

**IMPLICATIONS OF SOVEREIGN WEALTH FUND INVESTMENTS
FOR NATIONAL SECURITY**

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

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FEBRUARY 7, 2008
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UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
WASHINGTON : FEBRUARY 2008

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The Commission's full charter is available at www.uscc.gov.

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THE IMPLICATIONS OF SOVEREIGN WEALTH FUND INVESTMENTS FOR NATIONAL SECURITY

THURSDAY, FEBRUARY 7, 2008

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
Washington, D.C.

The Commission met in Room 562, Dirksen Senate Office Building, Washington, D.C. at 9:05 a.m., Chairman Larry M. Wortzel and Commissioner Patrick A. Mulloy (Hearing CoChairs), presiding.

OPENING STATEMENT OF CHAIRMAN LARRY M. WORTZEL (HEARING COCHAIR)

CHAIRMAN WORTZEL: Good morning. Welcome to this hearing on the "Implications of Sovereign Wealth Fund Investments for National Security."

My name is Larry Wortzel. I'm the chairman of the U.S.-China Economic and Security Review Commission for the 2008 reporting year. Along with Commissioner Pat Mulloy, I'm going to be one of the cochairs of today's hearing.

Congress has given our Commission the responsibility to examine the implications of U.S. trade with China for the American economy and for national security. China has about \$1.5 trillion in foreign reserves and is actually the single largest buyer of U.S. external debt. Actually right now we probably ought to be pretty grateful for that.

More recently, the Chinese government has created a fund and a management mechanism to grow its own sovereign wealth at a higher rate by branching out of U.S. government debt. Now, the People's Republic of China isn't unique in creating a sovereign wealth fund for these purposes. There are dozens of sovereign wealth funds in world finance, but with \$200 billion in its sovereign wealth fund, China is actually one of only seven countries with over \$100 billion in such funds.

The U.S. economy has to remain open for investment. We've predicated our markets on that, and I think we all agree on that. However, some observers have questioned whether one nation's sovereign investments could lead to influence over key industries, access to technology or influence over another nation's policies.

Leaders in France and Germany have expressed concerns about Chinese investments in some sectors of their economies while at the same time the British Prime Minister has invited China's sovereign wealth investments in with open arms.

In this hearing, we're going to explore the nature of sovereign wealth investments in general. We're going to ask whether China's sovereign wealth investments should be treated differently from those of other countries, and we'll examine the institutions that the United States government has in place to ensure that foreign investment does not affect national security.

Now, we expect this morning three members of Congress in to talk about the issue, and then we hope he's able to, but Senator James Webb of Virginia has said that he will come by or try to get by here at 2:30, so although we have other things scheduled, we'll probably interrupt the hearing at 2:30 if he's able to make it to let him speak and then go back to our regular hearing.

I now want to turn the floor over to my cochairman, Pat Mulloy. It's been a pleasure to work with him on this and I always learn a lot from him.

**OPENING STATEMENT OF COMMISSIONER PATRICK A.
MULLOY (HEARING COCHAIR)**

HEARING COCHAIR MULLOY: Thank you, Mr. Chairman. I'm pleased to have the opportunity to cochair today's important hearing with Larry Wortzel, the chairman of our Commission.

I first want to thank the members of Congress who are going to testify at today's hearing: Senators Bayh, Brown and Webb and Congresswoman Kaptur. I also want to thank the Congress for the support and interest so many members have shown in the work of this Commission since it was chartered by them in the year 2000.

The subject matter of today's hearing is extremely important and has attracted much attention in the press and in the policy community in recent months.

We will in this hearing try to gain a better understanding of how nations acquire the dollars to build these sovereign wealth funds and what large investments by these foreign government-controlled vehicles portend for our nation. This isn't like private investment. These are government controlled and owned vehicles with these

investments.

My own view is that the Chinese policy of keeping its currency undervalued by buying dollars has contributed to our nation's vast and growing trade deficit with that country. Last year our trade deficit with China was \$270 billion. This year it will probably reach 300 billion.

Since 1995, our cumulative trade deficits with China are well over \$1 trillion. These large and growing trade deficits have helped China accumulate foreign currency reserves of about \$1.5 trillion, which are growing at about a billion dollars a day.

Now, China has recently taken \$200 billion from its foreign currency reserves and put them into a sovereign wealth fund, but they have so many more foreign currency reserves, they can add to this fund at any time. So just talking about a \$200 billion fund I don't think really gets the magnitude of the potential problem here.

On October 26, 2003, Fortune Magazine carried an article by Warren Buffett, whom I always admire and pay attention to; his article was entitled, "Why I Am Not Buying the Dollar: America's Growing Trade Deficit is Selling the Nation Out From Under Us."

In that article, Mr. Buffett warned that America's continuing and massive trade deficits were causing a massive outflow of our national wealth.

He likened our country to a rich family that is selling off portions of its farm to support a lifestyle it was no longer earning.

On October 24, 2007, the Washington Post, which is hardly known at a protectionist newspaper, published an editorial entitled "Countries Buying Companies," which was on the subject of sovereign wealth funds.

In that editorial, the Post said, quote:

"Sovereign wealth funds, however, offer governments a way to take over businesses for political as well as economic purposes. The accumulation of so many dollars in foreign hands is the result of years in which the United States has imported more than it has exported."

One observer has noted that our country is collectively behaving like the Indians who sold Manhattan Island for some gaudy trinkets that at that time appeared attractive to them. We are allowing this to happen because we as a nation have failed to develop policies to deal with the mercantilist trade practices being used against us by other nations such as China.

Until the United States makes it a national priority to reduce our trade deficits, we're going to have to live with increasing foreign ownership of our economy. So we must then try to ensure that we have laws and regulations in effect that at least limit foreign purchases of U.S. assets whose ownership could threaten the national security.

Congress is aware of this problem and last year updated the law governing the Committee on Foreign Investment in the United States.

Today, we're going to hear from witnesses who are going to speak on all aspects of this issue. This is not a one-sided hearing. This is a hearing in which all sides are going to be represented. The Commission will take all such views into account when it later formulates its own recommendations to the Congress. I see that Senator Bayh is here so I am so happy to welcome him and thank him for being with us.

Senator, if I can introduce you and then we can get started. I want to thank you very much for honoring us with your presence here today. Senator Bayh was first elected to the United States Senate in 1998 and is currently serving in his second term.

In 1986, he was elected Indiana Secretary of State. In 1988, Senator Bayh was elected Governor of Indiana. As governor, he stressed fiscal responsibility and job creation. During his time as governor, 350,000 new jobs were created.

The Senator currently serves as the chairman of the Subcommittee on Security and International Trade and Finance of the Senate Banking Committee. Just this past year, he held two hearings very closely related to the subject we're dealing with today.

In May, he had a hearing on China's exchange rate practices, and then in November, he chaired the full committee hearing on sovereign wealth funds. The Senator is well positioned to understand the national security implications of these matters as he serves on the Senate Armed Services Committee and the Senate Select Committee on Intelligence.

As a long-time former staffer on the Senate Banking Committee, I welcome you, Senator, and thank you for being here.

PANEL I: CONGRESSIONAL PERSPECTIVES

STATEMENT OF EVAN BAYH A U.S. SENATOR FROM THE STATE OF INDIANA

SENATOR BAYH: Thank you, Commissioner Mulloy, for that moving eulogy. I really appreciate it. You're much too kind this morning. Chairman Wortzel, thank you for your hospitality today and your invitation, and to the members of the Commission. I appreciate this opportunity to testify. More importantly, I'm grateful for the good work you do on behalf of our country and this very important relationship, one that may very well be defining for our country and for much of the rest of the world over the next 50 to 100 years.

Commissioner Mulloy, it's good to be with you again. As you

pointed out, you have been kind enough to come testify before our subcommittee on two occasions, and your testimony was very informative. I personally chalk that up to the fact that you are a good Notre Dame man and so your Hoosier roots are much appreciated, and it's good to be with you again here this morning.

Ladies and gentlemen of the Commission, imagine for a moment what would happen were a candidate for President of the United States to propose that our federal government begin buying up shares in major U.S. companies. Denunciation would be swift amid cries of socialism. Critics would warn of the potential for undue political interference in private economic decision-making.

As chairman of the Federal Reserve, Alan Greenspan said, quote, "The federal government should eschew"--that's Fed-speak for avoid--"private asset accumulation because it would be exceptionally difficult to isolate the government's investment decisions from political pressures."

In 2001, Treasury Secretary Paul O'Neill told Congress, quote, "Government has no business owning private companies." He got no arguments.

As Americans, we realize the folly of allowing our government to own our industry. Yet paradoxically some appear far less alarmed by the prospect of another country's government doing exactly the same. Foreign governments operating sovereign wealth funds have in recent weeks been purchasing sizable stakes in U.S. companies, particularly in the financial services sector, and hardly a question has been asked. It's time that we started to.

Since our colonial days, we have always welcomed private foreign investment. This tradition stretches all the way back to 1606 when King James granted a charter to the Jamestown Company to finance the first British colony.

Our earliest forefathers realized full well that capital from abroad is instrumental to a growing American economy. But more recently, it's been foreign governments, not private companies, amassing large financial reserves and looking to invest. Driven by America's unprecedented trade imbalances and costly energy imports, this trend is almost sure to continue with amounts totaling well into the trillions of dollars.

Now, it would be folly to prohibit these investments. Allowing these funds to be reinvested in America mitigates the consequences of transferring so much wealth abroad for energy and consumption.

It also strengthens our economy, creates jobs, improves productivity, and keeps interest rates low. But neither these long-term economic benefits nor our short-term need to weather the subprime crisis should obscure the fact that investments by foreign governments

are inherently different than private investment.

Sovereign nations have interests other than maximizing profits and can be expected to pursue them with every tool at their disposal, including their financial power. For these reasons, we must establish standards for transparency in behavior now to prevent unwarranted interference in our economy by foreign governments.

The current administration has suggested a purely voluntary approach based on best practices, but mere suasion alone has rarely deterred nations from pursuing their interests. Incentives for compliance and meaningful consequences for a lack thereof must be adopted.

It would be a mistake to give a multinational organization like the International Monetary Fund responsibility for oversight because the IMF lacks enforcement power and has proven ineffective in discharging many of its current responsibilities like limiting currency manipulation. We cannot outsource the responsibility for protecting our nation's security.

At a minimum, the United States ought to require passive investment by sovereign wealth funds. Fortunately, the oil-rich nations of the Persian Gulf have a long track record of passive investing, but Russia's recent behavior and China's drive for economic advantage including rampant intellectual property theft, currency manipulation, and subsidies for manufacturers and export raise serious concerns about how sovereign wealth funds might be used.

A cautionary example of how foreign government influenced investment can undermine America's national security interests comes from my home state of Indiana. A company named Magnaquench once made 80 percent of the rare earth magnets used in one of our military's most advanced munitions--our laser-guided smart bombs.

In 1995, the company was purchased by three buyers: one American, two Chinese. The Chinese firms were partly owned by their government and headed by the sons-in-laws of their then paramount leader Deng Xiaoping. As a matter of fact, one of the son-in-law's wife was Deng's daughter. She was the vice chairman of a ministry charged with acquiring sensitive military technologies.

In 2003, the company was closed and production moved to China making us dependent upon them for access to this critical weapons component. It's not very smart to have to rely upon the Chinese government for the weapons that we need to defend ourselves, but that's exactly what we've done in this instance.

The Committee on Foreign Investment in the United States is charged with reviewing these kinds of foreign transactions for national security considerations, but regrettably CFIUS has all-too-often been a toothless watchdog and has proven willing to sacrifice our nation's

security on the alter of both ideology and monetary gain.

But even if CFIUS were effective, many benefits detrimental to broader U.S. security interests can be derived without formal power like a ten percent ownership stake or a seat on the board of directors or regular shareholder voting rights.

Another example comes from the recent purchase of an ownership stake, or rather I should say the change in leadership, at our nation's largest bank, Citigroup. In that case, the change was brought about, at least in part, by a Saudi prince whose ownership interest constituted about five percent. Now, I want to emphasize the Citigroup deal may have been exactly the right decision undertaken for entirely appropriate reasons. But it would be naive for us to believe that influence cannot be had for something less than a ten percent ownership stake.

Clearly, that is often not the case. It is often not the case in our domestic business practices. We should expect no less when transactions involve foreign governments.

Globalization of capital flows is irreversible and has many benefits, as I have indicated, for the U.S. economy. We should also be a safe and attractive place for investment from whatever origin. But occasionally, just occasionally, our national interests will diverge from purely pecuniary concerns.

We care about more than money as Americans. We should assume that other nations do too. Occasionally foreign governments will have agendas different from our own. They will pursue them using all the resources at their disposal including financial levers.

No great nation can permit such interference with its sovereignty, and America must not. Our craving for capital and the benefits that it brings must not deter us from acting. Reasonable regulations now will keep foreign investment flowing and hope to avoid potentially xenophobic reactions down the road.

I hope that your hearings today will help us to achieve this result and I'm grateful to you for allowing me to share my thoughts with you this morning.

HEARING COCHAIR MULLOY: Thank you very much, Senator. We appreciate your appearance here today.

SENATOR BAYH: Thank you, Mr. Mulloy. Thank you, ladies and gentlemen.

CHAIRMAN WORTZEL: We'll take a break in place here for a couple of minutes until Congresswoman Kaptur gets here.

[Whereupon, a short recess was taken.]

HEARING COCHAIR MULLOY: Let me now introduce Congresswoman Marcy Kaptur who represents the 9th congressional district in the state of Ohio.

Congresswoman, thank you for being here with us. She was first elected to the House in 1982 and is now serving her 13th term. She is the most senior Democratic woman on the House Appropriations Committee and she's a member of the Congressional Executive China Commission and has a very strong interest in the matters that this Commission is looking at today and also how this issue is related to the trade problems that we've had with China.

So Congresswoman, thank you again for being here. You honor us with your presence and we'll open it up for your statement.

**STATEMENT OF MARCY KAPTUR
A U.S. CONGRESSWOMAN FROM THE STATE OF OHIO**

MS. KAPTUR: Thank you very, very much, Mr. Mulloy. It is truly a privilege to testify before your august Commission today, and let me thank your cochairs, Chairman Wortzel as well as Commissioner Mulloy, along with all the commissioners who are here this morning, for the opportunity to address the increasingly important topic of sovereign wealth funds and their impact on America's national interests.

Please let me begin with a real story from a senior citizen from our Ohio district who this past week told me about her family's plight, and she and her elderly husband live frugally on Social Security and, sadly, their married son's wife recently died and he also lost his job and has responsibility for two children.

So the grandparents are doing their best to help their son get through difficult times. In wondering where good jobs were to come from for her son, she lamented to me how America had transformed into a totally different place from when she and her husband were working. She said, "Marcy, our country doesn't belong to us anymore."

I think it's important to begin with a story from a taxpayer and someone who has contributed so much to our country to give a perspective on the mind-set of many people that I represent and why your Commission is so very important.

It is refreshing that there is a body here on Capitol Hill investigating the explosion of foreign government investment into our economy. This is an issue not only central to U.S.-China relations but also to our relationships with a number of other countries. China is not the only country to invest its surplus savings into our cash-short banks and financial institutions.

As America becomes more debt-laden and faces recession, oil-producing countries and other Asian countries with which we have already staggering trade deficits, which are growing--Japan, Russia,

Singapore, Kuwait, United Emirates, among others--contribute more and more to this trend.

These funds are the latest symptom of a decades-long problem. It actually is the result--it's sort of a reciprocal of failed trading relationships and a very serious long-term debt that confronts this society.

When I first arrived in Congress and was appointed to the then Banking Committee, now Financial Services Committee, I pointed out and fought against the trend of growing foreign ownership of our public securities. At that time, in 1983, the percentage of foreign-held U.S. debt was less than 17 percent and of U.S. savings bonds, less than eight percent.

I remember we had in those days a "Save for the USA" campaign. We tried to get the Federal Reserve and Treasury interested in and found it very difficult to move them.

Today--by 2006, that foreign-held debt figure has risen to over half, 54 percent and, in fact, total debt security offerings now over at Treasury, on any given week, two-thirds to 80 percent are purchased by foreign interests if you look at the figures.

This is unacceptable to me as an American. Today, your Commission has focused on issues relating directly to Chinese-American policy and China's financial maneuvers certainly present a threat, a large threat, to America's economic security.

However, I believe this issue is so important it must be viewed through a larger lens. An old professor at the Harvard Business School used to admonish us if you want to know the way the world works, follow the cash. I urge you to follow the cash.

Technically, these funds have existed for decades starting with Kuwait in the 1950s. Yet, the term "sovereign wealth fund" has only recently entered the public's vocabulary as America's sovereignty and economic ownership slip out of our grasp.

These funds, enriched beyond imagination by U.S. dollars from foreign imports, especially petroleum, have swooped in only too happily to rescue Wall Street, its investment houses and its banks that are faltering as a result of the subprime mortgage crisis and the very flawed trade models like China Permanent Normal Trade Relations that passed this Congress.

In some ways, I view the increase in these funds as trademarks of America's failed economic policies. The power of petroleum is obvious on chart one, which I have included in the packet that we have given you, which shows that among ten of the largest sovereign wealth funds, 69 percent of these assets, over two-thirds, exist in funds

financed by oil revenue.¹

To prop up Wall Street, Chinese funds recently invested \$5 billion in Morgan Stanley and \$3 billion in Barclays. Citigroup just accepted \$22 billion in buyouts, including a significant amount of money from Singaporean, Kuwaiti, and Abu Dhabi funds. Of course, the United Arab Emirates has always been the banking center for oil in the Middle East.

Merrill Lynch sold a stake to these funds when the governments of Korea, Kuwait and Singapore contributed to a buyout.

Mr. Lou Jiwei, the head of the China Investment Corporation, China's \$200 billion sovereign wealth fund, claimed last week in the New York Times that the Chinese government through his fund is focused more on investments in portfolios than in individual companies. He did not rule out making direct investments, as in the case of Morgan Stanley I mentioned earlier.

He said if there is--and I quote him--"If there is a big fat rabbit, we will also shoot it. Some people will say we were shot by Morgan Stanley, but who knows?"

Think about that statement--"If there is a big fat rabbit, we will also shoot it." Mr. Lou Jiwei fancies himself to be a big game hunter, to be sure. He's not content with small game. Oh, no. He loves to shoot big, fat targets, targets such as Morgan Stanley and Blackstone.

He certainly has plenty of ammunition, \$1.4 trillion in foreign reserves and growing. Again, those reserves growing because of our growing trade deficit with China.

The policy question for us is whether the United States will require him to buy a hunting license? Will we regulate Mr. Jiwei's hunting by declaring a season and a bag limit? Will we require background checks before he buys a gun to hunt his prey?

And what if Mr. Jiwei's acquisition threatens U.S. security interests in products, processes or intellectual property? Will we sit back and let the Lou Jiwei's of the world fire at will claiming our assets and extirpating our businesses?

These are the issues before your Commission. Instead of rescuing our economy, these investments only deepen America's insecurity forcing the United States further into debt to foreign interests. And the American people know it and they expect us to do something about it.

More often than not, these deals are presented as purely financial when they are, in fact, political and strategic.

The funds suffer from a severe lack of transparency, especially

¹ [Click here to view the chart: Ten of the Largest Sovereign Wealth Funds](#)
[Source Morgan Stanley]

with regard to governance. So many are run by undemocratic governments with powerful strategic objectives. I included with this testimony a graph plotting the funds that we know currently exist according to their level of transparency, and we provided that in the testimony, and I refer it to you as I talk about it.

Plotting the funds according to their level of transparency and the style of investment approach, if one looks at this chart, one can see funds such as Norway's have a high level of transparency and they have an investment approach that is not strategic. They're at the bottom of the chart.

But if one looks up to this corner where China sits, we will see a huge lack of transparency and huge strategic objectives. There is a possibility that ulterior motives exist for some of these countries and that these financial investments are aimed at strategic results.

For those who think there should be little government involvement in the workings of our markets, it should be obvious that foreign governments meddling and takeovers of private enterprise are even more dangerous--some would say socialistic; some might say fascist.

When the means of private production become owned and financed in greater and greater shares by foreign governments, many of them or most of them undemocratic, at what point would you say America's political independence, and I underline political independence, is in jeopardy? Have we already passed that point? Does this place us on a path, as I have said, to some type of socialistic or fascistic compromise of our political ideals?

America needs to reclaim our economic independence and security while retaining the integrity of our markets to remain prosperous. What should we do about these threats?

Three things. First, secure transparency. Move everybody on this chart here. Then analyze the nature of that effort, and if there is the potential for destructive practices, regulate.

Let me go into a little more detail. We must require disclosure and increased transparency of all sovereign wealth fund bids. We must analyze their stakeholders, stockholders, and our government needs to ask who operates these funds; how big are they? How are they audited? If so, by whom? What are their investment policies? And what are their motives?

Some funds are willingly transparent like Norway's. So there does exist a standard for how much information can and should be disclosed. Others like the Chinese funds that bring us here today obscure their investment and banking practices and have unconventional investment patterns.

That brings me to a key concern, and that is political motives. It

is not just academics raising the alarm. In a cover story last month, The Economist reported that China and South Korea want returns, and possibly access to markets, ideas, and technology.

In addition to requiring transparency and analysis, in order to see how immense this issue has grown, Congress needs also to examine regulation. This would normally fall to the Committee on Foreign Investment in the United States known as CFIUS, but there are questions as to how reliable that body actually is.

Beyond methodological objections regarding how well these funds can be tested by existing models, many of us have expressed concern that the committee, CFIUS, is governed by the skewed interests of those involved in approving those very transactions.

President Bush recently signed an executive order transferring his own power, the power of the president, to the Treasury Department to authorize or reject foreign takeovers of American companies, but officials from the Defense Department, the Department of Justice, and the Department of Homeland Security objected to the order over the past few months saying it served business interests over security interests. I would encourage you to include those documents in this Commission record.

We cannot allow Wall Street to profit at the expense of national security. Furthermore, President Bush stripped from this order the provision that required the committee to monitor, and I quote, "the effects of foreign investment in the United States."

He stripped from the order the provision requiring the committee to monitor the effects of foreign investment in the United States. We need to restore that.

Congress needs to reassert our power and pass legislation that maintains as presidential the authority to approve or reject these deals.

I have drafted legislation to do exactly that in the House. Congress must require the administration to report back in order to prevent the president from delegating this important national security authority to any cabinet officer or executive agency.

The United States government always needs to act in the name of national security before private interests. After all, our congressional oath requires us to support and defend the Constitution of the United States against all enemies, foreign and domestic.

Some might object to increased government involvement in the economy if we require transparency. But American government involvement is preferable to foreign government involvement. We need to prioritize the security of our citizens, businesses and economy as a whole.

Our national security is far more important than Wall Street's interests and more important than doling out U.S. liberty in order to

rescue reckless megabanks from their own bad investment decisions.

Furthermore, our nation should regulate a savings policy and reject the debt path Wall Street is imposing on Main Street. Our economy is suffering enough as it is. Our federal government should be working to rebuild our economy, create new jobs and lessen our dependence on foreign oil, which is so very much a part of the conundrum in which we find ourselves.

Instead, it is allowing foreign governments to control greater and greater shares of our economy. Let's require transparency, balance the approval process for foreign investments, and reclaim our national security from sovereign wealth funds. The United States government must stand up for the American people in the face of this opaque and increasingly powerful threat to our sovereignty.

I thank you very, very much for the opportunity to appear this morning.

[The statement follows:]

**Prepared Statement of Marcy Kaptur
A U.S. Congresswoman from the State of Ohio**

It is my privilege to testify today before the United States-China Economic and Security Review Commission. Please let me thank the hearing co-chairs, Chairman Larry Wortzel and Commissioner Patrick Molloy, along with the rest of the Commission, for this opportunity to address the increasingly-important topic of sovereign wealth funds and their impact on America's national interest.

Please let me begin with a real story from a senior citizen from our Ohio district who this past week told me about her family's plight. She and her elderly husband live frugally on Social Security. Sadly, their married son's wife died recently. Moreover, he has lost his job with two children to support. So the grandparents are doing their best to help their son get through difficult times. In wondering where good jobs were to come from, she lamented how America had transformed into a totally different place from when she and her husband were working. She said, "Marcy, our country doesn't belong to us anymore."

It is refreshing that there is a body here on Capitol Hill investigating the explosion of foreign government investment into our economy. This is an issue not only central to U.S.-China relations, but also to our relationships with a number of other countries. China is not the only country to invest its surplus savings into our cash-short banks and financial institutions. As America becomes more debt-laden and faces recession, oil-producing countries and other Asian countries with which we already have staggering trade deficits like Japan, Russia, Singapore, Kuwait, and the United Arab Emirates, among others, contribute more and more to this trend.

These funds are the latest symptom of a decades-long problem. When I first arrived in Congress, I pointed out (and fought against, to no avail) the growing trend of foreign purchases of U.S. treasury securities. In 1983, the percentage of foreign-held debt was less than 17%. But by 2006, that figure rose to 54%.

To date, your Commission has focused on issues relating directly to Chinese-American policy, and China's financial maneuvers certainly present a large threat to American economic security. However, I believe this issue is so important it must be viewed through a larger lens. As my old professor at Harvard Business School used to admonish, "If you want to know the way the world operates, follow the cash."

These funds have existed for decades. Yet the term "sovereign wealth fund" has only recently entered the public's vocabulary as our sovereignty and economic ownership slip out of our grasp. These

funds, enriched beyond imagination by U.S. dollars from foreign imports such as petroleum, have swooped in only too happily to “rescue” Wall Street, investment houses, and banks that are faltering as a result of the sub-prime mortgage crisis and the very flawed trade models, like China PNTR, that are trademarks of American economic policy. The power of petroleum is obvious on the chart I included, which shows that among ten of the largest sovereign wealth funds, 69% of these assets exist in funds financed by oil revenue.

To prop up Wall Street, Chinese funds recently invested \$5 billion in Morgan Stanley and \$3 million in Barclays. Citigroup just accepted \$22 billion in buyouts, including a significant amount of money from Singaporean, Kuwaiti, and Abu Dhabi funds. Merrill Lynch sold stake to these funds when the governments of Korea, Kuwait, and Singapore contributed to a buyout.

Mr. Lou Jiwei, the head of China Investment Corporation, China’s \$200 billion sovereign wealth fund, claimed last week in the *New York Times* that the Chinese government, through his fund, is focused more on investments in portfolios than in individual companies. He did not rule out making direct investments, as in the case of Morgan Stanley I mentioned earlier.

He said, “If there is a big fat rabbit, we will also shoot it. Some people will say we were shot by Morgan Stanley. But who knows?”

Think about that statement. “If there is a big fat rabbit, we will also shoot it.”

Mr. Lou Jiwei fancies himself to be a big game hunter, to be sure. He’s not content with small game. Oh, no. He loves to shoot big, fat targets. Targets such as Morgan Stanley and Blackstone.

He certainly has plenty of ammunition: \$1.4 trillion in foreign reserves.

The policy question for us is whether the United States will require him to buy a hunting license. Will we regulate Mr. Jiwei’s hunting by declaring a season and a bag limit? Will we require background checks before he buys a gun to hunt his prey?

And what if Mr. Jiwei’s acquisitions threaten U.S. security interests in products, processes, or intellectual property?

Will we sit back and let the Lou Jiweis of the world fire at will, claiming our assets and extirpating our businesses?

Instead of rescuing our economy, these investments only deepen America’s insecurity, forcing the U.S. further into debt to foreign interests. More often than not, these deals are presented as purely financial when they are, in fact, political and strategic.

The funds suffer from a severe lack of transparency, especially with regard to governance. So many are run by undemocratic governments with powerful strategic objectives. I included with this testimony a graph plotting the funds according to their level of transparency and style of investment approach. There is the possibility that ulterior motives exist for these countries, and that these financial investments are aimed at strategic results. For those who think there should be little government involvement in the workings of our markets, it should be obvious that foreign government meddling and takeovers of private enterprise are even more dangerous—some would say socialistic. America needs to reclaim our economic independence and security while retaining the integrity of our markets to remain prosperous.

What should we do about these threats? First, secure transparency. Then, analyze. And if there is the potential for destructive practices, regulate.

We must require disclosure and increased transparency of all sovereign wealth fund bids. Stakeholders, stock-holders, and the government need to ask: Who operates these funds? How big are they? Are they audited? If so, by whom? What are their investment policies? What are their true motives?

Some funds are willingly transparent, like Norway’s, so there does exist a standard for how much information can and should be disclosed. Others, like the Chinese funds that bring us here today, obscure their investment strategies, and have unconventional investment patterns.

That bring to light my second concern—political motives. It is not just the rogue academics raising the alarm. In a cover story last month, the *Economist* reported that “China and South Korea want returns—and possibly access to markets, ideas and technology.”

In addition to requiring transparency, in order to see how immense this problem has grown,

Congress needs also to examine regulation. This would normally fall to the Committee on Foreign Investment in the United States, also known as CFIUS, but there are questions as to how reliable this body is. Beyond methodological objections regarding how well these funds can be tested by existing models, many of us have expressed concern that the Committee is governed by the skewed interests of those involved in approving these transactions.

President Bush recently signed an executive order transferring his own power to the Treasury department to authorize or reject foreign takeovers of American companies. But officials from the Defense Department, the Department of Justice, and the Department of Homeland Security objected to the order over the past few months saying it served business interests over security interests. It allows Wall Street to continue to profit at the expense of national security. Furthermore, President Bush stripped from this order the provision that required the Committee to “monitor the effects of foreign investment in the United States.”

Congress needs to reassert our power and pass legislation that maintains as presidential the authority to approve or reject these deals. I have drafted legislation to do exactly that. Congress must require the Administration to report back in order to prevent the president from delegating this important national security authority to any cabinet officer or executive agency. The U.S. government always needs to act in the name of national security before private interests. After all, our Congressional oath requires us to “support and defend the Constitution of the United States against all enemies, foreign or domestic.”

Some might object to increased government involvement in the economy if we require transparency. But American government involvement is preferable to foreign government involvement. We need to prioritize the security of our citizens, businesses, and economy as a whole. Our national security is far more important than Wall Street’s interests and more important than doling out U.S. liberty in order to rescue reckless megabanks from their own bad investment decisions. Furthermore, our nation should regulate a savings policy direction and reject the debt path Wall Street is imposing on Main Street.

Our economy is suffering enough as it is. Our federal government should be working to rebuild our economy, create new jobs, and lessen our dependence on foreign oil. Instead, it is allowing foreign governments to control greater and greater shares of our economy. Let’s require transparency, balance the approval process for foreign investments, and reclaim our national security from sovereign wealth funds. The U.S. government must stand up for the American people in the face of this opaque and increasingly-powerful threat to our sovereignty.

HEARING COCHAIR MULLOY: Thank you, Congresswoman, very much.

Now, we have with us Senator Brown. Would you prefer to let him testify and stay before taking questions and then there could be questions for you both together or however you would prefer?

MS. KAPTUR: Senator Brown and I know one another.

HEARING COCHAIR MULLOY: Thank you, Senator Brown, for being here.

SENATOR BROWN: Thank you.

HEARING COCHAIR MULLOY: We really appreciate your interest and your support for this Commission and your interest in this particular subject matter.

The Senator was first elected to the United States Senate in 2006 and one of the key issues on which he based his campaign was the fact that the United States was running these major trade deficits which are so damaging to the economy of Ohio and, I think, the country as a whole.

Prior to being in the Senate, he served in the House of Representatives as a member from the 13th district of Ohio since 1992.

In both the House and the Senate, he has been an outspoken advocate of his beliefs in fair trade and he outlined them in his book called, quote, "Myths of Fair Trade."

So, Senator, thank you again for being with us. You can give your statement now.

