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SOVEREIGN WEALTH FUND ACQUISITIONS AND OTHER FOREIGN GOVERNMENT INVESTMENTS IN THE U.S.: ASSESSING THE ECONOMIC AND NATIONAL SECURITY IMPLICATIONS

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HEARING

before the

COMMITTEE ON
BANKING,HOUSING,AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

ASSESSING THE ECONOMIC AND NATIONAL SECURITY IMPLICATIONS OF SOVEREIGN WEALTH FUNDS AND FOREIGN ACQUISITION

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WEDNESDAY, NOVEMBER 14, 2007

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SOVEREIGN WEALTH FUND ACQUISITIONS AND OTHER FOREIGN GOVERNMENT INVESTMENTS IN THE U.S.: ASSESSING THE ECONOMIC AND NATIONAL SECURITY IMPLICATIONS

WEDNESDAY, NOVEMBER 14, 2007

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The Committee met at 2:02 p.m., in room SD-538, Dirksen Senate Office Building, Hon. Evan Bayh presiding.

OPENING STATEMENT OF SENATOR EVAN BAYH

Senator Bayh. I would like to call the meeting of the Committee to order. I would like to thank you all for being with us today. And I would like to begin by thanking Chairman Dodd for making this hearing possible and for elevating this important issue to such a priority position. Without the Chairman's support this could never have happened, and so I want to express my gratitude to him.

Chairman Shelby, I want to thank you for most especially your friendship, but also the good working relationship we have had on so many issues over the years, and it is good to be with you today.

And Senator Webb, welcome. Senator Webb is one of the driving forces behind this hearing, and so I am looking forward to hearing from you today, Jim, and thank you for continuing to focus on this very important, very important issue.

Senator Webb. Thank you, Mr. Chairman. Good to be with you.

Senator Bayh. I am going to make a brief opening statement and then hear from my colleagues, and then we will get right to the witnesses.

The issue of sovereign wealth funds is a significant one. The number of these funds is growing. Of the 20 largest, 13 were started since 1990. With foreign currency reserves up 140 percent over just the last 5 years, this trend is likely to continue.

The size of these funds is also growing. There are now seven over $100 billion in assets, including Abu Dhabi at $625 billion, Singapore at $215 billion, Norway at $322 billion, Kuwait at $231 billion, China at $200 billion, Singapore at $108 billion, and Russia now at $127 billion.

These now dwarf in size the multilateral organizations designed to be the governing architecture of the global financial system. For perspective, the International Monetary Fund now holds assets with a market value of just $76.9 billion. The World Bank has just $40 billion on its balance sheet.

The number and size of these funds is likely to continue to grow. This is being driven by the increasing price of commodities, principally oil, trade imbalances and currency practices by countries that have the effect of increasing their foreign currency reserves. These situations show no signs of abating.

This situation presents the United States with both opportunities and challenges. It is better for the United States to have capital invested here to create jobs, improve our productivity growth, keep interest rates low, and our standard of living high. But sovereign wealth funds are inherently different than private investors.

As the Chairman of the SEC, Christopher Cox, recently observed--and I quote--government ownership of companies and investment funds poses a fundamental challenge to the market premise upon which the SEC operates. The lack of transparency that characterizes many sovereign wealth funds undermines the theory of efficient markets at the heart of our economic system. In addition, unlike private investors and their representatives--pension funds and mutual funds, for example--government-owned entities may have interests other than and that occasionally will take precedence over profit maximization.

Just as the United States has interests in addition to financial ones, so do other countries. Just as we value some things more than money, so do they. Why should we assume that other nations are driven purely by financial interests when we are not? Or are we?

The issue before us, and the subject of this hearing, is how to strike the right balance of interests. How do we attract capital from abroad and pursue our financial goals while reconciling this with other vital national concerns?

To help explore this, we have an extraordinary panel of witnesses today. But first, we will hear from other members of the Committee and Senators. Senator Shelby, I would like to begin with you.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator Shelby. Thank you, Chairman Bayh.

This afternoon, as the Chairman has pointed out, we are meeting to examine the dynamic growth of sovereign wealth funds. A lot of this he has outlined in detail.

I hope this hearing, Mr. Chairman, is the first of several so that we have an opportunity here at the Banking Committee to examine fully the range of issues that these funds present to our economy and to our national security.

As you well know, we are entering to a different economic world where a lot of wealth has shifted from the United States and from Western Europe to developing countries like China and the Gulf States.

There are two unique features of sovereign wealth funds, as I understand it. First is their size. I have been told that they hold in excess of $2 trillion, Mr. Secretary, now and could go to $13 trillion to $15 trillion. This is serious, serious business. Recent trends indicate that these funds will continue to grow no matter what we do.

Second, sovereign wealth funds are not private investment vehicles, as what we have traditionally been involved in. They are government-controlled entities, as the Chairman pointed out. Government control introduces the possibility that they may be used for purposes other than their economic return.

For this reason alone, I think it is important to try to get a basic understanding of the various funds and their activities and perhaps their objectives. We need more information on how they are managed, how they are structured, and the types of investments they make.

We also need to know more about the objectives that I mentioned behind their investment activities. What is their motives here? Are they seeking higher returns, as the Chairman indicated? Are they also being used as a foreign policy tool, oftentimes maybe in the long run, against our interests.

Is there a role for global financial institutions such as IMF, OECD, and the World Bank in dealing with these funds? Finally, what effects can these funds have on exchange rates,

Treasury securities, and the economic health of this country? We had better know, and this hearing today will get us going in the right direction.

But we have to remember, because sovereign wealth funds are only going to increase in asset size and continue to expand their global reach, this Committee, Mr. Chairman, has a continuing responsibility to monitor and understand these unique and growing investment vehicles. If we let this continue to grow, we will not be in control of our own economic destiny, as we have in the past.

Thank you.

Senator Bayh. Thank you, Senator Shelby, for those perceptive remarks.

Senator Dole, I think we go to you next, as a member of the Committee. And then, Senator Webb, to you.

STATEMENT OF SENATOR ELIZABETH DOLE

Senator Dole. Thank you, Mr. Chairman, Ranking Member Shelby. I appreciate so much your holding this hearing on sovereign wealth fund acquisitions and foreign government investments in the United States.

I appreciate this Committee's recent work on currency manipulation by foreign governments, namely China, as this issue has great importance for my home State and its manufacturing jobs. I agree that today's hearing topic, too, is of particular relevance to this Committee.

Sovereign wealth funds have existed since the 1950's and the total number of these institutions has grown dramatically over the past 10 to 15 years. According to the IMF, there are currently more than 20 countries--including China, Russia, Venezuela, and United Arab Emirates--that have these state-sponsored investment vehicles, and half a dozen or more nations have expressed interest in establishing one.

Research conducted by Standard Chartered Bank in the United Kingdom indicates that the total investment by these funds is estimated at $2 trillion to $3 trillion. Based on current projections, this is more than hedge funds manage, with $1 trillion to $1.5 trillion, and more than private equity firms manage with $700 billion to $1.1 trillion.

The IMF estimates or projects that sovereign wealth funds will continue to accumulate international assets at the rate of $800 billion to $900 billion per year, which could bring the aggregate total up to $12 trillion by $2012.

One of the issues that has emerged with these funds is their transparency and whether they are willing to disclose and disseminate information. Some of these sovereign wealth funds already provide information regarding specific investments. For example, Norway's Government Pension Fund disclosed that it owns significant stakes in American financial institutions such as Bank of America, Citigroup, and AIG, as of December 31st, 2006. Unfortunately, other countries such as China and Venezuela do not make such data readily available.

I am pleased that this issue has captured the attention of Treasury Secretary Paulson, and I encourage the SEC and the IMF to continue monitoring sovereign wealth funds and to keep this Committee fully apprised. I hope that increased disclosure and transparency will instill a greater sense of confidence and understanding with regard to these investment vehicles, which no doubt have significant impacts on the continued integrity of the United States in international capital markets.

Again, I thank the Chairman, the Ranking Member, for holding this important hearing and I look forward to hearing from our witnesses regarding this emerging issue.

Thank you.

Senator Bayh. Thank you very much, Senator Dole.

Senator Webb.

STATEMENT OF SENATOR JIM WEBB

Senator Webb. Thank you, Mr. Chairman, and I appreciate you allowing me to sit on this hearing today, to be something of an interloper in your business.

This is a very important hearing. It is a follow-on to a letter in September that I sent to Treasury Secretary Paulson, along with you, Senator Bayh, Ranking Member Shelby, and also the Chairman of this Committee, addressing the importance of the Committee for Foreign Investment in the United States to take into consideration passive foreign ownership interests and assets in the country, including the sovereign investment funds. The letter urged Treasury to promulgate regulations broad enough to ensure that potential national security implications of such investments are appropriately addressed in the context of ongoing foreign investment in our economy.

Although foreign governments have been investing for years in the United States through different investment vehicles, sovereign wealth funds have risen to recent prominence on a wave of high levels of foreign exchange reserve associated with increased commodity prices and export led growth. The growth of these funds demand that we focus on their strategic implications.

The practice of state capitalism which is a phrase, I believe, was coined by Dr. Lyons, who will be testifying before us today, allows sovereign wealth funds to potentially improve their strategic advantage or to secure access to sensitive technology from other countries.

Relative to our own security, the Committee on Foreign Investment in the United States is the primary source of protection from investment that threatens our national interest. The increased number, size, and growth potential of sovereign wealth funds raises the prospect that they may be structured so as to escape scrutiny in ways not yet contemplated by current law.

So the question before us really is how we balance the need for investment with safeguarding our national security assets in the context of these funds. Our witnesses today are going to provide us with an opportunity to ensure that we have adequate regulations and that we seek policy recommendations regarding the risks of these funds as they may affect not only our market stability, but also our national security.

I thank you again for inviting me to participate in this hearing.

Senator Bayh. Senator Webb, thank you, and I am particularly grateful for your interest in national security related issues, of which this is one. And you are always welcome to contribute to the work of the Committee.

We begin today with the Honorable David H. McCormick. As a matter of fact, you constitute a panel of one, David, so we are looking forward to hearing from you.

David McCormick is Undersecretary for International Affairs at the Department of the Treasury, where he oversees policies in the areas of international finance, trade and financial services, investment, economic development, and international debt policy. Until August, he was the President's Deputy National Security Advisor for International Economics and previously served as Undersecretary of Commerce for Export Administration.

In the private sector, Mr. McCormick ran a software company and was a consultant for McKinsey & Company. He is a graduate of West Point and holds a Ph.D. from the Woodrow Wilson School at Princeton University. He is a former Army officer and a veteran of the First Gulf War.

Mr. McCormick, we thank you for your service to our country and for you presence here today. We welcome your statement.

STATEMENT OF DAVID H. McCORMICK, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. McCormick. Thank you, Mr. Chairman, Ranking Member Shelby, Senator Dole, Senator Webb. Thank you for the opportunity to be with you here today. I very much appreciate the chance to come and discuss sovereign wealth funds. At Treasury, we have been increasingly focused on sovereign wealth funds for more than a year now, and I am pleased to be able to share with this Committee our views.

As was said by many of your statements, sovereign wealth funds are not new. The oldest funds date back to the 1950's in Kuwait and Kiribati. Over the next four decades, these numbers have slowly grown. By the year 2000, there were 20 sovereign wealth funds worldwide, managing a total asset base of several hundred billion dollars.

Today, what is new is the rapid increase in both the number and the size of sovereign wealth funds. Fueled by high commodity prices and rapid accumulation of official reserves, 20 new funds have been created since 2000, more than half of these since 2005. Today there are nearly 40 funds managing total assets in a range of $1.9 trillion to $2.9 trillion.

At the Department of the Treasury, we define a sovereign wealth fund as a government investment vehicle funded by foreign exchange assets and managed separately from official reserves. These sovereign wealth funds generally fall into two categories. There are commodity funds, which are funded through commodity exports, owned or taxed by the government. Commodity funds serve different purposes, including the stabilization of fiscal revenues, intergenerational savings, and the balance of payments sterilization.

There are also non-commodity funds, which are established through the 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 these stand-alone funds.

Now it should be noted that within this group of countries, foreign exchange reserves are now sufficient by all standards of reserve adequacy and it is our view that greater exchange rate flexibility is needed and we are actively engaged on many fronts calling for that increased flexibility in a number of countries.

In contrast to traditional reserves, sovereign wealth funds seek a higher rate of return and are invested in a wider range of asset classes. Their managers emphasize expected returns over liquidity and many investments are in the form of stakes in U.S. companies, as has been witnessed in recent months.

Sovereign wealth fund assets are large in their importance, but very concentrated. While a fraction of global financial assets, sovereign wealth funds are currently larger--as was already said--than the total assets under management by either hedge funds or private equity. However, by some market estimates, only a handful of funds account for the majority of total sovereign wealth fund assets. 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 to the economy and they also pose concerns.

