free market shackled by unfair, mercantilist, beggar thy neighbor policies. In fact, if the free market were in effect, China would float its currency like the U.S. and Europe and Japan, market forces would quickly drive up the value of the Chinese yuan, U.S. exports to China would rise, Chinese imports to the U.S. would fall, trade would come back into balance, and China's SWFs would have no long term source of funding.

The surprise here is that the U.S. Treasury Department continues to turn a blind eye to Chinese currency manipulation via its fixed peg despite urging by this Commission to act. Congress and the White House similarly continue to largely ignore China's flagrant violations of the WTO via export subsidies and import barriers as well as China's industrial strength counterfeiting and piracy. Both practices are in sharp contradiction to free market principles.

Finally, there is the matter of China's lax environmental and health and safety regulations. This lax regulatory environment generates significant "negative externalities" in the form of pollution and health and safety risks that impose substantial social costs on the Chinese people that are not reflected in the private cost of production. That these negative externalities and resultant market failures help swell China's SWF coffers likewise undercuts any claim of a free market efficiently allocated global capital.

Spurious Claim #5: *China's fund, the China Investment Corporation, has actually lost money on its first purchases of U.S. assets.*

So what? So did everybody else who bought Blackstone shares at the top. This means nothing for the future of China's SWFs.

On this point, China's money managers will steadily improve their trading skills, and China is unlikely to make the same mistakes that Japan did during its American buying spree in the 1980s. That said, Claim #5 is really irrelevant and a red herring.

As outlined in my testimony, the real concern with Chinese SWFs is whether they will use their SWF investments as a loss leader to promote other policy goals detrimental to the U.S. and the broader global economy. Everything we know about China and its management of its excess foreign reserves to date tells us there is great danger.

Spurious Claim #6: *China has avoided purchasing voting shares or has otherwise signaled its intention to avoid participating in or influencing management decisions.*

In the absence of appropriate legal and regulatory constraints, China's past certainly need not be its prologue to a future where Chinese SWFs will rapidly swell in size and influence. There is a very clear and future danger here.

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