**STATEMENT OF SHERROD BROWN
A U.S. CONGRESSMAN FROM THE STATE OF OHIO**

SENATOR BROWN: Thank you. Thank you very much, Commissioner Mulloy. I appreciate that. Chairman Wortzel, thank you, and Vice Chair Bartholomew, thank you very much. Commissioner Slane, welcome. Good to see an Ohioan on the panel, and Commissioner Wessel is sort of an honorary Ohioan, but you're the real thing. So thank you.

It's my pleasure to appear with Congresswoman Kaptur, whom I've learned a lot from over the years when she, starting in the early '80s here, made such a difference in beginning to redirect our trade policy.

I appreciate the opportunity to join you today to discuss what sovereign wealth funds means for our national security and our families' economic and community security. It's an important topic. I appreciate your giving attention to it.

Some governments around the world today are confronted with a nice problem: what to do with all the money earned from their abundance of exports, whether it's from barrels of oil or from "Barrels of Monkeys" and other toys.

Our own government is faced and continues to face a variation of the same dilemma. The \$400 billion deficit projected in the president's budget is really a 600 billion on-budget deficit coupled with the 200 billion off-budget surplus, principally caused by receipts to the Social Security Fund.

For at least a decade, a policy debate has intermittently focused on how to best invest that surplus. In the late 1990s, President Clinton proposed we invest 15 percent of Social Security assets in the stock market. The reasoning was fairly simple: with a projected rate of return of less than three percent on Treasury securities, equity investment offered the prospect of perhaps more than doubling that return if the historical seven percent real rate held true.

Needless to say, that proposal was not enacted, but the same underlying principle, seeking the higher return from equities, was part of the motivation, I think, for President Bush's proposal to establish

individual accounts within the Social Security system. His proposal also failed to be enacted.

The merits of these two proposals and the reason for their failure, in my view, are quite different, but both took pains to ensure that the U.S. government would not be involved in making selective equity investments.

The Clinton proposal would have established an independent board to make investments in index funds, much as the Thrift Savings Plan does today, while the Bush proposal would have left decisions to individual investors.

As the Heritage Foundation put it at the time, giving federal bureaucrats the power to invest huge amounts of money in the stock market would create a fundamental conflict of interest between the long-term needs of future retirees and short-term political goals.

Although that doesn't really describe the Clinton plan, the sentiment is correct and is shared across the political spectrum. In fact, Dr. Wortzel, this may be the first time in my career that I've testified in agreement with the Heritage Foundation so I'm thankful for that.

CHAIRMAN WORTZEL: But we consider you a friend.

SENATOR BROWN: That will work. So if our country has broad agreement on how ill-advised it would be for our own government to select particular companies for investment, it comes as no surprise that some of us are troubled when other governments do so.

My only surprise is I wonder why this discomfort is not broader or deeper. Our difference, of course, is that it's not the U.S. government investing in U.S. businesses. Maybe so. But suppose President Clinton had proposed selective investment overseas? Would that proposal have been met with a warm embrace? Of course not.

I think most of us would see a huge potential for mischief if the U.S. government had invested in one company overseas but not with its competitors, and as globalization continues, a distinction, of course, between U.S. and foreign businesses becomes increasingly blurred.

Yet, this is exactly the situation we're facing with respect to these sovereign wealth funds. If the China Investment Corporation has invested millions of dollars in Morgan Stanley or Blackstone, can Carlyle or Bear Stearns rest easy that they will have an equal opportunity to get access to China's markets?

The answer is fairly obvious. Do we really think that a nearly ten percent stake is a passive investment in the practical sense of the term?

These are just some of the earliest investments, and we know how they're exploding. As we've seen, the appetite of foreign governments and their investments goes well beyond the financial

sector, as we saw with China National Offshore Oil Corporation's proposed purchase of Unocal.

Energy companies might be a particularly sensitive industry when we have troops in the Middle East and oil fluctuates between 90 and \$100 a barrel. But the same issues are raised in other industries.

President Bush views the sale of U.S. assets as testimony to our attractiveness to foreign investors. That may be true, but it's also evidence of the failed policies of the administration which has presided over an explosion in our trade and in our budget deficits.

I remember back when I first ran for Congress in 1992, we talked about the twin deficits, and you'll look at what the budget and trade deficits were then, contrasted to now. President Bush, who inherited a federal budget that was in surplus, is leaving a successor budget that will likely set a record for red ink, especially when the full cost of the wars in Iraq and Afghanistan are included.

As you know, in the president's five year budget, in 2010, there is zero dollars allotted for Iraq.

Unwilling to ask Americans to bear the cost of these wars, the administration has handed an IOU to our children and their children. The public debt held by foreigners has doubled on his watch.

As China has deliberately undervalued its currency, providing what Chairman Bernanke has accurately termed an "effective subsidy," the administration has responded with little but talk. A "dialogue," the term du jour of several months ago, is hardly the right response when our manufacturing sector is being hollowed out.

China's mercantilist trade policy is at the heart of what the Commission is discussing today. Unfair trade practices contribute to the enormous imbalance in trade between China and the U.S. Again, back to 1992, our trade deficit bilaterally, U.S.-China, was barely into double digits. Now it's exceeding a quarter of a trillion dollars.

Currency manipulation, massive export subsidies, counterfeiting, piracy, lax labor, environmental, safety/health standards, all of that, have contributed to a manufacturing crisis in America and the massive trade deficits that afflict us.

These are the issues the executive branch and Congress need to address of course. Just last week, I was joined by seven freshmen senators, eight out of nine of us, in a letter affirming that China-related trade legislation should be our number one domestic trade issue priority.

Without sensible fiscal and trade policies, we can only expect the increased growth of sovereign wealth funds and the subsequent sale of one piece of America after another. That's no legacy to leave behind for our children.

Thank the chairman and thank you, Commissioner Mulloy.

HEARING COCHAIR MULLOY: Thank you, Senator, very much. Are you both prepared to take a few questions?

PANEL I: Discussion, Questions and Answers

SENATOR BROWN: Yes, sure. Of course.

HEARING COCHAIR MULLOY: Chairman Wortzel.

CHAIRMAN WORTZEL: When we talk about transparency, can we really trust the good intentions of the Chinese Communist Party, which shrouds its own decisions and literally its operations in secrecy, to make transparent the intentions of the financial decisions of the government that it directs?

SENATOR BROWN: No, but in the words certainly of the hero of most of the presidential debates, "trust but verify." I think that I go back to this: during the China PNTR debates and discussions, some of us would talk about the fact that we were China's biggest customer. About 35 to 40 percent in those days of Chinese exports came to the United States.

Many of you have been successful in business. I know certainly Dan has. And if Dan has one customer that represents 35 percent of his sales, he's going to pay a lot of attention to that customer.

While the Chinese are not willingly going to be as transparent as we like. We're are not going to willingly do many things that we'd like, we're in a position of strength still, although that 35 percent figure, whatever it precisely is today, declines over the years as the rest of the world gets wealthier, of course, and they find new lucrative markets.

It's important that we act sooner rather than later, but I think that we have carrots and we have sticks with China. If one of their sovereign wealth funds wants to purchase something big in the United States, we're in a position we can demand certain benchmarks for transparency and for other issues.

MS. KAPTUR: Maybe I would just say again, bringing it back to my own district, in my district resides a young woman who is the roommate of one of those Chinese citizens who was killed at Tiananmen Square, and I'm thinking of her as I'm answering this question because she cannot go back into her own country. As her father was dying, her government would not allow her to go back and visit him. What kind of a country is that?

I think about people in business that I know that have tried to place offerings on the stock exchange here in our country, Chinese firms, and they lost their shirts. It was an untransparent firm, and we have lawyers in this country now trying to adjudicate and try to get back damages related to that particular situation.

I think the company was called Brilliant China. I may have the wrong name. I think we have to look at the record. We have to look at the political record. We have to look at the financial record and we have to stand up for our political values which make a vibrant capitalism possible, and I think Senator Brown used the word "mercantilist economy."

When you have an economy that is not transparent, a political system that is repressive, how can you possibly think that you are going to get transparency? And therefore we have to set up rules of engagement. I think the role of your Commission is extraordinarily important and you are working under duress because we have let this go on for too long, acting here in Washington as if nothing had changed, and yet we have huge deficits that we are bearing, and because of our oil dependency and the dollar reserves that are being held by others around the world, we're in a particularly vulnerable position.

I will also say as a member of the Defense Committee, China has strategic objectives. She has a record that people in our intelligence services know. I would commend it to you. And those strategic objectives are very important to the extent that they can be placed on the record, and those strategic objectives take the form of targeting of certain types of companies and technologies and not always in the nicest way.

So I think when we're dealing with countries who have strategic objectives, we have to have strategic objectives, and that has to start with regulation by our own behavior or how we relate to societies that are very different from our own, and we have to protect our own vital interests.

HEARING COCHAIR MULLOY: Thank you, Congresswoman and Senator. Commissioner Fiedler.

COMMISSIONER FIEDLER: We're talking sovereign wealth funds today, and there is a lot of debate about sovereign wealth funds, but is it really a debate about sovereign wealth funds or government-controlled entities?

For instance, the Chinese have huge state-owned enterprises that invest in the United States. Are they different from the sovereign wealth fund only in that they have less money? We should be concerned about those equally as well, it seems to me. Do you have any sort of thoughts about broadening the discussion?

The Saudis don't have a sovereign wealth fund but have \$285 billion in corporate money invested.

MS. KAPTUR: I think it's very, very important to look at the transfusions of wealth that are coming into this economy and what price they are exacting, whether they be in a more hidden form like

sovereign wealth funds, which the public really doesn't know a great deal about, or whether they are direct buys, and what implication that has down the road for our own financial stability?

To what extent could those investments be withdrawn or what price can be exacted for that investment down the road? What constitutes a controlling interest if you take a sovereign wealth fund? If you're dying and someone gives you a tourniquet and it saves your life, that's a pretty important investment.

Those just seem small at that moment, but it's very, very controlling. So is it a figure that we're looking for? Is it ten percent? Is it 50 percent? If Citicorp had fallen on its face, if Morgan Stanley or any of these other companies, Blackstone, how important was that investment?

It seems to me it was vital. Without it, would they have failed? And so whether that is in the form of asset ownership, which is a concern of mine, particularly from undemocratic countries, this is what troubles me.

If it's Norway, I'm a little less concerned because we share a rule of law, we share a set of political values, but when you have countries, whether it's Middle Eastern, whether it's Chinese, that share none of our political values, how can you not be jeopardizing the purposes for which your society stands politically when you're selling off pieces of it to those whose values, political values, are very different?

To me it's not just about business, but it's about our value set, and to what extent do those investments threaten that value set that we hold dear?

SENATOR BROWN: I agree as Congresswoman Kaptur pointed out, that the American public has so little understanding. I would add that the Senate and the House have little understanding of sovereign wealth funds.

It's a term that only recently has worked its way into vocabularies in floor speeches and committee hearings, for that matter. I think people are aware of the sort of intractability, if you will, of the difficulty of changing policy in China generally from our standpoint, that the people who have so much at stake in China, the People's Liberation Army, which owns some number of major enterprises, the Communist Party, the government, and I would put in that category American investors, in many cases. While roles are different, they have some of the same things at stake, and none of them much want a change in Chinese government policy.

The policy works. It may not work for Hasbro so much as it used to, but it certainly works for American investors, as it does for the Chinese Communist Party and the People's Republic of China's government. That's the insidiousness of it, and that's why it's so

reluctant, so resistant to change.

I think the sovereign wealth funds perhaps beg the question. The sovereign wealth funds are even, to the American public, even more impenetrable and darker in terms of understanding, if not motive. I don't know if Americans understand that the Chinese government is investing in the U.S., whether they understand what the wealth funds are, or whether they understand where these investments all come from, but the more light we shine on it--I think the question sort of implies that the more light we shine on it, the better, if there's not much difference in the two.

MS. KAPTUR: May I just add on to what the Senator has said and give you a perspective, why this is so, I think so critical--this hearing today? We are living through the largest mortgage foreclosure crisis since the Great Depression, and our shared state of Ohio is suffering as much as any other one in the union.

If one looks back at the 1990s and how did we get in this pickle, I was fortunate to serve in the House during the '90s when we made the decisions to balance the national budget, and by the year 2000, with the leadership of Leon Panetta and a lot of other people, Martin Sabo, Dick Gephardt, we got to the point where we had an annual surplus. We had an annual balance, and we were paying back our long-term debt.

I can remember Alan Greenspan saying back then, well, gosh, what if we didn't have any debt? Where would that place us? And I thought isn't that an odd statement to make because the American people want to pay their bills. That statement still stands out as one of the most abhorrent ones I've ever heard.

But during the '90s, the indebtedness that had created certain relationships around the world, those relationships in some ways, in my opinion, became a bit threatened because we were paying our bills.

I think, my hypothesis is that during the '90s, because we began to pay off those bills, those set of relationships that wanted to continue found another way to exact connection to the American people's pocketbooks, and that was through the housing system. The most important form of savings of any American family is their home.

And we began to see invented new instruments to draw equity from the American people. We began to see a pro-savings economy that had existed for most of the post-World War II period transformed into a pro-debt economy. We fought those battles on the Banking Committee. We moved from thrift institutions where people actually had savings and were paying off their home loans to a system of megabanks, and drawing out home equity and people saying, you've got to do this, Congresswoman, because we're doing to securitize that, and we're going to break it up into pieces and we're going to make it a

lot easier. You'll see. We'll never have a bust in the real estate market.

I said that's the craziest thing I've ever heard. Why should we trust the market which has ups and downs more than the system that we've had in place since the Great Depression?

During the '90s what happened? For the first time in American history those debts were securitized into the international market. Why did that happen? It secured certain relationships to backfill where those relationships were beginning to be severed because we were paying our bills.

And now what do we have? We are linked at the hip with the very same places that we were severing those financial relationships with during the 1990s. But it was no longer public debt, but it was the private savings of the American people that had been sucked out of every community in this country.

The vacuum cleaner of Wall Street--I'm sorry to refer to it as that--did a great job. But I'd like to challenge any one of those executives to come to my district and to deal with the pain that our public is feeling right now, and what's been great out of Wall Street is to say to them, well, you were greedy. You're the one that's the problem. You out there in Ohio, that hardly can even work for minimum wage anymore, it's your problem when the head of Citigroup walks off with--what was it--\$110 million? What did he take home? That was just a little golden balloon payment he got.

I'd like to challenge any one of them: do they have the manhood to come to my district and face the damage that they have done across this country? So it's a very clever system, and I guess my message to the Commission today is the role of these megabanks and investment houses is profound, whether they are channeling Chinese money or Saudi money, they hit us in the gut in Toledo, Ohio, and it hurts bad, and we resent what they have done to us.

As the representative of the people of the 9th district of Ohio, I did everything in my power over a quarter century to prevent this, and I was not successful. They have much more power than I have and they shouldn't. We should control that power.

HEARING COCHAIR MULLOY: Thank you, Congresswoman and Senator. There are more questions, but we have the SEC and the Treasury about to come and testify, and then we have a long day of other witnesses, but we are going to focus on these financial issues on a panel that we have this afternoon, Congresswoman.

I want to thank you both very much for being with us today and for your help and contributions to our work. Thank you.

CHAIRMAN WORTZEL: Thank you very much for your testimony. We're going to seat the other panel and we'll take about

three minutes in between.

SENATOR BROWN: Thank you.

MS. KAPTUR: Thank you.

[Whereupon, a short recess was taken.]

PANEL II: GOVERNMENT PERSPECTIVES

HEARING COCHAIR MULLOY: We're moving on to the second panel. We have two witnesses from the United States government. Our first witness is Robert Dohner, who is the Deputy Assistant Secretary of the Treasury for Asia in the International Affairs Division.

We want to thank Secretary Paulson for making you available to the Commission. This is the first time in the history of this Commission that the Treasury, despite a number of invitations, has come to testify. So please tell him we really appreciate your being here.

Mr. Dohner has a Ph.D. in economics from MIT, and he's been involved with Chinese and other Asian matters with the Department of Treasury for a number of years, and was a Senior Economist on the President's Council of Economic Advisors. A very distinguished background, and we appreciate you being here.

Secondly, we have Linda Chatman Thomsen, who is the Director of the Division of Enforcement at the Securities and Exchange Commission.

She's been at the Commission since 1995 and has served as the Division's Deputy Director since 2002.

Before joining the Commission, she was in private practice with the distinguished LPW firm of Davis Polk & Wardwell in Washington and New York and also served as an Assistant U.S. Attorney for the District of Maryland.

We thank you both for being here, and we'll open with Dr. Dohner and then turn to you, Ms. Thomsen.

STATEMENT OF DR. ROBERT DOHNER, DEPUTY ASSISTANT SECRETARY FOR ASIA, U.S. DEPARTMENT OF THE TREASURY WASHINGTON, D.C.

DR. DOHNER: Commissioner Mulloy, thank you very much for your introduction. Chairman Wortzel and members of the Commission, thank you for the invitation to speak to you today about sovereign wealth funds and the activities of the Treasury.

Sovereign wealth funds are not new. The oldest funds date back

to the 1950s. By 2000, there were about 20 sovereign wealth funds 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. Fueled by high commodity prices and a rapid accumulation of official reserves, 20 new funds have been created since 2000. Today, there are nearly 40 funds managing total assets in a range of 1.9 to \$2.9 trillion.

Sovereign wealth funds generally fall into two categories based on the source of the foreign assets. First are commodity funds, funded through commodity exports owned or taxed by the government. Commodity funds serve several purposes including stabilization of fiscal revenues and the preservation of natural resource wealth for future generations.

Second are non-commodity funds which are established through transfers of assets from official foreign exchange reserves. Large balance of payment surpluses have enabled non-commodity exporting countries to transfer excess foreign exchange reserves to stand-alone funds.

It should be noted that for this latter group of countries, foreign exchange reserves are now sufficient by all standard metrics of reserve adequacy. It is our view that greater exchange rate flexibility is needed by these and other countries, and we are actively engaged on many fronts and calling for increased flexibility.

Total sovereign wealth fund assets of 1.9 to 2.9 trillion are only a fraction of the \$190 trillion stock of global financial assets, but sovereign wealth fund assets currently are larger than the total assets under management by either hedge funds or private equity funds.

Roughly two-thirds of sovereign wealth fund assets are commodity fund assets, while the remaining one-third are non-commodity funds transferred from official reserves.

The rise of sovereign wealth funds clearly has implications for the international financial system. They bring benefits and they also pose some concerns.

In evaluating sovereign wealth funds, it's useful to stress the benefits provided by open trade and foreign investment regimes. As reiterated by the President in his May 10 statement, the United States is committed to open investment and advancing open markets at home and abroad.

The U.S. economy benefits from foreign investment including investment from sovereign wealth funds. The United States has derived benefits in the forms of jobs, research and development spending and higher wages.

Sovereign wealth funds also have the potential to promote financial stability. They are in principle long-term stable investors

that provide significant capital to the system. They are not highly leveraged and cannot be forced by capital requirements or investor withdrawals to liquidate positions quickly.

Sovereign wealth funds also raise potential concerns. First, the rise of sovereign wealth funds could provoke a new wave of investment protectionism, which raises risks for the health of the global economy.

Second, investments in U.S. companies or other firms by sovereign wealth funds, as with other types of foreign investment may create legitimate national security concerns.

Third, sovereign wealth funds raise non-national security issues related to 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 strategic objectives over return-oriented investments, sovereign wealth funds could potentially distort markets.

Finally, sovereign wealth funds may raise financial stability issues, as actual or perceived shifts in their holdings could cause market volatility.

At the Treasury Department, we're working on a number of steps to ensure the United States continues to benefit from open investment while addressing these concerns.

First, the new Foreign Investment and National Security Act signed into law by President Bush last summer, implemented through the Committee on Foreign Investment in the United States, or CFIUS, ensures robust reviews of investment transactions that pose 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.

Second, we have proposed the creation of a multilateral framework for best practices. The International Monetary Fund should develop best practices for sovereign wealth funds, building on existing best practices for foreign exchange reserve management.

These best practices would provide guidance to funds in areas such as fund objectives, structure, transparency, and risk management, while demonstrating to critics that sovereign wealth funds can continue to be responsible, constructive participants in the international financial system.

Treasury initiated the international discussion of sovereign wealth funds, and meaningful and timely progress has been made. Last May, Treasury hosted a G-20 meeting of finance ministry and central

bank officials that included the first multilateral discussion of sovereign wealth funds.

Last October, Secretary Paulson hosted a meeting with G-7 finance ministers and the heads of sovereign wealth funds from eight countries to build support for best practices. The next day, the IMFC, a ministerial level advisory committee to the IMF, called on the IMF to begin a dialogue to identify best practices for sovereign wealth funds.

At Treasury, we have taken a number of steps internally and within the U.S. government to respond to the issues posed by sovereign wealth funds.

Treasury has created a working group that draws on the expertise of International Affairs and Domestic Finance. Treasury's market room vigilantly monitors sovereign wealth fund trends and transactions, and we have informed Congress of some of our initial thinking in our foreign exchange report and will continue to do so in the future.

Through the President's Financial Markets Working Group, chaired by Secretary Paulson, we continue to discuss and review sovereign wealth funds. We have also initiated outreach to ensure an ongoing and candid dialogue with countries that have these funds.

The Treasury Department will continue its work on sovereign wealth funds analytically, bilaterally and multilaterally so that the United States can shape an international response to this issue that addresses legitimate areas of concern while ensuring that the United States and other countries remain open to foreign investment.

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

The China Investment Corporation is an example of a non-commodity fund and was created to diversify management of a portion of China's rapidly growing foreign exchange reserves.

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.

The need to rebalance the sources of Chinese economic growth has 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 enterprises 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 flexibility, and China should not use the earnings of its sovereign wealth fund to delay prompt adjustment of the renminbi.

The China Investment Corporation, or CIC, was officially launched in September last year with \$200 billion in registered capital.

Two-thirds of the assets of the CIC, about \$133 billion, have been dedicated to the recapitalization of domestic financial institutions. According to public comments by Chinese officials, the remaining one-third of CIC's assets, or about \$67 billion, has been allocated for overseas investment.

CIC has so far made investments in Blackstone, the Hong Kong IPO of China Railway Group, and has announced its intention to invest \$5 billion in Morgan Stanley.

Press reports indicate that CIC is also recruiting external asset managers to help manage its offshore portfolio.

Chinese official statements have characterized the objectives of CIC as commercial. It is important that CIC operate on a commercial basis, as China's leaders have claimed. We will continue to work with CIC and other sovereign wealth funds and watch their activities vigilantly.

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 sovereign wealth funds 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.

[The statement follows:]

**Prepared Statement of Dr. Robert Dohner
Deputy Assistant Secretary for Asia
U.S. Department of the Treasury, Washington, DC**

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 (FINSAs) 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 (FINSAs) 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.

HEARING COCHAIR MULLOY: Thank you, Dr. Dohner, and now Ms. Thomsen.

**STATEMENT OF MS. LINDA CHATMAN THOMSEN
DIRECTOR, DIVISION OF ENFORCEMENT
U.S. SECURITIES & EXCHANGE COMMISSION
WASHINGTON, D.C.**

MS. THOMSEN: Thank you. Chairman Wortzel, Vice Chairman Bartholomew, and members of the Commission, good morning and thank you for inviting me on behalf of the Securities and Exchange Commission to discuss issues raised by the participation of government-owned commercial investment funds in the United States' capital markets.

I'm going to focus my remarks on issues related to the enforcement of the federal securities laws.

Government ownership of large investment funds, known as sovereign wealth funds, is not new, but it is a growing trend that raises important issues for policymakers to consider.

The world's sovereign wealth funds, estimated to hold \$2.5 trillion in assets, are significantly larger than all of the world's hedge funds combined. According to some estimates, sovereign wealth funds could grow to hold as much as \$12 trillion over the next eight years.

The Abu Dhabi Investment Authority, Norway's Government Pension Fund, and Saudi Arabia's Wealth Fund, according to IMF estimates, each currently have more than a quarter of a trillion dollars in assets to invest.

Kuwait, Singapore, Russia and Hong Kong also each have sovereign wealth funds totaling more than \$100 billion in assets. The Chinese government recently established the China Investment Corporation with assets estimated at \$200 billion.

These funds raise a number of securities law enforcement issues. At the Securities and Exchange Commission, an essential part of our mission is investor protection, and essential to the protection of investors is the protection of market integrity.

As with other participants in the United States capital markets, sovereign wealth funds are subject to the requirements of the federal securities laws including a variety of disclosure requirements and the anti-fraud provisions.

One series of enforcement issues associated with sovereign wealth funds are similar to issues associated with hedge funds. We are concerned that some sovereign wealth funds, or persons associated with them, like some hedge funds or persons associated with them, may undermine market integrity by engaging in inside trading or other market abuses.

Sovereign wealth funds, like hedge funds, have by virtue of their substantial assets substantial power in our financial markets. However, in addition to this financial power, sovereign wealth funds, unlike hedge funds, have power derived from being governmental entities which may give them access to information that is not available to other investors.

There is the potential for these powerful market participants to obtain material non-public information either by virtue of their financial and government powers or by use of those powers, and thereafter engage in illegal insider trading using that information.

To put a little bit of that in context, in our last fiscal year, we brought 47 insider trading cases involving 110 defendants or respondents. Those cases showed a disturbing number of market professionals including professionals associated with hedge funds engaging in illegal insider trading.

Another series of issues associated with sovereign wealth funds relates to the need for law enforcement authorities to work together in order to effectively police our increasingly global markets.

Each year the Securities and Exchange Commission makes hundreds of requests to foreign regulators for enforcement assistance and responds to hundreds of requests from other nations. To facilitate this type of assistance, the Securities and Exchange Commission has entered into more than 30 bilateral information sharing agreements as well as the IOSCO Multilateral Memorandum of Understanding.

In our last fiscal year, we made 556 requests of foreign regulators and received 454 requests from foreign regulators. These numbers reflect a 24 percent increase in requests to foreign regulators from our 2002 fiscal year and a 28 percent increase in request from foreign regulators from our 2002 fiscal year.

Returning for purposes of illustration to our insider trading cases from last year, of the 47 cases, 16, or about 34 percent, had an international component. The international aspects of our insider trading cases involve many countries and no particular country stands out.

Of the 110 defendants or respondents, 24, or approximately 22 percent, were residents or citizens of foreign countries.

To cite a very current example of our international work, this week, we filed a settled action related to alleged insider trading in the

securities of Dow Jones, a United States registered issuer, ahead of the public announcement of an acquisition offer by News Corp.

The SEC's complaint alleged that a Dow Jones board member, a prominent business and political figure in Hong Kong, tipped a close friend, another prominent Hong Kong businessman, about the News Corp. acquisition offer before it was publicly announced.

Based on this inside information, the friend bought \$15 million worth of Dow Jones common stock through a brokerage account in the names of his daughter and son-in-law, who were also residents of Hong Kong. Ultimately, the purchased shares generated an illegal profit of \$8.1 million.

This week's civil action was against the board member, his friend and the friend's daughter and son-in-law. Without admitting or denying the Commission's allegations, the defendants settled the actions for a variety of sanctions including payments of close to \$25 million.

In conducting the investigation, the SEC requested and received assistance from the Hong Kong Securities and Futures Commission.

Given the inherent difficulties of conducting a cross-border investigation, this kind of cooperation is essential for our effectiveness and the need for that kind of cooperation is increasing.

In the context of sovereign wealth funds, we are concerned that if the government from which we seek assistance is also controlling the entity under investigation, the nature and extent of the cooperation could be compromised.

Indeed, in other contexts, we have seen less than optimal cooperation when foreign governments have an interest in the issue or person we are investigating.

The issues raised by the growth of sovereign wealth funds are under consideration in a number of venues including the President's Working Group on Financial Markets, of which the SEC is a member, as well as in the G-7, the World Bank, the OECD, and the IMF. The outcome of these analyses may be a generalized agreement about the kinds of strong fiduciary controls, disclosure requirements, professional and independent management, and checks and balances needed to prevent corruption, all of which may help protect both investors and markets.

We are, of course, committed to vigorously pursuing our mission of investor protection and look forward to continuing and deepening our relationships with our counterparts around the globe.

Thank you so much for inviting me to appear today and I would be happy to take any questions. Thank you.

[The statement follows:]²

Panel II: Discussion, Questions and Answers

HEARING COCHAIR MULLOY: Thank you, Ms. Thomsen, for your statement. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you both for being here. Very helpful testimony on the very timely topic that is gaining more and more attention day by day.

I'd like to gain some knowledge from you about how these funds work and how we might look at some of their investments. Last year, before this Commission, an official with the Defense Intelligence Agency testified that the transaction involving Blackstone, for example, where there could be derivative ownership as a result of Chinese investments in that, meaning that Blackstone would then go out and buy certain companies, might invest in certain transactions, et cetera, might create issues that have national security repercussions.

I'd like to understand from you whether the administration is looking at that--the official said at that point there was going to be a working group to look at that within the administration as it related to CFIUS--what the result of that has been and whether CFIUS and other statutes need to be looked at more broadly in terms of how these, the participation in some of our hedge fund, private equity, merchant banks, et cetera, that China may gain some access that would not necessarily trigger direct scrutiny under the old standards?

DR. DOHNER: I can give you a partial answer, I'm afraid, not a very satisfying answer. My responsibility at the Treasury is Asia. I've been involved directly in the discussions with China. I've also been involved with the sovereign wealth fund discussions.

I have not, am not, involved in CFIUS matters at the Treasury, but I can tell you that we cannot comment on particular transactions that either are or might be subject to CFIUS review.

In general, to your first point about how sovereign wealth funds operate, I think it's important to recognize that these funds have grown out of official foreign exchange reserves and the desire to earn a higher return and accept more risks than official foreign exchange reserves have ordinarily borne.

They have generally been conservative and generally been passive investors. Now that's no indication that that may not change, but that I think has characterized the operation of sovereign wealth funds to date.

COMMISSIONER WESSEL: I'm not seeking any comment on

² [Click here to read the prepared statement of Ms. Linda Chatman Thomsen](#)

specific CFIUS transactions. What I'm interested in and the question is we've seen a number of transactions, whether it's by China or others, called into question either within our security system, political system, et cetera.

Some have been concerned about cash and carry transactions that our companies are going to be bought, productive enterprises moved overseas. There have been some who have been concerned about brand acquisition as a way of gaining immediate access to the U.S. market for companies that don't have a U.S. presence.

If these sovereign wealth funds now, rather than doing direct transactions, do them through U.S. intermediaries, whether it's a merchant bank, whether it's a hedge fund, et cetera, is that something that you're looking at to determine what derivative impact that might have, that they're using, if you will, it's a U.S. shell or a U.S. front to do what they might have trouble doing otherwise?

DR. DOHNER: Thank you for that question. There are a couple points that I would make. First, the debate about what foreign investment review should cover is a long-standing one. The Congress approved the Foreign Investment and National Security Act in the summer with broad bipartisan support.

That legislation maintained the focus of the CFIUS process on genuine national security concerns and did not include broader concerns of economic security or industrial policy.

We're now in the process at Treasury of issuing implementing regulations for the Foreign Investment and National Security Act. We will publish those for comment and we encourage your comments and other comments on the kind of transactions that should be subject to CFIUS review.

COMMISSIONER WESSEL: Ms. Thomsen? Any questions also as it relates to materiality and how those investments may be viewed, market integrity and the desire for investors to have full information?

MS. THOMSEN: I should start, of course, by reminding everyone I'm an enforcement lawyer and worried about issues of whether or not a particular transaction has violated the securities laws, and I take your question, commissioner, to relate largely to issues of passivity, whether or not the investments are passive or more active, et cetera, and from a law enforcement perspective, I can anticipate or foresee or imagine almost any kind of investment as raising the potential for a securities law issue.

So, for example, without regard to any particular investment, any particular fund, or indeed sovereign wealth funds generally, you could have a long-term passive investment, but should you come into information about the company that you're invested in, bad news, for example, and you then sell that investment, that raises issues from an

insider trading law perspective without regard to how you got into the investment in the first place.

On the broader policy issues that you've raised, I did attach to my statement statements made by Chairman Cox that address some of those issues more generally, but I am most concerned with issues of illegal trading as opposed to policy issues.

