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SOVEREIGN WEALTH FUNDS: FOREIGN POLICY CONSEQUENCES IN AN ERA OF NEW MONEY

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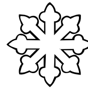

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SOVEREIGN WEALTH FUNDS: FOREIGN POLICY CONSEQUENCES IN AN ERA OF NEW MONEY

WEDNESDAY, JUNE 11, 2008

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC

The committee met, pursuant to notice, at 9:35 a.m., in room SD–419, Dirksen Senate Office Building, Hon. Joseph R. Biden, Jr. (chairman of the committee) presiding.

Present: Senators Biden, Dodd, Nelson, Menendez, Cardin, Webb, Lugar, Corker, Isakson, and Barrasso.

OPENING STATEMENT OF HON. JOSEPH R. BIDEN, JR., U.S. SENATOR FROM DELAWARE

The CHAIRMAN. The hearing will come to order, please. I apologize to the witnesses and my colleague for starting a few minutes late here.

We have a very distinguished panel this morning. I should start by saying that in the beginning of the year Senator Lugar's staff and mine sat down to talk about what hearings we thought were important ones to conduct. Back then the chairman said we should be holding hearings on—and I'm sorry it took so long, Mr. Chairman—on sovereign wealth funds. So I thank him for his leadership here and I look forward to hearing from each of you.

Most Americans know all too well from their trips to the gas pump that record oil prices are now overtaking the housing crisis at the top of their economic worries, anyway. On top of the weakness in consumer and financial markets, now we have the threat of inflation rooted in energy prices, adding to the pain and complicating the task of restoring growth and stability to our economy.

There is another effect of those high oil prices and our continuing dependence on imported oil. That is the historical shift which we saw back in the 1970s, but in earnest now, is the historical shift of wealth from our country to the oil producers, from Russia to the Persian Gulf.

At today's prices, the United States is sending $800 million a week to OPEC—every single—excuse me—every single day of the week, $800 million. In exchange for full tankers of their oil, we're sending them boatloads of money. Their bulging treasuries have now become powerful investment tools, so-called sovereign wealth funds, a phrase I think most Americans never heard of. Although

they've been around since the mid-1950s, only recently they have caught our imagination, attention, wonderment, and concern.

In addition to those oil-based funds, other nations such as China with export-based economies are accumulating their own large piles of money, which they are now using to buy assets around the world.

Today the Committee on Foreign Relations will look at sovereign wealth funds and examine their foreign policy implications. I want to thank again the ranking member, Senator Lugar, for urging us to focus on this.

Sovereign wealth funds are not new, as I've mentioned. In fact, the first sovereign wealth fund was established in Kuwait in 1953. Yet only recently have they found themselves in the public eye. This is partly due to the fact that they are big and getting bigger. Today analysts estimate that these funds are worth somewhere between $1.9 and $2.9 trillion, and some predict that by 2012 they could control $12 trillion worth of assets.

What should we make of all of this? Should we be concerned that the Governments of Russia and China control billions of dollars in assets and directly invest in U.S. institutions and companies? What threat does this exposure hold for us, if any? What financial imbalances does it create?

The IMF has called for an international effort to increase the funds' transparency. Where is the money coming from? Who controls it? Where is it going?

Some senior officials of this administration also seem to consider sovereign wealth funds as a serious risk. The Director of National Intelligence Michael McConnell said in testimony in February, "Concerns about the financial capabilities of Russia, China, and OPEC countries and the potential use of their market access to exert financial leverage to achieve political ends represents a major national security issue."

From the financial perspective, however, these funds could be an important source of capital in our global economy. Wealth funds can bring benefits to our economy. They have helped keep our banks afloat in the midst of the subprime mortgage crisis and ensuing credit crunch. They could offer a fresh infusion of capital to fuel employment and stimulate U.S. industry.

When Citicorp needed capital to stabilize its balance sheet after the subprime mortgage crisis, the Abu Dhabi Investment Authority injected $7.6 billion, or a 4.9-percent stake, in the bank and bailed it out. In fact, on his recent trip to the gulf Secretary of the Treasury Hank Paulson struck a very different tone than McConnell on sovereign wealth funds. He said, "America will keep our markets open at home to investment from private firms and sovereign wealth funds. We reject measures that would isolate us from the world economy."