As reiterated by the President in his May 10th statement, the U.S. is committed to open investment and advancing open markets at home and abroad. The United States economy benefits from open investment, including investment from sovereign wealth funds. The depth, liquidity, and efficiency of our capital markets make the United States the most attractive country in the world in which to invest. And the U.S. has derived many benefits in the form of jobs, R&D spending, and higher wages.

Sovereign wealth funds also have 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 they cannot be forced by capital requirements or investor withdrawals to liquidate positions rapidly.

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

Sovereign wealth funds also raise non-security issues related to the 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 over return-oriented investments, sovereign wealth funds could potentially distort the market.

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

At the Treasury Department, we are 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, authored by the Chairman and Ranking Member of this Committee and signed into law by the President last summer, implemented through the Committee on Foreign Investment in the United States, ensures robust review of investment transactions that pose national security concern. It requires heightened scrutiny of foreign controlled investments. CFIUS is able to review investments from sovereign wealth funds, just as it is other foreign government-controlled investments, and it has and will continue to exercise this authority to ensure our national security.

Additionally, the new CFIUS legislation reaffirms investor confidence and longstanding U.S. open investment policy. We believe the U.S. investment security framework provides a good model for other countries where protectionist sentiment has been on the rise and we are actively engaged with these countries to head off undue protectionist responses abroad.

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 the existing best practices for foreign exchange reserve management. These 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 be responsible, constructive participants in the international financial system.

Third, we have proposed the Organization for Economic Cooperation and Development, OECD, should identify best practices for countries that receive foreign controlled investment. I should say that many of the countries that are the holders of these sovereign wealth funds are also significant recipients of foreign investment. These practices should focus on avoiding protectionism and should be guided by the well-established principles embraced by OECD and its members for the treatment of foreign investment.

Meaningful and timely progress has been made. In May of this year, the Treasury hosted a G-20 meeting of Finance Ministry and Central Bank officials that focused the first multilateral discussion on sovereign wealth funds. Just last month, Secretary Paulson hosted a meeting with the G-7 Finance Ministers and the 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 best practices. The next day, the IMFC--which is a ministerial level advisory committee to the IMF--called on the IMF to begin a dialog to identify best practices for sovereign wealth funds.

Also, at Treasury we have taken a number of steps internally and within the U.S. Government to enhance our understanding of sovereign wealth funds. Treasury has created a

working group on sovereign wealth funds that draws on the expertise of our international affairs team as well as domestic finance.

We informed Congress in June of some of our thinking on sovereign wealth funds in an appendix to the Report on International Economic and Exchange Rate Policies, and we will continue to provide updates on a semi-annual basis.

We also created a new market room for ensuring vigilant ongoing monitoring of sovereign wealth funds trends and transactions. And through the President's Working Group on Financial Markets, which is chaired by Secretary Paulson, we continue to discuss and review sovereign wealth funds.

We have also initiated outreach to ensure an ongoing and very candid dialog with countries that have these sovereign wealth funds. The Treasury Department will continue its work on sovereign wealth funds through analysis, through bilateral and multilateral outreach, so that the United States can shape any international response to this issue in a way that addresses legitimate areas of concern while ensuring that the United States remains open to and welcoming of foreign investment.

Thank you.

Senator Bayh. Thank you, Mr. McCormick.

Senator Crapo, it is good of you to join us. I would give you an opportunity to make a statement at this time, or you can waive that, if you would prefer.

Senator Crapo. I will waive that, and let's go ahead with the witness. Thank you.

Senator Bayh. Thank you.

I think these are 5 minutes rounds. Five minute rounds. Very good. I will try and keep my first round of questions to 5 minutes. I would ask my colleagues to try and do the same, and if need be we will be happy to have another round of questions.

Mr. McCormick, I am far from being the longest serving member of this body, but I have been around long enough now to have a little institutional memory. So I would like to take you on just a brief trip down memory lane.

I think it was 2001 when the financial projections for our country were that we would run surpluses that were of such magnitude that, in fact, we would pay off our national debt in fairly short order. There was a big debate at that time that if that, in fact, happened what would we do with the extra money? One of the things we heard pretty consistently from this administration was that well, we should not invest it in the private economy. I will read you a quote to that effect. I think it was from the then Chairman of the Federal Reserve, Alan Greenspan.

This is a quote from his testimony to the Budget Committee. ``The Federal Government should eschew--'' that is Greenspan-speak ``--should eschew private asset accumulation because it would be exceptionally difficult to insulate the Government's investment decisions from political pressures.''

That same year, before that same Committee, then-Secretary of the Treasury, Paul O'Neill, said ``Government is big enough and has no business owning private companies.''

My question to you is if it was wrong for the U.S. Government to invest in our private economy, why is it right for other nations? And what do we do to protect against the political influences that Chairman Greenspan warned about?

Mr. McCormick. Thank you, Mr. Chairman. I think it is a very legitimate question. Through our policy focus, both with the non-commodity funds, as well as the commodity funds, we have very active dialogs about how to reduce the accumulation of foreign reserve, which I noted in my testimony far surpasses any reasonable level.

Senator Bayh. We wish you good luck with that.

Mr. McCormick. Yes, sir. It is not an easy task.

So my discussion of sovereign wealth funds is by no means meant to encourage or validate or accept that that is good policy on the part of the countries that are accumulating these

reserves.

With that said, the fact remains that a very significant amount of assets have already been accumulated. Under even the most conservative projections they will continue to accumulate. And so we are faced with the very real issue that there's a significant amount of capital out there which is going to be invested abroad.

Senator Bayh. And as I said in my testimony, we would like the capital. But I guess, to get back to my question, if we were concerned about political influences on decisions by our own Government, why should we not be equally concerned about political influences on the parts of other governments? And what can we do to protect ourselves from that?

Mr. McCormick. Mr. Chairman, I think it is an area that we should monitor very carefully. And by that I mean if you look at the track record of the sovereign wealth in the United States to date, it is a track record that has generally been very responsible investing, long-term investing, and overall a very stable investment track record. That is not to suggest that the concern you raise is not a very legitimate one. And so I think that puts an added responsibility on us, through the CFIUS process, but also through our ongoing monitoring of this market and of these developments, to ensure that that is not happening.

Senator Bayh. You make a good point, that the track record to date has been a positive one without pernicious influence. But as all of us have noted, the size of these funds, the numbers of these funds, are growing very rapidly. And now they are growing in some countries that view themselves, at least in part, as competitors of ours, both economically and in other spheres, which raises a host of different questions.

So I will not continue to ask you about that, but I think you understand what I am saying. If it is a legitimate concern on the part of our own Government--for example, I just--one last point here. We have a big debate about what to do to solve the Social Security imbalances in our country. We currently invest, at least as an accounting matter, in Treasury bonds with the excess fund that are paid in to the Treasury in terms of Social Security payments. If our Government decided that we could gain a higher rate of return by, instead of investing in Treasury bonds, let's say invest in Blackstone or something like that, a hedge fund, would our Government encourage such a policy?

Mr. McCormick. Mr. Chairman, you know, it is an interesting question, in part because within the United States we already have what many would characterize as a sovereign wealth fund in the Permanent Fund in Alaska, which is a significant accumulation that is invested both at home and abroad.

I think one of the things that is interesting about the discussion on sovereign wealth funds is really there is a whole continuum of official reserves, which are increasingly being invested for higher returns in the equity markets; sovereign wealth funds, as we have just discussed; state-owned enterprises; and pension funds. And all of these are becoming much more significant global actors. Some of the same issues that we are discussing apply to some of those other investment categories, as well.

Senator Bayh. Well, and as a former Governor with a State that has a pension fund that does invest in the private marketplace, I have seen that as a positive development. But there are policies in place that try and insulate those investment decisions from political concerns, and I think legitimately so. And at the national level, when this whole subject was raised, there have been examples where States only occasionally--not frequently--have pursued social investing, shall we call it. And that raised enough alarm bells that it gave rise to Chairman Greenspan's testimony and several others.

So I raise it as an important issue.

I see my time has expired. I did have a couple of extra

questions, but I will save that for the next round, Mr. McCormick.

Senator Shelby.

Senator Shelby. Thank you.

Mr. Secretary, I have been looking at a sheet, and I have marked it up a little bit. I do not know if you have seen it. It shows the compilation of the estimated size of sovereign wealth funds in billions of U.S. dollars, and it adds up today to over $2 trillion. Some people think it will go up $12, $13 billion, could go more. And this is not exactly accurate, but it is close. About 80 percent of this money is connected to oil and gas one way or the other. Does that bother you that we have no energy policy, that we have become more and more dependent on foreign sources of energy and we are exporting our wealth and then they want to come back and invest in our company? And that is good to a point, but to what point? Does that concern you at times?

Mr. McCormick. Yes, Senator Shelby, it does. I think this is really what lies behind the President's focus on energy security and the emphasis that he has placed on that particular area.

Senator Shelby. Now, you do not have any illusions about energy security by any of the bills that we have been pushing and the President has been pushing, do you? You know, whether it is ethanol or whether it is solar power, all that is good. But it is not going to make much of a dent in our energy needs, is it, unless we really conserve energy, all of us, cut down on our energy consumption 25 percent, or build nuclear power plants and start walking more? You do not have any illusion about that, do you?

Mr. McCormick. No, Senator, I do not.

Senator Shelby. OK. So we can look for these sovereign wealth funds to grow rather than contract, could we not?

Mr. McCormick. Yes, sir.

Senator Shelby. And as they grow, they want to invest somewhere, and that somewhere is generally the United States or Western Europe, is it not?

Mr. McCormick. Yes, sir, I think that is true, although I do think they are also beginning to see the emerging markets as a very attractive investment area as well.

Senator Shelby. Does it concern you at all that companies' sovereign wealth funds would like to buy up some of our most strategic materials? What about iron or coal or oil, everything, oil companies? Does that concern you?

Mr. McCormick. Yes, Senator, it does. I think the recent legislation that you and others here in Congress--specific legislation that you and others have recently passed and the President has signed is a great step forward in guarding against that possibility.

Senator Shelby. Could you just highlight some of the differences here briefly this afternoon with respect to the management, internal controls, disclosure, and investment strategies of the different countries? Just pick out several that have sovereign wealth funds and how they are used.

Mr. McCormick. Well, Senator, what is interesting as you look at this group of 40 or so is that they fall generally into two camps: in addition to the commodity/non-commodity distinction that I made, there are those that have been around a long time, and those that are relatively new. My experience, having talked to many of them on both sides of that divide, is that the ones that have been around for quite some time have really put in place an investment process, an investment decisionmaking, a governance structure that is very much like what we would see in a big private equity fund or a big hedge fund. The focus, of course, has been in creating intergenerational wealth, largely, and maximizing returns.

The funds that are relatively new I think are very much in the process of trying to define how they are going to do business, and I think therein lies our challenge, frankly, and

our opportunity in terms of developing a coherent set of best practices that the newer funds might adapt to.

That is not meant to suggest that the transparency and the clarity within sovereign wealth funds is the same as you would find in a pension fund or in other areas where there is a great deal more transparency, and I think that also is our opportunity, is to get a higher level of governance and transparency across the entire sovereign wealth fund sector.

Senator Shelby. How do you separate the objectives of a nation to survive, to expand for their own people, and the objectives of a sovereign wealth fund which is controlled by the nation?

Mr. McCormick. Well, Senator, I mean, I think at its core, we have to acknowledge that they are different. However, the path that we have been going down----

Senator Shelby. And how are they different?

Mr. McCormick. Well, they are different in the sense that a private investment vehicle, a private company is designed, exists for the purpose of maximizing profit. The sovereign wealth funds can exist solely for the purpose of maximizing returns, but there is a possibility that they----

Senator Shelby. But it is for the benefit ultimately of the state, is it not?

Mr. McCormick. It is indeed.

Senator Shelby. OK, as opposed to the shareholders that you----

Mr. McCormick. Right. Yes, sir.

Senator Shelby. So basically what we are doing in a sense is exporting our wealth to the world, especially in the energy areas, and others, and then they are using our wealth to buy back our companies. Is that correct? You know, money is looking for its best investment, and the money is going to be invested somewhere, is it not?

Mr. McCormick. Senator, it is. I would look at that inbound investment. I would describe that inbound investment I think a little bit differently.

Senator Shelby. How would you describe it?

Mr. McCormick. I would describe that as in many ways the lifeblood of what has allowed companies in the United States to grow, to capitalize, to invest in R&D, to create higher-paying jobs. So investment as a general rule, as I know you know, Senator, has been a very critical part of our prosperity, and this sovereign wealth fund investment can also be a critical part of our future prosperity, but if and only if it operates within our markets in a way that is consistent with market fundamentals and market-driven investment decisions.

Senator Shelby. I know you have a portfolio over at Treasury, and we set up CFIUS for Treasury to head that up, but you are not alone. But I hope that you will be very careful as you look at sovereign wealth funds' investments in this country as to who they are, what they are investing in, and the long-term repercussions for this country, our workers, and our companies.

Thank you, Mr. Chairman.

Senator Bayh. Thank you, Senator Shelby.

Senator Webb.

Senator Webb. Thank you, Mr. Chairman.