COMMISSIONER WESSEL: I understand, but let me then just ask a quick question regarding materiality. Let us say that a China sovereign wealth fund, CIC, invests in a U.S. merchant bank or investment house, and their funds are segregated within, as they often are, into certain classes of funds, and that fund were then to invest in a U.S. defense program.

That I assume would be a material issue that an investor would want to know, but it would not necessarily be triggered under the normal, if you will, standard we're looking at these days. We're seeing a changing standard of materiality, I think, over time.

MS. THOMSEN: Again, now you raise an issue that I wish I had my counterparts in the Division of Corporation Finance here for. But to the extent the nature of the issuer's business is changing or the risk that the issuer has by virtue of the business it's in or the businesses that it is going--that it is considering based on its shareholder base, that raises disclosure issues for the issuer, and those, materiality is an ever-changing issue, always has been, and it's an issue of all the facts and circumstances taken into consideration, so that could very well raise issues that disclosure counsel for the issuer would have to consider.

HEARING COCHAIR MULLOY: Thank you. I should have made this announcement when I was introducing Dr. Dohner. In arranging for you to be here, we did talk with Deputy Assistant Secretary Bartling and made clear that you were speaking on the sovereign wealth fund issue, that if you did not have the capacity to answer certain other questions dealing with CFIUS, that you could take those back to the Treasury and provide answers for the record.

DR. DOHNER: Yes, I would be happy to do so.

HEARING COCHAIR MULLOY: We should note that. Thank you. Commissioners, let's try to keep within our five minutes, because there's a lot of interest in asking questions. Commissioner Fiedler.

COMMISSIONER FIEDLER: Ms. Thomsen, a hypothetical enforcement question. Assume my facts are correct, which they may not be. So you have three entities, three Chinese entities. One is called CITIC, the other is called the China Development Bank, and the other is called CIC, and they each buy 4.9 percent of a U.S. company over several months at different times.

Ultimately, each of those entities is owned or is under the

control of the Chinese State Council. Should they have disclosed that they were a group?

MS. THOMSEN: Again, I really wish I had some of my colleagues from the Division of Corporation Finance. It raises an issue that we've seen not only in the context of sovereign wealth funds but for other funds, hedge funds and others, who may be acting in concert or in a coordinated fashion as to whether or not, if you accumulate related investments, they have crossed the disclosure threshold, and that issue is reasonably fact specific and depends on the circumstances. But it is, certainly there's a potential disclosure issue which is certainly true.

COMMISSIONER FIEDLER: Okay. Let me ask you another. In your formal testimony, you refer to Section 13 of the Act, and let me get at that in two ways.

MS. THOMSEN: Sure.

COMMISSIONER FIEDLER: One, we require or the SEC requires, the law requires investment managers in the United States--I don't know if the figure is 100 million, \$150 million of other people's money to register--

MS. THOMSEN: Right.

COMMISSIONER FIEDLER: --to disclose, and to file 13(f)s on a quarterly basis of all the holdings of their stocks and bonds. So we already require transparency and disclosure of investment managers of pension fund monies. Conceptually, what's the problem of having a sovereign wealth fund or any government-controlled entity filing a 13(z), a new number, listing all of its subsidiaries and all of its holdings in the U.S. public securities markets on a quarterly basis?

Is that a great inhibition to investment?

MS. THOMSEN: That's a policy issue that I truly leave to those who are interested in the issues associated with disclosure. We are as a base matter a disclosure agency. You know it is, is what we--

COMMISSIONER FIEDLER: Then let me address it to Mr. Dohner even though we'll get out of the details of Section 13. The disclosure question, the transparency question of them disclosing to the SEC?

DR. DOHNER: Certainly the disclosure, we think the transparency of sovereign wealth funds including asset holdings is very important and should be a part of best practices for these funds.

COMMISSIONER FIEDLER: But best practices are unenforceable so I was talking about an enforceable U.S. government activity to compel transparency at least as they operate in the United States of America?

We make lots of people have these disclosures. Why are we so hesitant as a matter of policy to have the Chinese government--why are

we requiring more of individuals in the United States than we are of the Chinese government?

DR. DOHNER: Again, I would prefer not to answer for the SEC on this question. I believe that disclosure is desirable for sovereign wealth funds, and I believe personally that sovereign wealth funds should be subject to the rules regarding any large institutional investor.

COMMISSIONER FIEDLER: One last question.

MS. THOMSEN: I should note that to a certain extent under the current rules disclosure is already required in some circumstances regarding holdings from sovereign wealth funds.

COMMISSIONER FIEDLER: On transaction basis?

MS. THOMSEN: On transactional basis and to a certain extent there may be some circumstances where there are disclosure requirements associated with 13(f).

COMMISSIONER FIEDLER: There is no current disclosure requirement for CIC, for instance, to list all of its subsidiaries anywhere in the world all the entities through which they buy. For instance, SAFE, a company that bought into the banking system of Australia, I believe, which is their foreign exchange company, has a subsidiary in Hong Kong called Bo An. We found it by accident by looking for it, but nowhere could you look in U.S. government filings and find any information about it.

Thank you.

HEARING COCHAIR MULLOY: Thank you. Commissioner Reinsch.

COMMISSIONER REINSCH: Thank you. Let me pursue that just a minute with more of a more general question for Ms. Thomsen.

First, do you think the disclosure requirements that you already have in place by statute and regulation are adequate to deal with sovereign wealth funds or do they pose a challenge that would require something more than what you already are doing?

MS. THOMSEN: Again, I'm trying to stick to my sort of comfort level or certainly my base of expertise.

COMMISSIONER REINSCH: I know, but you're the enforcement person.

MS. THOMSEN: Right.

COMMISSIONER REINSCH: Do you have the tools that you need to do the job that you're assigned to do?

MS. THOMSEN: And that's a better question.

COMMISSIONER REINSCH: Right. Thank you.

MS. THOMSEN: And indeed where we are right now is I think we have the tools to enforce the laws that we have on the books. The big concern or one of the concerns, as I identified in my testimony, is

to the extent we need to work internationally in order to enforce the rules that we have, one of the challenges may be that we foresee is that we are going to be asking governments for assistance to investigate funds that they control.

COMMISSIONER REINSCH: Yes.

MS. THOMSEN: And that could be a challenge.

COMMISSIONER REINSCH: Your testimony noted that. Have you encountered that? Is that a hypothetical problem or have you encountered that as an actual problem so far?

MS. THOMSEN: I think, what I do say and can say is that outside of the context of sovereign wealth funds, that has been an actual problem.

COMMISSIONER REINSCH: But not inside the context of sovereign wealth funds yet?

MS. THOMSEN: I think it's fair to say it's something we can anticipate.

COMMISSIONER REINSCH: What do you do, without getting into the specifics, when you encounter that problem with the other government? Can you enlist other pieces of the United States government to assist you or are you on your own?

MS. THOMSEN: We do a variety of things. We try to get the information we need through other sources, and oftentimes in an enforcement investigation, there are multiple channels you can pursue so we pursue alternatives. We also try to work with our counterparts to persuade them of the value of providing cooperation, provide them with assurances. Sometimes issues that arise are misunderstandings about how we will use information.

I mean one of the great success stories of the past several years is by virtue of the fact that we have increasingly global markets, all of us need to work with other more often than we ever used to, and based on that experience we have learned how each other's systems work. I mean one of the issues that we have run into is the fact that people don't understand--we don't understand how their system works; they don't understand how our system works. And based on that misunderstanding or lack of understanding, it sometimes takes longer.

COMMISSIONER REINSCH: Have you found that your regulatory counterparts or your enforcement counterparts in other countries, particularly in Europe and Asia, have the same level of concern about this problem and are proceeding generally equally aggressively?

MS. THOMSEN: It varies country to country. It varies issue to issue. I think what is consistent is the concern on the part of securities enforcers that we cannot operate strictly within our national borders, that our markets are all global, and that all of our markets

depend or their integrity depends on worldwide integrity.

COMMISSIONER REINSCH: Is there some relevant international body that everybody that matters belongs to including the countries that operate these funds where these kinds of issues can be addressed or taken up?

MS. THOMSEN: Certainly, the IOSCO MMOU is one way through which we are all--

COMMISSIONER REINSCH: China is a party to that?

MS. THOMSEN: China is a party to that, became a party in 2007, I believe.

COMMISSIONER REINSCH: And the various Arab states that also have sovereign wealth funds are there as well?

MS. THOMSEN: There are at least 40 securities regulators who are signatories to that MMOU, and I, as I sit here, can't name them all unfortunately.

COMMISSIONER REINSCH: You don't have to. That's all right.

MS. THOMSEN: Thank you.

COMMISSIONER REINSCH: Let me ask Dr. Dohner a question because I don't want to deprive him of the opportunity to say something in this round.

You have mentioned what the IMF is working on and we've actually had a briefing with the IMF. Is the Treasury Department satisfied with the progress that the IMF is making in developing whatever it is that it's developing?

DR. DOHNER: I think we're satisfied with the progress that's being made and with the participation. We think good progress is being made by the IMF, with the participation of the sovereign wealth funds. We don't have an exact time table. I think it's reasonable to expect that something would be finished by the time of the annual meetings in the fall in October.

COMMISSIONER REINSCH: The fall annual meeting rather than the spring?

DR. DOHNER: Yes.

COMMISSIONER REINSCH: All right. Thank you very much.

HEARING COCHAIR MULLOY: Thank you. Chairman Wortzel has let me know that at 11:10, we're going to close this panel off and move on. So fellow commissioners, if you can get in and out because there are more than one who wants to ask a question.

Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you very much for your testimony. We're chartered to look at the national security implications of our growing economic relations, and obviously this gets more and more complicated as our economic relations go to new

levels and we get more intertwined with the Chinese economy.

This testimony is very useful. When I look at Dr. Dohner's testimony about potential concerns, I guess you pointed to some hypothetical national security concerns that would then be covered by CFIUS, and some other questions of market volatility.

I'm trying to figure out where we should focus our efforts in terms of our work. Is this the sort of thing you think that with sovereign wealth funds that the need for CFIUS will be greater or more robust than in the absence of sovereign wealth funds because of certain types of acquisitions?

Another reason I ask is because so far it seems that the Chinese sovereign wealth fund has made an attempt to purchase or purchased some financial positions. So you pointed to hypothetical concerns about national security concerns, but is this something that one can foresee becoming more of a national security issue in the sense of buying companies with the types of technology we'd rather China didn't have?

DR. DOHNER: Certainly, any kind of acquisition of a stake in an American company that carries with it an element of control, whether it's done by a private firm or a government firm, whether it's done by a sovereign wealth fund or a state-owned enterprise, if that transaction poses national security considerations, then it is subject to review by CFIUS.

I think it's important to remember that sovereign wealth funds are one channel or one conduit by which governments can deploy their resources and they're not the resources themselves. Sovereign wealth funds do pose certain issues, both for national security and for financial market stability, and for the maintenance of open investment regimes, that we've tried to identify and we're thinking closely about.

COMMISSIONER BLUMENTHAL: Of those, which ones most concern you? You've laid out concerns that I think are hypothetical concerns, and I'm trying to get a roadmap for how we should focus our work as we think about this. But of the ones you mentioned, financial volatility, potential CFIUS issues, what do you think people who focus on this issue should be most worried about?

DR. DOHNER: In answering that question, I can speak to the things that I know, which are economics and financial issues. I think the greatest risk that we have identified is the possibility of the rise of sovereign wealth funds would lead to a protectionist reaction in a number of places that would restrict international investment and thus diminish the benefits that our country and other countries get from open investment regimes.

We at the Treasury are obviously also very sensitive to anything that would affect financial market stability and so we've looked very

closely at the implications of sovereign wealth funds for financial market stability.

Here the existence of large holdings indicates the importance of transparency, both so that actual movements of holdings don't disrupt markets, but also so that market perceptions or perceived movements of holdings by sovereign wealth funds don't affect markets.

COMMISSIONER BLUMENTHAL: Thank you. My time is up, I think.

HEARING COCHAIR MULLOY: Thank you, Commissioner Blumenthal. Commissioner Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thank you very much and thank you to our witnesses for coming today. We really appreciate your appearance and your testimony. These are complicated questions and it's interesting that everybody is focused on sovereign wealth funds. But of course one of the reasons that there's so much concern is because of the nature of the Chinese government and the nature of the Chinese economy. I think a lot of these questions were actually summed up yesterday in a Wall Street Journal article entitled "China Shows Savvy in Rio Tinto Deal," and it really brought up a number of the issues:

It isn't a sovereign wealth fund deal, but it is a purchase by a company that is a Chinese state-owned enterprise. The CEO of that company is noted in the article for being a member of the Chinese Communist Party. I think he's an alternate to the Central Committee, and it raises all sorts of questions.

I think it's also important because of the whole nature of showing savvy. We have found in a lot of the military issues, a lot of the economic issues, the Chinese are moving ahead. People seem to continue to be surprised by how quickly they're overcoming barriers, be it militarily or the economic growth as they're moving up the supply chain.

So I would ask both of you a simple question. If you're not the right people in your agencies, let me know, but do you think that you have the tools, both in terms of the laws that you have and also in terms of the manpower that you have, to address what I think all of us can agree is going to be unfolding as an increasingly complex situation?

DR. DOHNER: That's an excellent question, commissioner. And I believe that we have the tools that we need to address the issues raised by sovereign wealth fund investments and by investments by state-owned enterprises.

However, these issues are issues that we're considering in the President's Working Group, in our own internal discussions, and we, as I mentioned, are putting out the revised CFIUS regulations for public

comment, and would invite comment by you and by others on the issues that CFIUS review should now face.

MS. THOMSEN: Surely from an enforcement perspective, I do think we have the tools and indeed I think it is a positive development that the Chinese securities regulators have now signed the IOSCO MMOUs, and those kinds of developments are things that we look forward to and will need, and so from that perspective I think we do have those resources, but it is something.

The world is changing; it's getting bigger, and we all have broader jurisdictions. So it's something we have to keep our eye on.

VICE CHAIRMAN BARTHOLOMEW: Okay. So we will keep in touch with you. Ms. Thomsen, I would like to acknowledge the work of the SEC in this Dow Jones case. It was politically well-connected and wealthy individuals who were involved. I think it should be acknowledged that it was through Hong Kong that the cooperation happened. I have my own doubts as to whether if it had been based in Beijing, you necessarily would have gotten the cooperation that you got in this, but I think that it's certainly important to recognize the success that you've had with this.

We look forward to working with you both as things move forward.

HEARING COCHAIR MULLOY: Thank you, Commissioner Bartholomew. Before we turn to our last questioner, Commissioner Shea, I just want to thank Chairman Cox and Commissioner Casey for having you available. I think you put into the record the statements that Commissioner Cox has made up at the Kennedy School and then the other speech he made. Those are well worth people reading because he's saying normally we don't want our own government controlling our economy. There are concerns in his mind. Then why are we letting foreign governments buy chunks of our economy? I think that's a very important issue and it was raised here by some of the congressional representatives.

Secondly, Mr. Dohner, I just note that in the report that was put out by the McKinsey & Company called "The New Power Brokers," dated October 2007, the question was how do the Asians accumulate this money so rapidly? And at least according to the McKinsey, its report said that because they're managing their currencies. They're intervening in currency markets to prevent appreciation of their own currency and for Asia, quote, "This system has assured the success of their export-led growth model and continuous and growing current account surplus with the United States."

That's the McKinsey Company. So when Treasury says their biggest worry is protectionist reaction in the United States, I think we ought to get policies, not protectionist policies, but we have to have

policies to deal with this type of behavior on the part of others because you can see where it's taking us.

Commissioner Shea.

DR. DOHNER: May I comment?

COMMISSIONER SHEA: Sure.

DR. DOHNER: Thank you very much, Commissioner Mulloy. Countries run balance of payments surpluses because they have an excess of domestic saving over domestic investment. And Asian countries have accumulated large balance of payment surpluses, large reserves, over the past ten years because investment has never, investment in countries outside of China has never really recovered from the Asian financial crisis.

The situation in China is different. China's investment is high, but Chinese saving is very high, and this reflects the fact that the social safety net is very weak, that there are limited financial services available to households, and that state-owned enterprises pay very little in dividends. In fact, these are factors that you pointed out in your annual report in 2007.

The foreign exchange rate levels of these countries facilitate the accumulation of balance of payment surpluses and reserves, but they are not in themselves responsible for the excess of domestic savings over domestic investment.

Our discussion in China in particular has emphasized the need for China to rebalance the sources of their growth, to reduce domestic savings, to reduce their current account surplus, and also to increase currency flexibility, which will be an important part of bringing this rebalancing about.

This is true of our discussions with China. It's also true of our discussions with a variety of Asian countries.

HEARING COCHAIR MULLOY: Thank you. Commissioner Shea.

CHAIRMAN WORTZEL: I want to thank both Ms. Thomsen and Dr. Dohner. I appreciate your testimony, your patience in allowing our members of Congress to get through theirs, and the forbearance of your agencies and departments in getting you here. Thank you very much.

DR. DOHNER: My pleasure. Thank you.

MS. THOMSEN: Thank you very much.

CHAIRMAN WORTZEL: We'll reconvene at 11:15.

[Whereupon, a short recess was taken.]

PANEL III: OVERVIEW

CHAIRMAN WORTZEL: This Commission intended and

designed this third panel as a broad overview of the topic from three well-qualified experts. I'll introduce them in the order that they will speak.

First is Brad Setser. He's an economist with expertise in finance, global capital flows and emerging economies. He's a fellow for Geoeconomics at the Council on Foreign Relations.

Dr. Setser is the author of several publications including the political economy of sovereign debt restructuring mechanism, oil and global adjustment, and the political economy of sovereign debt restructuring--you got that in there twice, Brad. I'm just reading here.

DR. SETSER: I know.

CHAIRMAN WORTZEL: That's all right.

DR. SETSER: Always embarrassing when your own bio is--

CHAIRMAN WORTZEL: That's okay. It's great. Dr. Setser earned his Bachelor of Arts degree from Harvard University, his DEA from the Institute des Etudes Politiques in Paris. Did I do that right? I'm a Chinese linguist. And his Master's of Philosophy and Doctor of Philosophy degree from Oxford University.

Second, Dr. Peter Navarro. He's a Professor of Business at the Merage School of Public Policy at the University of California Irvine.

Professor Navarro graduated from Tufts University in 1972, served in the Peace Corps in Southeast Asia from '73 to '76, and after working as an environmental and policy analyst in Washington, he received a Master's in Public Administration from the John F. Kennedy School at Harvard and a Ph.D. in Economics at Harvard.

He writes frequently in economic, energy and environmental issues. He's the author of five books on economics and public policy including *The Dimming of America*, *The Policy Game*, and *The Coming China Wars*. And I think this is your second time testifying here.

And third is Dr. Michael Martin, an analyst in Asian Trade and Finance for the Congressional Research Service with the Library of Congress. His professional career has included work in China, Japan, Hong Kong and Vietnam.

From 1994 to 1998, he was the Assistant Chief Economist for the Hong Kong Trade Development Council and taught at Hong Kong Baptist University, Doshisha University in Kyoto, Japan, Colby College and Tufts. He holds a B.A. in Economics from Michigan State University, and an M.A. and Ph.D. from the University of Massachusetts in Amherst.

So with that, it will be seven minutes of oral testimony each and then we'll move into a round of questioning from the commissioners, the first of which will come from Commissioner Shea because I cut him off.

Dr. Setser.

**STATEMENT OF DR. BRAD SETSER, FELLOW FOR
GEOECONOMICS, COUNCIL ON FOREIGN RELATIONS
NEW YORK, NEW YORK**

DR. SETSER: I want to thank the Commission for giving me the opportunity to testify here today on sovereign wealth funds. It's a very timely hearing.

The prominence of sovereign wealth funds stems from the combination of high oil prices and in Asia extensive exchange rate management. This together with the adoption of investment strategies that have raised the public profile of many long-established funds has elevated the salience of their activities and their economic importance.

Today's global economy, as I mentioned, is marked by an unusual combination of large current account surpluses in both East Asia and in the oil-importing economies, even though East Asia itself is an oil-importing economy.

The simultaneous presence of a large surplus in both Asia and the oil-exporting economies differentiates today's era of high oil prices from the 1970s. The large current account surpluses in both regions are largely financing a build up of foreign assets by their respective governments, not financing private capital outflows.

As former Assistant Secretary of the Treasury Ted Truman noted, recent developments have shifted wealth toward countries with different conceptions of the rule of government in their economic and financial systems than in the United States.

Until recently, though, the friction or the potential tensions, I think, intrinsic in that shift have been minimized by the fact that most of the increase in official assets globally has come in the form of central bank reserves and that these reserves have been invested fairly conservatively.

For all the attention that the \$40 billion that various sovereign wealth funds have injected into large U.S. and European financial institutions over the past several months, legitimately so since it is comparable in size to the amount of money that the IMF lent to the emerging markets back in the late 1990s--so it's a big sum of money—that investment is still quite small relative to the likely \$1.2 trillion increase in the foreign exchange reserves of the, mostly in the emerging world. The orders of magnitude are completely different.

A lack of transparency makes it difficult to assess precisely how much sovereign wealth funds added to their assets in 2007, but it is reasonable to think that the total sum is roughly \$200 billion, again, far smaller than the increase in the assets of foreign central banks.

If overall official asset accumulation, though, continues at

something like its current pace, a pace of well in excess of \$1 trillion, and if more of that increase is managed by sovereign wealth funds, as many investment banks now anticipate, the pace of growth of sovereign funds will increase dramatically.

These broad global trends apply with particular force to China. China's government right now is adding at least \$400 billion a year to its foreign assets and perhaps up to \$600 billion. There is a certain amount of uncertainty about the scale of the build up of the foreign exchange assets of the Chinese state banks.

Right now the China Investment Corporation only manages a very small share of the total stock of Chinese investment abroad. Separating out the funds that the CIC injected into the state banks, I would put that total at the end of 2007 at only about \$20 billion. However, going forward, it is reasonable to think that the CIC will account for a much larger share of the total outward investment of China and hence the focus of this hearing.

My remarks are going to be organized into two broad parts. The first briefly is going to make some general observations about sovereign wealth funds. The second will focus more specifically on the CIC.

As I think Robert Dohner mentioned, sovereign wealth funds originate in three different ways: first, from the fiscal surplus of commodity exporters; second, from a decision to manage a portion of a country's foreign exchange rates more aggressively; and then third, and this wasn't mentioned, the proceeds from the successful privatization of state enterprises sometimes are handed over to a sovereign wealth fund, or if a sovereign fund, which previously had managed the state sector domestically, if some of those companies are successful, and there's a partial divestment, that fund may morph into an international investment manager.

While all sovereign funds manage money for governments, I think the differences among sovereign funds are far more striking than their similarities. This is a reflection of the fact that very diverse sets of countries have large funds. Norway and Chile, transparent democracies, are going to have different kinds of funds than the funds of countries with different political systems.

I think sovereign funds can be differentiated along five different criteria. The first is their mandate and investment style. Some sovereign funds are very close to being pure money managers that try to replicate the returns of a broad index. Others are willing to make concentrated bets on individual companies. Some funds have a mandate that is exclusively getting the highest risk-adjusted return. Others have a mandate that includes promoting to the extent possible local economic development subject to the constraints that they have

to invest abroad.

Second, the funds can be differentiated on their transparency. Ted Truman's work here is the gold standard. I think there's a reasonably strong correlation between the level of transparency of a sovereign fund and the level of democracy or political openness of that fund, of the country that hosts the fund.

Third criteria is the size, and again, self-evident that a \$700 billion fund, which is a reasonable estimate for the size of the current largest-existing fund, that of Abu Dhabi, is going to raise different issues globally, than a \$10 billion fund. And a fund that is growing at \$100 billion a year is going to raise different issues than a fund that's growing by \$1 billion a year.

Fourth criteria would be the wealth of the host country, and here I think it is important to differentiate China from many of the large existing funds. The average PPP exchange per capita GDP of the countries with the big funds now is probably around \$50,000.

China's average per capita GDP on PPP terms is more like \$5,000. There is a meaningful difference. China is the first poor country that will have a large fund.

And then finally, the geopolitical position of the country from which the fund comes. Funds from small city states aligned with the United States are going to raise different sets of issues than funds from large countries with broader regional or global aspirations. I think that's a statement of fact. How exactly that plays into the policy debate is a much more difficult issue.

The activities of the China Investment Corporation, I think, are going to raise a particularly vexing set of issues, both for China and for the countries that will be receiving investment. That is a reflection of the fact that the CIC is potentially quite large. While it is currently small, the foreign assets of China's government, as I mentioned, are growing by 500, 600 billion a year, and it is reasonable to think that a meaningful fraction of that could be managed by the CIC, which would change its nature.

It also reflects the fact that China itself is a country which looks quite different from the countries that have existing funds. I wanted to conclude and wrap up by highlighting I think four characteristics of the CIC apart from its size that differentiate it.

The first, the CIC is indirectly financed by debt issuance, not by a commodity fiscal surplus. That means that in effect it has a degree of leverage because it has to generate enough returns to pay the debt that the Finance Ministry has issued in order to buy the foreign exchange that it is managing.

Second, it is taking an unusually high level of exchange rate risk because of its role supporting China's currency policy. It's issuing

bonds at four-and-a-half percent and it is buying foreign assets whose value according to the market is expected to depreciate by somewhere between eight and nine percent, which generally implies that it needs a 13 percent return in its foreign current investments--ball park--to break even. That implies either taking a very high level of risk and it's probably accurate to say that the political willingness of China to absorb losses has not been tested.

Third, the CIC has a complex mandate that goes well beyond simply maximizing the returns on China's foreign assets. That shows up most cleanly in the fact that it manages China's stake in the state domestic, state commercial banks, but I think it also is expected to support the outward expansion of Chinese state firms.

And then finally, China is simply a far poorer country than any of the other countries with large funds. That likely will give its fund a higher emphasis on national economic development than has been the case so far.

I'm going to stop here and I'll happily take questions later.

[The statement follows:]³

CHAIRMAN WORTZEL: Thank you very much, Dr. Setser. Dr. Navarro.

**STATEMENT OF DR. PETER NAVARRO, BUSINESS PROFESSOR
THE PAUL MERAGE SCHOOL OF BUSINESS, UNIVERSITY OF
CALIFORNIA, IRVINE, CALIFORNIA**

DR. NAVARRO: Thank you so much, Chairman Wortzel, and thank you so much for the invitation. I'd like to applaud this Commission. You've consistently performed the highest level of policy analysis on this issue over the last several years of any government or academic institution. You're tackling a really important problem today.

My message to you today is a simple one: that sovereign ones are neither good nor bad, but governments make them so, that China itself is likely to be a government that's likely to have a bad sovereign wealth fund that's not in the interest of the United States, and that tough regulations and oversight are needed now in advance of a problem that has not yet emerged, but given the magnitude of the flow of funds over the next decade, it's going to be a serious one.

Let me propose a very simple test of how you determine whether a sovereign wealth fund would be good or bad. On the one hand, a fund may simply invest to maximize its financial return on a specific

³ [Click here to read the prepared statement of Dr. Brad Setser](#)

asset, and if it did that, it would meet the requirements of efficient capital markets and everything would be fine.

I think Norway, by and large, does that. On the other hand, if you have a sovereign wealth fund that is willing to invest in assets as a “loss leader,” in order to promote economic, political, military or other types of strategic goals, then you have a very serious problem and a very serious threat to American economic, political and military sovereignty. And I think that's what we have here because China has already established the principle that it will use its excess foreign reserves as a strategic weapon through its currency manipulation. This is a different way of looking at currency manipulation than has been looked at, but if you think about currency manipulation, it's a perfect example of using excess foreign reserves as a weapon of economic policy.

How does it work? Well, China basically takes our dollars from Wal-Mart, and they “sterilize” those dollars in their local economy by selling bonds to their people at over four percent. They then bring those dollars back here and buy our bonds at two percent, and they earn a negative net return -- a negative net return! on those excess foreign reserves. Why would they do that?

They do that because they are strategic. Such currency manipulation boosts their exports. In doing so, it boosts their jobs, and the people of Ohio and the people of Michigan and the people of California suffer. So they have established the principle that excess foreign reserves may be used as a “loss leader” to achieve economic goals..

The other thing China has established is that its government will use their excess foreign reserves as a political weapon. Every time people in Congress talk seriously about any kind of policy response to China's unfair trade practices, what do they do? They threaten what they themselves call the “financial nuclear option.” That option is to dump our dollars and bonds on global markets, drive our interest rates up, our mortgage rates up, ruin our stock market, and cause a recession. And so far, unfortunately, that financial blackmail has worked on Capitol Hill because we have not had action on China's many unfair trade practices.

So there's a very clear danger here. It's not clear and present danger; it's a clear and future danger. But it's a future that's not that too far away. And let me give you an example. Let's suppose that Commissioner Mulloy holds stock in an American company for his retirement, and a Chinese company comes in and buys a controlling interest in that company, and they decide that with that controlling interest, they're going to offshore production, that they're going to offshore managerial talent, that they're going to offshore research and

development, and they're going to transfer that technology either to the government, the military or maybe a rival to that American company.

What will happen to Commissioner Mulloy's investment is that it will go down. That American company will essentially be gutted, as will the sovereign wealth fund's investment in that company, but the managers of the sovereign wealth fund don't care because the net gain to the homeland is substantially higher. That's the major risk we have to worry about here, and it's a risk that will only grow in size and danger as sovereign wealth funds grow dramatically in size. So we need to act.

The global solution here is basically to get rid of sovereign wealth fund's financing. How would we do that? Well, if we had an energy policy we'd be able to cut off the Middle East and Russia's excess foreign reserves that they're accumulating. Wouldn't it be nice if we could do that on Capitol Hill?

And the other thing, of course, and this goes to Senator Brown's eloquent statements on the big five unfair trading practices of China-- export subsidies, currency manipulation, counterfeiting and piracy, lax environmental, health and safety regulations--we need to crack down on China's unfair trade practices which are a prime cause of the U.S.-China chronic trade imbalance.

In formulating an SWF policy, we can't rely on the International Monetary Fund, which is trying to establish voluntary guidelines. Voluntary guidelines simply don't work. We cannot rely on the Treasury Department. Let's face it, if the Treasury can't handle China's rampant currency manipulation, they're not going to handle sovereign wealth funds. It's just not going to happen.

So Congress has to act. What does it need to do? It needs to have full transparency for sovereign wealth funds. That means quarterly and annual reporting requirements, including disclosure of assets and holdings. That's the first, but that's not enough.

Here, I strongly disagree with Senator Bayh. He says it's folly to limit restrictions on global investment in the U.S. I think it's folly not to. Here, we simply need reasonable restrictions. In one option, you could either limit sovereign wealth funds to investments in index funds. That would be a hard limit. Or alternatively, simply limit them to a share where they cannot gain controlling interests in companies. In that math of all this, you have to do what Commissioner Fiedler suggested: If you have three entities from one country, you have got to sum their shares up and count them towards the limit.

In addition, we need to put off limits to SWFs all strategic sectors such as telecommunications, ports, energy, defense. I mean it's ludicrous to think that the Chinese do not covet these assets, given their past behavior, given the difference in their ideology, and given

the conflicts we're going to have with China over natural resources in this world over the next several decades because of their emergence as the world's factory floor.

So, again, I salute this Commission for tackling what is a very difficult problem in a very timely way. It's going to require some courage to put forward some solutions that will actually work, but it is a clear and future danger that's emerging and better that we nip it now in the bud rather than wait for the problem to get even worse. Thank you very much.

[The statement follows:]

**Prepared Statement of Dr. Peter Navarro, Business Professor
The Paul Merage School of Business, University of California
Irvine, California**

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. Direct action by the U.S. Congress is critical.

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]he [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 crippling 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.

CHAIRMAN WORTZEL: Thank you very much, Dr. Navarro. I appreciate that. Dr. Martin.

**STATEMENT OF DR. MICHAEL F. MARTIN
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WASHINGTON, D.C.**

DR. MARTIN: Chairman Wortzel and Commissioner Mulloy, the rest of the Commission, I want to thank you for the opportunity to speak today. Before I begin my testimony, I need to clarify that I am here as Michael Martin and not speaking on behalf of Congressional Research Service. Otherwise, I won't be able to go back to Congressional Research Service if I don't make this statement. However, the Congressional Research Service has granted me the permission to submit my report on China's sovereign wealth fund as my written testimony, so it is for the record.

In addition, there's another CRS report that may be available to you if requested, and we can discuss that. My colleague Marty Weiss is with me so if I stumble, I can turn to him. I've also submitted a formal copy of my oral presentation, which will also be for the record, and what I will now do then is completely ignore that said document, in part because much of it has already been covered by other presenters so far.

What I want to focus on are four questions that were sent to me by people who work for the Commission, and my compliments to them for their work, having to do specifically with China's sovereign wealth fund.

They are, one, what is the growth potential of China's sovereign wealth fund; two, what do we know about China's sovereign wealth fund, CIC; three, sort of a quick summary of what may be the major concerns about it? A warning, I'm an economist, so I will focus on economic issues. And four, if time should allow, what can we do about it? And because of time constraints, what I'll signal is that what's interesting to me is it seems that regardless of the perspective an individual has on sovereign wealth funds and specifically the China Investment Corporation, or CIC, they seem to come to the same conclusions on what are our options before us. So that's an interesting end-point which I may not get to.

Let me start out with the simplest of the questions: what is the growth potential? And here I'll sound like an economist. Well, the growth potential is anywhere from zero to over \$1 trillion. Let me be a little more specific on that.

A number of people have pointed out the CIC were initially invested with about \$200 billion, depending on exchange rates at the

moment. And as people have pointed out, about two-thirds of that has already been taken up with domestic investments, and here let me step aside for a second and comment on something that the CEO, chairman of CIC, Lou Jiwei, said about the genesis of the CIC.

Effectively, he talked about it as if it were an afterthought--that China faced some domestic economic problems, that they had money that they needed to sterilize, and as well as a couple other economic problems, and so this idea of starting a sovereign wealth fund that could outwardly invest the money came about.

Now, there is always a question on the reputability of public statements by Chinese officials or sometimes other officials, but setting that aside for a second, he did seem to indicate that when he was appointed to the position, there had not been extensive thought about what CIC was going to do with this roughly \$70 billion of overseas investments that they could make.

So I inferred from things that he said publicly, and other sources, that if they have a poor performance, that there may be political will inside China to just close down the CIC. Say that didn't work. We'll try something else.

If, on the other hand, they are successful, according to some criteria, then an increasing portion of that \$1.5 trillion in foreign exchange reserves that's available may be given to the CIC.

And on that, I will quote Chairman Lou again. Quote: "If I'm making losses everyday, how can I face asking the government for more money?" So he is concerned about the rate of return of his investments.

One other point on that, Dr. Setser talked about the exchange rate risk. According to Lou, he is not responsible for a set exchange rate risk. He only needs to earn a four or five percent rate of return in order to be considered successful internally inside China. Again, that's taking him at his word.

Second, what do we know about China's sovereign wealth fund? There I'll talk, as Brad did, about Truman's transparency, governance and other criteria. And there the record in China is kind of mixed. In some situations, they're very transparent. We know who the board of directors of the CIC are. We know when they have made a decision about an investment, what they're going to invest in.

But what we don't end knowing is when exactly that transaction takes place and the details of the transaction. I see I'm running even faster on time.

So there's problems there. There's problems with the interlinking of the sub-investments. The example of Rio Tinto where the China Development Bank was part of the financing. The China Development Bank is also invested by CIC.

Real quick on the concerns. I was correct. I won't get to what we can do about it. You can ask about that. There's been a lot of talk about the motivation behind the CIC. As an economist, to be honest, I'm less concerned about the motivation of what the CIC's investments are. If they want to make a stupid investment, they can make a stupid investment.

What I am concerned about are the potential economic implications of investment decisions or transactions that take place. The "nuclear option" certainly is a potential risk that's out there. The likelihood, though, of China making such a transaction of dropping half a trillion dollars in U.S. government debt in a short period of time, which would be the scenario in which they could do it, I see as low personally.

The more greater concern that I would have in the macroeconomic environment is actually on the market's ability to deal with rumors or speculation about what the CIC or other sovereign wealth funds are doing. We saw with Rio Tinto a month ago when there were rumors that China was going to--that CIC was going to invest, that the stock price went up ten plus percent in one day.

We just saw it the other day with yet another speculation or rumor about a CIC investment where stock jumped up double digits in one day.

In the current environment where financial markets are a little bit skitterish because of the subprime loan crisis, there is a certain anxiety that can be created if rumors or speculations about sovereign wealth fund investments start circulating at a high level.

I see I'm out of time; I am open to questions.

[The statement follows:]

Prepared Statement of Dr. Michael F. Martin
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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. 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 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 conform 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 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 as 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 deciding what – if anything – the U.S. government should 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.

PANEL III: Discussion, Questions and Answers

CHAIRMAN WORTZEL: Gentlemen, thank you very much. Commissioner Shea.

COMMISSIONER SHEA: With this build-up to my questions, I think I'm going to fall short of the mark. Thank you very much, all three of you, for participating today. I have two questions.

Dr. Dohner briefly went through the history of sovereign wealth funds. He said they have long-term horizons, generally conservative in approach, and Dr. Setser also basically described the different levels of risk that sovereign wealth funds are willing to bear.

But my question for you is this: could you give me one or two examples in the United States regarding investments by sovereign wealth funds in the United States or elsewhere where the interest has not been wealth maximization but rather strategic and political? That's number one.

And number two, on the theory that personnel is policy--Dr. Martin, you briefly mentioned Mr. Lou. Could you give us with some detail who is filling the slots at the CIC? Are these investment banking types or national security types or who are the people who are populating this relatively new agency in China?

DR. SETSER: I'll take the first question. I think it is actually quite hard to differentiate between commercial and noncommercial investments. I think drawing a clean line is an ideal that we always look for which in practice is really hard.

I would note in this context that the CIC's investment in the offshore IPO of China Railways, which presumably was motivated, at least in part, by a desire to be seen politically as supporting Chinese state enterprises, not just supporting American banks, has performed financially far better than the CIC's presumably commercial investment in Blackstone. So I think it is going to be the lines are far more blurry

than we would often like to recognize.

I think a couple of examples of sort of sovereign wealth funds investing where part of the value of the investment and could be part of its commercial value stems from its role in supporting their own national economic development program, and in this case I think is one way that didn't have any adverse impact for the U.S., but the bidding war over NASDAQ and the stock exchanges between the sovereign funds from Qatar and Dubai where the value of that investment was perceived to be that it would influence where they set up their regional headquarters and which capital city would emerge as the regional financial capital for the Persian Gulf.

So there was a motivation that went beyond simply return.

COMMISSIONER SHEA: Rate of return, yes.

DR. SETSER: But at the same time, that may not be different than some of the motivations for other stock exchanges looking to consolidate exchanges. That sort of line is never completely clean.

Another example is there's a small fund from Abu Dhabi, whose name I cannot pronounce, Mubadala roughly, that made an investment in Ferrari. Ferrari is building a theme park in Abu Dhabi because, well, they think it will probably make them a lot of money. But I'm sure the fact that they have the support of the government and the government has a stake Ferrari has contributed to that commercial decision.

So I think there's a, rather than a pure either on/off switch, I think it's usually much more of a continuum. I would note, though, that almost every sovereign fund does have as, if it's not its primary objective, a very high objective, making money.

Throwing out commercial considerations has a cost. It would have to be something that would be agreed with the government because if you end up losing money, someone else has to bear those losses. The public uproar that the unrealized loss of the investment in Blackstone has generated suggests that the CIC is not currently looking to make investments with a negative expected return.

I think its problem is finding the investments that will generate the positive expected rate.

DR. NAVARRO: I think that's a great question, and I think one of the most important value added of my testimony today is the idea of being able to see currency manipulation as a way of using your excess foreign reserves for strategic purposes. If China is willing to do that with their central bank operation through currency manipulation, they should be willing to do that with their sovereign wealth funds.

Having said that, I was very interested in Senator Bayh's example this morning of the company that made magnets--

CHAIRMAN WORTZEL: Magnaquench.

VICE CHAIRMAN BARTHOLOMEW: Magnaquench.

DR. NAVARRO: The magnets are used in precision military instruments, and the company basically was bought and then taken offshore. That's a classic model of China expropriating technology.

And then I would simply ask you, I mean do we want to be in a position of unreadiness when China comes in and buys a controlling share of GE or Cisco or Raytheon or Boeing and not have some kind of safeguards in place because it's not a clear and present danger? I think with sovereign wealth funds that it is a clear and future danger.

What this Commission can do is to get us prepared for that rather than be caught blindsided.

DR. MARTIN: I'm going to focus on your second question: basically who's who in CIC? And I see two sides to that. One is if you look at their board of directors, you have a mixture of representatives from the Ministry of Finance, Ministry of Commerce, the People's Bank of China, which is their central bank, and also the National Development and Reform Commission, which is the leading think tank of the endless stream of think tanks that China comes out with for their leadership.

It's a very august group in terms of economics or knowledge of China's economy, but the question is then how do you look at? And some people have suggested that this was sort of a political compromise. Each of the different interested parties wanted to have a seat on the board to make sure they could keep an eye on what it's doing due to political kind of infighting within China, which Dr. Setser mentions or Dr. Setser mentions in his testimony.

Others see it as they just wanted to come up with the best minds that they could to be on the board. Another aspect to keep in mind is that it is a separate legal corporation so it reports to the State Council, but it is not part of the Chinese government at this point in that respect.

The other aspect of the who's who, which a couple of people I think in testimony have alluded to, is that they are now looking for fund managers. They have come out with this idea that rather than directly organizing or managing the investment of the CIC, that they're going to pick external fund managers who will be given an allotment, goals and objectives, certain overall criteria, performance for their portfolio, and let them compete amongst themselves. Within that, again to allude to an earlier testimony, then do you see the willingness of Morgan Stanley or Citigroup or Lehman Brothers to be part of the CIC investment family as maybe a conduit of getting involved and being a fund manager for CIC?

And that alludes again to the comment I was making about the interrelationships that are starting to develop out of the China

sovereign wealth fund.

CHAIRMAN WORTZEL: Thank you. I have a question myself and it gets back at the grouping issue that you have raised and that Commissioner Fiedler raised.

Dr. Setser, you reduced the magnitude of CIC's managed funds to somewhere around \$20 billion if I heard right.

Other witnesses said it might approach \$67 billion, but, okay, it's not 200 billion. Do any of you think there might be some central coordinating authority somewhere in the Communist Party or in China's government that can actually direct various forms of government-owned wealth in China strategically?

To restate that, is it even sensible that we try to distinguish between CIC-controlled sovereign wealth and other government organization controlled wealth in China?

DR. SETSER: Just be clear, my \$20 billion number was the estimate for the funds invested abroad at the end of calendar year 2007. The next allotment of foreign exchange hadn't yet been delivered to the CIC at the time, and by the end of the first quarter this year, it will be \$70 billion. So I don't think there is any meaningful difference in the testimony.

I think that the issue you highlight about how to differentiate the CIC from the state banks, state commercial banks that it owns, as a result of the decision, which I would interpret as bureaucratic logrolling, to bring central Huijin--the central bank's asset manager, the owner of the state banks, as a result of the use of foreign exchange for the recapitalization--into the CIC is a critical question.

Personally, I think that if the CIC is the dominant owner and it is the source of the foreign exchange that has been put into these banks, then it is very hard to differentiate their activities from the activities of the CIC in any meaningful way. The legal structure gives the CIC formal ownership of the banks as a result of the injection of foreign exchange. So I think that's very hard.

The caveats I would mention are three. One is that the state banks also have other sources of foreign exchange, whether because they are forced to hold some of their mandatory reserves in foreign exchange to reduce the need for sterilization, or because of swaps with the central bank, so not all the foreign exchange in the state banking system comes from the CIC.

Second caveat, and we really don't know the extent of this, but we know that there is both competition and coordination inside the Chinese state. The Chinese State Air Lines got into a bidding war amongst themselves even though they're all ultimately owned by the same entity.

I think the different state banks are competing to show that they

can do the best job of managing this portion of the foreign exchange because they hope that will increase their relative standing.

Finally, and it pushes a little bit the other way, I'm not sure you actually need coordination in a formal sense. There's so much foreign currency liquidity sloshing through the state commercial banking system that any state enterprise that wants to do an outward expansion can find financing. There is no financial constraint there. What it needs is permission.

So I don't think you need coordination amongst the financing bodies. What you need is permission from the relevant bodies in the Chinese government to make that investment. That permission wasn't granted for the China Development Bank's investment in Citi. It apparently was granted quietly for Chinalco's bid for Rio Tinto.

So I think it's probably inaccurate to think of a single coordinating committee, but I think it is accurate to think that there's plenty of money there available for ambitious state companies looking to expand or buy.

DR. NAVARRO: And that's a great question, too. I think it also dovetails nicely with Commissioner Fiedler's great question that went unanswered, which is: Should we be talking beyond sovereign wealth funds and also about state-owned companies as well? Because that does raise the possibility of coordination with the sovereign wealth fund types of investment. I think Professor Setser is right: there is both competition within any bureaucracy, but there also can be coordination. I think if we would expect a central strategy from any country in the world, it would have to be a centrally planned state like China. So that there are significant risks.

Also I see the proliferation of sovereign wealth funds within China. They may, as their money sloshing through the system grows, create other SWFs that target specific sectors and things like that. So bottom line, yes, we do have to worry about a coordinated industrial policy and economic and military strategy from China. There is no question.

CHAIRMAN WORTZEL: Thank you. Commissioner Wessel.

COMMISSIONER WESSEL: Thank you, Dr. Setser and Dr. Navarro for your return to the Commission. Your testimony in the past and today is very helpful, and, Dr. Martin and your colleague, thank you and thanks to CRS for allowing you to be here today. CRS is a tremendous resource and we're pleased to have you here and the work that you've done has been very helpful, and I hope that we'll request the other document that was referred to and have that brought before the commissioners' attention.

I'd like to follow up on our last panel where there was understandably some concern about answering questions regarding

CFIUS.

And a question for each of the panelists as to whether we should be looking at CIC and potentially other sovereign wealth entities in China as simply another weapon in China's arsenal at expanding its economic and military capabilities, that we should treat sovereign wealth fund investments the same as we would investments by other state-controlled entities, whether it's the CNOOC transaction of several years ago, the current issue related to Huawei and 3Com, Lenovo, et cetera?

We've had a number of transactions, many of which have raised substantial concerns here. Should we be treating the sovereign wealth fund investments the same way that they should trigger CFIUS reviews, either whether they are done directly or whether they are done through portfolio transactions through a Blackstone or someone else? Each of the witnesses, please.

DR. NAVARRO: I'm told that CFIUS is Greek for toothless. I haven't confirmed that, but to continue on this theme, the myth of CFIUS is that it would actually lead to some enforcement, and this goes to your very astute question, Commissioner Bartholomew, because you asked representatives from the administration whether they had the tools already to get the job done?

And the question is well taken, but the other part of the question is: Do you have the political will and good sense to use those tools? And that's why this is not an administration job per se, but rather a legislative function for the Congress to deal with, and that's really critical. Because Treasury is unlikely to act.

And then, yes, in answer to Commissioner Wessel's question, yes, we should treat sovereign wealth funds just like we would other government entities and we have to treat them collectively per Commissioner Wortzel's questions and Commissioner Fiedler's questions. This is a danger.

COMMISSIONER WESSEL: Thank you. Dr. Setser and Dr. Martin?

DR. MARTIN: I guess I'll jump in here. In my mind, it's really not--let me take it just a couple of ways. One, what's behind your question is not necessarily CFIUS-specific.

The question is do we have the tools or mechanisms available under current law and regulation in order to keep and monitor the activities of CIC or other Chinese investment bodies or other sovereign wealth funds to protect national security?

Congress just recently passed P.L. 110-49, which amended CFIUS to cover government-owned--they didn't talk about sovereign wealth funds--but government-owned, but in the context of takeovers or full control of, and there's ambiguity about the meaning of the word

"control." So things have been done. Congress has done, made changes already in CFIUS. It's up to Congress to make the determination whether they think it's adequate at this point, at this stage, to look at that.

Earlier I think some of the hesitance may have come about in part because of--I wish I could remember the Chinese phrase. My wife tries to teach to me, and I always forget. But the English equivalent is "what's good for the goose is good for the gander," which is the matter of reciprocity that is floating around behind here.

That if we had disclosure requirements on Chinese sovereign wealth funds companies under the WTO and other international bodies, China could come back and ask us for similar disclosure requirements.

Now, whether or not we'd be fully comfortable with that information, I think is one of the issues that is floating around in these situations. The information would flow both ways. I'll stop there.

COMMISSIONER WESSEL: Could I just clarify one matter, and I'm not sure I agree with your interpretation of the national treatment standard as it relates to the disclosure? I think we'd have to have disclosure as it relates to other entities, sovereign wealth funds doing business here, not necessarily reciprocity there.

But as you've done research and others at CRS have done research, to the extent there, and I know that the Chinese entity is fairly new, how much access to information do you have vis-à-vis what others have done? Do we have a substantially different situation in terms of transparency? Again, it's fairly new.

DR. MARTIN: I'll give an answer and probably, maybe Dr. Setser will too. There was a chart, which I have not seen, earlier by Representative Kaptur that--

CHAIRMAN WORTZEL: It's your chart.

VICE CHAIRMAN BARTHOLOMEW: It's a CRS chart.

CHAIRMAN WORTZEL: It's your chart.

DR. MARTIN: Okay. Oh, it's the standard chart.

CHAIRMAN WORTZEL: She used your chart.

DR. MARTIN: Okay.

CHAIRMAN WORTZEL: Or Weiss' chart.

DR. MARTIN: Okay. Oh, it's his chart. I couldn't see it. There are different ways you can assess levels of transparency. As I was saying earlier, I think China has been really making great efforts to try to be open about what they're doing.

But at the same point--the Chinese are great for quotes--Chairman Lou said at one point that they will be open and transparent, but if they're too transparent, something about the wolves will eat us up. He's concerned that if they're too open about their internal dynamics and their decision-making process, that in the international

financial markets, that they will be harmed.

So they are concerned about it. Later on in a conversation I had with him after a presentation, he mentioned that a gathering of sovereign wealth funds had got together to discuss the matter of transparency and openness. There was no consensus among the sovereign wealth funds about the level of transparency or what exactly transparency would require.

My feeling is that they've been a bit more open than some of the sovereign wealth funds, where we have some of them, we have no idea how big their portfolio is. China has been up-front--we have \$200 billion--and they've been very detailed about how that \$200 billion were generated.

But on the other hand, I keep scouring the Chinese press to find out when indeed the investment in the Agricultural Bank of China takes place and exactly how is it done. So it's a mixed story.

COMMISSIONER WESSEL: How about for the record later, written, as my time has expired?

CHAIRMAN WORTZEL: Thank you very much for that very astute addition in the hearing. Commissioner Fiedler.

COMMISSIONER FIEDLER: A research question. Is there anywhere in academia or in government, to your knowledge, a list of government-owned companies from various countries world over? World over? Anybody?

DR. SETSER: I will answer that I do not know.

DR. NAVARRO: Not to my knowledge, but I could get on Google Scholar and get on it for you.

DR. MARTIN: I would suspect no or that, having been a recovered academic--probably if anybody came out with such a study, there would be a lot of questions about the methodology and how you define a state-owned or government-owned entity.

COMMISSIONER FIEDLER: Because there is not a lot of transparency in corporate information worldwide, generally speaking, and there's less transparency about government-owned corporations.

So we talk about regulation. We cannot regulate in the absence of information. And part of regulation is the initial requirement of information. Do you actually believe that the Chinese won't invest in the United States if they have to register with the SEC, list their subsidiaries, and disclose the stocks and bonds that they own in the public markets of the United States?

Does anybody actually believe that?

DR. SETSER: I'll give an answer to that. And that is that it would be very easy to evade, as a practical matter, that kind of requirement through the use of equity derivatives, and there certainly have been for reasons not linked to avoiding disclosure requirements

but just because of a desire to have embedded, so-called embedded leverage in the transaction, certain sovereign funds have made use of European banks to invest through equity derivatives to take large stakes in companies, and in that case, the formal owner would be the bank that is hedging its equity derivative position. So it is a kind of a technical answer, but it is easy to get around that.

DR. NAVARRO: I think the principle you're trying to establish here, that foreign companies should at least abide by the same guidelines as American companies, is taken, well-taken.

COMMISSIONER FIEDLER: No, I'm actually talking about government companies. I'm not talking about foreign companies. I'm talking about government-owned entities, not foreign. That's different.

DR. NAVARRO: The answer to your question is, no, they would continue to invest here if they had to meet those regulations, and the point I was trying to respond to is that if we've got regulations on our own companies here or entities, why shouldn't foreign entities abide by at least the same level of restrictions? I mean it's ludicrous that they wouldn't.

COMMISSIONER FIEDLER: Do you have a quick answer? Do you know the place or whether they would invest there?

DR. MARTIN: What I could say is at a forum at the World Bank the other day, Lou Jiwei said, somebody asked him about Europe and, in particular, conversations that he's had with representatives of the EU about oversight and regulation on the CIC, and he shrugged his shoulder and sort of indicated that if they felt that the requirements were too high, that they would invest elsewhere.

COMMISSIONER FIEDLER: Yes. That's like the Chinese said during 16 different burps in the relationship between the United States and China, they wouldn't buy Boeing Aircraft, that there were only two choices, Airbus and Boeing. That all sounded good and everybody screamed and ran, but they bought Boeing Aircraft in increasing numbers after the burp is fully expired.

You only have certain choices in the world where to invest where the investment is stable and remunerative. Those tend to be in the West, and the United States is still a very good place.

We are apparently worried more from the testimony, not from your testimony, but from the written record I read, about people not investing here than we are worried about our national security or worried about gathering up information that allows us to protect ourselves at a minimum level of information. Our information is not keeping up with globalization of economies, movements of capital, and I'm just trying to see where people are willing--what simple level of registration people are willing to accept in official positions that is

not onerous and that is already required of other people?

DR. MARTIN: With that, my wiser mind, which is sitting behind me, did let me know that the OECD is developing guidelines that would cover sovereign wealth funds that would have a higher level of information.

COMMISSIONER FIEDLER: Please, please, this is conduct--

DR. MARTIN: This is getting back to your question or comment about whether or not we have adequate transparency, whether or not we have enough information? I think there's sort of a general consensus that we need more. I haven't heard any of the speakers--

COMMISSIONER FIEDLER: Nobody seems to want to discuss in official positions what the nature of that information is. They just talk about best practices and guidelines, which I will again reinforce are not laws, are not regulations, are not enforceable, and are variant in their implementation, depending on who the sovereign wealth fund or government-controlled entity is. Yes?

DR. MARTIN: If you're talking about the IMF, the--

COMMISSIONER FIEDLER: On anybody's guidelines or best practices.

DR. SETSER: I think the resistance there to this kind of disclosure would be very strong in the U.S. financial sector.

COMMISSIONER FIEDLER: I know it is.

DR. SETSER: Because the U.S. has historically in hedge funds and private equity funds have not wanted disclosure of their positions in other countries' markets or an international register. So that a move in that direction by the part of the U.S. almost certainly would be met by another move by other countries. And I think it gets to the difference--the core challenge that we are facing is that the outward flow of capital from the U.S. is private. The outward flow of capital from many of the countries which are now our biggest creditors is overwhelmingly government controlled.

So things which apply to government entities would be perceived in the U.S. as not being discriminatory will be perceived by those on the other side as discriminating against them because almost all of their outflow is government controlled.

COMMISSIONER FIEDLER: Thank you. If we have time, I want to come back.

CHAIRMAN WORTZEL: Thank you very much. Commissioner Mulloy is next.

HEARING COCHAIR MULLOY: Thank you, Mr. Chairman. Watching this and learning more about this, I feel like the United States is in a super bowl competition. The other guys have a game plan and we don't. So we're not doing so well.

I'm really struck by Mr. Navarro's testimony. A couple of

points. You get into the issue of where do these funds come from? With regard to the energy producers, you say you've got a cartel that helps manage the price of the oil. So that's part of a fruit of a poison tree, you put it.

I think part of it is the fact that we never developed an energy policy. So we're paying for it.

The second part of it, you point out, is that you have these other countries which are carrying on mercantilist trade practices including underpricing currencies. They're deliberately underpricing their currencies to gain trade advantage, making our exports there more expensive, making their imports here cheap.

But the third point I think is going on is that this practice also then incentivizes our corporations who are focused on shareholder value. They're moving their operations to there to ship back here, and they're moving R&D operations there because of this mercantilist system that we're part of, and I think our corporations are thinking if our government is not going to do anything about it, we have to survive, and so we're going to do what we have to do to survive.

So their interest is increasingly diverging--

DR. NAVARRO: And you might add here that they're telling their lobbyists on K Street to come down here and switch positions on the China issue.

HEARING COCHAIR MULLOY: Yes.

DR. NAVARRO: Making your job and Congress' job much more difficult.

HEARING COCHAIR MULLOY: Yes.

DR. NAVARRO: For every job you outsource, you lose an American corporate incentive basically to deal with the economic and political issues from China we're facing.

HEARING COCHAIR MULLOY: Yes.

DR. NAVARRO: It's an astute observation.

HEARING COCHAIR MULLOY: So what I see is, Dr. Setser, when you testified before the House Budget Committee, you did point out that the Asian countries are propping up the dollar. Right. And you believe that the Asian countries are propping up the dollar for trade advantage. You saw when I read from the McKinsey report to our Treasury witness, that McKinsey & Company believes that the mercantilist practices of the Asians are creating these sovereign wealth fund assets for them, you saw our Treasury react as if I shouldn't talk about that in public.

In their testimony, all of these issues that you hear elected representatives of the people, you experts bringing before us about sovereign wealth funds, and they come in here and tell us that their biggest concern is that it may raise protectionist sentiment here in our

nation.

DR. NAVARRO: Yes.

HEARING COCHAIR MULLOY: They're not worried about foreign governments owning our economy; they're worried about protectionist sentiment. And it's unbelievable to me. So I would ask you, learned men, what is underpinning this Treasury myopic view of this problem from your perspective? With Dr. Navarro, Mr. Setser, and then Mr. Martin.

DR. NAVARRO: The first book I ever wrote was called The Policy Game. It basically was an analysis of public policy from the standpoint of what drives policy from ideological considerations and what drives it from special interest considerations.

I think on this particular issue, Treasury's perspective basically has both of those components. There is Treasury's free market ideology driving the notion that somehow we should let these global capital flows have their way with the world, and that somehow it's Adam Smith, when in fact as I point out in my testimony, and you have noted, it's fruit of the poison tree. There shouldn't be chronic trade imbalances between countries.

We have these global trade imbalances because of monopoly cartel pricing for oil and we have them because of mercantilist unfair trade practices by China. So that's ludicrous to begin with to defend SWFs on free market principles. But that's Treasury's ideology on this, and I think they are blind with respect to this issue. However, we also have to recognize the special interests involved. As you pointed out, once American corporations go over to China and to Asia, they become vested in the system of those unfair trading practices that help their bottom line but don't help the people of Michigan or Ohio or Illinois or California.

And so you get arguments to justify all this like it's just the excess savings of the Asian people that basically are responsible for the global trade imbalances when, in fact, we're in a system of currency manipulation and other unfair trade practices that create those imbalances.

And the last point I'll make is that when China manipulates their currency, it forces, it forces Japan to engage in the carry trade to manipulate their currency, it forces the South Koreans and Taiwan to intervene in currency markets to manipulate their currency. And that's why it's not a Chinese glut; it's an Asian glut of money; and that's why we have these huge Asian trade deficits, and it is all fruit of this poison free market tree.

HEARING COCHAIR MULLOY: I may be restricted by--

CHAIRMAN WORTZEL: You are restricted by time.

HEARING COCHAIR MULLOY: Yes, by time. But if I have a

second round, I'll let you answer the question.

DR. SETSER: I'd be happy to.

CHAIRMAN WORTZEL: Vice Chairman Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thank you very much, Mr. Chairman, and thank you to our witnesses. We try on this Commission to be forward thinking, to try to identify some of the issues that are coming up, and I have to say honestly, the more that I think about this, the more that I think that our questions about sovereign wealth funds don't begin to address the bigger range of questions that we have.

If this were Norway, even with a vast amount of money, we would not be having a hearing about the sovereign wealth funds. I think that we're here both because of the amount of funds that we're talking about, but also it's the nature of China's government that has really raised a lot of these concerns.

I mentioned earlier the Wall Street Journal article about China showing savvy in the Rio Tinto deal, and it's really clear that the Chinese government in whatever capacity is very smart in learning how to sidestep concerns that are being raised. They did this. They pulled this off successfully with Rio Tinto. They learned from CNOOC they're trying to keep the investments under certain thresholds.

They're saying they don't want seats on boards. We're talking about much more subtle ways of exercising control, power and leverage. Chinese state-owned enterprises, both central and locally controlled state-owned enterprises. Their profit rose 31.6 percent last year--this is from a Reuters story--to essentially \$224 billion. We are talking there more than the \$200 billion that CIC is talking about investing.

What I'd like you all to think about and answer is while we are focusing on this sovereign fund wealth, what are missing? What other kinds of investments could the Chinese government be doing? If it becomes too politically fraught to use CIC, what else are they going to be using to try to deal with this money that is sort of state-owned enterprise based?

What comes next if it turns out that it's just too much of a hassle to go through transparency with sovereign wealth funds?

DR. SETSER: I think the example that you brought up, Vice Chairman Bartholomew, about the Chinese aluminum company's participation in Rio Tinto is in a lot of ways the most likely way forward. I think the CIC because of its personnel constraints is actually not looking to take seats on the boards and it doesn't really have the people to do so.

It raises a lot of political issues. It's not worth it. Moreover, they don't really need to do so. If a Chinese company wants to expand

abroad, there's a range of different ways it could get the financing. One is to do an offshore IPO, raise money from a host of private investors, and the CIC could take a stake in that offshore IPO, as happened with China Railways. That's one way.

Or you could go to the China Development Bank or to any other state bank, which is now sitting on \$300, maybe \$400 billion of foreign exchange, some of which that was invested in subprime, and they lost money on that. They aren't looking to buy more subprime. They view lending to another Chinese state enterprise in dollars as a better credit risk than taking the kind of risk in the U.S. capital markets that led to their current round of losses.

So they are very willing to lend, and that provides a very large pool of funding, and if that pool of funding gets short, then there's an additional pool of funding out there, which is the State Administration of Foreign Exchange can put more dollars on deposit in the Chinese banking system or do it through a currency swap. So there is no constraint there.

The other thing I would look at because I think the CIC is domestically and internationally so visible, and it's fairly easy to track because it has to raise money visibly through the Ministry of Finance bonds, whereas commodity funds whose budget is much harder to track.

The State Administration of Foreign Exchange, the main reserve manager, has likely received flexibility and freedom to be more aggressive with the management of its funds in order to seek higher returns. It's unlikely like the CIC to seek controlling positions, but it is likely to be making more aggressive, more risky kinds of investments.

DR. NAVARRO: One of the things I think it's really important to remember here is that there is a compelling need for the Chinese to invest here in America. The whole idea of recycling first their central bank reserves into U.S. bonds and now as they get an excess of those reserves into other U.S. assets is driven by this currency manipulation.

They cannot keep their fixed dollar-yuan at peg unless they do that. So then if that's true, then the question is what are they going to do? And I see a clear progression. You start with controlling interest in companies. At some point when they've developed their own domestic markets in relationships with India and Brazil and their economy is going strong, then they do let their currency totally revalue, and guess what? They'll be able to buy American companies outright really on the cheap.