Mr. McCormick, I want to understand your views and the administration's views in terms of any level of concern that you have about this concept. I did not quite get that from your testimony. Do you have concerns, national security concerns?

Mr. McCormick. Senator, the national security concerns that I think can exist from a sovereign wealth fund investment, a state-owned enterprise, or other investments, we believe can be addressed through the legislation that this Congress has passed.

Senator Webb. So you believe under current policy there is no cause for national security concerns about the nature of these investments?

Mr. McCormick. Well, Senator, I would say it a little bit differently, which is I believe that any given transaction from a sovereign wealth fund could pose very severe national security consequences. I believe the legislation that you have passed allows us the authority to deal with that appropriately.

Senator Webb. How would you characterize the relationship between the United States and China? Adversary? Competitor? Ally?

Mr. McCormick. I guess, Senator, I would characterize that as one of constructive engagement across a number of areas, and also a relationship that is tense and where we have lots of disagreement in other areas.

Senator Webb. You would agree that in areas where two countries of the size and global interests on the United States and China, if there are disagreements that one country would want to be able to use leverage against the other?

Mr. McCormick. As a general rule, yes, Senator, I think that----

Senator Webb. I assume you would agree that there is--or maybe not. But I would assume you would agree that there is a difference when you look at an investment that actually is made by a foreign government and particularly into direct areas of the economy as opposed to, say, something like a T-bill?

Mr. McCormick. Yes, Senator, I agree there is a difference. I would describe this as a continuum, so on the one end would be investment in T-bills and official reserves. Then you could see passive investment in the equity markets, and all the way up to a controlling investment in an individual company.

Senator Webb. So in a situation that would likely--or can generally occur with this type of investment, I would think that, on the one hand, we could get ourselves into a situation nationally where we are dependent on certain levels of investment--there are sort of three areas of concern. One is that we would be dependent on a certain level of investment which would give another nation a form of quiet leverage. You have another situation with respect to the potential of access to sensitive information depending on what the investment is. And then, third, just due to the liquidity of our markets, which you commented on, there could conceivably be overt leverage in a situation where we would be having a confrontation with a country like China.

Would you care to comment on that?

Mr. McCormick. Yes, Senator. I think just as you were on your second point in particular, access to sensitive information, sensitive technology, that was--I want to reinforce the point I made earlier, which is that I believe the CFIUS legislation that the Congress passed allows us to address that very direct national security concern. And I think those other areas of potential risk that you identify are legitimate ones and ones we need to monitor very carefully to ensure that that is not the case.

Senator Webb. How would we resolve a situation if that were to occur? Given the construct of the law and of our governmental policies right now, what would we do?

Mr. McCormick. Regarding market instability, Senator?

Senator Webb. Both forms of leverage, if we were to find ourselves in a situation of some tension, not necessarily even military tension but tension between ourselves and China in a situation where these types of investments were growing.

Mr. McCormick. Well, Senator, I think a characteristic, for better or for worse, of a global economy and one that is as integrated as ours is, is that we are dependent--and other countries are dependent--on this inflow of foreign capital. And this becomes the basis for growth and continued investment within the private sector of those respective countries.

I think if you looked at the distribution of the investment in the United States today, one of the things that would be most telling is the diversity of that investment and the degree to which we truly are the investment destination for the world.

Senator Webb. But we do not do this, right?

Mr. McCormick. Excuse me, sir?

Senator Webb. The U.S. Government, do we have these types of sovereign wealth funds? You mentioned one example in Alaska.

Mr. McCormick. We have that one----

Senator Webb. As a National Government, we do not have this policy.

Mr. McCormick. We do not.

Senator Webb. OK.

Thank you, Mr. Chairman.

Senator Bayh. Thank you, Senator Webb.

Mr. McCormick, as my opening comments indicated, I think it is good for our country to attract capital investment into our society. We need to do that in a way that does not compromise our other interests, and the reason for my quoting Chairman Greenspan is that I could not help but think that some people who now are desirous of this kind of investment would pitch a fit if our own Government was doing the same, and, therefore, we do not. But we do have State investment funds, as you pointed out, in Alaska, Indiana, and elsewhere, but we have built-in protections that insulate that from political decisionmaking and so forth. And so it seems to me that is what we need to do in this instance as well, and so we can get the benefit without the downside, and that is what I would like to ask you a couple of extra questions about.

You mentioned the work of the G-7 in terms of promoting transparency and best practices for sovereign wealth funds. Is it your opinion that those should be purely voluntary? Is that enough to protect the national interest? And whether voluntary or involuntary, if they are violated, what should the consequence for that be in terms of allowing sovereign wealth funds that do not follow best practices to continue to invest in our country?

Mr. McCormick. Senator, to begin with, I think that----

Senator Bayh. Is your microphone on, Mr. McCormick? The little red button. OK. You might pull it a little closer.

Mr. McCormick. Senator, as we review the current state of sovereign wealth funds, I think the starting point is that we believe there is a common objective here for most of the players involved, which is the free flow of investment. The sovereign wealth funds desire markets where they can maximize their return, and the investment destinations want to remain open to that foreign investment.

Senator Bayh. Life is easy if everybody plays by the rules, but what do we have if they do not?

Mr. McCormick. At the G-7, I think there was agreement that some of the areas we outlined previously in the testimony and in our discussion are areas of concern. As I described earlier, on the national security front, we feel like we have the appropriate authorities to deal with that issue from a sovereign wealth fund or another investor in the United States.

Senator Bayh. So you are satisfied with having voluntary best practices?

Mr. McCormick. Well, Senator, for the national security dimension of this, whether it is voluntary or not, if there is a sovereign wealth fund investment or any investment in the United States that raises a national security concern, we believe we have the authorities to deal with that appropriately.

The issues that could be raised that would be dealt with by best practices that we do not have a legal authority necessary to deal with are non-commercial intent, so investment for non-commercial reasons.

As I said before, the track record on this to date has been very positive, but we need to monitor it very carefully. And if we begin to see evidence that sovereign wealth fund investors are not investing in a market-determined way, then I think that would raise additional concerns.

Senator Bayh. Well, let me give you an example. One of the

largest of these funds is now Russia's, and their behavior toward some other countries using energy as a leverage I think can best be described as thuggish. They are making substantial investments in some of the Balkan nations, perhaps as part of their intent to influence policies in those countries. When you have a country that has behaved like that, are voluntary guidelines enough?

Mr. McCormick. Well, Senator, it remains to be seen. We have initiated a conversation on this. We have asked the IMF to take a leadership role. The IMF is now beginning to do that, and I think it will be a very telling process to determine what those best practices might be and how the sovereign wealth funds begin to work together, along with the investment destinations, to try to develop those.

There are other areas where these types of best practices have really had a positive effect, and we are optimistic they could be very helpful here as well.

Senator Bayh. As Chairman Cox mentioned in his statement, for American investors in America and American-operated companies, they are not entirely voluntary. I mean, we have mandatory standards of transparency and those sorts of things. I would encourage you to think carefully about what the consequences should be for non-American investors investing in our economy who choose to not play by the best practices. My guess is that if there are no consequences, we should not be too surprised if some decide that the rules are just simply inconvenient and they do not abide by them, and in this area I think that is probably not satisfactory.

Let me ask you one other question. My time on this round is up, and I will return to Senator Webb. I did have just a couple more.

You mentioned the IMF, and I think, you know, continuing to push on the currency manipulation front is a good one. I encourage you in that effort. I know the report due October is a little bit overdue. We are going to be interested to see if we actually made any tangible progress or whether we are just continuing to jawbone them.

But here is my question: The IMF is a good organization, but as a part of their charter, maintaining stable currencies, you know, market-based currencies, is a part of what they do. They have not had much impact on these countries that are maintaining artificial exchange rates. Why should we expect them to be any more effective in this area when they have been ineffective in the area of exchange rate policy?

Mr. McCormick. Well, Senator, I think it would be fair to say and I think the new leadership at the IMF recognizes that it is a very dynamic time for the IMF when they really do need to reinvent themselves and define their mission for the next coming decades. And a critical part of that in the view of the United States is taking a very aggressive posture on currency surveillance and implementing the recently designed surveillance program that is being put in place--I know the Managing Director is committed to that--and taking on issues like sovereign wealth funds, which is an issue that is ideally suited in my view for the IMF to play a leadership role.

Senator Bayh. I am going to turn to Senator Webb. I would only observe that redefining their mission and, quote, taking on an issue, that is all well and good. But if they are not able to do anything about it, if people simply do not abide by the rules, well, that is not enough. And that is what we need to think carefully about, whether that organization, as well intentioned as they might be, is capable of being effective.

Senator Webb.

Senator Webb. Thank you, Mr. Chairman.

Mr. McCormick, I have one other question, and I would like to presage it a little bit with looking back on a different kind of institutional memory. We went through a period in the 1980's where particularly with the competition against Japan, we saw as a result of their ability through MITI to develop an

economic strategy for their companies, that policies were put in place, underpricing, dumping, designed to sort of unfairly diminish the abilities of American companies, whether it was pianos or guitars or motorcycles or cars, whatever. That kind of pales in comparison to what possibly could be the result of these practices if they go out of control because, on the one hand, Japan is an ally, and on the other, China particularly is a competitor, you know, at a minimum.

But we are having a--we are seeing a new phenomenon here in many ways, and that is that you have Government wealth entering a direct competition with private corporations in a way that, when I go back in my mind and look at what the Japanese were doing at that time, when you can concentrate your wealth, you can drive out competitors in the same business. You know, just totally serendipitously this morning in the Financial Times, there was an article--I do not know if you saw it or not--which discussed the--David Rubenstein of the Carlyle Group was talking about the potential of these types of investments taking down the predominance of American corporations that are in the same business, saying that these types of funds over the next decade could challenge the predominance of U.S. buyout firms because of the explosion of wealth and the ability to concentrate it, so you can compete in a way with very, very deep pockets that corporations cannot.

Would you have any thoughts on that? Actually, I would be interested in hearing from our witnesses on that point, too.

Mr. McCormick. Well, Senator, I think it is a legitimate concern whether the degree to which these funds are so well capitalized allows them to invest in non-market ways based on non-market principles--in other words, investing more than the market would determine, and in doing so gain some advantage. It would not be an advantage in terms of its returns because it would have paid above market for the asset, but in terms of some political advantage.

So I think that is something we have to monitor very, very carefully, and I do not mean to suggest that the past is a flawless predictor of the future, but what we have seen here are very, very focused investors trying to maximize returns that have been largely managed by investment professionals, often not from the country themselves, invest in a passive way.

And the question, I think, that certainly we are contemplating, what steps should we take, working with others in the international community, to ensure that that is largely the kind of investment that we see going forward. And that I think is going to require a collection of actions, some multilateral, some bilateral, which I tried to describe earlier.

Senator Webb. Thank you.

Thank you, Mr. Chairman.

Senator Bayh. Thank you, Senator Webb.

Mr. McCormick, I just have one last area of inquiry, and it has to do with the letter that was sent by Chairman Dodd and Senator Shelby and myself and Senator Webb about this sort of in-between area, where someone takes a minority interest stake in a company; it is not yet 51 percent, so they do not have absolute control; and yet it is possible that they exercise some considerable influence over the affairs in the company.

So my question to you is: First of all, what does the Department plan to do in response to the issue we raised? Are you contemplating anything in this area? That is No. 1.

No. 2, isn't it possible that the significant minority owners can exercise that kind of influence? And if the answer to that is yes, well, what do we do when it is short of 50.1-percent ownership stake?

Mr. McCormick. Thank you, Senator. As you know, Exon-Florio allows the president to take action in situations where there is a demonstration of control. But the line, the red line in terms of what defines control--let me say it differently. There is no hard and fast red line in terms of what defines control.

Control will be identified based on an evaluation across several different factors. Those factors would include ownership, voting rights, board seats, and so forth, which, when viewed in their totality would be demonstrative of a party's ability to significantly influence major decisions for the company.

There has been a presumption----

Senator Bayh. The ability to influence major decisions. And so you take all those factors together and the question is: Can they influence major decisions of the company?

Mr. McCormick. Yes, Senator. There has been a presumption up until this point that a passive investment was one that was roughly at the 10-percent level or below. But there may even be instances when there is a 10-percent investment that the--because of other factors, that there is actually the ability for control.

So our challenge here is to really review each case on a case-by-case basis and do that in a way that identifies whether there is a controlling interest, but to also do that in a way that does not create so much uncertainty around transactions that you have ultimately created an incremental burden or chilling effect on investment.

Senator Bayh. Well, let me give you a recent for instance. I do not know how much you followed the recent change in the CEO position at Citigroup, which their largest shareholder is a Saudi prince who has apparently a 4-percent ownership stake, significantly below the 10-percent threshold that I gathered that we normally would assume would be passive. And according to published reports, he played a very active role in bringing about a change in the leadership of that company.

Now, I am not being critical of him. It may have been exactly the right thing to do. But, you know, there is an example of someone with a 4-percent stake who, I think by your definition, he apparently exerted influence over a significant development at that company.