Consider this calculation. I looked at the Russell 2000 and China could buy one company a week on the Russell 2000 and within a decade own all of them. And the reason why that's important is that

the Russell 2000 is home to the small companies that are the future of innovation in our country. If the Chinese are smart, and they certainly are, they shouldn't be going after big companies and causing themselves political problems. They should be buying all of our small technology savvy companies that wouldn't raise anything on anybody's radar screen, and acquire biotech, defense, whatever.

That's what ultimately worries me, and if we don't have a regulatory structure in place, we're not going to pick up that stuff below the radar screen because we're going to be worried about the big targets.

DR. MARTIN: Real quick. I guess the way I look at it, I don't know if I can pick out any entity or group or subpopulation in China that we should be keeping particularly an eye on outside of the ones that have already been discussed, but more looking in general at our trade policy process, which is in some ways predicated on the notion, as somebody mentioned earlier, that our foreign direct investment flows were going to be outward, that U.S. companies were going to be investing overseas.

We are now facing I think a new era where increasing number of foreign companies, government-owned, some, some of them not government-owned, some state-owned, whatever, are going to be coming here in the United States to buy, and that's why I brought up the issue earlier of reciprocity.

We've had a notion where we should have-- U.S. companies have had this notion we should have the right or the opportunity to buy foreign companies, and now the foreign companies are coming back saying, hey, we've got the money, may we do the same?

VICE CHAIRMAN BARTHOLOMEW: Thank you.

CHAIRMAN WORTZEL: Back for another round. Commissioner Fiedler.

COMMISSIONER FIEDLER: Thank you. Let's follow up, Dr. Setser, on your last comment when you and I were talking--the concern of U.S. companies' retaliation in disclosure in other countries is what you were talking about. Let me add something here.

There's been much written about, and most of it is speculation--I don't think that any of the companies at issue have explicitly admitted this-- but that there was solicitation of CIC and other sovereign wealth fund money, and in the case of China, there were expected or anticipated quid pro quos or at least the improvement of their own investment environment in China as a result of having absorbed this large stake.

So there's another dynamic here at issue, and would you address that, please?

DR. SETSER: Sure. I think that the chairman of the SEC,

Chairman Cox, mentioned this, when he mentioned about the dynamics that changed when a state is both an investor and a regulator. That actually is a much bigger issue for China than for the U.S. because many companies that have accepted investment from the CIC, obviously they like the capital, and they like the opportunity to do business with the CIC because the CIC will be or Chinese state banks that are owned by the CIC are a major source of investment, potentially investment banking fees. And they are looking for opportunities to increase their ability to invest inside China.

Now, it probably is up to China to decide whether it wants to favor companies with which it has already invested at the expense of giving them potentially monopoly profits or not. But it is, I think, a dynamic that is different.

Like many things, when countries with a much different conception of the role of the state in the market are the largest global creditors, I think it is realistic to expect that things will change, and it is realistic to expect that American companies looking to invest inside China, looking to position themselves to profit from the faster growth in China that is expected, will countenance doing deals with the state that will encourage access.

Now, the problem, and this is, I think, a question of coordination within China, is that if-- remember the goal of this, as Dr. Navarro has mentioned, is to move money out of China that's associated with the effort to keep the currency down--if you invest a certain amount of money in a U.S. financial company, and then allow that U.S. financial company to make an equal amount of investment back inside China, you actually haven't succeeded at your goal of moving the money out. You've just shifted the money around.

You just kind of do a swap and it doesn't achieve the goal. And this, I think, is something the central bank is very worried about. They are exceptionally concerned that the rest of the world wants to exploit China's undervalued currency to get easy profits, and I think their big concern is that companies that get investment from the CIC, which is kind of their bureaucratic rival, will, in return, get a favor, which lets them move money into China, which makes the central bank's job of sterilization more difficult.

So I want to always emphasize that the challenges that these changes bring about apply on both sides of the relationship.

COMMISSIONER FIEDLER: I agree. One other question. We've dealt with the issue of reciprocity only lightly. It's been mentioned a couple of times today. So, for instance, if China wanted to buy a major coal company in the United States on the U.S. stock exchange--okay--controlling interest, 51 percent, there's nothing that inhibits them to do it, and I wouldn't think that CFIUS would object.

Yet, we can't do that there. All right. Does the concept of reciprocity have any role to play in our policymaking in the United States vis-à-vis not just China's sovereign wealth fund but anybody's sovereign wealth fund?

DR. SETSER: It certainly could and it would tend to have the effect of limiting sovereign wealth fund's ability to invest in the United States. Now, in general--

COMMISSIONER FIEDLER: Because they restrict our investment in their country.

DR. SETSER: So the practical effect would be restrictive. Now, I want to make one very important point which is that we do not live in a reciprocal world. We live in an asymmetric world where we are the borrower, where we need a net inflow of \$750 billion a year to cover our current account deficit, which means that on aggregate, there has to be a lot more money coming in than going out.

So the notion that there will be a reciprocal exchange of assets where we will have one billion of Chinese assets for every one billion of Chinese investment in the U.S., it won't happen.

COMMISSIONER FIEDLER: I wasn't talking one for one. I was talking ability to invest.

DR. SETSER: I would say that the effect that the ability to invest right now would mean, if China didn't adjust other policies, that more U.S. money would be invested in China, that this would increase the foreign assets of China's government because in order to keep the exchange rate down, the government has to intervene in the foreign exchange rate market, so you would see an increase in capital inflows into China, private capital inflows into China, and an increase in Chinese reserve growth, and an increase in government outflows given all the other policies that are in place.

And that is why it's almost impossible so long as China is maintaining this exchange rate at a low level, which keeps its financial assets inside China underpriced, for China to fully liberalize capital flows.

DR. NAVARRO: Just one quick comment here. I would discourage a bilateral approach in terms of policy on this issue. We don't need to target China with a sensible sovereign wealth fund policy. We just need to write legislation that sets down a set of rules that would protect this country from any sovereign wealth fund that engages in strategic manipulation of its reserves and leave it at that.

DR. MARTIN: A couple quick comments. One, though it has been implied that the only motivation or the pure motivation of the sterilization effort in China is to keep the currency exchange rate where it is right now, certainly within the Chinese press and the media, their concern is for domestic inflationary purposes, not for the

global exchange rate phenomenon. They are letting their currency gradually appreciate against the U.S. dollar, and it's gone up about 14 percent, which leads to the second point, which is, as Dr. Setser mentioned, we're really in a situation where we need capital to come in.

But the reciprocal is that for China they have to move that money somewhere overseas. So if we block off one conduit or one area where it can go, for domestic political purposes, they have to move it elsewhere for economic purposes. They do not want to incur the domestic inflationary impact that they would incur.

COMMISSIONER FIEDLER: I understand.

DR. NAVARRO: But they can't move their back to the U.S. currency pressures undue their peg.

DR. MARTIN: If I may finish. So they need to invest overseas in some format so that if, indeed, you close off one avenue whereby the capital could flow into the United States or elsewhere around the world--okay--then it will have to find some other method of getting or flowing to where it goes or China would be forced to take the economic medicine that macroeconomics would say it must take, given a fixed exchange rate, which is rapid inflation. Politically right now, my sense is they're not willing to accept that level of inflation. They want to keep it below five percent.

CHAIRMAN WORTZEL: Commissioner Slane.

COMMISSIONER SLANE: Are there clandestine methods that CIC may implement in the future that we should focus on such as dummy corporations, subsets of other entities?

DR. SETSER: Yes, there will be subsidiaries. We also see that with the State Administration of Foreign Exchange. You could, in some sense you could say that the CIC has effectively subcontracted the management of the majority of its initial allocation of \$200 billion to five state banks inside China.

They are acting as the asset managers for the CIC as a result of the recapitalization. Now, there's an offsetting equity interest that the CIC received in return. But the effect is that the management of that has been outsourced to certain managers inside China.

If you look at how sovereign wealth funds manage their funds globally, they make very heavy use of financial intermediaries. Most cases, those financial intermediaries also manage other people's money, and you participate in a broader portfolio.

But it's very difficult to know exactly, to trace all these flows in part because, to be honest, we in the U.S. haven't necessarily wanted the world to know, and those investing in the Middle East haven't necessarily wanted their publics to know precisely how much of their wealth has been kept in dollars. So there's a very well developed

mechanism that uses various financial institutions in Europe that for not any nefarious purpose, but just it has the effect of keeping some of these flows from being easily trackable.

CHAIRMAN WORTZEL: Commissioner Mulloy.

COMMISSIONER REINSCH: Commissioner Fiedler already asked my question.

HEARING COCHAIR MULLOY: I promised that we would get back to the issue of the Treasury saying that the biggest problem, their biggest worry is protectionism. Just to put further context, this Commission in the past strongly recommended that Treasury not chair the CFIUS precisely because your point, CFIUS means toothless in Greek.

They never used it. They've also, everybody in the world knows China is intervening in currency markets to keep their currency underpriced contrary to their IMF obligations except the United States government, which refuses to name them a currency manipulator.

So now they're saying the biggest problem here is protectionism.

So I'm just wondering what is going on here in your perspective. I was asked that one time when I testified before the Senate Banking Committee, why is Treasury behaving this way? I gave them an answer, but I'd be very interested in what you folks think on that point, starting with Dr. Navarro.

DR. NAVARRO: You start with the presumption that for ideological reasons and also for political reasons, given the Wall Street connection to Treasury and those set of interests, that Treasury has a view, and the view is that they're not going to crack down on currency manipulation.

If they won't do that, we can't expect them to crack down on sovereign wealth fund. So then it becomes a question of how do you argue this in the public arena? How do you argue this in the public arena to the press and to policy people who may or may not be deeply familiar with the kind of issues? So you start with a free market argument. You talk about the global flow of capital and how that's efficient for global capital markets and you don't mention the fact that it's the fruit of the poison tree.

You blame the Chinese and the Asians for saving too much rather than blame China's currency manipulation and the export subsidies and every unfair trade practice that basically creates China's excess reserves. Then of course to scare people, you wave the Smoot-Hawley bloody shirt that everybody always waves when they want to do anything about it and you use the "P" word—"protectionism.". It's more powerful than the "F" word when it comes to trade.

But cracking down on China's unfair trade practices is not protectionism. I have to say this over and over again when I talk

about this. It's not protectionism for this country to basically promote a set of rules which basically would allow us to have free trade in the best sense of Adam Smith.

You have market failures when you have monopoly elements, when you don't have good information and lack of transparency, when you have blatant subsidies that ruin the price signals. I mean everything about our economic relationship with China including their own import barriers and protectionism, and their great wall of protectionism suggests that they are the real protectionists, and all we're trying to do is basically remain true to American capitalist roots.

That's the only way I can answer that question, and anybody whoever uses the "P" word on you, you got to shake your head and come right back at them and say, no, we are not the protectionists.

DR. SETSER: I should thank Chairman Wortzel right now for not getting to the portion of my biography that mentioned that I spent five years working at the United States Treasury. So I presume that with that disclosure, my response will be duly discounted as representing the Treasury/Wall Street financial conspiracy. But I am speaking entirely on my own behalf and not as a representative of any institution that has employed in the past or that currently employs me.

Let me give you a couple of points in response to your question. The first is that I personally do not share the Treasury's framing that the greatest risk is investment protectionism. To me, the greatest risk is a failure to have the necessary adjustments in the global balance of payments that would bring the surpluses in the surplus countries down, that would bring the deficit in the deficit country, the U.S., down, and that would allow the U.S. to run a deficit which could be financed by a private flow of capital rather than by the build up of government assets.

That kind of adjustment, which I think is necessary, is to some degree being impeded by the decision by the United States Creditor, to shift to sovereign wealth funds rather than to accumulate fewer official assets.

So I would not accept the framing as the only or the dominant risk is investment protection. The dominant or overarching risk is an inability or an unwillingness on the part of all parties in the system to adjust.

That said, I think that the Treasury is responding to three realities. One byproduct of China's currency policy and, at least in my judgment, of the foreign exchange that they have to accumulate as a result of that currency policy is that they're overpaying for a host of financial assets, including American financial assets, and they are keeping the price of a host of financial assets higher than they otherwise would be, and that that creates winners in the U.S. economy

just as the underpricing of China's currency creates losers in the tradeable sector.

And that Treasury is balancing those interests, and it reflects, to a degree, the interest of those people who have been gaining from the intrinsic overpay--

HEARING COCHAIR MULLOY: Who are they?

DR. SETSER: American households, although that may be hard to believe to the extent that housing is a value as a function of interest rates and to the extent that Chinese bond purchases have kept the prices of bonds up and kept interest rates down. Chinese demand has helped anybody who bought a house in 2002. Clearly, it didn't benefit anyone who bought a house in 2006 expecting ongoing household price appreciation.

But a world where U.S. interest rates, long-term interest rates on treasuries are six rather than four to five would be a major blow to the net worth of anybody who has a home. And then it's also true for anybody else who is selling debt. Various groups that have sold debt to finance the purchase of equity are doing an arbitrage whose economic logic hinges on a great deal of demand for debt relative to equity, and recently a big source of that demand for debt has been from central banks.

I think the second point is the issue of China's nuclear option, so-called, which is to sell its U.S. holdings. It doesn't actually have to sell. It just has to stop buying and there would be, in my judgment, a very meaningful impact.

U.S. has its nuclear option which is to close its market to Chinese imports, Chinese, U.S. imports from China. I think the Treasury has been reluctant to take steps that would lead on a path that might result in that outcome. And again, that outcome would have economic costs to many in the U.S., just as it would perhaps generate benefits for other parts.

But it would be a very aggressive move that would be perceived as a step by the U.S. to force adjustment rather than an attempt by the U.S. to persuade the rest of the world that adjustment makes sense.

The third point is, and I think it's an important point to consider, is that China is a country of 1.3 billion people, a group which will because of its own industry and its thrift will be much wealthier in 20, years no matter what the U.S. does, than they are today. Because of its size and because of its economic growth will likely be a very important player in a planet that we all hope to inhabit.

And I think the U.S. appropriately is reluctant to initiate a path that might lead to a widespread popular perception inside China that the U.S. is taking steps to keep it from growing, to keep it from developing, and therefore has put a high premium on persuasion rather

than force.

The difficulty is that those persuasive effects have not generated the results at a sufficient pace for those who have not benefited from the changes in the U.S. economy that have been induced by the combination of cheap Chinese exports, cheap goods, and strong demand for U.S. financial assets. Groups that don't benefit, I think quite rightly, are asking, particularly now when the U.S. economy is not doing so well, what's in it for me, why isn't this happening faster. These broader considerations don't carry much water if you're out of a job.

CHAIRMAN WORTZEL: Gentlemen, I want to thank the three of you for your wisdom and for sharing your time and knowledge with us. If you have more that you want to say, we'll be happy to get it into our written record of the hearing.

We're going to break now. We will reconvene at 1:45 with the next panel. Thank you all for being here. You're awesome.

DR. NAVARRO: Thank you so much.

HEARING COCHAIR MULLOY: Thank you all.

[Whereupon, at 12:45 p.m., the hearing recessed, to reconvene at 1:45 p.m., this same day.]

A F T E R N O O N S E S S I O N

PANEL IV: IMPACT ON FINANCIAL SERVICES INDUSTRY

HEARING COCHAIR MULLOY: Thank you. This afternoon, the Commission in continuing this hearing on sovereign wealth fund investments, their implications for our own national security, we're going to look at the impact on the financial services industry because there have been particularly active sovereign wealth funds making purchases in the American financial services industry.

So we were very fortunate in getting three top rate witnesses to come in here and discuss the issues with us.

Leading off will be Charles Dallara, who is the Managing Director of the Institute of International Finance. The Institute is an association of over 340 global financial institutions. Previously, Charles served as a Managing Director of J.P. Morgan & Company.

I first met Charles when he was down in the Treasury Department. He was a DAS when I first met Charles, and then he became an Assistant Secretary, and had the international trade portfolio down in the Treasury Department.

Charles holds his Ph.D. from the Fletcher School of Law and Diplomacy, and he's one of the top people to bring us a perspective

from the financial community on what is happening with regard to these sovereign wealth funds.

Our second witness is Dr. Peter Morici. Peter is a Professor of International Business at the University of Maryland and he also has great government service over at the International Trade Commission where you were the Chief Economist.

He also has been an advisor to key trade committees on the Hill, and he has his Ph.D. in economics, and I know he's a person that writes a lot in the press, and we've all paid a lot of attention to what you say, Peter, so thank you for being here with us.

DR. MORICI: You're welcome.

HEARING COCHAIR MULLOY: And now the third one on the panel is Karen Shaw Petrou. When I worked for the Senate Banking Committee, I first met Karen over 20 years ago. She's now the Managing Partner of Federal Financial Analytics which is a privately held company that specializes in information and consulting services for financial institutions.

She's one who really understands the financial services industry and a person of great integrity and independence to give us a very good analysis of what she thinks is happening with regard to the sovereign wealth funds and our own financial services industry.

Prior to founding her own firm in 1985, Ms. Petrou worked in Washington as an officer at the Bank of America where she began her career in 1977.

So we thank you witnesses for being here and for the help that you're giving to the Commission so we can in turn be of help to the Congress. So thank you. Dr. Dallara.

**STATEMENT OF DR. CHARLES DALLARA, MANAGING
DIRECTOR, THE INSTITUTE OF INTERNATIONAL FINANCE,
WASHINGTON, D.C.**

DR. DALLARA: Thank you very much, Patrick, and thank you and the chairman and all of the commissioners for affording me this opportunity. It is an honor to be with you today.

I'm aware that you've had already a half day of discussions, and I would like to position my brief comments in the way that you find most useful. I was given a handful of questions which I'll be glad to respond to briefly, and I assume that's the best way to proceed.

Let me begin, if I may, just by saying that I do congratulate the Commission on selecting this topic because I think it is one of the most complicated, one of the most important geopolitical financial issues that will dominate the global financial landscape in the next decades and perhaps have important national security implications. I

particularly think that is potentially the case when you view it through the prism of U.S.-China relations.

What is a sovereign wealth fund? I'm sure that through the discussions you've had already today, you're aware that there is no universally accepted definition. What I think we should be looking at are government investment vehicles that control the assets that are owned or controlled by government entities around the world.

That is such a broad definition that I think we're going to have to be somewhat flexible and dynamic. Is the China Development Bank part of the sovereign wealth fund world? Many would suggest no, but indeed many analysts would say that because it is a government-owned development bank, that its actions fall in the scope of this.

My own view is that we should not be too dogmatic in determining or doctrinaire in determining what is a sovereign wealth fund. I think we should be looking at this broad universe of the diverse entities which control government assets and which, in the circumstances in which we look at these things, invest them overseas, and of course, we know that many of these assets are derived from or in some cases still part of official reserves of monetary authorities.

How large are these sovereign wealth funds? I think we all are aware that they are still relatively modest in the total global scheme of global finance. For example, 1.9 to 2.9 trillion is an estimate that we believe has some validity, and I would suggest that the numbers are currently in the middle of that range.

This relates to \$120 trillion in stocks and bonds globally. It's I think a relatively modest proportion of the global financial landscape, but one that is growing rapidly, and I think that is why attention is merited and warranted on this entire matter.

Of course, again, definitions matter, and you have many sovereign wealth funds, as they would be categorized, which have been with us for many decades and are managed in a highly professional fashion.

How fast are they expected to grow? We do expect that they could grow to a total of seven to eight trillion by as soon as 2012, and 12 to 15 trillion by 2015. It seems to me that it's important in this context to recognize the strong growth of, well, the funds in the Middle East driven by oil revenues and in China, and if I could just say in that connection that obviously the Chinese sovereign wealth funds are a function of two things: the very large and high and continuing to grow current account surplus of China; and the decisions which they have made and will make to transfer certain funds from their regular reserves into this new sovereign wealth fund entity.

How long have they been in existence? Certainly, two of the funds were founded more than 25 years ago: the Abu Dhabi Investment

Authority and Singapore's Government Investment Corporation. But you could go back even further and look at the initial accumulation of assets by the Saudi Arabian Monetary Authority and see there the seeds of what might be considered a sovereign wealth fund.

Of course, today, the Saudis do not necessarily feel comfortable considering the reserves a sovereign wealth fund, and they in fact resist the nomenclature and resist the notion, and I think we have to have some understanding of why that might be the case and we can certainly discuss that later.

Just to wrap up my comments, if I may, coming specifically to China. Right now China's official foreign exchange reserves are roughly \$1.6 trillion, huge by any standard relative to China's domestic needs.

We expect that those reserves will climb to two trillion by the end of this year, and easily to 2.5 trillion by the end of next year. As you can see with the large current account surplus, these reserves are growing rapidly.

A critical decision, however, is whether or not the Chinese authorities transfer substantial amounts of those funds into the new corporation which has been designated as their primary vehicle for sovereign wealth fund investment. I think it's called the China Investment Corporation, or CIC.

The initial capitalization of that is 200 billion, much of which will be used for domestic recapitalization of insolvent financial institutions or financial institutions with serious weak assets.

So it remains a big unknown how much of the future accumulation of Chinese reserves would be transferred into this new entity. I think there is a key issue, and I will only mention it very briefly. Do commodity-based sovereign wealth funds differ from non-commodity-based funds?

I would suggest that it's not terribly useful to spend a great deal of time on that distinction because whether a country generates these assets through accumulation of reserves because of high oil prices or whether it generates it through reserves accumulated as a result of a current account surplus owing to other circumstances, the fact is, is that these are funds which are accumulated by a sovereign entity and managed for various purposes, which they will need to define and clarify.

Certainly, in the last few months, they have come increasingly to the fore of our attention, and these will conclude my opening comments, Mr. Chairman, because of their timely and I would say constructive investments in U.S. and European financial institutions.

We're going through a period of remarkable stress in the global financial community, particularly in the U.S., Canadian and European

financial institutions, which is obviously having the severe adverse impact on economic activity in the U.S. and potentially around the globe.

It would not have been easy and may not have even been practical for the financial institutions that have raised capital from sovereign wealth funds over the last few months to do so in a timely manner through other means.

I think we have to recognize that the presence and willingness of these sovereign wealth funds to inject capital into U.S. and European financial institutions has, in my view been an important stabilizing factor in the operation of these financial institutions. At the same time, I think there are important issues of governance, of transparency, and of fundamental objective that need to be explored with the future operations of these sovereign wealth funds in order for us to feel comfortable that these are, on the whole, very beneficial operators in the global financial scene.

Thank you, Mr. Chairman.

HEARING COCHAIR MULLOY: Thank you, Dr. Dallara. Before we call on Dr. Morici, I just want to let you know that at 2:30 today, Senator Webb is going to come by, and he'll make some comments. At that point, we'll let him have the witness, make his comments. I don't think he's going to take questions. And then we'll come right back to this panel.

Thank you. Peter.

**STATEMENT OF DR. PETER MORICI
PROFESSOR, ROBERT H. SMITH SCHOOL OF BUSINESS
UNIVERSITY OF MARYLAND, COLLEGE PARK, MARYLAND**

DR. MORICI: To just pick up on what the previous panelist said, and then I'll get to my testimony, China right now has about \$1.5, \$1.6 trillion in its foreign exchange funds. The U.S. equity markets are only worth \$15 trillion so they could buy ten percent of all the equities in the United States tomorrow morning with the cash on hand.

Now to my formal testimony. A sovereign wealth fund is a pool of resources owned or controlled by a government invested in public or private assets, including debt instruments, equities and direct investments in property.

The China Investment Corporation is an example of such an entity, but so too are national and subnational interests that European governments have in industrial companies. For example, Airbus.

In the United States, there's a Social Security Fund. It's huge, and that's a sovereign fund, as is say Calpers, the California Public Employee Retirement Fund, which does investment in equities.

My point is that identifying sovereign wealth is fairly easy to do, but identifying those sovereign investments that should concern us is difficult. Clearly, instruments owned by national governments such as China and its state-controlled companies raise issues, but generalizing policy is a tangle of string.

U.S. policy with regard to sovereign wealth is largely underdeveloped. It has to be discerned from a variety of laws and regulations. With regard to our own sovereign wealth, we don't let the Social Security Administration invest in equities because we don't want the federal government influencing private sector decision-making with regard to how capital is allocated. We let Calpers do it, though Calpers is largely interested in making a profit like a big mutual fund.

It certainly has voted and influenced the behavior of companies, but it hasn't had, for example, an industrial policy concern similar to the Quebec Pension Fund in recent years.

In contrast, in China and Europe, national and subnational governments make investments with specific industrial policy purposes which have profound effects on international competitive outcomes.

Once upon a time there was no Airbus, and McDonnell Douglas was a thriving commercial enterprise. Now, Airbus is a thriving commercial enterprise and McDonnell Douglas no longer exists.

Sovereign wealth funds have the capacity to influence American companies greatly if their investments become large. For example, how would a major China Investment Corporation (CIC) investment in one of our major automakers affect the location of a facility to produce small cars when those cars could be made here and sent to China or made in China and sent here, when it is a clear industrial policy objective in China to get into the car business?

The influence of sovereign wealth on the U.S. economy through the political process is another very serious consideration. It is an unspoken fact of life that under our campaign contribution laws, given that we largely raise money from private individuals to finance campaigns, the major sources of financing are on Wall Street, the Silicon Valley and Hollywood because those industries have lots of people who can max out.

Right now, we have major, major investments being made in our large financial corporations on Wall Street.

Clearly, some sovereign investments are more troubling than others, and I would suggest that we should ask two questions in trying to evaluate what we should worry about and what we shouldn't worry about.

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

and the global economy?

In China, for example, sovereign investments have specific purposes 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 a Canadian provincial pension fund in the United States.

Second, does the sovereign entity share U.S. political values or does it see itself in competition from the West? We have to remember China remains an autocratic regime. The United States offers to the world democracy and markets. That's our prescription.

China offers order and prosperity as justification for shunning democracy and controlling markets. Large investments by such a government in the largest U.S. financial institutions would create important concerns regarding independent decision-making by those banks. The potential for compromise in the allocation of U.S. investments and enduring independence of U.S. political figures should not be and cannot be denied.

The United States has campaign finance laws because Americans believe that campaign money can influence legislation and public policy. Hence, major holdings by sovereign funds in U.S. banks that are now emerging should be the focus of attention. It is hard to imagine that a U.S. executive will not be sensitive to the political concerns of large shareholders when they choose candidates to support for public office. You can't work for the Chinese government and not be looking over your shoulder.

The United States is in a box. We have created a mousetrap for ourselves by running up very large trade deficits and consuming more than we produce. In standing idly by while foreign governments buy up massive amounts of dollars to maintain undervalued currencies, we have put the very cash in the hands of these sovereign investment vehicles.

There are no two ways about it. 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 that these sovereign investments pose no real concerns or issues.

I would point out to you that these sovereign investors are not requiring these banks to make changes in their business models. Private capital would, given their recent performance.

Clearly, they have interests other than making a profit. Bankers will tell us that there is no danger from these investments. But I would suggest to you that these are the same folks that just told us that collateralized debt obligations and structured investment vehicles and

engineered financial products were just as sound as the American dollar, and they have just squandered away one-and-a-half percent of U.S. GDP on their adventures.

So take that for what it's worth. I would leave you with the notion that fundamentally, when money comes into a failed institution--and Citigroup, Merrill Lynch, USB are failed institutions--they need to raise capital, they need to sell off their shareholders' value to stay in business, they have large distribution networks, they have brands. Normally the new investor expects them to change what they do. They haven't been asked to change what they do. And so we have to ask what is the motivation for those investments?

Thank you.

[The statement follows:]

**Prepared Statement of Dr. Peter Morici
Professor, Robert H. Smith School of Business
University of Maryland, College Park, Maryland**

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 Public 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 outcry 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.

HEARING COCHAIR MULLOY: Thank you, Dr. Morici. Ms. Petrou.

**STATEMENT OF MS. KAREN SHAW PETROU
MANAGING PARTNER, FEDERAL FINANCIAL ANALYTICS,
INC.
WASHINGTON, D.C.**

MS. PETROU: Thank you very much. It's a real honor to appear today before this Commission, in your very important inquiry into an issue, that while an emerging one has yet to be very well studied.

In a recent Foreign Affairs article, Deputy Treasury Secretary Kimmitt commented that sovereign wealth funds are what he called a structural shift in the world economy, and he urged policymaker attention to it. And you I think are taking an important leadership role.

Fundamentally, any sovereign investment is at odds with the premises on which the U.S. financial system, indeed the U.S. economy, is premised because we are a private sector economy with express statutory and even constitutional barriers to the government's involvement in our private market.

As a result, our regulatory system and our review of investments has yet really failed to take account of what a sovereign investor might do, and so we are singularly in need of the attention that you are bringing to this issue.

As former Treasury Secretary Summers has recently argued, government investors are fundamentally different than private ones, and policy therefore needs to be different as well.

I think this is especially true with regard to financial institutions. Financial services firms in the United States and indeed abroad have a variety of implicit and explicit guarantees, such as Federal Deposit Insurance and access to the Federal Reserves discount window.

Even perhaps more importantly, they take other people's money. Depositors and investors, who place their funds in trust, either in a safekeeping or even fiduciary capacity with an expectation that those funds will be safeguarded and used for economic purposes, not political, economic or military ones with which the depositor might well disagree or even be afraid of.

Financial services firms, most notably private equity firms, also take direct stakes in other firms often as controlling interests, and therefore they have access to insider information and intellectual property. That again can place significant risk to our fundamentally

private approach to capital markets.

For all of these reasons, your look at sovereign wealth funds and the financial services industry is an urgent and very important one.

With specific regard to the financial services firms, I'd like to make five recommendations to this Commission.

First is that sovereign wealth funds do, as I suggested, require an express and new policy by the United States. This is a policy that I think needs to be broadened not just to any firm that is deemed to be a sovereign wealth fund, but indeed to any that is a sovereign entity that invests in private debt, in private equity.

Dr. Dallara has rightly talked about the definitional complexities and I think these will, should we seek to come up with a definition, delay us from urgently needed policy action. We think we know who they are because they are not fundamentally persons subject to U.S. law.

In that regard, I do not think we need a differentiated policy for China. I think we need a U.S. policy for all sovereign investors that fully takes China and its goals and objectives and its important capital into account.

I think it's important not to try too hard to come up with these complex definitions because we already see firms that are not technically sovereign wealth funds behaving in ways that may well not be economically driven. I would note, for example, the Gazprom investment in energy pipelines in Europe. These are very troublesome investments from a national security objective.

Are they made by a private company because Gazprom is shareholder owned or by a government entity because it is, of course, totally government controlled?

A legal definition of that would take a lot of time, but I think we all know the answer to that question from an economic reality point of view.

Going specifically to the financial services industry, as has been said, clearly sovereign investments have become a major issue. We have calculated that since 2006, sovereign entities replaced \$44.3 billion in U.S. financial services firms.

Now this is a drop in the bucket compared to the trillions in market cap of the U.S. financial services industry, but it is an important investment in many firms, in Blackstone, Merrill Lynch, for example, Citigroup, and Morgan Stanley. These investments make the sovereign entity the largest private shareholder or give that investor significant share in a company.

Each of these investments has been carefully structured to meet the passive requirements of the CFIUS process and U.S. financial law, but I think all are of a size to raise significant questions about the

degree to which they are indeed passive, and therefore they warrant significant additional controls.

I would recommend two such controls. First, I would argue that all sovereign investments in U.S. financial services firms be placed through third-party asset managers. I think in fact this is an important policy for all sovereign investments in the United States, but it is especially critical for financial services because of the unique nature of these firms and the role they play, both for individuals and for the economy as a whole.

To the degree that any investment is placed outside of a third-party asset manager, then I believe we should establish a rebuttable presumption of control when that share exceeds five percent. That should apply not only to the CFIUS review, but also to review by the appropriate functional financial regulation. We have long established in U.S. law a policy of special review from financial services firms because of their unique role, and that should be recognized with regard to sovereign investments in the United States.

The Federal Reserve and FDIC are now calling upon Congress for new policies with regard to commercial ownership of insured depositories through what's called an industrially-owned company. Those concerns related to a commercial company subject to U.S. law are clearly far more magnified when a sovereign investor becomes a holder of a U.S. insured depository with a potential controlling stake.

Prior Federal Reserve review therefore should be required of any investment by a sovereign entity in an insured depository or related company with a share above five percent. I believe that securities and insurance regulators should be given comparable authority for prior advance and transparent review of any sovereign share above five percent.

This would ensure most fundamentally that someone subject to U.S. law is governed by principles that condition the transaction. I do understand, as Chairman Cox has pointed out in his testimony, that sovereign entities engaging in the United States in commercial ventures are subject to U.S. law, but enforcing that will prove extremely problematic. So I would argue for building in controls now that either ensure true passivity through the requirement for third-party asset management or effective control and enforcement by advance approval that binds parties and persons subject to U.S. law.

I think this is an open policy because we do need the sovereign investment in the United States, especially in the financial services industry, but I think it is one that will put some essential controls in place in advance.

Thank you.

[The statement follows:]⁴

Panel IV: Discussion, Questions and Answers

HEARING COCHAIR MULLOY: Thank you, Ms. Petrou. Commissioner Wessel, are you going to start the round of questioning?

COMMISSIONER WESSEL: Thank all of you for being here and very interesting points. I'd like to ask you a question or springboard off of a recent CRS report done early in January. The title was "Foreign Ownership of U.S. Financial Assets: Implications of a Withdrawal."

In the summary, it says if a withdrawal occurred when the economy were not experiencing robust rate of growth or if credit financial markets were under duress, the withdrawal could have a stronger effect on the economy.

The flip side of that, and Ms. Petrou and Dr. Morici, I think going off of your comments, that potentially the investments, not just the withdrawal, the investments that have recently been made in a number of our financial companies on Wall Street may exert undue influence as well.

One would have assumed, for example, that as a result of the subprime debacle last year, that many of our Wall Street traders would not have gotten as robust bonuses as they did, but rather they'd share in the losses that a good portion of America has shared as their mortgages have gone into foreclosure.

Have we passed the tipping point? Dr. Morici, you talk about the influence in the political system that now exists. Has policy, our ability to control policy been eroded by not just sovereign wealth funds, but the China deficit, and if so, what evidence or what policies have you seen that have changed it as a result?

DR. MORICI: Well, I don't think we've reached the tipping point because it's so new, and we are just beginning to see these very, very substantial increases in capital to our banks from sovereign funds.

However, I think that we have always had the issue that certain industries enjoy more influence in the media and in the political process because of their size and their campaign contributions, and that's just a fact of life in America.

It's not a perfect system, and I'm not saying that people here or people that work in these buildings that are elected are imperfect individuals. It's just the nature of financial power.

However, I do think that if we're going to talk about safeguards

⁴ [Click here to read the prepared statement of Ms. Karen Shaw Petrou](#)

and screening and creating arm's length investments, then I think we also need to entertain whether that should apply to the political process as well if it's constitutional.

For example, should it be possible for either the Democrats or the Republicans or anyone running for public office to raise campaign contributions from executives employed by a company with more than five percent ownership by a sovereign fund?

I think that's a very interesting question we should ask. I would suggest that probably you would start to get some of the same assurances about objectivity and all the rest from politicians that you're going to get from financial executives right now because that is how they raise their money, and they need to do that to be competitive.

But I don't think we've reached the tipping point. We can say you have to keep your money in Treasury securities if we choose to. We can do that. We can make a distinction. The real problem is where do you draw the line? What is a sovereign investment and what is not?

Airbus has government ownership and it invests here. Is that a problem? The real problem is redlining, is drawing the red line around the investments that you don't want to have here. It's an enormously difficult problem, but yet if we get involved in definitions, we're going to get involved in an endless morass.

I would suggest to you that the fact that we are having this discussion should finally move us to the purpose of fixing the trade deficit because that's where the money comes from. And to some degree fixing what's going on on Wall Street because that's where the need comes from, which is bigger than what this Commission is supposed to address. But the fact is we are living through systemic breakdown.

We have always presumed that if the federal government stayed out of the private sector, that governments were out of the private sector. That doesn't apply anymore because we have so financed the Chinese to be in our private sector and others including the Saudis and the Persian Gulf states and so forth.

COMMISSIONER WESSEL: Ms. Petrou, any comments?

MS. PETROU: I think we are at a position in our financial markets where many players--for example, I don't know how many people knew what a monoline bond insurer was before a couple of weeks ago, but the fate of seven remarkably small financial guarantors is now driving equity markets up and down and posing potentially trillion dollars' worth of risk to the financial system.

We need new governance of our financial system designed to reflect the new risks. I'm very glad that the Treasury Department is hard at work on a blueprint to rewrite U.S. financial regulation. We really do need that, but the role of the sovereign wealth funds isolated

within that would be very difficult to do, and that's why I think we need both the specific standards I suggested to limit and control their role, combined with a larger financial reform that I think is already beginning to be well underway.

COMMISSIONER WESSEL: Thank you. Dr. Dallara, any quick comments?

DR. DALLARA: Very briefly, Commissioner Wessel, if I may. I do believe that we should not look at the recent investments in U.S. and European financial institutions as major sources of concern. I think it's good to treat them as a wake-up bell for looking at some of these broader issues which the Commission is focusing on and which my colleagues here on the panel have raised, which should be our overall policy here.

But I believe we have witnessed a series of passive investments, and somewhat in contrast to Dr. Morici, I actually welcome the fact that they're not seeking management changes or business model changes. I would be concerned if the Abu Dhabi Investment Authority or the China Investment Corporation was bringing in two or three or four percent and immediately engaging in discussions with management about business models.

They are seeing these, I believe, largely as passive investments, and rightly or wrongly, I believe, as investment opportunities. Now time will tell whether or not they prove to be sound investment opportunities, but I believe that there is a potential that in our understandable concern about protecting U.S. national security interests here, that we might get pulled in the direction of protectionist policies which actually undermine the fundamental vitality of flows of capital to this country.

As Dr. Morici pointed out, we are heavily dependent on foreign capital to run our economy. For better or worse, that is the reality in which we are in, and I think he's right to say there's some fundamental issues here and that we realize that go beyond the scope of this committee. But certainly the current account surplus, which we have constantly managed, which increases this dependency on some \$2 billion of foreign capital, we can't close the books on this economy any day of the week, including a Saturday or Sunday, without \$2 billion of capital inflows.

It's a serious dependency, which we must address at the fundamental level, including, in my view, avoiding excess tendencies toward running our fiscal deficit up again. We also should look in the context of our China relations, at whether or not we are comfortable with their exchange rate policy.

In the context of the sovereign wealth fund issues, I think the most fundamental issue is whether or not they are investing for

investment commercial purposes or whether they are motivated for political or geostrategic considerations, and it seems to me that we have every right, you have every right, and this country has every right to expect an answer to that question by any sovereign wealth fund investing in this country.

It seems to me that is the fundamental litmus test which must be put around any of these investments. Thank you.

HEARING COCHAIR MULLOY: Thank you, Charles. Chairman Wortzel.

CHAIRMAN WORTZEL: I have a question for Dr. Dallara and then one for Dr. Morici and Ms. Petrou.

Dr. Dallara, I take it that the analysts who caution that there could be some instability in China because of an insolvent banking system are just wrong from what you've said here? That given your testimony about both the current amount of their foreign reserves and the way you see it growing, they've got quite a cushion there.

And then I would ask Dr. Morici and Ms. Petrou, why did you peg five percent? What's the magic at five as opposed to three or six?

DR. DALLARA: If I may, I'm going to let her tackle the second part of that, Mr. Chairman, and I'll say a brief word, and I'm sure my colleagues may wish to add on the very pointed and very important first question.

I would see it somewhat differently than the analysts that you suggested perhaps see it. They do have a cushion. It's a huge cushion, but it's not altogether a beneficial cushion. Does it really make sense for a country that is still relatively poor in terms of per capita income to be transferring overseas billions of dollars of wealth every year? That's what China is doing by running such a current account surplus.

They have a banking system which is unique in the world today. It is attractive for foreign investors. It is in the process of being reformed impressively in terms of corporate governance, in terms of risk management, but that reform process, in my view, is still in an embryonic stage.

The quality of assets in these financial institutions ranges still, in my view, with all respect to my friends in the Chinese banking community, from mediocre to very, very poor. This cushion does not protect them from financial instability. They have markets which are isolated from global markets such as the Shanghai exchanges and other phenomena which needs to be tackled as this economy is integrated into the world economy.

So I think we continue to need to monitor very closely developments in the Chinese economy and the Chinese financial sector, not the least reason is because of growing inflationary pressures there.

So by no means do I come away in an extremely comfortable

frame of mind with regard to the minimum term outlook for the Chinese financial or economic system, Mr. Chairman.

DR. MORICI: Ms. Petrou, do you want to handle the five percent?

MS. PETROU: Sure. I think with regard to the five percent, I picked that number based on various legal standards, most importantly the requirements for the Federal Reserve, but U.S. law now requires the Fed to assume control exists when a share stake exceeds 24.9 percent.

But there is a rebuttable presumption of control at shares of five percent or greater. So I looked at that five percent and higher as the point at which the rebuttable presumption of control should kick in, and even then I think it's important to mention, which I should have suggested in my opening remarks, that none of these are red bright lines because the law now requires the Federal Reserve to intervene when there are what are called indicia of control.

For example, I would argue that a sovereign entity that took a one percent share but had a seat on the board of directors, had those indicia of control, and that should be deemed a controlling influence regardless of the nominal nature of the shareholding. I think that is what is so troubling right now about the careful work being done to structure all the financial services investments as nominally passive ones where, in fact, significant control may well exist by virtue of the relative size of the investments.

DR. MORICI: And what I was doing was extending the standard that is applied to commercial control to the campaign finance laws, saying if that's going to be the standard that we evaluate commercial control. Then if a sovereign fund has that kind of control over a company, then its executives should be barred from making campaign contributions in the United States.

I don't know whether that's constitutional because I know that when we try to deal with campaigns, we run into all kinds of issues. But I am quite concerned that whether or not the China Investment Corporation says it's passive or not, if a congressman wants to take a hard line on the yuan, it might not be smiled upon as much, a contribution by an executive to that congressman, that someone who says there's no problem here.

One of the problems that we do face is that our major banks see vast opportunities in China, and well they should, because until just a few months ago, we thought we had a superior financial system. Now, it seems as though we have the kinds of troubles we saw in Asia in the 1990s with banks making loans to their cousins and brothers and all the rest. Not that we've done that here, but we've had that kind of outcome.

But they see vast opportunities in China and, therefore, they're rue to support any kind of legislation, any kind of policy that would challenge the Chinese yuan policy. You're not going to get much help from Wall Street on the Chinese yuan policy. It's kind of like what goes on in Detroit. They see all kinds of problems with the yen, but none with the yuan, because they're competing with the Japanese cars but not the Chinese cars.

HEARING COCHAIR MULLOY: Thank you very much. Commissioner Fiedler.

COMMISSIONER FIEDLER: A couple of quick questions. I notice that you said sovereign entity instead of sovereign wealth fund. While we're avoiding specific definitions, if we're to take your advice, that is a very different definition than sovereign wealth; right? It's a broader group of entities, sovereign entities.

DR. MORICI: My view is that if the money is--

COMMISSIONER FIEDLER: Is controlled by the government.

DR. MORICI: --owned by the sovereign--

COMMISSIONER FIEDLER: Right.

DR. MORICI: --it doesn't really matter to me what the investment vehicle is because the sovereign can pull the string.

COMMISSIONER FIEDLER: I share that view. I was just getting clear--

DR. MORICI: I didn't realize that coming here today that semantics would be as much of an issue as it might be in some people's minds. I think that is an escape hatch that people may be using to get away from the fundamental issue. I'm not saying you are, but I'm saying if we get involved in these kinds of games.

COMMISSIONER FIEDLER: We're going to interrupt for Senator Webb.

CHAIRMAN WORTZEL: As a citizen of the Commonwealth of Virginia, I have to say that we're really blessed that we have and are represented by two senators who are absolutely devoted to our military and the national security of the nation.

Both are former Marines, both are former Secretaries of the Navy. Senator Jim Webb was first elected to the Senate in 2006. As a Marine in Vietnam, he was awarded the Navy Cross, the Silver Star, two Bronze Stars and two Purple Hearts.

From 1984 to 1987, he was the first Assistant Secretary of Defense for Reserve Affairs, and in 1987, he was Secretary of the Navy. Senator Webb serves on the Armed Services Committee and the Foreign Relations Committee where he is assigned to the Subcommittee on East Asian and Pacific Affairs.

He's also on the Committee of Veterans Affairs and Joint Economic Committee. Senator Webb, we're honored to have you with

us today.

**STATEMENT OF JIM WEBB
A U.S. SENATOR FROM THE STATE OF VIRGINIA**

SENATOR WEBB: Thank you very much, Commissioner Wortzel, and I'd also like to express my thanks to Commissioner Pat Mulloy for having helped to arrange my invitation to come and talk to you today. The room definitely looks different from this side of the dais. I really would like to thank you for your decision to hold a hearing on this issue. It's one that started to concern me about a year ago, when we started seeing larger scale investment at a time when our economy has become more vulnerable.

You've been meeting all day. I won't repeat a lot of the things that have been said, in general, about sovereign wealth funds, but I would point out that although foreign governments have been investing in this country through a number of different vehicles, sovereign wealth funds have definitely captured our attention up here, as they increase their footprint.

Information that has been supplied to my office indicates that while currently valued at \$2.2 trillion, sovereign wealth funds could be worth more than \$10 trillion within five years. With sufficient foreign exchange reserves to cushion against economic shocks, foreign governments seem to be seeking investment alternatives to our Treasury securities.

And what we're seeing obviously is not merely private foreign investment; it is foreign government investment. That gives us a whole new series of policy challenges and we quite clearly don't have all the answers to that. So it's one of the reasons I'm really glad to see your Commission taking this on.

Governments are motivated by a broader array of factors than commercial investors are. While foreign governments can invest money in our country to make a profit, they may also do so in order to further their foreign policy ambitions, to acquire national security assets, or to purchase state and strategic industries.

Gerard Lyons, the Global Head of Treasury Research at Standard Chartered Bank, coined a phrase at one of the hearings that we were holding on this subject, "State Capitalism" to describe the phenomenon of sovereign wealth funds.

I quite frankly don't know what kind of label should be put on this phenomenon. I've been doing a lot of thinking about this over the last year or so, considering the progression of government policies that started with colonialism and go through other forms of government. I don't think we really have experienced anything quite like this, and

we're struggling to define what it really means.

There are a lot of people who say that because we are raising these warnings, that it is protectionist. In relation to concerns that we're bringing forward, I do not believe that's true. I think that no one wants to slow down the American economy and no one wants to impose barriers to investment without good reason.

No one wants to build a wall around our country. We want a healthy economy. We want good jobs, but we have to fulfill our fiduciary responsibilities here in the government to make sure that investments are done in a manner that's consistent with protecting our national security and the stability of the markets. We have a role to play here.

We're still sorting out what that role entails. These investments so far, if you look at the reactions from the administration, have been discussed as politically benign. But I believe it would be naive to assume that other motivations are not capable of entering into the picture. There are a number of different examples of these issues in my formal statement. I would just ask that it be entered into the record. It's been recently noted that the difference between sovereign wealth funds and other foreign investment is the political element and the desire of these funds to play a more prominent global role. Undoubtedly, some sovereign wealth funds are interested solely in financial return and will invest in a purely commercial manner, but we cannot presume in our positions of responsibility that that will always happen.

All proposed foreign investments that have national security implications are potentially subject to review by the Committee on Foreign Investment in the United States. I have been particularly concerned regarding passive investments that may nonetheless provide foreign governments and state-owned corporations with control over sensitive national security information. Holding a small minority of shares or not taking a board seat does not provide a guarantee that there will be no influence or control.

You don't always need a seat on a board to have a seat at the table. That's a reality, I think, of the business world.

I was able in September, along with Chairman Dodd, and Ranking Member Shelby of the Banking Committee, and Chairman Bayh of the Subcommittee on Security and International Trade and Finance, to send a letter to Treasury Secretary Paulson about this matter. We expressed our concern that CFIUS regulations, which I understand will be issued this month, are broad enough to address the potential national security implications of ongoing foreign government investment in our economy. We have been pursuing this with Secretary Paulson since then.

In November, I participated in a Banking Committee hearing that I had actually requested of Senator Dodd regarding the implications of sovereign wealth funds.

Sovereign wealth funds are now large enough to shift markets. At the core of maintaining market stability is transparency and the free flow of information. Unfortunately, some of these funds operate in effect in a black box. Decision-making is opaque and their investment strategies are known only to a few.

I applaud on the one hand the efforts of the Treasury Department to work with the International Monetary Fund, the World Bank, and the Organization for Economic Cooperation and Development to promote transparency and best practices, but there is also a legitimate question to be raised regarding compliance with the standards that these institutions will establish: how will a mechanism that relies on peer pressure ensure compliance among the least transparent sovereign wealth funds?

And finally, the issue underlying this discussion is the transfer of our productive wealth away from the United States, a trend that imperils our economy, a critical concern as we consider national strategic impacts.

We know that we need an inflow of capital. We know that the economy is in some peril, but there are decision points that need to be examined before they are crossed. I was given an article by a staff member today from the Wall Street Journal Asia talking about sovereign wealth funds and the reaction of the Australian government to regulating those funds.

I'm not sure if the Commission has seen the article. It is very interesting because Australian Prime Minister Kevin Rudd mentioned on Tuesday that separate rules apply to an investment in Australian assets by a foreign government than they do to investments by private foreign investors. I think that's something we might want to examine as a potential template as we move forward in this issue.

We do need to ensure that we're taking adequate stock of a foreign government's strategic priorities when we review the national security implications of different transactions. We need to ensure that our laws and policies distinguish between politically motivated sovereign investment and commercially motivated sovereign investment, we need to closely scrutinize strategically motivated investments, and we need to adequately define what control means as it pertains to the acquisition of U.S. assets.

In my view, we may need to examine the possibility of designing strict controls, perhaps looking at something like the Australian model for regulating the type and extent of investments by foreign governments. I know that this is an issue that is becoming more and

more visible in the debates here in Congress.

We're having a hearing of the Joint Economic Committee soon regarding sovereign wealth funds. We really need to maintain close oversight of this issue in a way that helps us to protect the true interests of our country.

I tend to stay engaged on these issues, I again thank you for holding this hearing. We look forward to examining closely what your recommendations are, and I look forward to working with you on a continuing basis in the future. Thank you very much.

[The statement follows:]

Prepared Statement of Jim Webb
A U.S. Senator from the State of Virginia

I would like to thank Commissioners Pat Mulloy and Larry Wortzel for their invitation to speak today. I applaud the decision of the U.S.-China Economic and Security Review Commission to hold a hearing regarding China's sovereign wealth fund.

Let me take a few moments to make some general remarks regarding sovereign wealth funds. Then I would like to speak briefly about the political, national security, and economic implications of the growth of these funds. I will conclude by raising issues for follow-up by Congress and the U.S.-China Economic and Security Review Commission.

Although foreign governments have been investing in the United States through various investment vehicles, sovereign wealth funds have captured the attention of lawmakers as the funds increase their footprint in the U.S. economy. According to the International Monetary Fund, while currently valued at \$2.2 trillion, sovereign wealth funds could be worth over \$10 trillion within five years. With sufficient foreign exchange reserves to cushion against economic shocks, foreign governments are seeking investment alternatives to U.S. Treasury securities.

But what we're seeing is not merely private foreign investment—it is foreign government investment, which raises new policy questions for which we do not have all the answers.

Governments are motivated by a broader range of factors than commercial investors. While foreign governments may invest money in our country to make a profit, they may also do so in order to further their foreign policy ambitions, to acquire national security assets, or to purchase a stake in strategic industries. Gerard Lyons, the global head of treasury research at Standard Chartered Bank, coined the phrase "State Capitalism" to describe the phenomenon of sovereign wealth funds.

Some commentators are quick to levy warnings of "protectionism" in relation to any concerns that are expressed regarding the potential impact of sovereign wealth funds. Their critique falls wide of the mark. No one is advocating building a wall around our country. I welcome investment that promotes economic growth and generates good jobs for American workers. But such investment must do so in a manner consistent with protecting U.S. national security and the stability of U.S. markets.

Congress has an important role to play in making sure these concerns are addressed. We don't fully understand what these funds mean for our country and there are serious policy questions that need to be raised. Let me address a few of these concerns in turn.

The investments made by sovereign wealth funds are largely discussed as politically benign, but it would be naïve to assume other motivations will not enter into the picture. The Qatari Investment Authority's recent failed effort regarding J. Sainsbury in the United Kingdom included an aggressive effort to seek management control.

Norway, which is held up as the model for sovereign wealth funds, incurred the ire of Iceland when it sold short on bonds issued by its banks, a move perceived as undermining Iceland's economy. Iceland's prime minister at the time protested vehemently. What will we do when a fund takes such actions in relation to the United States?

As Felix Rohatyn has noted, the difference between sovereign wealth funds and other foreign investment is "the political element" and the desire of the funds to play a more prominent global role. Undoubtedly some funds are interested solely in their financial return and will invest like a commercial investor, but we should not presume that all funds will act in this manner.

All proposed foreign investments that have national security implications are potentially subject to review by the Committee on Foreign Investment in the United States. I have been particularly concerned regarding passive investments that may nonetheless provide foreign governments and state-owned corporations with control over sensitive national security information.

Holding a small minority of shares or not taking a board seat does not provide a guarantee that there will be no influence or control. For example, Saudi Prince Walid Bin Talal, who holds a 3.9 percent stake in Citibank, was closely consulted in the ouster of Chuck Prince from Citibank as its CEO. Prince Bin Talal does not sit on the board. You do not need a seat on the board, however, to have a seat at the table.

Prince Bin Talal has invested his money, not his government's, and he is held up as a responsible and conscientious investor. The Prince's role in another Prince's ouster, however, speaks volumes to those who suggest that you need to be on the board to exert influence.

In September, I, along with the Chairman Dodd and Ranking Member Shelby of the Banking Committee, and Chairman Bayh of the Subcommittee on Security and International Trade and Finance, sent a letter to Treasury Secretary Paulson. The letter requested that the Committee for Foreign Investment in the United States examine passive foreign ownership interests in assets in the United States, including through sovereign investment funds.

The letter urged the Treasury Department to draft regulations, which will be issued this month, which are broad enough to ensure that potential national security implications of such investments are appropriately assessed in the context of ongoing foreign investments in the U.S. economy. In December, I participated in a Banking Committee hearing regarding the implications of sovereign wealth funds.

Sovereign wealth funds are now large enough to shift markets. At the core of maintaining market stability is transparency and the free flow of information. Unfortunately, some sovereign wealth funds operate, in effect, in a black box. Decision-making is opaque and their investment strategies are known only to a few. While I applaud the efforts of the Treasury Department to work with the International Monetary Fund, the World Bank, and the Organization for Economic Cooperation and Development to promote transparency and best practices, there is a legitimate question to be asked regarding compliance with the standards that these institutions will establish: how will a mechanism that relies, in effect, on peer pressure ensure compliance among the least transparent sovereign wealth funds?

Lastly, the issue underlying this discussion is the transfer of our productive wealth away from the United States, a trend that imperils our economic well-being. Our need for the inflow of capital is unsustainable.

As Jeffrey Garten at Yale noted regarding sovereign wealth funds, the “U.S. is going to be extremely vulnerable for a long period of time because we’re so hooked on foreign capital.”

Although the investment by sovereign wealth funds represents a small proportion of overall flows of foreign capital into the United States, it affords the opportunity to highlight the precarious financial position our country is in. We cannot keep selling off our country; we cannot continue our excesses of spending and borrowing; and above all, American Capitalism must be reminded to nurture the democracy that allowed it to thrive.

With a tight credit market, we can expect to see investment by sovereign wealth funds continue to grow. As such, we need to ensure that our policies protect our national security and our economy from the risks associated with these funds.

We must ensure that we are taking adequate stock of a foreign government’s strategic priorities when we review the national security implications of particular transactions. We need to ensure that our laws and policies distinguish between politically motivated sovereign investment and commercially motivated sovereign investment. We need to closely scrutinize strategically motivated investments, and adequately define “control” of U.S. assets, which triggers review by the Committee on Foreign Investment in the United States. And we need to design strict controls regarding the type and extent of such investments by foreign governments. Congress also needs to maintain close oversight of the Committee on Foreign Investment in the United States.

Any efforts that the U.S.-China Economic and Security Review Commission can make to further these goals, by collecting relevant information and data, would be helpful to Congress.

I intend to stay engaged on these important issues. Thank you for your time and attention.

CHAIRMAN WORTZEL: Senator, thank you very much. We'll make sure we get that Wall Street Journal article of February 6 in our record.⁵

SENATOR WEBB: I appreciate it and I'm sorry to have broken up the panel here, but it was a pleasure to be able to be with you. Thank you.

HEARING COCHAIR MULLOY: We'll come back and right now Commissioner Fiedler has the floor and he's questioning. Thank you for giving us the opportunity to have Senator Webb speak to us at this time.

PANEL IV: [Discussion resumes]

COMMISSIONER FIEDLER: Ms. Petrou, let me ask you a question since you are with a group that advises other financial institutions, right? It's an association of financial institutions, in effect.

⁵ [Click here to read the referenced article: China Shows Savvy in Rio Tinto Deal, WSJ, February 6, 2007](#)

The Federal Reserve required Citigroup, for instance, as a bank holding company in the United States, to disclose, and it's on their Web site when you click on hierarchy, you'll get a list of every subsidiary that Citigroup has, ad nauseam actually, probably in excess of 90 pages long--if anybody cares to know.

If you're an insurance company, another form of financial institution in the United States, you file separate accounts, general accounts, reports that are this thick and this big. Every stock and bond owned, when it was purchased and when it was sold, every piece of land owned. So we have a history of importantly regulating and very specifically regulating financial institutions.

Sovereign wealth funds are financial institutions, are buying significant pieces of our financial institutions, and all we know in the Morgan Stanley investment banking situation is whether somebody has got 9.9 percent. That's ultimately convertible to common stock somewhere down the line, by the way, which gets to her five percent rule. They don't have to file this five percent controlling interest now until they convert; right?

MS. PETROU: Correct.

COMMISSIONER FIEDLER: Yet, they have the ability to convert in time. The question of disclosure seems to be a problem for the witnesses this morning for sure--requiring disclosure in the United States. Could you comment on what the problem is? Do you really think that the Chinese would not invest in the United States if they had to disclose similarly as Citigroup does to the Federal Reserve?

MS. PETROU: I doubt it because the appeal of the investments is so great, and I think the idea that you've outlined is a very, very interesting one. What troubles me about relying solely on transparency and disclosures, and perhaps you don't intend it as solely-

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COMMISSIONER FIEDLER: Right.

MS. PETROU: --is what will we do if the disclosure is incomplete, wrong, or worse, intended to mislead, because of the difficulty of the reach of U.S. law?

COMMISSIONER FIEDLER: As I say, I understand that. I actually just want to start with transparency, but I can't get anybody to start with transparency because transparency is disclosure. Disclosure is controlling in the United States, not best practices, to me.

The other point here that was made, I think it was you, Dr. Petrou, that Wal-Mart couldn't buy an industrial bank. We didn't want Wal-Mart to own the banking system, but we have less concern about the Chinese owning substantial interests? Can Wal-Mart buy a controlling interest in Citigroup?

MS. PETROU: No.

COMMISSIONER FIEDLER: Under current law?

MS. PETROU: No. No, sir.

COMMISSIONER FIEDLER: Can China?

MS. PETROU: Only filing an application and doing so through a sovereign entity. They could not do so directly as a government.

COMMISSIONER FIEDLER: No, not as a government, as the CIC? Can the CIC buy ten percent of Citigroup?

MS. PETROU: Yes.

COMMISSIONER FIEDLER: Wal-Mart can't?

MS. PETROU: Correct.

COMMISSIONER FIEDLER: I don't like Wal-Mart anymore than I like the Chinese government particularly, but it shows an interestingly stark difference in values; doesn't it?

DR. MORICI: You've hit something right on the head, commissioner. We are permitting the China Investment Corporation to do things that we don't permit entities within the United States to do because we have concerns about keeping different pots of capital separate so our enterprise system can function effectively.

COMMISSIONER FIEDLER: We actually used to refer to things as "Chinese walls."

DR. MORICI: I know, but it's not politically correct anymore. We're going to assign some doctoral students the opportunity to get Ph.D.s, to come up with a new word.

COMMISSIONER FIEDLER: I mean it's paradoxical, it's ironic, it's contradictory. It's a lot of different things.

DR. MORICI: One of the things I would point out to you is in U.S. law, and I'm not a lawyer, I'm an economist, but having studied antitrust law where economics is rather persuasive, we do treat sovereigns as commercial entities when they have a commercial purpose. You know, the Polish government gets involved in a monopolistic practice through a state-owned company; it's subject to U.S. law.

The trouble is our government has to balance lots of different things. For example, by any reasonable estimate by antitrust lawyers, scholars, the behavior of OPEC is monopolistic, but we don't treat it as such because of foreign policy considerations.

I would suggest to you we can subject the Chinese to the same disclosure requirements as Wal-Mart or the same rules as Wal-Mart, and then we get all tangled up in other foreign policy considerations. Our whole structure of thinking is based on the notion of there being a public sector that does certain things, a private sector that does certain things, and we being very careful where one becomes the other. Yet, in China, they don't have that because it's a different system, and we're letting them come here and buy up the economy. That makes no sense

to me.

DR. DALLARA: Commissioner Fiedler, if I could just make a few points. I think I would, first of all, underscore, as you have, the importance of transparency and disclosure. I think it is an essential part of building a trusting framework for these flows of sovereign funds into global market, and without it--it's certainly not sufficient, as Ms. Petrou said--but without it, I think you don't have that essential building block.

Let me return, if I may, though, to the issue that I mentioned at the outset, the importance of clarification. To me, the most important point of disclosure in all is what the basic objective and purpose of the sovereign wealth fund is because to me that's even more important than the ownership itself because in many ways I think we would be healthier to have some of these so-called sovereign wealth funds, the Futures Fund of Australia, or even the Kuwait Investment Fund, who have a long history of investing for commercial investment purposes, we're better off having them invest than to have state-owned companies in these same countries.

And that's why I don't think we can allow ourselves to be framed by kind of a pure definition of sovereign wealth funds just relating to the reserve management.

There is a long history in many of these countries, in many of the funds actually, of investing for commercial investment purposes, and if you look at the behavior, transactions and behavioral tendencies of a Kuwaiti Investment Authority and Abu Dhabi Investment Authority, and even Chinese authorities who have managed their exchange reserves, so-called State Administration for Foreign Exchange, SAFE, they've been very professionally managed for commercial and investment purposes, generally in a prudent fashion.

What concerns one is when one sees new entities being created that appear to have a more political coloration, and what concerns me, to be honest, about the China Investment Corporation, is that there is not a clarified framework of governments and a clarified statement of objectives, and I would raise the same concern about any other sovereign wealth fund which doesn't have it, that give you comfort that it is divorced from the political process.

The first antenna that was raised in my recognition of the concerns here was the indications when I visited China last spring that the China Investment Corporation reported directly to the State Council. So immediately that sends antenna up, whereas the State Administration for Foreign Exchange, which manages the bulk of China's reserves, reports to the People's Bank, which is a very professionally run technocratically-oriented organization.

DR. MORICI: Can I ask a question with regard to that? Can I

raise an issue? Suppose that it meets all of your requirements and it amasses ten to 15 percent ownership in the five or six largest banks in the United States, but it has that arm's length structure and so forth, and then the Chinese government changes its mind about what its charter should look like, how do we get it easily to divest?