Does he have a controlling interest in the company? Most people would ordinarily say at 4 percent, no, but it is hard to say he did not exert some significant influence over a major decision. So what do you do in a case like that?

Mr. McCormick. Well, Senator, obviously all this is within the context of national security, so----

Senator Bayh. That is the largest private financial institution in our country.

Mr. McCormick. Senator, as I said, all this is viewed within the context of national security, so if the ability to significantly influence decisions that could come at the expense of the national security of the United States, then control in that case would go into CFIUS and go through the appropriate review to ensure that that security interest can be mitigated or the transaction is not approved.

Senator Bayh. Well, one of the--and, again, you have been very patient here today, Mr. McCormick, and I know you are just here by yourself taking all these questions. But one of the things I think Chairman Shelby alluded to and, in fact, the CFIUS law spoke to was that in today's world--and you look at the Russian behavior as an example, and there are some others--the definition of ``national security interest'' is broader than it used to be. You will see the Chinese going around the world acquiring what they view as strategic energy interests, and it is not impossible that financial positions might be used in a similar vein.

And so we just need to see the world that is evolving and be ever mindful that in some non-traditional areas in today's world and tomorrow's world, they may, in fact, implicate national security interests where 20, 30 years ago, perhaps it was not the case.

Senator Webb, is there anything else you would like to touch upon before we let this good man go?

Senator Webb. No. Thank you very much, Mr. Chairman.

Senator Bayh. Mr. McCormick, thank you very much.

Mr. McCormick. Thank you, Senator.

Senator Bayh. As I said, I appreciate your service to our country.

Mr. McCormick. Thank you.

Senator Bayh. We have a very distinguished second panel. If it is all right with you, gentlemen, I would like to introduce all of you together, and then, Mr. Larson, I think we will start with you, then Mr. Truman, and just move in that direction down the table.

Ambassador Alan Larson is senior international policy advisor at Covington & Burling where he counsels clients on issues of international business and public policy. He joined the Foreign Service in 1973 and retired in 2005 as Under Secretary of State for Economic, Business, and Agricultural Affairs. During his tenure, he served as Ambassador to the OECD in Paris and in numerous posts as an economic officer in Washington and at missions in Jamaica, Zaire, and Sierra Leone. He earned the rank of Career Ambassador in 2004 and was honored with the Secretary of State's Distinguished Service Award in 2005. Ambassador Larson is currently Chairman of Transparency International USA. He holds a Ph.D. in economics from the University of Iowa. There seems to be a great interest in all things Iowa these days, Dr. Larson, so we are glad that you are here representing that fine State--at least in part.

Dr. Edwin ``Ted'' Truman is also with us today. Ted Truman is a senior fellow at the Peterson Institute for International Economics in Washington, D.C. He served as Assistant Secretary for International Affairs at the Treasury Department from 1998 to 2001. Previously, he led the International Finance Division of the Federal Reserve Board and staffed the Federal Open Market Committee. Dr. Truman has been a member of a number of multilateral working groups on economic and financial issues and has published widely on international and sovereign investments. He holds a B.A. from Amherst and a Ph.D. from Yale. Dr. Truman, thank you for joining us.

Next is Patrick Mulloy. Mr. Mulloy, you are no stranger to this Committee. It is a pleasure to welcome you back once again to share your perspective. Pat Mulloy served on the bipartisan U.S.-China Economic and Security Review Commission from 2001 to 2006, including a period as Acting Chairman. The Commission reports to Congress on the national security implications of our economic relations with China. Mr. Mulloy also served as Assistant Secretary for Market Access and Compliance in the Department of Commerce's International Trade Administration. He spent 15 years on the staff of the Senate Banking Committee, including as chief international counsel and general counsel. Mr. Mulloy is currently the Washington representative for the Alfred P. Sloan Foundation, which funds studies and programs regarding the competitiveness of American industry and citizens. He is also an adjunct professor of international trade law at both Catholic University and George Mason University. A native of Pennsylvania, he holds a J.D. from George Washington University Law School and an M.A. from Notre Dame. Mr. Mulloy, welcome back. We are sorry about the Fighting Irish's football team this year, but there is always next year.

Dr. Gerard Lyons, welcome. Dr. Lyons is chief economist and head of Global Research at Standard Chartered Bank in London. Although based in the U.K., he travels extensively, visiting the bank's operations and clients in Asia, Africa, and the Middle East. He has held senior positions at a number of major financial institutions. Dr. Lyons is an expert on the world economy, the international financial system, macroeconomic policy, and global markets, and is invited to speak frequently on these topics. Originally from London, he obtained an M.A. from the University of Warwick and a Ph.D. from the University of London. Dr. Lyons, we are grateful for your presence here today.

Mr. Larson, why don't we begin with you. Technically, we

are supposed to limit our comments to 5 minutes. If you need to run over a little bit, that is OK, but you could also submit--if it is a much longer statement, feel free to submit that for the record.

STATEMENT OF ALAN P. LARSON, SENIOR INTERNATIONAL POLICY ADVISOR, COVINGTON & BURLING, LLP

Mr. Larson. Thank you very much, Senator Bayh, Senator Webb. It is a pleasure to be here. I would like to submit a longer statement for the record, and to summarize it, I would just begin by confirmation my name is Alan Larson, and when I was a Career Ambassador and an Under Secretary of State for Economic Affairs, I often used to deal with policy with respect to investment and inward acquisitions. Today, in my current private sector position, I sometimes get involved as an advisor on inward investment acquisitions, including some transactions that involve entities with foreign government ownership. So I have seen it from both the public and private sector side.

My testimony summarizes how foreign investments and acquisitions can benefit the United States by putting to work here capital that supports investment, growth, job creation, innovation, and competitiveness in our own economy. And I think all speakers have touched on that point.

In addition, foreign investments can mitigate the disruptive effects of global imbalances. They can transform foreign entities into stakeholders in the U.S. economy, stakeholders who prosper when our economy prospers.

There are a number of reasons why foreign entities may want to invest in the United States. My testimony goes into those. I am just going to touch on three here.

One is that some foreign government pension funds want to invest in assets that are diversified across sectors, across countries, and across different types, and in that they are like lots of other investors everywhere.

Second, as we have already discussed, some countries are very dependent on a single resource, such as oil, and they have economic reasons for wanting to diversify across investments in other countries in other sectors.

And, third--not conclusively--many foreign governments, including some of our closest allies, own operating businesses. We have discussed that that is not the American philosophy, and I agree with the American philosophy, but the fact is that some countries do have foreign-owned entities or foreign-owned enterprises, and we sometimes go abroad in trying to leverage the expertise that they have developed in their home market.

As has been discussed, these trends look very likely to continue to grow. As we know, high oil prices and current account surpluses provide some of the financial fuel for the rapid growth of these types of investments and acquisitions. Studies suggest that these surpluses are likely to continue and that a strong energy policy, even if we were to adopt a stronger one, and great progress in rectifying international imbalances, even if we were able to achieve that, are not going to dramatically change this picture.

Many of the speakers today rightly have emphasized the importance and the issue of transparency of Government investment entities. I think it is important that the G-7 has been prodded by the U.S. Government into leading an international exercise. It is designed to identify best practices on transparency, and that these best practices would be strongly recommended to Government investment entities. It is also important that the G-7 has asked the OECD to lead a similar exercise with respect to transparency on the part of investment-receiving countries so that their investment policies are transparent and that they avoid a lurch into protectionist policies.

Here in the United States, we have followed a clear policy of welcoming foreign investment while maintaining effective

tools to allow us to scrutinize any transactions that might raise national security concerns. I think that the recently enacted Foreign Investment and National Security Act of 2007 is a robust tool for addressing any national security issues involving foreign acquisitions, including those by Government-owned entities or sovereign wealth funds.

FINSA mandates that the executive branch will focus on those acquisitions that raise national security concerns. I think it rightly does not look at economic factors or industrial policy considerations that could distract FINSA and lead away from--and dissipate resources on issues that are not crucial for national security.

I think that FINSA also requires--or, excuse me, I have lost my place here.

The acquisitions that do not result in control correctly lie outside the jurisdiction of FINSA, and this gets very much at the important point that Senator Webb and you, Senator Bayh, were raising. When there is not control, there is not, in my opinion, a risk that foreign persons might direct, determine, or decide core business policies in ways that raise national security concerns. I think this language is important. Is it influence? Is it the ability to direct, determine, or decide what the business strategy is going to be?

Again, I think that it would be important, if we want to protect national security, to keep our eye on those transactions that could result in foreign influence--in foreign ability to direct, determine, and decide these decisions.

Whenever an entity that is controlled by a foreign government makes an acquisition in the United States that falls within FINSA--and, therefore, within the scrutiny of CFIUS--this law already mandates that there is a presumption that the transaction will go into a second-stage review or an investigation. I think that is also an important safeguard. These transactions that involve Government-controlled entities are going to be looked at very, very carefully, and I think that is what Under Secretary McCormick was underscoring as well.

It is my understanding that the executive branch is mandated to promulgate regulations by next April in terms of the implementation of FINSA and that these regulations may address, update, and clarify the factors that the Government is going to consider when determining whether an acquisition would result in control by a foreign entity and the factors that the Government will consider in determining whether a foreign entity is, in fact, controlled by a foreign government. Therefore, I think this is a very important process that will take place between now and April and that in writing these regulations, it is going to be important for the executive branch to look carefully at other control tests that have been used and look carefully at some of the considerations that have been raised thus far in this hearing.

I think it is important, as well, that FINSA gives those agencies with security responsibilities an appropriately strong voice; it also gives the executive branch flexibility in defining when national security concerns are present, and this gives the administration the flexibility to recognize that national security may be touched by different considerations this year than it appeared that national security was touched by 10 years ago. This is an important aspect of the law, in my judgment.

I think that Congress and the administration should alertly monitor the new developments we are discussing today. But I think it is also important to recognize that Congress and the administration have worked together to put in place an effective law and an effective policy to address national security issues that may arise and that these equip us to address a future where foreign investments and acquisitions may well play a larger role in the American economic landscape.

Thank you.

Senator Bayh. Thank you very much, Mr. Larson.

Dr. Truman.

STATEMENT OF EDWIN M. TRUMAN, SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. Truman. Thank you, Chairman Bayh, Senator Webb. It is a pleasure to appear before you here this afternoon.

In my longer written testimony, which I have submitted for the record, I make five main points.

First, sovereign wealth funds and related vehicles for external or cross-border investments by governments have been around for a long time, are growing in relative importance, and are here to stay.

Second, the existence and growing importance of these types of vehicles raise profound questions about the structure and functioning of the international financial system, as was reflected in the introductory comments by various Senators.

Third, the continuation of these trends does not currently pose a threat to U.S. national or economic security, in my view, that cannot be dealt with under existing laws, procedures, and regulations.

Fourth, it would be desirable to consider possible improvements in the U.S. statistical information base on foreign-government-related investments in our country.

Fifth, the U.S. Government should continue actively to encourage foreign governments with large cross-border investments to develop and follow a set of best practices with respect to managing those investments in their interests, in our interests, and in the interests of the stability and openness of the international financial system.

The scoreboard on existing sovereign wealth funds, which I have developed with my colleague Doug Dowson, provides a starting point for the development of such a set of best practices for sovereign wealth funds.

In the remainder of my oral testimony, I will touch on my fourth point and elaborate a bit on my fifth point.

In my view, consideration should be given to improving our statistical information in this area. I summarize in my written testimony my understanding of the nature and limitations of our current data. It would be useful to know about, one, the data that are currently available or not available on U.S. assets and liabilities of governments and government-owned and -controlled entities, broken down by the nature of those entities; two, the costs and complexities for the United States of expanding the collection of such information; and, three, the prospects for encouraging similar efforts in other countries.

Now, turning to my fifth point, what should be done to make the world safer for sovereign wealth funds? In my view, large sovereign wealth funds--at least it got a laugh out of Mr. Larson. Large sovereign wealth funds should increase significantly their accountability to----

Senator Bayh. People laugh at my testimony all the time, Dr. Truman. Don't take it personally.

Mr. Truman. No, I was intending--I thought I might get a laugh. It is rare that my laugh lines get laughs.

Senator Bayh. Well, good.

Mr. Truman. In my view, large sovereign wealth funds should increase significantly their accountability--and I would like to stop and emphasize the issue is not just the question of transparency. It really is a question of accountability. Transparency is a means to accountability. Accountability is what we are after. Accountability first to the citizens of the countries involved; second, to our citizens and Government as well as to those of other countries; and, last, not least to participants in international financial markets.

The most promising way to increase the accountability of these activities is through the establishment of a standard or

a set of best practices for international investments in general and for sovereign wealth funds in particular. For sovereign wealth funds, best practices, in my view, should cover four broad categories: structure, governance, transparency and accountability, and behavior.

As I said earlier, to aid in the development of a set of best practices for sovereign wealth funds, my colleague Doug Dowson and I have developed a scoreboard for 32 sovereign wealth funds in 28 countries, which are listed in Table 1 in the testimony before you.