COMMISSIONER FIEDLER: We confiscate it.

DR. MORICI: I would suggest to you that's a very difficult question to answer. That's why in my mind money from a regime that doesn't share our values is very troublesome and requires a different screen than say a French pension fund or the Ontario Pension Fund. It's just a different thing, and you have to be very careful to remember whereas companies cannot change their spots very easily because they are subject to sovereign control, sovereigns are subject to no control but their own.

MS. PETROU: If, however, we subject the U.S. recipient of the sovereign control, then we have significant control over it. Every approval I've ever read of an acquisition approval from a U.S. regulator includes the phrase "subject to the terms and conditions represented herein. Should these change"--

That's one of the reasons I did recommend, and I think appropriate, would be to have a prior approval process, particularly for financial services acquisitions, because then we may stipulate through a U.S. governmental agency, what terms and conditions are appropriate such as the nature of the entity taking the ownership stake. Should that change, then the divesture you seek would be accomplished, not by seeking to reach back to China or the other national government, but rather through the influence we have on U.S. persons under U.S. law.

DR. MORICI: I would suggest to you that that would not be enough. There's a difference between a competitive buyer of assets and a monopoly buyer of assets. If the Swiss government were to make such investments and then in some way trigger a mechanism you describe, it is doubtful that the scope of its investments would cause indigestion in financial markets if asked to divest.

But if the Chinese government were to invest \$500 billion in the United States and to focus that money in a few sectors, which is highly possible, though I don't think it's going to be buying any textile mills any time soon, then asking it to divest when it changes its stripes could cause major disruption. There's a difference between Calpers and the China Investment Corporation because of its size and because of its mission.

You can't make a very large owner divest easily without causing major disruption to your financial markets.

HEARING COCHAIR MULLOY: Thank you. I think that

exchange was very helpful in clarifying some points that were made. Commissioner Reinsch.

COMMISSIONER REINSCH: Thank you. Karen, it's good to see you again. It's been a long time. I'm going to come back to you. I was struck by Dr. Morici's comment about sharing values. I think China may be an easy example. I'm not entirely sure the French pension fund shares American values either, and you might want to think a little bit about where that logic takes you.

DR. MORICI: Actually, I wasn't talking about values. I was talking about size.

COMMISSIONER REINSCH: Well, I think you said the word "value." If you said the word "size," that's fine. That's a different matter.

DR. MORICI: Well, the focus there was on size.

COMMISSIONER REINSCH: Ahh. Well--

DR. MORICI: Remember, China can buy seven-and-a-half percent of the equities tomorrow morning if it chooses to.

COMMISSIONER REINSCH: That was not my question.

DR. MORICI: Okay.

COMMISSIONER REINSCH: Let me get to my question. Otherwise, my time is going to be up. Let me ask--Ms. Petrou made a number of recommendations. I'd like to ask the other two of you to comment on two of them. One, the five percent one, which there's already been some discussion about, but also the one about requiring sovereign investments to be channeled through third-party asset managers. Do you think that's a good idea or not? Dr. Dallara, do you want to go first?

DR. DALLARA: I think both of her proposals merit consideration. I am certainly open to the idea of having an arrangement which would ensure monitoring and review at certain thresholds. Whether five percent is the right threshold, I'm not sure.

I don't really at the outset, without further understanding of what lies behind her thinking and analysis, see an overwhelming case for the third-party approach. I think that investors anywhere, whether they are government-owned or private, must choose their own techniques for investment.

Ultimately, of course, you and the sovereign in this case, the United States, has the prerogative of shaping the environment within which those investments were made. But to require them to be made through a third party, I'm not sure it would accomplish a great deal in initial reflection.

COMMISSIONER REINSCH: Dr. Morici, do you want to comment on her two proposals?

DR. MORICI: Yes, I think the idea of a third party works better

again if you're dealing with smaller investments rather than larger investments. If the third party is dominated by very large investments from a single investor, it becomes its instrument, and then you lose transparency as oppose to gain it, and the problem becomes worse. It goes back to the sheer size of the investments from some sources.

COMMISSIONER REINSCH: Ms. Petrou, let me pursue the five percent thing for just a moment. Larry asked one of the questions I was going to ask, well, if it's going to be five, why not six, why not ten? But let me ask it differently because you opened a different door when you talked about other indicia of control, which I think may be a more appropriate route.

Given the complexity of the transactions and the complexity of the structures we're talking about, and all of you have I think made that point one way or the other, why doesn't it make more sense to try to move to some sort of list of reference points or indicia of control rather than using a percentage which is inevitably arbitrary no matter what number you pick?

MS. PETROU: I use it as an arbitrary. It is completely arbitrary. And yet it has worked well, and the reason I picked it, as I said, is not because I'm clever, but I looked for precedent. I think it has worked very well over the last 50 plus years in the bank holding company environment.

That is not to say certainly that there are ways around strict numbers. There are all sorts of convertible equity structures and lots of ways to subvert control by simple percentage, and again that's why the indicia of control criterion, I think, is a critical one along with what I suggested was only a rebuttable presumption of control.

COMMISSIONER REINSCH: Just thinking about this, I suppose to reject my own suggestion, if you were to go to a more complex analytical method and use of indicia control, wouldn't that have an effect in the marketplace? First of all, substantially expanding the number of transactions subject to review and thereby increasing uncertainty, and wouldn't that be a bad thing or would that be a good thing?

MS. PETROU: I think generally it would be a bad thing because--let me back up and simply say control is always a subjective judgment, and we see this with the banking regulators; you see that in many aspects of corporate law.

What I was trying to do with both the rebuttable presumption threshold and also the asset management structure was to come up with something that permitted what I hoped would be the free flow of sovereign funds into the United States because, like it or not, we need them. I fully concur that we need to do something about our fiscal policy, but until we do, we've got to deal with the sovereign wealth

funds because it's going to be awhile.

So I tried to come up with something that would subject U.S. persons to the kinds of controls, including transparency, but also the economic focus of their companies, and to limits on transfers of intellectual property, the various other issues that have been raised in the debate on sovereign entities.

Rather than trying to reach out and across the waters was to come up with a system that under U.S. law would insulate us without being too intrusive. I'm not sure this is it, but that was the goal in trying to propose these two options.

COMMISSIONER REINSCH: Well, I'm glad you proposed them. I think you deserve great credit for coming up with some serious relevant micro ideas that work within the framework we've got. And they deserve consideration. I don't know what I think of them, but I appreciate the exchange.

I've got one more, but I'll wait until the next round if there are others that have questions.

HEARING COCHAIR MULLOY: Thank you, Bill. Commissioner Bartholomew. Vice Chairman Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thank you and thank you to all of our witnesses. It's a really interesting discussion that we have going. I have one question following up on this, and then I want to take us on a slightly different path since we've got some expertise here.

Ms. Petrou, one of the issues--I'm sort of borrowing from point Commissioner Fiedler raised earlier today, and that is when we talk about the nature of the sovereign investments, would the framework that you're proposing deal with the fact that the sovereign might control or might invest in the same entity through several different mechanisms?

So if you had a five percent threshold and there was 4.5 percent from CIC and then 4.5 percent from another, from CITIC, and 4.5 percent from SAFE, I mean if there are other intentions going on, how do you structure a framework that would get to that because ultimately then the sovereign has the kind of control that we're talking about, but no single instrument necessarily does?

MS. PETROU: I think one could do that. We've done it, again in the bank holding company arena, again because it's a rebuttable set of presumptions and you look beyond the threshold. And we and Congress would need to rely on the appropriate regulator in an advance review in a transparent way, to look for what we already know how to look for, which are hidden owners or families.

For example, when you look at a bank holding company, if it's mama and papa and baby makes three, that's considered control even if

each one of them has a small share structured to evade scrutiny. Indeed in such transactions which are in such, that's a violation of law, an attempt to evade review. That should be an enforceable one that would bar the transaction.

VICE CHAIRMAN BARTHOLOMEW: And do you have any recommendations on how we could make sure that the regulators who are supposed to be tracking this believe that they should exert what might end up having to be political will in order to be able to make the difficult decisions?

MS. PETROU: I would suggest clear instructions in law, a transparent rulemaking process, and then hauling them up here from time to time in the hopes that there are competing political objectives that would ensure appropriate advance review of problematic transactions.

VICE CHAIRMAN BARTHOLOMEW: Okay. Thanks, and since we have all three of you with some expertise on financial institutions, I'm just wondering to what extent our financial institution minority joint ventures with China's state-run financial institutions are building up competition, longer-term competition and expertise? We've seen this happen in the automotive sector with GM and Shanghai Automotive. We've seen it with Motorola and Huawei.

Are we heading down that same path where our financial institutions through their minority joint ventures are building up the competition that they're not going to be able to compete against five, ten, 15, 20 years down the road?

DR. DALLARA: Madam Vice Chairman, I think it's a fair question to ask, but fortunately notwithstanding the recent demonstrations of some serious flaws in our financial system, the U.S. financial services industry historically has remained and I think will continue to be very competitive globally.

I think the investments, the minority investments you've seen in Chinese financial institutions, will over time, of course, strengthen their capacities to compete, but primarily I would say at least in the near to medium-term in the Chinese financial space. I think that we do have to look over the medium and long term about where Chinese financial corporations move globally, and this is why I would come back to the issue of what constitutes a sovereign wealth fund.

If one of the large Chinese banks, and they're now very, very well capitalized, decides to invest in a financial institution, does that fall under the framework of your and collective scrutiny? I would suggest it should. That to me is where one needs to focus: what are the corporate governance issues that potentially arise when those institutions invest in western financial institutions, be they U.S. or Chinese?

I am not too concerned about the competitiveness angles because U.S. financial service organizations have proven themselves to be very competitive over time, and I think that over time, they will acquire serious market share in the Chinese market.

DR. MORICI: We cannot expect the Chinese to reform their financial system without developing expertise. We have determined as a matter of public policy, as a matter of foreign policy, we want the Chinese to develop a western financial system so we need to expect some transfer of expertise.

I am not particularly concerned with the quality of expertise on Wall Street, which is where I think the problem is. It's not in our regional banks, but rather the incentive structure that has emerged there, largely, and this is again subject for another day, from the combination of investment and mortgage banking with traditional investment banking.

My feeling is real power in the financial sector emerges from access to capital which can be channeled to other enterprises either via creating instruments to obtain capital in bond markets, through the sale of financial instruments, or through the capital of the bank in deposits, things of that nature. The real source of power of the Chinese financial institutions is the war chest that China has of U.S. dollars because of our trade deficit, which is not driven by our budget deficit but rather other policies, and that's where the real power is in China.

My feeling is it's going to be a very long time before China's banks can compete with ours simply because they're still so protected.

VICE CHAIRMAN BARTHOLOMEW: Ms. Petrou, anything to add?

MS. PETROU: No, I would agree, I think, with the view of technology transfer because of the benefits ultimately to the United States from that. As we've seen the systemic risk implications of the recent volatility, and all that can be done to stabilize the Chinese banking system in terms of better capital reserves, transparency and efficiency is ultimately in our best interest.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

HEARING COCHAIR MULLOY: Thank you, Vice Chairman Bartholomew. Let me ask. I want to get through two quick topics. Do any of you know whether CFIUS reviewed any of the investments in the financial firms by the Chinese or even of the other sovereign wealth funds? Did CFIUS review those and make any decisions? Do any of you know that?

MS. PETROU: I believe the answer to that is no, because they were all structured to fall below the current controlling share.

HEARING COCHAIR MULLOY: So you don't think any of them

had a review by CFIUS?

MS. PETROU: No. I believe the Citibank acquisition, not Chinese, but the Abu Dhabi acquisition, was informally cleared with the Federal Reserve. I don't believe any of the others have come before regulators or before CFIUS.

HEARING COCHAIR MULLOY: Under the new statute governing CFIUS, control is to be defined during the regulatory process which is going to be Notice and Comment rulemaking. I was talking with a friend who was a former general counsel of one of the banking agencies because I've been troubled by this. He gave me the same answer that you came up with, Karen. He said you should use the Bank Holding Company Act, the rebuttable presumption that if you're over five percent, you've got control.

I very much appreciate that because this other fellow is thinking the same way you are thinking on that area. So obviously you heard Senator Webb raise his concern about passive investment and control and his concerns along those lines, so this is very, very helpful to this Commission to get that testimony.

Now one other issue I wanted to ask Charles, and then all of you could comment, but the first question to Charles. On January 29, there was an article in the New York Times by Steven Davidoff called "What You Don't Know About Sovereign Wealth Funds," and it gave different myths about these sovereign wealth funds.

One of them, myth number two, that there was no other way for financial firms to recapitalize themselves rather than selling off portions to these sovereign wealth funds. The author of this article disagreed, he said, we have pension funds estimated at 14 trillion; mutual funds, ten trillion; hedge funds, two trillion. There's capital available from other U.S. companies. He said that there were other ways for these financial firms to recapitalize themselves. Now this is the New York Times guy writing.

You said that we really almost had to do this; we didn't have a choice. Is that correct? Am I reading you right? Or were there other reasons why the firms wanted to do it this way? I think Dr. Morici said one reason is they didn't get a lot of scrutiny and have to change their present practices so they could still ride in the saddle and get their bonuses.

So I wanted to get your take on that and then have the others comment.

DR. DALLARA: Patrick, I think that there can be no obviously definitive answer. My answer earlier, and I will elaborate briefly, was a matter of conjecture, but I do believe it is unlikely that in the time frame required in order to simultaneously announce losses and new capital raising, which was very constructive to stabilizing the outlook

for these financial institutions, and stabilizing their ability to continue to lend because, let's face it, in the absence of capital, additional capital, these major losses would have severely affected their capacity to continue to use their balance sheet for lending.

So in the time frame, and within the framework of the goal of simultaneous announcement of losses and capital raising, I doubt seriously that it would have been feasible at anything remotely approaching a reasonable price to raise comparable amounts of funds given the magnitudes required from pension funds, insurance companies and other investors.

Over a longer period of time, certainly a variety of techniques, rights issues, private placements and other techniques, could have been used, but we've been going through this remarkable stressful period for these financial institutions where many of them have discovered that they have made huge mistakes which required the recognition of huge losses, and I don't think in that time frame, it would have been easy and maybe not even feasible to raise comparable amounts of funding.

HEARING COCHAIR MULLOY: Do either of you have a comment on that?

DR. MORICI: Yes. I would suggest that it would have been difficult, as Dr. Dallara says, to do this quickly, wholly with private money within the United States. It would have required infusion from the Federal Reserve. However, that might have been in the form of some kind of loan, or temporary funding, or perhaps changing regulation on a temporary basis.

The benefit of that would have been as follows: the basic flaw in Wall Street right now is that the business model that has been applied to traditional investment banking has been applied to mortgage banking, and mortgage banking cannot create the kinds of profits and unlock the kind of value by borrowing at 7.5 and lending at seven, then taking apart and putting together companies can unlock. So they cannot support the same kind of compensation structures and profits and so on.

By permitting the sovereigns to come in, they have been able to perpetuate the myth that they can continue to do this. In reality what may happen is they actually withdraw from that kind of activity all together, which would be very deleterious for the continuing well performance of our capital markets.

We would have been better off if we had struggled through and suffered and found another avenue. What we have basically done is swept the problem under the rug by inviting in funds that attach no condition so that they may achieve whatever other purposes those funds may have.

HEARING COCHAIR MULLOY: Ms. Petrou, and then I'll wrap

it up.

MS. PETROU: Chairman Mulloy, please correct me if I'm wrong, because you know better than I, but there is no provision of U.S. law that would permit the Federal Reserve to infuse capital into a U.S. depository institution.

Certainly, any of the regulators could forebear, for example, waive the capital requirements and permit Citigroup to operate at lower capital ratios, but we have a very dangerous history of having done that with the savings and loan industry, and it is something to think through quite carefully before we recommend forbearance.

In your New York Times article, there are also a variety of both logistical and in some instances statutory impediments. For example, corporate funds cannot flow in size into an insured depository or its holding company for the reasons discussed with regard to Wal-Mart.

Pension funds often have rules requiring that they invest only in AAA or AA securities. So for all of the reasons, I would concur with Dr. Dallara's suggestion that these were expedient and exigent investments, which does not make them good. It does not mean they should proceed without future scrutiny, but it does argue for considerable care that anything we do does not choke them off.

DR. MORICI: We let the foreign sovereign funds do things that we would not let domestic entities do under law.

HEARING COCHAIR MULLOY: I'm going to have to turn to Commissioner Esper, and, Charles, you can jump in response to him.

COMMISSIONER ESPER: Thank you. I just have one question. I note the time is short. Is there any movement or discussion within the financial sector to take their own actions, not out of concern for issues we're raising today, but out of concern that sovereign wealth funds may take actions or make decisions that don't seek to maximize return but instead seek political or other objectives and therefore increase the risk to investors or to themselves? Is there any discussion about this on Wall Street or in financial institutions to give these sovereign wealth funds greater scrutiny?

DR. DALLARA: My clear impression, commissioner, is that right now that is not a matter of focus at all. They are so concerned, first of all, they were so anxious to be able to acquire capital in the circumstances, and I think they're so concerned with cleaning up the problems that exist in their financial institutions today, that they're not looking at a longer term issue here.

If I may add just two brief points: I think there are many fundamental and legitimate questions about the operations, objectives and transparency of these sovereign wealth funds. But we should recognize that they do have one advantage in their investment mentality: by and large, they are long-term investors. Part of the

incentive structure, which Dr. Morici referred to, which has created such problems in the investment banking community, is the short-term return mentality which exists up and down the financial chain in our financial system today.

Many of these investors from sovereign wealth funds are willing to look at a five, seven, who knows how many year time horizon. That is not all together--yes, many other factors here--but not all together an unhealthy characteristic of these investors.

HEARING COCHAIR MULLOY: Does anyone else have anything further? I want to thank this panel for the very helpful testimony you've given to us. Ms. Petrou, I particularly want to thank you for your written testimony, which had some very good legislative recommendations for the Commission.

Thank you all for being here, and we'll close this panel now.

CHAIRMAN WORTZEL: We'll reconvene at 3:30 in about ten minutes.

[Whereupon, a short recess was taken.]

PANEL V: IMPACT ON NATIONAL SECURITY

CHAIRMAN WORTZEL: Ladies and gentlemen, we have gone through a day with some excellent explanations about sovereign wealth funds and their nature, some very good ideas on how to limit their effect on the economy and on national security.

This panel addresses about 50 percent of the mandate of the Commission and focuses specifically on the potential impact on national security of sovereign wealth funds.

We're very pleased to have two excellent witnesses on this. We'll hear from Ms. Daniella Markheim, who is the Jay Van Andel Senior Analyst in Trade Policy at the Heritage Foundation.

Ms. Markheim specializes in international trade and monetary theory, comparative economic systems, and international financial management. She has a great deal of experience developing economic models for single-country and global trade and investment policy.

She has worked for the Department of Defense in the economic sector at the Joint Warfare Center.

Our second witness will be Mr. Alan Tonelson. He's a Research Fellow with the U.S. Business and Industry Council. This is a Washington research organization that studies U.S. economic, technology, and national security policy.

He's also been a fellow at the Economic Strategy Institute and was Associate Editor of Foreign Policy. His new book, *The Race to the Bottom: Why a Global Worker Surplus and Uncontrolled Free*

Trade are Sinking American Living Standards, was published by Westview Press.

Each of you should, if you can, restrict your oral remarks to seven minutes, and then we'll be able to have rounds of questioning by commissioners for five minutes each, but your written testimony, we will ensure gets into our own records in full.

Mr. Markheim.

**STATEMENT OF MS. DANIELLA MARKHEIM
SENIOR ANALYST IN TRADE POLICY
THE HERITAGE FOUNDATION, WASHINGTON, DC**

MS. MARKHEIM: Thank you very much, Chairman Wortzel, Vice Chairman Bartholomew, members of the Commission, for this opportunity to discuss the implications of sovereign wealth fund investment for U.S. national security. The views I express in this statement are my own and should not be construed to be representing any official position of the Heritage Foundation.

First conceived in the 1950s by foreign governments as a means to invest surplus foreign exchange earnings in U.S. and markets elsewhere around the world, sovereign wealth funds 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 nearly 40 funds managing an estimated two to \$3 trillion worth of global assets.

Analysts forecast that sovereign wealth funds could grow right along with the global market to manage an estimated ten to \$12 trillion assets by 2015. The size of these funds can be difficult to estimate because governments generally don't disclose information about the fund's assets, liabilities, or underlying investment strategy. While this makes it hard to assess the impact of such funds on the global economy, it's not likely that they will have enough power to dictate the world's financial fate any time soon.

Even with the higher estimate of almost \$3 trillion of assets now being managed by these funds, this is still just a fraction of total global investment conservatively estimated to be about \$165 trillion today.

However, there is mounting concern 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, exacting

a real cost on the economies involved.

Moreover, some fear that countries might use their sovereign wealth to destabilize financial markets, protect industries and companies, or 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 threat to their economic and national security.

However, it's important to remember that open 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 off chance that a country could decide that political objectives outweigh the economic costs of using its sovereign wealth inappropriately. It is against this chance and the predominance of the issue in the media and in governments that has driven home the need for sovereign investors and countries that receive sovereign investment to engage in meaningful debate about these funds and the role that they play in international markets. That debate is now occurring in the IMF, the OECD, the World Bank, and between governments.

Of special concern to U.S. policymakers is China's recent creation of its own sovereign wealth fund, the China Investment Corporation, in September of 2000. Prior to establishing CIC, China generally invested its surplus foreign exchange holdings in U.S. government debt. This enabled China to earn a 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 now has an opportunity to earn higher returns on a much more diversified portfolio.

Allocated an additional \$200 billion of China's excess foreign exchange reserves, the CIC is one of the largest sovereign wealth funds after the UAE's Abu Dhabi Investment Authority, Norway's Government Pension Fund, the Government of Singapore Investment Corporation, and Kuwait's Reserve Fund for Future Generations.

Of the 200 billion that was allocated to the CIC, so far eight billion has flowed to the U.S. Three billion has been invested in non-voting shares in Blackstone Group, and another three billion has been invested in Morgan Stanley. Much of the rest of the initial financing has been used for domestic purposes, leaving about 70 billion for

future investments.

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 and other internal investments raises legitimate questions about the role that China's government interests may play in how this fund functions.

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's the increasing threat that the U.S. will adopt protectionist investment policies in response to these funds operating.

Erecting barriers to foreign investment would stifle innovation, reduce productivity, undermine economic growth and cost U.S. jobs, all without making America any safer.

America already has, largely, the banking, investment, export controls and other policy mechanisms such as the U.S. Committee on Foreign Investments in the United States in place to help reduce the risk associated with foreign ownership of critical assets while still permitting the economic benefits that come from foreign investment.

Additionally, working groups across government have been formed to discuss and monitor sovereign wealth fund activity. With such a heightened sense of awareness concerning sovereign wealth funds, it's likely that risky transactions will attract some degree of scrutiny.

It is true that not every sovereign wealth fund may be large enough to trigger a CFIUS, SEC or other U.S. government investigation before a transaction occurs. However, markets, government monitoring and enforcement activities and media should combine to provide a solid measure of ongoing scrutiny even after an investment has been made.

Forcing potential wealth investment to forego a formal evaluation would only add to the cost and time associated with each potential transaction, driving perfectly safe foreign investment away.

The U.S. instead should continue to work with foreign investors, sovereign investors, to permit sound economic policies, financial development, and liberalization in their own economies; should continue to support multilateral efforts to establish a voluntary set of best practices for sovereign wealth funds.

The U.S. should continue to promote meaningful debate and research about sovereign wealth funds to better understand their impact on the U.S. with the world market and on the sovereign investors themselves, and stand firm against implementing protectionist barriers against foreign investment.

U.S. national security and financial reviews of foreign

investments should remain non-discriminatory, transparent and fair.

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 laws and procedures governing foreign investment are robust, up-to-date and functioning effectively to achieve the purposes for which they were designed especially with regard to U.S. national security.

However, the growing trade and investment ties that bind the economies of the world together are more likely to promote responsible economic behavior than cause enticement for mayhem. Properly monitored and regulated, sovereign wealth funds are not a threat to national and economic security.

Thank you for the opportunity to address this vital issue.

[The statement follows:]⁶

CHAIRMAN WORTZEL: Thank you, Ms. Markheim. Mr. Tonelson.

**STATEMENT OF MR. ALAN TONELSON
RESEARCH FELLOW, U.S. BUSINESS AND INDUSTRY COUNCIL
EDUCATIONAL FOUNDATION, WASHINGTON, DC**

MR. TONELSON: Thank you, Mr. Chairman, and in fact both the chairs of this session. I would like to say that on behalf of the 1,500 members of the U.S. Business and Industry Council, because we are also a national business organization, I'd like to thank you for the opportunity to testify about this extremely timely subject.

I'd also like to congratulate you for being out ahead of the Washington curve on this. I am in fact quite amazed that the Washington curve has been as shallow as it has been on this potentially momentous question of sovereign wealth funds, but that's precisely the situation we're in. Even the legislative branch seems just to be waking up about this, and again I think you really have, in fact, played a very important leadership role, which I hope and trust will continue.

I think that your leadership role has been especially important because I believe that time is not working on our side in terms of developing the appropriate policy responses for the challenges presented, not only by sovereign investment funds as such, but by the wide range of foreign government investments that have been coming into the U.S. economy or that clearly would like to. I think it's been especially salutary that there have been so many references in our

⁶ [Click here to read the prepared statement of Ms. Daniella Markheim](#)

proceedings today to the fact that we really shouldn't get too bogged down on I guess definitional questions: what is a sovereign wealth fund and should we treat it in some fundamentally different way than a state-owned oil company?

I think there has been broad recognition that as long as a foreign sovereign is in control, that's what really counts. Hopefully, that ability to cut to the chase will be reflected in our country's future policy response.

However, I still think that the discussion has been a little too mitered down at excessively low levels of the so-called policy weeds. On the one hand, there are clearly major conceptual challenges toward crafting appropriate responses to the prospective challenges and even threats presented by sovereign wealth funds and foreign government assessments of all kinds.

At the same time, I think that the challenge is ultimately not all that difficult, and that a relatively simple approach is probably likely to be our very best bet. I've had a fascinating time listening to the previous panels and I've learned a great deal from them.

The more that I've heard about specific proposals that have been floated by various speakers and even by some of you commissioners yourselves, the more skeptical I've grown about them.

For example, I've heard some folks allude to the fact that in some, admittedly unspecified way, we should treat foreign government investments from countries that do not share U.S. values, American free market values, American political liberty values, from investments from countries that actually share those.

And it sounds pretty good in principle. In fact, it sounds awfully compelling in principle, but, boy, that is going to be a difficult thing to write into legislation and regulation if we're going to have a share our values test. Good luck with that.

I think we would even face tremendous difficulties trying to distinguish between perhaps U.S. treaty allies and U.S. non-allies. One complication, we've certainly seen in recent years, that even American treaty allies are very prepared to sell lots of very controversial types of technologies, lots of militarily-sensitive equipment to rogue states, that we would never dream of.

We've also heard, for example, especially in the wake of the Dubai ports fracas, that the Persian Gulf kingdoms who are, of course, a leading source of some of the biggest sovereign wealth funds, even if they're not U.S. treaty allies as such like NATO allies, they're staunch friends, they're the kinds of regimes we want to see in the Middle East, and if we treat them in an adversarial way, that will turn into some kind of a self-fulfilling prophecy.

If we have learned anything since 9/11, it should have been that

in the Middle East and Persian Gulf, it is excruciatingly difficult to tell friend from foe, and often they are one and the same.

We should have also learned that many of these Gulf sheikdoms, including Saudi Arabia, are not so much governments in the proper sense of this word. They're family corporations; they're very opaque. Their makeup and their workings are very difficult for outsiders to get a good solid handle on.

And, in fact, as my written remarks mentioned, there have been credible press reports that the Bush administration has quietly pressured governments like Dubai's to crack down on trafficking in very dangerous types of products and technologies headed for places like Iran and also Syria. It's very important to remember that these countries have historically served as entrepot economies. They are just happy to see traffic in all sorts of things going back and forth. They don't especially care what it is, and they are especially happy to pay off large and very powerful neighbors.

I think what we need to focus on is that if we are worried about excessive concentrations of foreign political power, we should move decisively to prevent excessive concentrations of foreign political power by essentially banning them, and this would mean quite simply restricting foreign government ownership of all types to perhaps, and this is only a notional number that I'm throwing out today, ten percent of any one U.S. company and any type of government investment from any one country to one percent.

We have a \$13 trillion American economy. There is no shortage of very productive investment opportunities. If foreign government investors are really not concerned about control, they won't really be too concerned about being required to sprinkle these investments very lightly and very broadly throughout our entire economy.

Thank you so much.

[The statement follows:]

**Prepared Statement of Mr. Alan Tonelson
Research Fellow, U.S. Business and Industry Council Educational
Foundation, Washington, DC**

Good afternoon, Cochairman Wortzel, Cochairman Mulloy, and Members of the Commission. On behalf of the 1,500 member companies of the U.S. Business and Industry Council and the supporters of its Educational Foundation, thank you for the opportunity to share our views on the national security implications of sovereign wealth fund investments United States.

The small and medium-sized family held companies – mainly manufacturers – that comprise most of the Council's membership reject the view that the idea of free markets so central to our prosperity and our political liberties is a synonym for "anything goes." Our member companies and other supporters are all strong believers that business and economic activity should be dominated by private actors operating

within a legal and regulatory framework that emphasizes objectives such as vigorous and sustainable competition, equality of opportunity, and transparency and the freest possible flow of information.

Our members and supporters are just as insistent on the need for the federal government to take a realistic view of national security, one that fully recognizes its vital economic, financial, and technological dimensions. Finally, they believe that preserving the greatest degree of freedom of action for our country in world affairs – its sovereignty – is another central element of national security, and as such deserves the highest priority.

We believe that the ballooning role played by SWFs in the U.S. and world economies poses major potential threats to all these critical objectives, and that therefore Washington should adopt a highly restrictive posture toward them. Moreover, we believe that the same posture is needed for other foreign government actors seeking to acquire U.S. assets – e.g., state-owned or affiliated entities not mentioned often enough in the embryonic SWF policy debate. In fact, American policymakers must understand an added and critical complication to the challenge of formulating policy responses to official foreign investments – the immense buildup of capital and foreign exchange reserves by entire national economies where the line between public and private sector is difficult at best to draw.

SWFs have attracted the spotlight recently not because they themselves are an entirely new phenomenon. Many have existed and invested in the United States for decades. Rather, the new focus reflects a combination of:

>their rapidly growing dimensions, which carry the potential to disrupt markets. In this instance, however, the exact size of the funds and their growth rates are not the only issues that must be considered. Because SWFs and other state-controlled or related entities can typically mobilize very large amounts of capital very quickly, without resorting to elaborate decision-making processes, they are likely to continue to punch considerably above even their currently formidable weight – as has been seen recently by their sudden huge investments in major American and other foreign banks and brokerages;

>Their shift from the government bonds they have traditionally purchased to the entire range of financial assets, which raises the prospect of gaining control over these assets;

>The secretiveness surrounding the make-up and operations of most SWFs, which can also be detrimental to the functioning of genuinely free markets;

>The related issue of their origins in governments that have challenged U.S. national security interests, and that epitomize anti-market values such as cronyism and contempt for law.

In preparing for these hearings, the Commission has posed thoughtful questions about SWFs.. They are exactly the kinds of questions that U.S. authorities need to be asking themselves – and answering – before allowing SWFs and other foreign government entities to acquire even more of the American economy. At this point, however, definitive answers are very difficult to come by, and situation will remain murky for years to come because we stand at the very beginning of the Age of SWFs. It is simply too soon to describe clear patterns of behavior, much less draw bright-line distinctions among funds from different parts of the world or representing different types of governments, beyond a handful of observations already widely reported in the media – e.g., all SWFs so far seem determined to keep equity purchases below thresholds that would trigger regulatory oversight even though such oversight is quite threadbare at present.

For the same reason, it is simply too soon to know what kinds of challenges to and complications for national security policy SWF activities might present – or whether any significant threat will materialize at

all. Yet complacency is not an acceptable attitude for government to take in the face of such existential uncertainties. SWF enthusiasts who eagerly note that the funds so far have provided no concrete cause for concern are tantamount to teenagers who have begun to start driving under the influence, and brag that they're still alive. Government must provide the adult supervision, and specifically take a longer view informed by, among other factors, history, logic, and our knowledge (or lack thereof) of the countries and political systems that have created these funds. In this view, the potential causes for concern are more than adequate to justify extreme caution in policymaking.

In particular, it is all too easy to envision circumstances in which SWF and other official foreign investments in U.S. assets could threaten national security. As widely discussed already, such investors could seek to transfer militarily-sensitive know-how to home governments that often oppose U.S. diplomatic objectives, or to third-countries or non-state movements with similarly adversarial profiles.

But the simple possession of assets could create serious problems as well. If, for example, the Chinese government held significant stakes in a large number of big American financial institutions, especially market-makers, and if our nation's current period of financial weakness persists, how willing would Washington be to stand up to Beijing in a Taiwan Straits crisis? Moreover, a single instance of SWFs throwing their weight around or employing their leverage more subtly could produce genuinely disastrous results. Official investments in key U.S. assets, moreover, pose an entirely different set of economic and financial risks that deserve a separate discussion of their own. Such investments would need to create extraordinary and durable benefits indeed to justify living with the risks that we can know about and anticipate, as well as with the nasty surprises that events regularly serve up.

Do SWFs from resource/energy exporting countries or SWFs from Asian goods exports pose the greatest potential threats? Answering this question requires deciding which poses the greatest challenge to U.S. security – the emergence of a genuine Chinese military, economic, and technological superpower? The activities of Al Qaeda or other Islamic terrorist organizations? The reappearance of a powerful, adversarial Russia? In my view, no purpose is served by choosing. All such possibilities must be actively monitored and responded to, though of course the salience of each danger will vary with time.

Clearly, however, acquisitions by government-related investors from China or Russia – meaning any investors from those two countries, given the state's commanding role over the entire economy – raise a real danger of diverting sensitive products and technologies to potential adversaries, not to mention the implications of such lawless dictatorial governments gaining influence and even outright control over institutions vital to America's continued strength and prosperity.

Nor should anyone believe that the CFIUS process or any of the other statutory limits on foreign acquisitions of U.S. assets provides anywhere near the protection needed against such threats. The CFIUS process, for example, remains a rubberstamp even after last year's post-Dubai reforms. In particular, it lacks any provisions to monitor or enforce the modifications and conditions that it all-too-rarely imposes on prospective takeovers.

Foreign government investments from Persian Gulf oil kingdoms in particular – a second category of resource and energy exporter after Russia – raise the somewhat different yet equally worrisome possibility of transfers to third parties such as terrorist organizations or to rogue states like Iran and North Korea. For example, at the end of 2006, the Financial Times reported that "Washington is alarmed at the diversion of sensitive military technology to Iran and Syria via Dubai" and that U.S. officials had threatened reprisals unless the trafficking were halted.

In the case of these kingdoms' investments in financial institutions, U.S. officials need to consider the possibility of transferring funds to terrorist organizations through money-laundering schemes. Last

December, the Financial Times reported the emergence of just such concerns in the United Kingdom “thanks to the much-publicised arrival of significant capital from opaque sources such as the former Soviet Union, sovereign wealth funds, and Middle Eastern oil states.”

Washington clearly lacks the capabilities at present to monitor and enforce the manifold forms of communications and interactions between the management of these finance firms and their foreign government shareholders, whatever the formal U.S. legal status of these shareholders. (These same limitations obviously apply to cases involving Chinese investors in U.S. technology companies.) And banks and brokerages in financial distress will obviously experience great difficulties saying No to requests to handle controversial deposits, fund transfers, and clients.

In addition, those who call the Gulf kingdoms allies clearly have already forgotten one of the central lessons of 9-11 – that the Middle East is a region where distinguishing friend from foe can be excruciatingly difficult. Further, the composition and workings of these governments are extremely opaque to outsiders; in fact, so far as can be reliably known, the monarchies in question are essentially extended families characterized by the most Byzantine forms of inter-personal relationships and rivalries. Finally, as suggested by the reference to Dubai above, the kingdoms long have played the economic role of entrepôts, prospering by facilitating traffic all manner of licit and illicit goods, and continually seeking to appease larger, more powerful neighbors.

None of the most popular policy responses suggested in Washington or elsewhere to the emergence of SWFs has much potential to prevent these and other prospective dangers. Codes of conduct proposals that typically focus on securing greater transparency sound appealing. But given the financial weakness of the United States nowadays, and given the leverage consequently enjoyed by capital-rich SWF governments, it’s difficult for the time being envisioning Washington – or any combination of recipient-country governments – standing their ground on these questions, much less successfully insisting on the kinds of monitoring and enforcement that would give the Codes some semblance of teeth.

Far better for the United States to recognize explicitly that the benefits promised by foreign government investments fall far short of the dangers they pose, and understand that the best protection against their accumulation of power and influence is to prevent such accumulations in the first place. Washington should limit sharply the share of any one U.S. entity’s assets that can be bought by SWFs and similar investors in toto, and by government investors from any one country. A ten percent ceiling for total foreign government ownership seems a reasonable starting point, along with a one percent ceiling for the government-related investments from any one country (to guard against multiple official investors from the same country building up outsized stakes). Such a policy would permit SWFs and their various official relatives to inject plenty of capital into the U.S. economy. But it would require them to spread out their investments in ways that could not possibly create undue influence. Nor would such a policy cause significant hardships for official foreign investors. In a \$13 trillion economy, they should be able to find plenty of attractive opportunities for profitably deploying their cash.

Panel V: Discussion, Questions and Answers

CHAIRMAN WORTZEL: Thank you very much. We had some research done by a member of our own staff into the activities not only of the CIC, the China Investment Corporation, but three of the subsidiaries that it created, and at least our preliminary read of that is that the China Investment Corporation may have intentionally attempted to deceive both the western press and internal Chinese press

on the purpose of its investments in Australian banks and the nature of the fact that it was really a single investment entity masked as three different corporations.

So I ask both of you, could the Chinese government use a portion of its sovereign wealth either for strategic purposes or to gain access to technology or trade secrets, even if they took a loss on that? Because, Ms. Markheim, you said no government would take a loss on its sovereign wealth, but could they do that if in the aggregate with their whole 200 billion that's distributed across bunches of banks in China they may a profit?

Do we need to think about that?

MR. TONELSON: There's no question in my mind that we have to assume the default assumption must be that these types of situations will come up repeatedly. One reason being that it's very difficult for any management team to tell a five percent shareholder no or a 4.99 percent shareholder no, and I think that we genuinely delude ourselves into thinking that any U.S. regulatory apparatus of any size that could realistically be imagined in the foreseeable future could be large enough and could be effective enough and well funded enough to effectively monitor all the different kinds of informal communications that take place between shareholders and managements of companies on an ongoing basis.

It's simply too big a job, and again, the best way to make sure that foreign government influence is not improperly exercised is to limit it to a scale that would enable management and the rest frankly of the shareholding community to say no without fear that a sudden withdrawal of that investment would have ruinous consequences for that particular company.

If I may add one point: One other reason that I think that time is short is because even though one can trot out numbers and we've heard them several times today, that the sum total of all sovereign wealth funds is only a small fraction of the total value of U.S. stock markets, et cetera, et cetera. What we've seen in recent months is that these funds and other forms of foreign government investments can and will tend to punch way above their weight.

Why is that? Because as we've just heard from Charles Dallara in the previous session, they can make decisions real fast. They can respond to emergency distress calls from banks like Bear Stearns and Morgan Stanley, and they don't have to go through elaborate decision-making processes and they can shovel over billions of dollars of capital in the blink of an eye.

And so their effective influence over the American government and over the American economy will always be much greater than the raw numbers would actually indicate.

CHAIRMAN WORTZEL: Ms. Markheim, do you want to respond?

MS. MARKHEIM: It would certainly be easy to come up with a scenario that would, in fact, prove that these funds could be used in a way that was strategic rather than economic. But to respond a bit to what Mr. Tonelson has said, even though it's hard to ignore what a five percent shareholder or a shareholder with five percent of the fund may wish to do, there's still 95 percent held by other agents, and of course these companies are also accountable to them.

So there is this balancing that would have to go on between what these demands are from government owners as opposed to other owners within the company in and of itself. That's the first point. There is that give and take that would have to occur.

I also don't think, though, that any misuse of these funds could go on indefinitely. I think that the minute China attempted to use its investments in a way that either gained it technology that we'd been trying to keep out of their hands or what have you, the minute that hits the news, the minute Congress becomes aware of it, the minute this becomes something that we all recognize has now been accomplished through one of these funds, I find it very hard to believe that we would not respond on a way that would significantly limit China's ability to operate within the economy, at least in terms of its government-owned investments.

So I don't believe, while it's certainly the case that an incident could incur, I'm not certain that this could go on forever, and I'm still not certain that it would require us to go in a priori and establish regulations and barriers to this kind of investment.

Until we have hard evidence that China would do something like this, and there is no reason to think that there is any of this evidence quite yet, we should just be a little bit more objective with the approach that we take.

CHAIRMAN WORTZEL: Commissioner Wessel.

COMMISSIONER WESSEL: Thank you both. Ms. Markheim, I believe one of our Senate witnesses this morning referred to your organization and commended it for its activities. So you may want to refer to this testimony earlier today.

I'd like to go deeper into statements you've made and an approach you're taking, which is the question of loss and whether the Chinese will over a long period of time accept a situation of loss?

I guess I'd counter that loss is somewhat of an alien concept to the Chinese as they're a non-market economy. And indeed, as part of their WTO accession, they agreed through 2016, I believe, that there would be continued legal treatment under U.S. and foreign trade laws for them as a non-market economy. So taking that acceptance by them,

how do we treat this?

You say that they won't take a loss. Is sustaining their political system by keeping their people employed, by gaining access to foreign technology, is it a loss, or is it a, in fact, a supplement to the ruling regime? Should we be looking at China differently than others because they're a non-market economy?

MS. MARKHEIM: That is a valid point. It isn't the case-- because it's not a market economy, loss does mean very different things to China than it does, for instance, for our own economy.

That said, I do believe that China is trying to get itself slowly but surely on a path where they are adopting more market-oriented principles. They are trying to reform and liberalize their economy, albeit at a slower pace than perhaps we would like.

So I do think that these concepts matter in the sense that they understand that they do drive some of these market principles, that they are starting to introduce into their own economy. However, China is certainly not the only non-market economy that we deal with, and in terms of these sovereign wealth funds or any of the foreign-owned investments that can come into the United States, they should all be looked at with the same degree of scrutiny.

China shouldn't be separated out from other government investors for special discrimination; we shouldn't discriminate against China at all. If a foreign-owned entity wants to come in and acquire all or a share of a U.S. asset, it should be reviewed for its impact on national security--every one of those potential transactions should be evaluated in terms of the actual control the government would have over that investment and what the shape of the investment would be. Is the investment in or the acquisition of a firm, a U.S. firm that, in fact, does have technologies that we need to protect?

Whether it's China or it's Singapore or any of these other funds, I would like to think that we would treat each one of those potential transactions equally and with an equal amount of scrutiny.

I don't believe it's fair to single out China automatically because I do think that pulling them into more of a rules-based, market-based approach to investment will help them learn better ways of running their own economy, and that's why one of my biggest recommendations is that we continue to work very aggressively with trying to motivate China to introduce better market, financial market reform, as well as other economic reforms to balance their economy better.

So, yes, there is a concern, but China should not be discriminated against unnecessarily. We should treat all foreign government owners the same and apply the same level of scrutiny to each of the transactions as it's required.

COMMISSIONER WESSEL: I think our basic law, the CFIUS

statute, and if you look at Alcatel/Lucent, Dubai Ports, et cetera, it has been neutral in terms of the country from which the investment is coming from. We however have the government connection in the sovereign wealth funds.

In China, it is almost impossible, if not impossible, to divorce what they consider to be a commercial enterprise from government ownership, and therefore looking at their investments against the backdrop of larger government policies, their incursions into the Internet here at DOD, at Intel, et cetera, I think is a standard that's worth applying, not that we should not be viewing all foreign investments with skepticism through the CFIUS process.

MS. MARKHEIM: I agree that because China does has literally no separation between government and state, that we do need to look at each of those transactions, but not because it's China, but because it's a government-owned investor that wants to come into the U.S. It's a subtle distinction.

COMMISSIONER WESSEL: Okay.

MS. MARKHEIM: But it certainly applies and helps us present the fact that we do believe in non-discriminatory, fair and transparent approach to guarding our national security while letting investment come in and benefit the economy.

CHAIRMAN WORTZEL: Commissioner Fiedler.

COMMISSIONER FIEDLER: I don't disagree with you about having rules for everyone. I think that in your example if we have a transaction where the Norwegians were going to buy Bank A and the Chinese were going to buy Bank B, I bet you that the speed with which the Norwegian transaction could be analyzed would be quicker than the Chinese because we don't know how they made the decision even to create CIC.

We don't know if the Politburo sat; we don't know if the Party sat; we don't know if the Party set up a separate committee. We don't know who was on it. We don't know if the intelligence agencies were part of that decision. We don't know if the military was a part of that decision. And therefore that makes them different from the Norwegians.

I didn't want it that way. The facts made it that way. Now, by the way, I'm not anymore sanguine about Saudi decision-making processes than I am the Chinese. So it's only because we're the U.S.-China Commission that we're focused more on the Chinese than the Saudis. Maybe we should focus on the Iranians. So it is a broader discussion, I understand.

Do you want to limit, Ms. Markheim, to sovereign wealth funds or are you willing to accept the broader definitions that previous witnesses have had that sovereign entities are of a concern to the

United States or should be of concern to the United States? In other words, Gazprom, Russian state-owned enterprises, PetroChina?

MS. MARKHEIM: I think that, especially now with FINSA reform of CFIUS, I think that is something, this is a tactic we are going to be taking. The definition of government-controlled is pretty loose right now in terms of what CFIUS can apply as a definition for some of these government-owned entities in terms of the transactions they want to invest in.

So I think that we've already taken a step in the direction of looking at all of these particular vehicles for investment in terms of CFIUS. I think that we already have that potential.

What I hope, though, that is maintained through CFIUS and the FINSA update of CFIUS is that we do maintain the flexibility to distinguish between a Norway and a China so that we can better tailor a CFIUS investigation to those transactions that actually do raise some concerns.

I don't necessarily have any problem with keeping sovereign wealth funds separate from the rest of the other types of vehicles that can be used, but I think we still need to, regardless of what it is, whether it's a Gazprom or it's a pension fund, Canada's pension fund, or Norway sovereign wealth fund or China's, that we look at each one in terms of what it actually is, what we don't know about it, and then use that to help guide our decision as to whether or not an investment from that particular agent is safe.

COMMISSIONER FIEDLER: One last question. We require individuals coming into the United States to have passports, to be fingerprinted, and soon probably to have some biometric identity. There was initial concern that the people would reject that, they wouldn't come to the United States. One of the reasons we do that is because we're afraid that they may have some sort of nuclear dirty bomb and they would do us damage.

So money comes in the United States in the form of a corporation's ownership, doesn't need to have a passport, doesn't need to register, doesn't need to say who it is, and then it can do some damage or it can't do some damage. So why are we less, why are we apparently more hesitant to regulate corporate interests than we are individual passage in the United States in a post 9/11 world?

MS. MARKHEIM: I think the reason is because we're trying to strike that balance again between protecting our national security interests while still allowing our open and competitive market to function.

So there is more hesitance. I don't want to say there's more cost involved, there's not; there's a different kind of cost involved. Obviously, if a nuclear bomb comes in with one of our tourists, that

has a pretty significant cost associated with it, but there's a financial and economic cost that's also attributed to the nuclear bomb, but it's a different--there are long-term effects that--

COMMISSIONER FIEDLER: Isn't there a cost to the economy of me and you and everybody else in this room waiting two hours in line to get on an airplane?

MS. MARKHEIM: Absolutely. But that cost is relatively indirect. It affects productivity and we're standing in line--

COMMISSIONER FIEDLER: It adds up, though; doesn't it?

MS. MARKHEIM: I'm sorry?

COMMISSIONER FIEDLER: It adds up though.

MS. MARKHEIM: It does add up.

COMMISSIONER FIEDLER: I want to regulate the entrants. I want to know who's coming in with the money and who they are. I want to have a form of registration of foreign government-owned entities, and I didn't say every corporation in the world would have to specially register, only those that we believe are controlled by government. Is that a somehow abhorrent, ideological, overreaching regulatory suggestion? Is it onerous? Does it take more than two or three hours to file the paperwork?

MS. MARKHEIM: I think that that certainly would--I would need to think about this a little bit. This is an interesting idea. Just sort of a gut reaction, it certainly would raise the cost for business interested in potentially coming into the U.S. economy. It would probably have somewhat of a chilling effect on investment in the U.S. as a consequence.

If it's too hard to invest in the U.S. economy, there are other alternatives out there. And I'm not sure that it would be all that effective because the economy is pretty dynamic so we would have to make sure that we were constantly staying up with that list of companies to make sure that it was accurate, up-to-date, and I'm not sure that we could do that given that we don't have a lot of information about government-owned vehicles for investment.

If we don't know even what a sovereign wealth fund looks like, I'm not sure that we can with any accuracy to sit down and really make a comprehensive, accurate, up-to-date list of all the different firms from China and, from these other countries that we'd be concerned about, in a way that we could actually monitor that effectively.

COMMISSIONER FIEDLER: You just described the drug world internationally, but it didn't stop us from passing laws.

MS. MARKHEIM: It--I'm sorry.

MR. TONELSON: If I could just add one quick point. If it is so painfully difficult to find out what the ownership structure is of a prospective foreign investor, I would suggest that again the default

assumption is they've got some sort of state role or state affiliation that they're trying to hide, and let them, let the burden of proof fall on them to show that they are completely independent and U.S. authorities will be judge, jury and court of appeals.

CHAIRMAN WORTZEL: Thank you. If either of you has further thoughts on this, and you want to amend or add to your written testimony, we'll be happy to include that in the record.

Commissioner Mulloy.

HEARING COCHAIR MULLOY: Thank you, Mr. Chairman. My first question will be to Mr. Tonelson. McKinsey & Company in October of 2007 wrote a report about sovereign wealth funds called "The New Power Brokers." And they distinguished between the commodity sovereign funds and the non-commodity funds, and then they went into some analysis, where did this money come from.

Now, the commodity funds, the oil exporters, they get it because they're selling an asset which has gone up in price dramatically, and because they work together to try and keep up the price of that oil.

When they described the Asian funds, they talk about intervening in currency markets to keep a trade advantage against the United States by propping up the dollar. Now, it's in that area that I--do you have a view on how China has been able to achieve such large amounts of holdings of U.S. dollars that they're now coming back and investing in the United States, buying up assets here?

MR. TONELSON: I have no doubt whatever, and I think it's practically an open and shut case that the Chinese government intervenes massively in bilateral trade flows, and that in ways that we both know about and ways that we don't know about because after all when we use this relatively bloodless, I guess, Latinate word that a certain country lacks transparency or that it's opaque, what do we mean?

We mean we don't know very much about it or we certainly don't know as much as we would like to know, and as much as we need to know. Again, no doubt that the Chinese are engaged in a wide variety of interventions into trade flows, investment flows, and that these have had a major effect on the U.S., on these unprecedented U.S.-China trade imbalances that we've seen going back ten and even 15 years.

HEARING COCHAIR MULLOY: Do you have an opinion on whether China's practices are illegal under their international treaty obligations in the way they either manipulate their currency or have market access barriers or subsidize their exports?

Have you thought about that and do you know whether these violate any of their international treaty obligations?

MR. TONELSON: I've thought about that quite extensively, and once again I think it's a really rather open and shut case. When it

comes to trade practices and trade policies, China is the world's biggest rogue state.

HEARING COCHAIR MULLOY: Okay. Now, Ms. Markheim, then let me come to you. Are you speaking for the Heritage Foundation or are you speaking for yourself?

MS. MARKHEIM: Myself.

HEARING COCHAIR MULLOY: Okay. Because your testimony is very similar to that of the Treasury. The Treasury said the biggest problem with sovereign wealth funds is that the United States may do something protectionist. And you say the same thing on page, I guess it's page four of your testimony, where you say the biggest threat to the U.S. economic and national security is not foreign sovereign wealth investment; it is the increasing threat that the U.S. will adopt protectionist investment policies.

Let me ask you this. Do you think adopting legislation to counter China's illegal currency practices is a protectionist reaction in this country that we should not take or do you think that we should take action to deal with China's obligations that she's not carrying out, her IMF and WTO obligations, as Mr. Tonelson just told us?

MS. MARKHEIM: The written testimony that I have supplied for this was really specifically on sovereign wealth funds. That said I do believe that we are taking action, not through legislation, but through meetings of the SED, the JCCT, to try to shift China away from practice of using, propping up their exchange rates.

This is something I agree that they do intentionally do. I don't know if it's because if they wish to cause the U.S. harm, but it's something that they do as a piece of their overall strategy of promoting the export side of their economy, which has generated a great deal of imbalance, not only in China but arguably around the world.

I think it's important that we continue to engage with China through these mechanisms rather than through actual legislation because my concern is that if we do enact legislation that in some way punishes China or what have you, that we will no longer be able to maintain that access, which I do think is critical. I think our engagement with China can do far more than the IMF's engagement with China or even within the WTO or World Bank or wherever.

I think that the bilateral relationship is far stronger and carries a lot more meaning with China than these multilateral institutions.

HEARING COCHAIR MULLOY: I'll just have one comment on what you just said. I don't think the legislation would be designed to punish China. It would be designed, like any good law, to encourage people to live up to their legal obligations by providing penalties for them if they don't. So I heard what you said, but I think that's the way I would think of the way, rather than punishing, encourage them to live

up to their legal obligations. But thank you.

CHAIRMAN WORTZEL: Vice Chairman Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thank you. I actually wasn't going to ask questions, and they're really more comments than anything, Ms. Markheim, in particular.

It seems to me, if I heard you correctly, you said essentially we don't have enough information to know if there's a problem with the sovereign wealth funds and therefore we shouldn't do anything. Is that correct?

MS. MARKHEIM: I don't believe that we have enough information right now about these sovereign wealth funds to enact or write legislation that would counter them in some way above and beyond the regulations and the investigation processes that we already have in place.

I think that we still have a lot to learn about these funds, and I think that it's important to learn about these before we enact or potentially enact anything new.

VICE CHAIRMAN BARTHOLOMEW: Right. But do you think that the kind of information that is needed to understand what is going on is going to be willingly provided by the parties that are engaging in this?

MS. MARKHEIM: I'm hopeful. After all, since this has been getting so much more media attention and because our government, as well as others in Europe, have been expressing extreme concern about these sovereign wealth funds specifically, we know that a lot of these countries have been willing to come together and talk to the U.S., talk to the G-7, the World Economic Forum, about what their funds are.

Singapore has already stepped forward and said that it would become more transparent. Whether or not these countries actually do that remains to be seen, but I think there is, as they recognize growing concern about their funds, I think that they are being motivated to perhaps rectify some of those problems so that there isn't the loss of confidence or undue fear of them unduly.

They are looking for investment opportunities. They don't want barriers to be erected just because they're being so secretive.

So I think there is a chance that we will have information slowly but surely come out as these conversations go on.

VICE CHAIRMAN BARTHOLOMEW: Mr. Tonelson?

MR. TONELSON: We live in a world where if one can be confident about anything, it's that there is no shortage of risk and no shortage of danger. It's very difficult for governments, even one as big and powerful as that of the United States, to deal with these and to manage them.

It seems to me to be the essence of simple prudence to recognize

there is what you might call an existential threat here. We've recognized this regarding other parts of the American economy. We have strict limits on how much of a U.S. airline can be owned by a foreign entity. We have strict limits on what percentage of a media company can be owned by any foreign entity, public or private, drawing no distinction whatever.

Let's, for a change, take care of this risk or eliminate it to the best of our ability before it emerges full-blown, before we have to devote enormous budgetary resources toward the monitoring and managing and enforcing.

Again, we're faced with the problem or challenge of preventing excessive foreign government concentrations of power in the American economy. This should not be a terribly controversial goal whatever, and the way that you do this is that you ban the scale of investment that would make those concentrations of foreign government power possible in the first place, and by restricting a foreign official stake to one percent, you enable management to say no.

In fact, Professor Lim from State Research University No. 42,000 in Wuhan cannot visit this laboratory without any fear of any detrimental consequences whatever. It's out of bounds, forget it. Keep it simple.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

MR. TONELSON: Let's try to keep policymaking simple for once, not as complicated and intrusive and activist as it can possibly get.

VICE CHAIRMAN BARTHOLOMEW: I think what we also want is something that's effective, Ms. Markheim, I don't know yet that people are at the level of saying we should be banning or limiting or where people on this. We're all exploring.

But I would hope that you could find it in your thinking towards this approach that you could support some sort of increased disclosure because the reality is we do need to find out what the extent of the problem is.

I was really struck, as Commissioner Fiedler was talking, about what we do with individuals coming into this country. Individuals coming into this country who want to bring in more than \$10,000 must disclose what they are doing, and it is amazing to me that the Chinese government could be essentially investing hundreds of millions of dollars in this country and we don't know; we don't have disclosure.

Thank you.

CHAIRMAN WORTZEL: Commissioner Reinsch.

COMMISSIONER REINSCH: It's tempting to simply pass so we can all leave.

MR. TONELSON: Thank you.

COMMISSIONER REINSCH: I want to return to a topic that Commissioner Fiedler raised on the question of transparency.

COMMISSIONER FIEDLER: I'm sorry.

COMMISSIONER REINSCH: You're sorry. I'm sorry, too, but I couldn't let this just pass. First, Mr. Tonelson, let me come out in favor of complexity. I think my experience--

MR. TONELSON: It has its uses. No question about it.

COMMISSIONER REINSCH: Simple solutions are almost always wrong.

MR. TONELSON: Oh, okay.

COMMISSIONER REINSCH: So I'm comfortable with complex approaches to complex problems, and this is certainly one of them.

Let me pursue a couple of things you said. Commissioner Fiedler brought up the question of disclosure or reporting, if you will. And you were, I think, endorsing his view. If you want to limit, in this case, Chinese acquisitions to one percent, which you had said just a minute ago, why does anything Fiedler is talking about matter?

MR. TONELSON: I'm sorry?

COMMISSIONER REINSCH: Why does disclosure matter if you're going to limit it to one percent anyway? Who cares if it's that small a number?

MR. TONELSON: Because you have to know what you're actually dealing with, and just as you've said that complexity has lots of very useful purposes, I think knowing things is very useful. So I would like more information and I can't imagine that this requirement would become so burdensome as to deter any significant Chinese investment or any foreign government investment--again, that's what we're talking about--into the American economy.

It's a very attractive place to invest for all sorts of reasons. We have a financial system that requires disclosure of all sorts of information, and I have seen no evidence that would indicate that it has impaired its efficiency whatever.

COMMISSIONER REINSCH: Well, yes, it requires that disclosure, and I certainly support that when the investment is not de minimis. I'm not quite sure why it matters when the investment is de minimis. But let me move on.

MR. TONELSON: Why would it hurt?

COMMISSIONER REINSCH: I think you deserve a lot of credit for pointing out that the problem with what Commissioner Fiedler is talking about is not in the filing burden on the part of the investor because I think that probably is not significant unless you ask 500 pages of questions. It seems to me to the extent there's a burden, it's on the authorities in the United States, in this case, who have to decide

who has to file and who doesn't have to file.

And I want you to help me with that by giving me your parameters and then we'll find out what Commissioner Fiedler's parameters are. Do you want every foreign investor from all countries to file--disclosure, that is? Or are you only interested in sovereign wealth funds or sovereign wealth entities, to use Commissioner Fiedler's term, or are you only interested in selected countries?

MR. TONELSON: I'm interested in sovereign entities from all countries.

COMMISSIONER REINSCH: Sovereign entities from all countries.

MR. TONELSON: And recognizing once again that lots of these sovereign entities are not anxious to advertise the fact that they are sovereign entities. Clearly, it's going to take some administrative effort to find this out. But we can't let it take forever, and again if it's so excruciatingly difficult to find out conclusively whether some foreign entity has got a significant--and I don't know how to define that exactly--but I'm sure it won't be that tough to do. If it is so excruciatingly difficult for the U.S. government with all of its investigative powers to find out whether some foreign entity has a significant government link, then you presume that it does and that it's hiding something. And you put the burden of proof on that foreign investor.

COMMISSIONER REINSCH: Well, I assume we can ask somebody and find out if they think it's burdensome or not and draw our own conclusions about that. But it seems to me the burden is not necessarily in each investigation per se as it is in the fact that you would have to investigate every transaction because you have to make a judgment as to whether or not the entity falls into your universe.

So every single investment by any foreign party, it seems to me under your rubric, would have to be investigated to determine whether or not it is owned by, controlled by a sovereign entity.

MR. TONELSON: Or you have the alternative approach that making false statements carries severe criminal penalties.

COMMISSIONER REINSCH: Mr. Fiedler wants to say something to bail me out.

VICE CHAIRMAN BARTHOLOMEW: Now that would be a first.

COMMISSIONER REINSCH: I look forward to this.

COMMISSIONER FIEDLER: It's not a question of reporting on transactions. It's a question of registration. So in other words, you're a sovereign entity that wants to do business in the United States. You fill out the ticket. Now you go off and buy his one percent, two percent, three percent. You don't have to necessarily register that

transaction. We now know what to look for if we're interested.

COMMISSIONER REINSCH: Yes, but you still have to deal with the threshold question. Supposing I'm Chinese Entity A, and I decide that I'm not a sovereign entity and therefore I don't need to register.

COMMISSIONER FIEDLER: Yes, well, then, I find--

COMMISSIONER REINSCH: And I don't register.

COMMISSIONER FIEDLER: I the United States government finds you out. I can confiscate your property.

COMMISSIONER REINSCH: That's the point. You then--you have to--

CHAIRMAN WORTZEL: Gentlemen, believe it or not, we have to write a report to Congress about this due around November so we have a very long time to debate these things among ourselves.

COMMISSIONER REINSCH: Just tell me to shut up if you want.

CHAIRMAN WORTZEL: No, no.

COMMISSIONER REINSCH: You don't have to be graceful about it. Thank you.

CHAIRMAN WORTZEL: I want to thank both of you for coming here and see if you have any closing comments to us and then I will close out the hearing, I think.

MR. TONELSON: I would simply restate my skepticism about the very thoughtful and very detailed, but I think ultimately impractical, proposals that have been floated at various sessions of our hearing today. In terms of ascertaining motive and things of that nature, I just think it's too difficult for a government to do.

And while it is a very complex problem, the fact is that sometimes complex problems have relatively simple answers, and I think it's only the kind of hidebound Washington thinking that would insist that you always need the most complicated solution that you can possibly come up with.

CHAIRMAN WORTZEL: Ms. Markheim, anything?

MS. MARKHEIM: Very short and sweet. I know everyone is pretty anxious. You've had a long day. Just to reiterate the point again, that whatever the United States does come up with as a response to this issue, that we make sure that it is non-discriminatory, fair and transparent. That's the key to what our markets are about, and that's something that we need to always make sure to promote, not fall back to practicing those strategies that we are currently criticizing ourselves today.

Thank you very much.

CHAIRMAN WORTZEL: Thank both of you for being here. And to all the people that came to sit at the hearing and listen to the witnesses, thanks for your patience, too, and to my fellow

commissioners, and Patrick Mulloy, thanks.

[Whereupon, at 4:30 p.m., the hearing was adjourned.]