The scoreboard includes 25 elements grouped into four categories, and I want to emphasize that at least one sovereign wealth fund receives a positive score on each element, so I am not asking--maybe I should be, but I am not asking any--the collectivity to do anything that somebody else does not do, at least one other person does not do.

Table 3 attached to the testimony summarizes our results. Out of a possible 25 points, the highest score of 24 is recorded by New Zealand's Superannuation Fund, followed closely by Norway's Government Pension Fund at 23 points. The Abu Dhabi Investment Authority--ADIA--and its Investment Corporation--ADIC--in the United Arab Emirates record 0.5 points. The average is 10.27 points. Six of the ten largest sovereign wealth funds score at or below the average, including two of the three largest funds at the bottom of the table. One of the two is the Government of Singapore's Investment Corporation, called GIC. At the same time, Singapore's Temasek Holdings scores considerably above the average. I can answer more questions about this if you would like.

I endorse the Treasury's effort to encourage countries with sovereign wealth funds collectively and cooperatively to establish a set of best practices for those investment vehicles. The G-7, as you have heard, has embraced this approach to reinforce the global framework governing cross-border investment. The willingness of the Fund and the World Bank and the OECD to promote dialog on identifying best practices is also encouraging.

In the end, however, it will be the governments of countries that the sovereign wealth funds and their related activities that must decide that it is in their individual and collective self-interest to participate in those efforts. It is in our self-interest to facilitate that process.

Thank you very much.

Senator Bayh. Thank you, Dr. Truman.

Mr. Mulloy.

STATEMENT OF PATRICK A. MULLOY, WASHINGTON REPRESENTATIVE, ALFRED P. SLOAN FOUNDATION

Mr. Mulloy. Chairman Bayh, let me begin by thanking you, Chairman Dodd, Ranking Member Shelby, and Senator Webb for providing me the opportunity to testify today. I want to note that the views I will present are my own and not necessarily those of any of my employers. I also want to assure the Committee that I have no client, except the public interest, on these matters and have never been paid by any company or government or any other entity to advise it on foreign investment matters. I commend the Committee for holding this important hearing, and as an alumnus of the Committee staff, I am really honored to be here.

Senator Bayh. It is good to know that there is life after the Banking Committee.

[Laughter.]

Mr. Mulloy. It was terrific while I was here, let me assure you.

Senator, in May of this year, you had me up before the Committee to talk about China's exchange rate practices, and in my testimony then, we talked about the provisions of the 1988 trade bill and the responsibilities given to Treasury in that

bill--20 years ago almost--to identify countries that are underpricing their currencies to gain trade advantage. I told you in that hearing that Treasury had completely failed to carry out those responsibilities. I think one of the reasons we are here today to talk about sovereign wealth funds flows directly from the failure of Treasury to carry out those responsibilities given it by the Congress.

In June of this year, the Acting Under Secretary of the Treasury Clay Lowery made a speech in San Francisco to talk about sovereign wealth funds, and he said that these are Government investment vehicles which are funded by foreign exchange assets. So where do you get the foreign exchange assets to fund these? Trade surpluses are a big help.

So there are two aspects of these things:

One are the commodity funds, put together by the oil producers, and so they run trade surpluses because we are dependent upon imports of oil from them because we really do not have a good energy policy.

But the second part of this which Mr. Lowery identified were non-commodity funds. He said these are established through transfers of assets from official foreign exchange funds. In October of this year, the McKinsey group did a study on foreign sovereign funds. McKinsey told us that the Asian central banks will have $3.1 trillion in foreign reserve assets. It did so at the end of 2006. The study then went on to say, to put that amount in perspective, ``it is twice as many assets as global hedge funds manage and twice the size of global private equity.''

Now, these are huge amounts, and they are growing rapidly.

China's central bank right now has over $1.3 trillion in foreign currency reserves. Japan has $875 billion. The central banks of Hong Kong, India, Malaysia, Singapore, South Korea, and Taiwan together have another $1 trillion.

Now, the McKinsey study says--now, how are they able to accumulate these vast amounts of foreign exchange reserves? And the report put out by McKinsey says ``exchange rate management.'' McKinsey tells us that these governments have had these large current account surpluses, and they like it. So in order to maintain the money coming in, they intervene in currency markets to keep their currencies underpriced against the dollar. That way, they get the surpluses. We get the cheap goods. They get the money to put in sovereign wealth funds.

Now, it is very interesting. The McKinsey study said on page 78, ``For Asia''--and it is not just China; it is Asia--``the system has ensured the success of its export-led growth model and continuous and growing current account surpluses.'' Then the McKinsey study says, well, OK, what is the downside for the United States? They said the good side is we get a lot of good, cheap goods, and we get them invested in our Treasury to help us keep our interest rates down. What is the downside? They say we have a dollar, a higher dollar, which is propped up by the Asian central banks, which hinders our ability to export, particularly to Asia. We are getting some relief now on the euro because the euro is falling in value--I mean, is raising in value against the dollar. But we cannot--with Asia, they prop up the dollar. It harms our ability to export, and it knocks out our domestic industries that are competing against imports. It is a very--and then they say there are hazards for our country to be overreliant on foreign capital. I think these sovereign wealth funds are part and parcel showing that it is dangerous to be so overreliant on foreign capital.

Now, what are some of the problems? Senator Webb talked about strategic--that they can invest for strategic purposes. Mr. Lyons, who is here today, wrote a paper on that called ``State Capitalism: The Rise of Sovereign Wealth Funds,'' and talked about strategic investments in telecommunications, energy, the financial sector, or even to get intellectual property rights that they do not develop but that they can buy--that we develop or others develop.

Two, what is another problem? And, Senator Bayh, you talked about this. Chairman Cox of the SEC made a major speech up at Harvard at the Kennedy School a couple of weeks ago, and he made the point you made. We have not wanted to have our own Government owning large chunks of our economy, and the road that we are on now, we are going to have foreign governments owning large chunks of our economy.

Now, Mr. Cox said at least if our own Government owned portions of our economy we could presumably try to influence our own Government to carry out our wishes. Here is what he said about the foreign governments. If the owner, on the other hand, is a foreign government, ``the national interests a foreign government will advance will presumably be its own.'' OK. That is so clear.

Now, Warren Buffett, who I like very much--I follow him and I pay attention to what he tells me. He wrote an article in Fortune magazine in October of 2003 entitled, ``Why I'm Not Buying the Dollar: America's Growing Trade Deficit is Selling the Nation Out From Under Us.'' Selling the Nation out from under us. He says we are behaving like a rich family that has a farm and we are no longer earning our way in the world and we sell off portions of the farm to foreigners every year to maintain a lifestyle we are no longer earning. That, he said, is the trade deficit. He said it was imperative that we take ``action to halt the outflow of our national wealth.''

In 2005, he writes a letter to his shareholders, and he refers to the United States as moving toward ``sharecropper society.'' In other words, we are going to be working for other people because they are going to own us.

The Washington Post then put out an editorial in August of 2005 at about the same tine CNOOC was trying to buy Unocal, and the Post said Buffett's vision of where we are headed was ``distressingly plausible.'' And the editorial then went on to say ``the country is living beyond its means, spending more than it earns, and relying on foreigners to supply the difference.''

Senator Bayh. Mr. Mulloy, I am loath to interrupt, because I like you and I like Warren Buffett, we are a little bit over, and I would like to explore this with you in response to questions.

Mr. Mulloy. OK. I will make three key points.

One, we need an energy policy to reduce the outflow there.

Two, we have to understand these other Asian countries in particular are following mercantilist trade practices, and we need to address those. The bill reported by this Committee on exchange rates was very important. And in the provision that you have talked about, making these underpriced currencies and illegal export subsidy that should be countervailed, that is very important to get in that bill that you reported out of this Committee.

The third thing is, Senator Webb, keep an eye on that CFIUS process at the Treasury. There is going to be rulemaking, notice and comment rulemaking. The interests of the foreign governments and foreign investors are going to be all over that process, and I think a countervailing effort has to be made by this Committee to stay on top of that process, because Treasury in the past did not operate CFIUS the way you intended, and you had to amend it.

So those are my key points, and I thank you very much again, Senator, for the opportunity.

Senator Bayh. Mr. Mulloy, thank you very much.

Again, Mr. Mulloy, I apologize for intervening but I have some--part of having the gavel means trying to keep things more or less on schedule.

Mr. Mulloy. I understand.

Senator Bayh. Although, as you know, it is the Senate and we do tend to fall beyond. So thank you very much.

Yes, Dr. Lyons.

STATEMENT OF DR. GERARD LYONS, CHIEF ECONOMIST AND GROUP HEAD OF GLOBAL RESEARCH, STANDARD CHARTERED BANK

Mr. Lyons. Good afternoon, Senator Bayh, Senator Webb, members of the Committee. It is my pleasure and honor to appear before you today and offer views on sovereign wealth funds. Thank you for inviting me here to Washington to participate. I commend the Committee for devoting time to this examination of this issue.

I am going to offer brief oral testimony but I have, respectfully would request my written statement that covers the biggest 22 sovereign wealth funds be entered into the record.

I would like to talk about three areas. But before I do that, I should stress that sovereign wealth funds are both stakeholders and shareholders of Standard Chartered. Indeed, I met and sat with some last week when I was in the Middle East, so hopefully I'll give you some fresh thoughts.

But there are three areas I would like to talk about. First, the composition. Second, their possible impact on financial markets. And third, the strategic aspects of sovereign wealth funds that I think stresses the need for common ground rules.

First, in terms of composition, really I just want to reinforce the points already made. They are in the written paper. It is not just the size of these funds, which are $2.2 trillion and possibly more, in our view. It is difficult to contemplate fully how much or how big these funds will plump. In qualitative terms, they clearly are going to grow and therefore become far more important.

It is not just the size, as I say. Chairman Bayh listed what I call the super seven funds in his opening statement. But there is also the openness and transparency of these funds. One can differentiate between the funds. Some of them appear to be very transparent. They include Norway, Singapore's Temasek, Alaska, Malaysia and Canada's Alberta. Those funds provide detailed information on their size, returns achieved, and their portfolio composition. And many companies have seen these as investors without any apparent issues to date. One has to ask if these funds find it possible to provide such information and continue to perform as sovereign wealth funds, why cannot others?

In contrast, there are other, secretive, funds. They include the UAE funds, China, Qatar, Brunei, Venezuela, Taiwan, Oman, and Kuwait. And while secrecy in itself does not mean the funds will be a bad investor, in the global investor environment where transparency and accountability are seen as important positives, such opaqueness should be discouraged and openness clearly encouraged.

Second is their possible impact on the financial markets. I would stress that the source of these funds comes from four different areas. One has already been stressed, namely the movement in commodity prices. Second is the growth in foreign exchange reserves. And just to put that in perspective, a decade ago Asia held one-third of global currency reserves. Now it holds two-thirds. The bulk are still in dollars, although I would stress that, in my view, passive diversification from the dollar is already underway.

In addition to commodities and FX reserves, the third is clearly the investment performance. And fourth is what I would call the discretionary factor, how much a government wants to put into these funds. That is particularly important when one considers the new Chinese fund where, whilst in my view foreign exchange reserves in China will grow significantly--probably to $2 trillion by early 2009--it is not yet clear how much of that increase in reserves will be allocated to new funds.

Senator Bayh. What was your third factor, Dr. Lyons?

Mr. Lyons. Sorry, the investment performance of the funds. Basically how much money they are making.

They also will grow relative to other types of investors,

as has already been stressed. I think it is important to appreciate that in other parts of the world sovereign wealth funds are viewed as a force for good, particularly in emerging markets. And that is partly because of where I believe sovereign wealth funds are expected to invest their money. I would stress four particular areas, two of which come into the category of state capitalism, as Senator Webb mentioned in his opening statements.

In terms of where I expect the funds to invest their money: one, I do expect them to take bigger stakes in equity and bond markets across the emerging world. That makes sense in economic and financial terms. Second, I do expect them to feed more money into alternative investments such as hedge funds and private equity. And the third and fourth area which I would include under state capitalism, I believe that they will boost strategic links with countries that have not fully shared in globalization's success or, indeed, regions that have been shunned by the West. Africa comes immediately to mind. Although I would stress if a country wants to take a stake in such regions or areas, they do not have to just do it through sovereign wealth funds. And finally, I think they will take strategic stakes in sensitive areas within developed countries if, clearly, they are allowed to.

That leads on to the third and final aspect, which is the strategic aspect of these funds. I think this is very much in the case of trying to head off future problems rather than addressing the issue that is really big at the moment. In the paper I submitted, I said that my big concern is that these funds will see an opportunity to acquire strategic stakes in key industries around the globe, whether it be telecommunications, energy, the media, the financial sector, or indeed to secure intellectual property rights in other fields.

Whilst that can be viewed in a sinister way, I would also stress that it makes a lot of economic sense. If one is a low value-added country like China, then it makes sense to try and leap a few years by acquiring strategic assets that give access to intellectual property rights. Basically, countries will want to move up the value curve quickly. Of course, there may be other non-economic factors at play there. Also, buying into overseas firms will make sense for countries which are not thinking possibly of setting up sovereign wealth funds.

Reverse nationalism is an area that I think is already big, and that is basically the need to acquire strategic commodities and resources around the world. Not just energy but maybe hard metals and, indeed, soft commodities.

Despite that, I would argue a protectionist backlash against sovereign wealth funds would be damaging for global trade. I would reinforce some of the points already made about the need for sovereign wealth funds to be encouraged to adopt the best practice of open funds like Norway. I would also stress countries in the West to press for what I call the level playing field approach, to encourage the opening up of markets from which sovereign wealth funds emanate.

I think this is a particularly important point when we look at sovereign wealth funds. One of the reasons why I think they have become such a big issue is because of the imbalance to the global economy. For the global economy to become more balanced, it is not just a case of currency adjustment that is needed. One needs to see high savings regions like Asia and like the Middle East move away from export-led to domestic-led growth. Indeed, that is in their best interest as well, given their demographic profiles.

As they move toward domestic driven growth, part and parcel that process will be the opening up and deepening and broadening of their financial sectors. I think that is something that needs to be stressed. And that is a multi-year process which I think will address many of the issues here.

And of course, I would say and reinforce the point made that we need to try and improve the governance and transparency

of sovereign wealth funds and to promote an investment framework that is fair and commercial driven.

So finally, I would say the sovereign wealth funds debate is a further sign of the shift in the global economy, the shift in economic and financial terms. In recent years, there has been much talk about the need for global policy form to change. Whether they will change remains to be seen, but even if they do change, whether they will be effective again remains to be seen. But in this particular area, it is an opportunity for countries in the West to work with emerging economies, particularly those from where the big funds come, to basically get some ground rules and a common code of practice.

I would stress that the more sovereign wealth funds invest strategically, that would be a concern. Yet, as long as the investments by these funds are for commercial reasons and not for political purposes, then these funds should be accepted. But as clearly stated, there is lots of issues within that.

Senator Bayh. Thank you very much, Dr. Lyons.

Perhaps I should pick up where you left off. As I said at the beginning, and Mr. Mulloy was going on--I think appropriately so--and you mentioned as well, some of the forces that are leading to the reserves that enabled these funds to be created. It seems as if the macroeconomic factors are not going to be changing any time soon. So this phenomena is likely to continue.

So we want to see these dollars recycled into our economy. That is beneficial to us. But we want to insulate ourselves from any political agenda on the part of countries that have the sovereign wealth funds. So I would like to focus with all of you on that, perhaps, Mr. Larson, starting with you, and then Dr. Truman, and then Dr. Lyons. I am not leaving you out, Mr. Mulloy. I had another question for you, but my first two questions to you three gentlemen--maybe we can just go in order.

No. 1, should the best practices that we envision for these funds be entirely voluntary? And if they are, I think, Dr. Truman, you emphasized--and I think appropriately so--the notion of accountability. So if the best practices are voluntary, what should the accountability be if the best practices are not followed?

Mr. Larson. Thank you very much.

I do think that the international effort to develop best practices and get them adopted is an important one. My government career over 32 years was negotiation and I know that some of these can take a while. And I think that I would not want to offer undue hope that this will be quick and easy.

Having said that, I want to come back to the ``what if'' because I think that insofar as these entities are making acquisitions in the United States that have security implications, national security implications, that the law that Congress has put in place and the process that the CFIUS agencies run allows them to demand information with respect to a specific transaction, about the reasons why the investment is being made, whether it is political, whether it is----

Senator Bayh. Will the CFIUS process serves as a backstop to the voluntary nature of the best practices?

Mr. Larson. I think it is a safety net, sir, yes.

Senator Bayh. Is there any inconsistency in your mind about why we would not insist upon adherence to best practices from global investors when, for publicly held companies in our country, we would probably not countenance such a thing, voluntary standards?

Mr. Larson. Well, I think there is a difference.

Senator Bayh. In other words, if the SEC just said you know, the reporting requirements and that kind of thing, that is just best practices and you can follow it if you want to. And if you do not, the marketplace will do with you what it will?

Mr. Larson. I am glad you asked that question, because let

me zero in on some of the things that Chairman Cox said. I agree with the requirements that the SEC levies, and I do think that they protect investors and give confidence to investors. I agree with his comments that we have had, as Americans, a strong and correct desire to make sure that government is not conflicted as between its role as an owner of a company and its role as a regulator of an industry. And that was one of the things, I think, that was at the core of some of the remarks that the Chairman made in his speech at Harvard.

It is, in my judgment, a different set of issues that we face when we have foreign companies or entities and possibly government-owned entities making investments in the United States. And that is why the structure of the Foreign Investment National Security Act, I believe, took the form that it did. And it gave the executive branch tremendous authority to scrutinize, review, and if necessary prevent those acquisitions that would jeopardize national security.

Senator Bayh. I have only got 56 seconds left before I turn to Senator Webb, so I apologize. But I think you put your finger on an important point I wanted to make, which is I hope that the--and I was very grateful for the Under Secretary's comments and presence today. A lot of this will depend upon the zeal with which they enforce the new law.

In the past, it has been the perception of some that it has been largely a laissez faire interpretation of the regime that was in place. And perhaps they will have a bit more rigor going forward which, I think, would give a lot of people confidence in the fact that the appropriate framework may already be in place. But it is going to be dependant upon how they choose to enforce it. I guess that is what I--and some of us are going to be looking to see do they mean business here or is it going to be just kind of an anything goes attitude yet again.

And I apologize, Dr. Truman--thank you. I hated to interject, but I want to get to Senator Webb.

Dr. Truman, should it be voluntary? If not, how is accountability provided?

Mr. Truman. Well, I would--let me turn on the microphone, excuse me.

I would go the same place where Al Larson started from. In some sense, in terms of the national security dimension, we have a mechanism that--I would come at it the other way.

From the national security dimension, you have things that prevent--whether or not you have best practices. Right? Some foreign government comes in, buys something, does not tell us, we can throw them out of the country after the transaction is made, right, and have mitigation agreements and so forth and so on.

So the best practices, in some sense, has to do with the other things we are concerned about, right? The citizenship elements. Do we know what they are doing? Do we--what kind of things they are buying, whether they are passive investments, whether they--and so I think that is a--I would it the other way around.

You have the first line of defense, in some sense, is for government's own investments, is the CFIUS, whatever abbreviation you now call it.

And the second would be a set of best practices. I think to be successful the principle should be--as it is often called--comply or explain. If you have a significant number of countries who are following essentially the best practices, then the system--right--public opinion has a lot of leverage, a lot of leverage over countries and entities that are not following those best practices.

You can do it, if I may put it that way. You and your colleagues can do it. The newspapers can do it. And public opinion, since this is also in the interest of the people in the countries themselves, can do it.

Senator Bayh. If I could just interject, please go ahead and then I want to get to Dr. Lyons. But I am going to need to

get to Senator Webb. Two of the reasons that we are here today----

Senator Webb. Mr. Chairman, it is not a problem. I am interested in hearing this, as well.

Senator Bayh. Thank you, Senator.

Two of the reasons we are here today, Doctor. No. 1, the line between what constitutes a national security interest and what constitutes an economic or financial interest may not be quite as clear and bright as we would all like it to be. Part of that is a process of interpretation.

Dr. Lyons alluded to other countries perhaps having a strategic interest in acquiring our intellectual property, which if our national economic comparative advantage is going to be by being a more highly innovative economy and our intellectual property is bought for a few cents on the dollar, that has some potentially pretty significant ramifications for our country.

So that is just one example.

Mr. Truman. I accept fully that these lines are not easy to draw.

Senator Bayh. The second thing was what some of us would call the relaxed attitude of the administration on enforcing the previous regime.

Mr. Truman. We can discuss it. I favor a narrow approach personally. My judgment, and it is a matter of judgment and I understand it is a matter of judgment for a narrow definition of national security. But I recognize that there are other issues involved. There are issues involved whether you are a government-owned corporation or entity or not, about proprietary information and so forth and so on. Those are issues which extend, it seems to me, in the continuum extend from government to non-government and it is a very complicated issue.

I think it is appropriate that we have laws and rules and regulations in this area. I would note that, just to come back on the publicly held corporations, I mean it is true that outside of CFIUS itself, there are rules and regulations in terms of publicly owned entities that require certain disclosures when large--or even relatively small stakes--are accumulating, including your friend the Prince, the Saudi Arabian Prince. That had to be disclosed.

So it is not as if we do not--but on the other hand, I think it is in the interest of the countries involved, right, as well as our own, right, that there be more disclosure and accountability, including to the countries involved.

I say in my testimony that, in some sense, if this money is wasted, right, the biggest--which is one risk, right? You pursue non-economic objectives, right? And even if they are overall national security objectives and it is wasted, in some sense you get nothing on either dimension, right? Then the people who really pay are the citizens of the country involved.

And there are a lot of examples where that has happened already, whether it is Nigeria or Ecuador or appearing to be happening in Venezuela. So in that sense, accountability, in some sense, the biggest risk, in some sense, is to the countries' wasting their money. You can have issues about where the money came from in terms of the foreign exchange reserves. But at least as far as the commodity funds, it was dug out of the ground, right? And then the wealth became below ground, became above ground, and if it ended completely wasted, in some sense, the country in a longer term sense is much worse off.

And that also can have national economic and security implications for the United States if Venezuela, for example, implodes as a consequence of this process.

Thank you.

Senator Bayh. Dr. Truman, thank you. Dr. Lyons, I would love to hear from you, but I have run substantially over. Senator Webb has been very courteous, but I would like to turn to him and then maybe in a second round get back to you.

And I have not forgotten you, Mr. Mulloy. Do not worry.

Senator Webb.

Senator Webb. Senator Bayh, I would actually like to hear from Dr. Lyons on your question, if you do not mind. I did not anticipate we were going to get that long of an answer from Dr. Truman when I yielded a few minutes, but I would like to hear a little more if Dr. Lyons would care----

Senator Bayh. You were almost Senatorial in your response, Dr. Truman.

Mr. Lyons. Rather than repeat the comments that have already been made, and which I agree with, maybe just three different perspectives or three perspectives that reinforce.

One is, obviously this Committee is looking at things from a U.S. perspective. I would very much certainly encourage the Committee to try and view this in the multilateral basis and try and export best practice. If it is seen that the U.S. is putting up some blockages, justified or whatever, then the money from sovereign wealth funds will simply go elsewhere. I think it is therefore important to work with these funds to basically have best practice.

And best practice is only going to be adopted if the funds see it as being in their best interest, as well.

Senator Bayh. Well, we want the money and we would encourage them to follow best practices. The question is what do we do when they do not?

Mr. Lyons. Which leads on to China. It is interesting, I agree with the points about China's currency. When I go to China, it is very clear that financialism is how they approach all aspects of policy, including the currency. China, although it is one country, is a multitude of different economies, some of which are booming, some of which--Western Central China, Northeast part of China--have clearly been held back.

And Hu Jintao, the President, when he gave his policy speech earlier this year, was saying that even though China was growing strongly--indeed rapidly--it is not generating enough jobs at the moment for urban workers. It needs 25 million a year and it is currently generating 9 million to 11 million a year.

So when one looks at it from a Chinese perspective, they are almost very fearful of allowing their currency to appreciate more aggressively. And therefore, they approach financialism.

But what I find interesting is, in my view, the way the U.S. approach changed in recent years, rather than just focusing on the currency debate with China, but trying to package it as part of the need for China to open up and deepen its financial markets. I think that met with more reception in China, and I think that is the right way to proceed.

But I think it is inevitable that China will not allows its currency to appreciate too aggressively, but certainly one should encourage them to try and appreciate it further. But the point is that they will continue to accumulate reserves. We can all debate the speed at which they do so.

And the final point I would make about security, I think there is widespread global agreement about protecting areas of defense security. As you pointed out, it is very difficult beyond that. And indeed, in the U.K., in the Enterprise Act, the U.K. Chancellor, the Finance Minister, talked about areas of sensitivity, again far more vague.

But I think the important point is that for any investors, they need to know where the line in the sand is. And if one is to protect areas outside the defense, then that is in any country's--clearly in any countries' interest if they wish to do that--or agreement rather to do that. But I think it is important to actually know where those lines in the sand are.

But ultimately, I think we should be working closely to try and get best practice. But I think it will take time, actually, because many of these funds have only really come under scrutiny and under public domain in the last year. The more

they are in the public domain, under public scrutiny, then hopefully the more progress there will be.

Senator Webb. Thank you, Mr. Chairman.

I would like to request the Chair reset the clock, since that was not in response to my question. I would like to have a few minutes here.

Senator Bayh. The clock has been reset.

Senator Webb. Again, I would like to thank you for holding the hearing and to all the witnesses, I was very interested in all your testimony. I found it to be very illuminating. I took a lot of notes, a lot of things to think about.

From my perspective, I would just like to make it clear that the concern that I have, and I think a lot of people who see this the way that I do, is not foreign investment. It is foreign government investment. And that is something that is quite different.

And when we are talking about the individual transactions or the individual direct business activities that are going to be examined, there is another piece of that. And that is whether, in the aggregate, we might reach a tipping point with respect to one nation or another. It is a different kind of thing. In some cases, the economic and the non-economic factors tend to merge, just as the commercial and the political can tend to merge.

As I was listening to the testimony, one thought was going through my mind. And that is I do not think we have really yet come to grips philosophically with what is going on here. Dr. Lyons, you created a couple of terms here that I think are applicable. Mr. Mulloy, you talked about a sharecropper society in which that is basically the definition of colonialism, quite frankly, that somebody else owns the assets and somebody--another group of people does the work. One group gets the labor and the other group gets the profit.

But somewhere in here with this notion of state capitalism, we are emerging, in some cases, to a new form of national power. Very clearly, with the countries that are our competitors. It is a very unique situation to be in. It is almost--we went through colonialism and then we had socialism and then we had fascism with the government sort of accommodating large scale industry. And now we have state capitalism, and I think that is a very good term.

When it comes to nations that are in competition with us on a number of other fronts that affect a clear definition national strategy, we have to look at that. And we have to look at that not only in terms of individual transactions but the vulnerabilities that they are bringing to our ability to articulate our policy around the world. We can understand how this began. We can understand the inception of this, with the nations--particularly in Asia--having accumulated so much capital--or excuse me, so much money--that they want to invest and that is healthy when it is properly designed, that they do so in our country.

But I am just sort of curious. I would like to hear Dr. Lyons and Mr. Mulloy particularly, in the time that I have address this philosophical environment that we are moving into.

Mr. Lyons. I completely agree with the comments of Senator Webb. I think it is not just foreign investment. It is a differentiation between private foreign investment and state investment.

One phrase used in the U.K. is the Wimbledon effect, which relates to the first point about private investment. Basically, the feeling in England or Britain is that we have the best tennis tournament in the world. But Britain rarely ever wins it. But that is not the point. The important point is that the tournament takes place in London with all of the associated benefits.

The phrase is used, the Wimbledon effect, not so much for tennis but more because of the city of London. The city of London is seen as one of the world's major financial centers.

But the ownership, a very small part of it, is in British hands. Lots of it is international hands. And the important point is that that is the right thing. As long as you have the right legal framework, you have the right environment, then it does not really matter who owns the companies, who owns the business, as long as it takes place in London.

And I think that is the right approach. But as you say in your comment, it refers to the private sector part of the foreign investment.

When it comes to government involvement, it is a very difficult ball game for all the reasons we mentioned before. Governments approach things not just in terms of maximum short-term, maximum long-term return, it is maybe not to maximize returns for investors. It is very much a different set of criteria.

The interesting aspect is that this does not really just mean sovereign wealth funds. If one looks--let's take China as an example. China is investing heavily in Africa, not through China's sovereign wealth fund but through CMOOC or Petrol China. Indeed, one can argue China's Development Bank, Chen Yuan, the president there, have taken stakes overseas in Barclay's, et cetera.

Now all of this is justifiable in economic terms but all these different parts of China's ink, you could say, link back to the government. So when one starts to look at it in a government perspective, whether at different incentives structures, than it does actually have a profoundly different aspect. And therefore, it becomes very difficult to get the common ground rules to apply in that flavor.

The important point, I would argue, is maybe to try and step back and encourage China to open up its financial sector even further, one of the points I was making, and try and work with them so they see it as in their best interests to adopt the principles that we in the West see as in our best interest, as well.

Mr. Mulloy. Senator, thank you for the question.

Being on that China Commission for 6 years and reading the press clips that the staff would prepare for us every weekend--magazine articles, newspapers, everything--you begin to form some impressions of what you think is happening here. China was a great society, a great economy. They had a bad 200 years. They want it back. They tried communism and a collectivist economic approach. It did not work. Deng Xiaoping came in, in 1978, and he said, ``We need to have the Westerners, the foreign investors help us build our economy.'' And they provided all kinds of incentives and strategies to make that happen. And we have gone along, and many other foreign corporations have done so as well.

So there has been tremendous technology transfer, tremendous knowledge transfer. We have not fully grasped what is happening here, and we have no counter strategy. I am not out to demonize the Chinese. I mean, what the heck? If you were them, you would be doing the same thing. But they have a strategy, and we do not have any counter strategy.

This is an article by Peter Navarro that appeared March 13th. He is a business professor at the University of California, and he has written some books on China. He said, ``China may invest its equity funds strategically to established controlling interests in U.S. companies and thereby gain influence over decisions ranging from the offshoring of production and technology transfers to lobbying against U.S. legislation to promote fair trade with China.''

Now, let me just give you another one. This is from Inside U.S.-China Trade, September 12, 2007. There is an article here called ``Multinational Firms Begin Campaign to Derail China Trade Legislation.'' That is your bill, Senator. He said all the major exporters, importers, and firms with investments in China are all meeting to figure out--and they are being put together by the U.S.-China Business Council, the Retail Leaders

Association, ECAT, Chamber of Commerce, Business Roundtable. It is a lobby. It is a lobby----

Senator Bayh. It is always nice to be taken seriously.

Mr. Mulloy. I mean, really, it is an amazing situation.

So this is what I think we need to understand. There is a strategy. The U.S. Government, we need to really think and do some serious effort to have the committees of the Congress look into some of these things and begin to put together, just like we put together the 1988 competitiveness and trade bill, a new globalization bill to prepare us for this different kind of international economic competition that we are now in. And I think that is very important for the country to be doing, Senator, and thank you for the question.

Senator Webb. Well, thank you both for your responses. I am not one who is attempting to demonize China, either. I think that what we have seen over the past 36 years with China, being able to aggressively pursue relations with them, it has been very healthy. It is something that we probably should be thinking about with Iran. We have been able to bring them into the international community. At the same time, we have to recognize their size and the potential and the fact that they are a competitor, and we need to address those situations in a way that prevents us from further vulnerability, and that was my motivation--one of my motivations in asking for the hearing, and, Mr. Chairman, I thank you very much for having held it.

Senator Bayh. Thank you very much, Senator.

Mr. Mulloy, I think you addressed it. I was going to ask you about--oh, as long as we have the energy situation that we do and the trade situation that we have, and as I think Dr. Lyons pointed out, even the conscious currency policies that some countries have designed to promote domestic stability, we are going to continue to face the phenomenon that we are dealing with here today, and the question is: How do we responsibly deal with that? As I said at the outset, how do we get the advantages of the investment, but insulate ourselves from political pressure or an agenda on the part of other countries that may have interests other than our own.

And so with regard to the piece of legislation you mentioned, I would much prefer to have global currency markets establishing the value of respective currencies. But as long as some countries choose to pursue industrial policies, we have to think carefully about what the consequences of those are, and then act in accordance with our own interests.

Dr. Truman, you look like you are volunteering an answer.

Mr. Truman. If you will permit, Mr. Chairman, I just wanted to say on the record I agree 100 percent about this issue of the Government role, and I have said in my own writings--and I think the issue, if I may turn Gerard Lyons' phrase on its end, is state capitalism, the question is how much of it is state and how much of it is capitalism. That is essentially the issue that we have to try to sort out.

I would like to make one point on the question of the linkage of this to the imbalances. I agree with are living beyond our means, and that is a big problem. But let's say we magically went back to a current account deficit or a small--balance or small surplus or deficit. There actually still would be a case for a lot of cross-border investment because it is diversification. And it may not be so important for the United States, which actually has a lot more in terms of Government-owned, Government-managed--I mean, CalPERS and so forth and so on, and various Government-owned pension funds. We actually do have a lot of that, though it is structured in a way which is transparent and accountable and so forth and so on.

And that makes sense, even for the United States, which has a lot--we can diversify a lot within the country. It makes a lot more sense for Singapore to have a lot of diversification outside.

So even if we were in current account balance, in some sense, given the different governmental structures of the world

we have, even if we had current account balance and then built up an extra $10 trillion worth of--or net of $3 to $5 trillion worth--$2.5 trillion worth of debt over the last 24 years. The existing say $14 trillion on both sides would still be there, and in some sense raise all the same questions, right? Because we have different--because we would have our $14 trillion abroad, most of which was managed by private investors, right? And they would have their $14 trillion in the United States, a lot of which--of which a much more significant fraction was managed by governments. And that is the issue that you are raising, and I think it is a profound issue, and we cannot go remaking their governments. We can try to persuade them that our system works better, and my guess is that is what is going to happen over the next 25 years in some sense, just as with central planning. But the diversification motivation is still there, and we in some sense still have the same problem even in the absence--I agree with you entirely--of this overhang of living beyond our means that we have been living with for the last whatever number of years you want to pick.

Senator Bayh. Well, a lot of good issues have been raised here today, and, gentlemen--yes, Mr. Mulloy, you raised your hand.

Mr. Mulloy. I agree that we are in a bind now, that we need to get these best practices, and I agree probably the best way is to have a good CFIUS process that is quite aggressive and what we think the best practices are. And I do not think that will happen, Senator, without strong oversight from this Committee on the rulemaking and other things that go on in Treasury.

Senator Bayh. This Committee with the assistance of Senator Webb.

Mr. Mulloy. Yes.

Senator Bayh. Well, I think that is a good point, and, again, I want to thank all of you. I think there were some excellent points raised here today, and the first one being that there is a difference between foreign investment on the part of individuals or private entities and government-sponsored entities. That is No. 1.

No. 2, a good CFIUS process can backstop voluntary best practices. One of the hard parts about that is when is it a national security interest and when is it a financial or an economic interest and how do you differentiate one from the other and so forth.

I suspect that these imbalances will last for a while. You are right, it would make sense from a portfolio theory standpoint to diversify investments in any event, but I suspect what is happening today--and Mr. Mulloy would probably agree--is that we are at least temporarily maintaining a higher standard of living for us at the expense of our children and grandchildren, is what is happening here. And I do not think a great nation does that for long.

But that is a topic for another day and another panel, and until then I want to thank all of you for your time. Dr. Lyons, you have come a long way. We are grateful to you. And, again, thank you for your service to our country through your presence here today.

We stand adjourned.

[Whereupon, at 4:10 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

[GRAPHIC(S) NOT AVAILABLE IN TIFF FORMAT]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ALAN P. LARSON

Q.1. Please discuss the potential, if any, for systemic risk when Sovereign Wealth Funds invest in private equity, hedge funds, or regulated financial institutions.

A.1. Sovereign Wealth Funds (``SWFs'') invest capital that has accumulated in countries with financial surpluses. Their investments in financial institutions in the United States put that capital to work in our country. As a general matter, such investments reduce the systemic risk that would otherwise arise if capital surplus countries hoarded their surpluses.

Periodically, the international financial system comes under stress as a result of an excess of ill-considered investments in particular sectors, countries or instruments. The latest example of this phenomenon is the international financial disruption resulting from ill-considered investments in poorly understood sub-prime mortgage securities.

The sub-prime crisis resulted from, by and large, decisions by financial institutions in the United States. The sub-prime crisis elevated international systemic financial risk. Fortunately, the stability of the international financial system has been bolstered, and systemic risk has been reduced, by investments of ``patient capital'' from SWFs. The investments made by SWFs in financial institutions whose capital base had been badly eroded by investments in sub-prime investment vehicles have been stabilizing.

Q.2. Beyond choosing to invest through Sovereign Wealth Funds, what other means could countries with large current account surpluses employ? Are such other means more or less desirable than using Sovereign Wealth Funds?

A.2. Countries that accumulate current account surpluses could dispose of those surpluses in a variety of ways. The citizens of these countries are, of course, the persons in a position to decide which approach best serves their goals and objectives.

Most countries with large surpluses choose to devote part of those surpluses to the modernization of public infrastructure, including roads, ports and airports as well as social infrastructure such as health and education. Such investments make sense so long as they are well-targeted and subjected to rigorous cost-benefit analyses.

Countries with surpluses could choose to distribute a portion of those surpluses to their citizens in the form of grants or reduced taxes. Putting a larger share of the surpluses into the hands of the private sector is appealing.

At the same time, the citizens of some countries take the view that at least a portion of government surpluses should be invested in a way that creates returns for future generations. They believe that, after a certain level, the benefits of public sector investments or direct grants to citizens can be diminishing. These countries have chosen to invest part of their surpluses in funds or investment companies.

Q.3. Federal Reserve Chairman Bernanke has stated that he believes inflows of foreign capital into our markets, particularly to purchase Treasury bills and other dollar-denominated assets, have helped to keep interest rates low. In other words, the globalization of capital flows has benefited our economy by suppressing interest rates and maintaining the value of the dollar. Do you believe that Sovereign Wealth Funds can affect the value of the dollar or our domestic interest rates?

A.3. Chairman Bernanke is correct in asserting that foreign investment in the United States tends to lower interest rates and to support the value of the dollar in relation to other currencies. SWF investments in the United States have had this positive effect on our economy. Recent SWF investments in U.S. financial institutions have supported the capital base of these institutions, indirectly bolstering credit, growth and job creation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ALAN P. LARSON

Q.1. Do you have any evidence or reason to believe that sovereign wealth funds have invested based on, or shared, inside government information?

A.1. When sovereign wealth funds invest in the U.S. economy, the most important information relates to the firm or industry sector that is the target of the investment. In the transactions with which I am familiar, the foreign investors relied on investment banks and industry experts to assist the due diligence that guided their investment decisions. In my experience, SWFs and the governments whose money they invest do not have inside government information on U.S. firms or on the industries in which those firms operate.

Q.2. Do you have any evidence or reason to believe that countries have manipulated markets for gain in their sovereign wealth funds? For example, using the regulatory powers of the state to move market prices.

A.2. In the transactions I know about, sovereign wealth fund investors have not benefited from market manipulation. The SWF investors I know seek to comply with U.S. laws and regulations. Their home governments have not manipulated--nor do those governments have the power to manipulate--the international or U.S. markets in which the SWF invests.

Q.3. Do you have any evidence or reason to believe that sovereign wealth funds have used or had access to national intelligence or other state assets for their investment decisions?

A.3. I have not encountered instances when SWFs have used national intelligence to guide their investment decisions.

Under the new Foreign Investment and National Security Act of 2007, the CFIUS process will benefit from analyses by the Director of National Intelligence. I would encourage DNI to include in its analyses an assessment of whether a foreign investor has had access to national intelligence in making their investment decisions.

Q.4. Do you have any evidence or reason to believe that sovereign wealth funds have been used as a policy tool similar to how some state-run companies have been, most prominently in Russia?

A.4. SWFs differ significantly one from another. The ones with which I am most familiar operate commercially and are independent from government policy and government direction of their investment decisions. The SWF investments in the United States with which I am familiar have been used to advance commercial objectives, not the home government's policy objectives. The Foreign Investment and National Security Act of 2007 provides the U.S. Government with tools, which it should use, to investigate any proposed SWF acquisition when there is reason to believe that a foreign government might try to use that acquisition, to the detriment of the national security of the United States, to advance a national policy objective.

Q.5. Have there been any destabilizing effects of sovereign wealth funds, such as shifts of large amounts of capital?

A.5. Investments by SWFs have, on balance, promoted financial stability. They have recycled capital to the United States. In 2007, SWF investments bolstered the capital stock of fragile

U.S. financial institutions.

Most SWFs have a track record of being long-term commercial investors. Most SWFs have made diversified, minority investments. I am not aware of any instances where SWFs have shifted large amounts of capital in a manner that is destabilizing.

Q.6. We have CFIUS to look at foreign control for national security reasons. What do we have to look at political and economic security concerns of sovereign wealth (or other foreign) investments?

A.6. Congress was correct, in my judgment, in writing the Foreign Investment and National Security Act of 2007 in a way that keeps the focus of CFIUS investigations on possible threats to national security. Consistent with the President's broad responsibilities to protect national security, CFIUS has the flexibility to investigate potential national security threats that might arise from economic or political factors.

Some countries have engaged in screening of foreign investment based explicitly on economic criteria such as a ``net economic benefits.'' Congress was wise, in my view, to shun this approach. Markets rather than government policymakers are best placed to determine whether investments have a sound economic basis. The United States correctly has refrained from ``picking winners and losers'' and from designating ``national champions.'' The same American philosophy lies behind our decision not to have the Government decide, on economic or political grounds, which foreign investments to permit to take place.

Q.7. What tools do we have to monitor these investments?

A.7. I believe that the government's intelligence capabilities and its oversight of mitigation agreements provide the executive branch with tools it needs to monitor these investments. Congress has increased funding for agencies to monitor compliance with the mitigation agreements. The Executive Branch is obligated to report to the Congress on its oversight of mitigation agreements and should promptly inform the Congress if additional tools or resources are needed.

Q.8. China has been very active in traditional and economic espionage in this country. Are you worried they are using that information either to make investments or to pass information to companies they invest in?

A.8. The U.S. Government should actively use its counter-intelligence capabilities to defend against traditional or economic espionage. If there is reason to believe that a proposed acquisition by a foreign investor could be used to engage in espionage, that concern would be grounds for a rigorous CFIUS investigation. If the investigation confirms that a serious threat exists, CFIUS should take appropriate action to address the threat.

Q.9. The IMF is looking into voluntary best practices for sovereign funds. What other options do we have to learn more about what the funds are doing?

A.9. The IMF's work to develop a code of best practices is likely to expand information about the governance of SWFs, increase the transparency of their operations, provide a better understanding of the differences among SWFs, and offer greater clarity as to their investment strategies and methodologies.

When an SWF makes an acquisition that falls under the jurisdiction of the laws of the United States, our laws and regulations give the United States adequate tools to learn what we need to know about what the fund is doing. I recommend that

we place primary reliance on U.S. law to address the policy needs of the U.S. government.

Q.10. How can we leverage these investments in U.S. markets to get other countries to open their markets to U.S. private investment?

A.10. The Government of the United States should, and does, actively work to open foreign markets to U.S. private investment. The government uses a number of tools, including the negotiation of Bilateral Investment Treaties, to accomplish this. In addition, the World Bank has been an effective advocate in persuading foreign countries to reduce barriers to foreign investment. Country after country has come to see that private foreign investment brings a great boost for economic development and that barriers to such investment should be reduced or eliminated.

Using specific investment transactions as leverage to promote reciprocity in the provision of investment opportunities to foreign countries is neither necessary to encourage liberalization abroad, nor is it in the interest of the United States. We have adopted an open investment policy in the United States because it is in our own economic self-interest.

Q.11. Do countries with sovereign funds investing in the U.S. allow similar investments from U.S. private or government investment?

A.11. Each country that has established an SWF maintains a somewhat different policy towards foreign investment. In many cases, countries whose SWFs seek to invest in the United States have been quite open to foreign investments. Singapore, for example, has negotiated a Free Trade Agreement with the United States that has an investment chapter providing significant investment opportunities for U.S. firms. There also are substantial U.S. investments in Norway, Canada and those Middle Eastern countries which have government-owned investment companies.

In other cases, of course, U.S. companies still face significant investment restrictions in countries that are the home of sovereign wealth funds. The U.S. Government should make strong efforts to persuade these countries to open their investment markets.

Q.12. Are there any sovereign wealth funds being used to enhance the lives of the wealthy elites, while the general population suffers?

A.12. The SWFs with which I am familiar are directed to make investments that will provide broadly shared benefits for the citizens of their countries. Some government-owned investment funds are investing in order to finance pension benefits of their citizens. In other cases, SWFs have been accumulating assets for future generations, but the governments have not yet distributed the earnings of SWFs.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM PATRICK A. MULLOY

Q.1. Do you have any evidence or reason to believe that sovereign wealth funds have invested based on, or shared, inside or government information?

A.1. No. However, Chairman Cox of the FCC raised concerns about such issues in his Oct. 24th speech at the Kennedy School of Government at Harvard University.

Q.2. Do you have any evidence or reason to believe that countries have manipulated markets for gain in their sovereign wealth funds? For example, using the regulatory powers of the state to move market prices.

A.2. No.

Q.3. Do you have any evidence or reason to believe that sovereign wealth funds have used or had access to national intelligence or other state assets for their investment decisions?

A.3. No. I have no evidence, although it would not surprise me if they did.

Q.4. Do you have any evidence or reason to believe that sovereign wealth funds have been used as a policy tool similar to how some state-run companies have been, most prominently in Russia?

A.4. No. I have no evidence of that.

Q.5. Have there been any destabilizing effects of sovereign wealth funds, such as shifts or large amounts of capital?

A.5. Not that I am aware of.

Q.6. We have CFIUS to look at foreign control for national security reasons. What do we have to look at political and economic security concerns of sovereign wealth (or other foreign) investments?

A.6. You are correct. The CFIUS process currently examines the national security concerns of foreign acquisitions of controlling influence of U.S. companies. I think the Executive Branch interprets ``national security'' in the law governing the CFIUS process too narrowly. I believe that political and economic security concerns could be addressed in the CFIUS process if the Executive Branch carried out its CFIUS responsibilities in the manner intended by the Congress.

Q.7. What tools do we have to monitor these investments?

A.7. I am not aware that the U.S. government monitors foreign sovereign wealth fund investments or other foreign government investments in the United States. I believe the sole exception would be if such monitoring was agreed to as part of a CFIUS review of a foreign acquisition. Congress should enact legislation making the activities of foreign government controlled investment in the United States more transparent.

Q.8. China has been very active in traditional and economic espionage in this country. Are you worried they are using that information either to make investments or to pass information to companies they invest in?

A.8. The recently released Defense Department Annual Report to Congress entitled ``Military Power of the People's Republic of China 2008'' states on page 8 that, ``Officials from the FBI have identified China as running an aggressive and wide-ranging effort aimed at acquiring advanced technology from the United States.'' Thus, it would not surprise me if China targeted gaining access to key technologies as part of their government investment decisions in the United States.

Q.9. The IMF is looking into voluntary best practices for sovereign funds. What other options do we have to learn more about what the funds are doing?

A.9. The IMF codes, if developed and agreed upon, would not be binding on IMF member nations. Member nations of the OECD are also using that organization to examine and discuss the national security concerns raised by sovereign wealth fund investments. While I believe these multilateral efforts can be helpful in highlighting key issues and recommending best practices for such funds, I believe that the United States Government, perhaps after evaluating the IMF and OECD work products, should pass legislation imposing what it considers ``best practices'' on sovereign wealth funds. That way we would know what we think are the best practices could be enforced.

Q.10. How can we leverage these investments in U.S. markets to get other countries to open their markets to U.S. private investment?

A.10. China is desirous of making investments in the U.S., but as the February 2008 report by GAO entitled ``Foreign Investment: Laws and Policies Regulating Foreign Investment in Ten Countries'' makes clear, China prohibits foreign acquisitions in key industries and sectors of its economy. For example, CNOOC, which wished to purchase Unocal in the summer of 2005, could not itself be purchased by an American investor. We might with China enter into some kind of reciprocal investment agreement to gain leverage to open China's market to U.S. investment. We should not, however, waive our own national security concerns just in the interest of ensuring more open investment opportunities for U.S. firms abroad.

Q.11. Do countries with sovereign funds investing in the U.S. allow similar investments from U.S. private or government investment?

A.11. I refer you to the GAO report, ``Foreign Investment: Laws and Policies Regulating Foreign Investment in Ten Countries'', dated February 2008. GAO did this report at the request of Senator Richard Shelby, the ranking member on the U.S. Senate Banking Committee. It is a very good review of the foreign investment policies followed by a number of key nations.

Q.12. Are there any sovereign wealth funds being used to enhance the lives of the wealthy and elites, while the general population suffers?

A.12. While I have heard allegations along these lines, I have not studied the matter thoroughly. I do think that many of the trade policies being followed in the WTO and other bodies tend to focus on benefits for small groups within many societies and not for the populace of the countries as a whole. That is why within the U.S. and many other nations there is a growing resistance to ``globalization'' as it is now proceeding.

Q.13. Mr. Mulloy, I understand there is a relationship between China's accumulation of dollar-denominated assets--its $1.4 trillion war chest--and its efforts to keep the Yuan undervalued against the dollar. According to a recent survey of 18 exchange-rate studies by the Peterson Institute, the Yuan remains 40% undervalued, in spite of the dollar's recent fall against other currencies whose exchange rates are more market determined. China's accumulation of reserves and its deliberate, trade distorting policy to keep the Yuan undervalued are two sides of the same coin. I applaud Chairman Dodd and Senator Shelby for moving legislation out of this Committee to address the problem, and I hope they are able to persuade our Majority Leader to give it the priority it deserves. My question to you, Mr. Mulloy, is what effect would this legislation have on sovereign wealth funds, and what is the danger of Congress failing to use the tools it has

available to address currency?

A.13. On pages 4 and 5 of the prepared testimony I submitted to the Committee when I testified on November the 14th. I quoted from a McKinsey and Company report entitled, ``The New Power Brokers'', which examines sovereign wealth funds. That McKinsey Report tells us, on pages 77 and 78, that China and other Asian countries have accumulated huge dollar reserves through trade surpluses with the United States. It further tells us that exchange rate management, i.e. keeping the dollar overvalued by intervention in foreign exchange markets, has been part of their trade strategy, and has permitted them to acquire the dollars they have put in their sovereign wealth funds. As I noted on page 11 of my prepared testimony, the United States must craft trade policies to address the mercantilist trade practices being used by China and/or other Asian partners. I mentioned the Banking Committee bill to address currency manipulation in my testimony and strongly supported its passage. I also made other recommendations on pages 13 through 15 of my prepared testimony that we consider other legislation to combat China's IMF illegal currency practices. Their underpriced currency, as Chairman Bernanke noted in a December 2006 speech in Beijing, acts as an export subsidy. We should have a law to permit our industries to be able to bring countervailing duty cases against such a subsidy as you, Senator Bunning, along with many other of your colleagues have proposed.

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