Threat or opportunity, that's the question everybody's asking. Sovereign wealth funds have more than one dimension. They defy in my view simple definitions and simplistic responses.

We've called this hearing so we can get a better understanding of these funds: What are the threats, opportunities, and challenges along the way. As we move forward, I believe there are three issues that we should bear in mind, at least from my perspective. First,

we need a strategy to identify and deal with sovereign wealth funds which use their assets to achieve political objectives. We have already seen indications that Russia may be using its fund to promote strategic objectives, such as its recent interest in acquiring a large stake in Airbus's parent corporation. Similarly, Singapore's Fund has been linked to political turbulence in Thailand and Indonesia.

What should be our response? Greater transparency alone, at least in my opinion, will not resolve this issue. But punitive defensive regulation could be self-defeating, depriving us of potential benefits out of the fear of potential harm.

Second, I think it seems to me we have to strike an appropriate balance between protecting against threats and remaining open to economic opportunities. While we cannot overlook the national security implications of sovereign wealth funds, neither can we overlook their potential for providing needed investment and resources.

Finally, as we develop a policy toward sovereign wealth funds we should be careful not to confuse the symptoms with the cause. What I mean by this is these funds exist and are growing because we have no national energy policy in my view and no coherent trade policy. Short-sighted restrictions on international investment won't eliminate these underlying problems. We need to be smarter, more strategic, and more long term in our thinking, as we need to get our own house in order to reduce our economic vulnerability.

Our panel today is in a good position to offer advice on these funds. Let me emphasize again that I hope listeners don't confuse our interest in discerning how these funds function and whether they're good, bad, or indifferent with the underlying reason why these funds exist. This committee under the leadership of Chairman Lugar in previous years, and I've tried to follow suit with his help, has been trying to focus on those underlying causes, because the truth of the matter is until we deal with them we've got a real problem that goes well beyond the existence of these funds.

We have one of the best known and most respected voices from Columbia University, Professor Bhagwati. He's a noted economist and well-known financial commentator. He's particularly well placed to discuss sovereign wealth funds in the context of globalization.

Dr. Drezner comes to us from the Fletcher School at Tufts University and he's going to provide what I would characterize as a political science perspective, which I always like to have, to sovereign wealth funds. I'm surrounded by a lot of economists, but political science guys like me I keep looking for.

Finally, David Marchick, currently at the Carlyle Group and former official with the Clinton administration, is going to offer us a U.S. business perspective, although he spent considerable time in government as well, perspective on sovereign wealth funds.

I look forward to hearing each of their testimony and will end by again thanking the three of you for making yourself available. I know this is a pain in the neck and you have to alter your schedules to do it. But it's important to us and we truly appreciate it.

Chairman Lugar.

OPENING STATEMENT OF HON. RICHARD G. LUGAR, U.S. SENATOR FROM INDIANA

Senator LUGAR. Well, thank you very much, Mr. Chairman. I thank you for holding this hearing and I welcome, with you, our distinguished panel.

The rapid expansion in the number and the size of sovereign wealth funds is one of the most consequential international economic developments in recent years. The United States Treasury Department estimates that the number of sovereign wealth funds doubled between 2000 and 2005. As oil prices remain well above $100 a barrel, the incomes of oil exporting nations are soaring, as you pointed out.

By some estimates, these national investment reserves now hold close to $3 trillion. Russia has about $130 billion in its stabilization fund. Venezuela has an estimated $18 billion. News reports indicate that the Saudi Government is developing plans for the largest sovereign wealth fund in the world, which would exceed $900 billion. According to Treasury Under Secretary David McCormack, sovereign wealth fund assets are, "larger than the total assets under management by either hedge funds or private equity funds and are set to grow at a much faster pace."

The expansion of sovereign wealth funds is not an inherently negative development. They have infused helpful liquidity into international financial markets and in some cases promoted beneficial local development. Yet sovereign wealth funds are not ordinary investors. Their ties to foreign governments create the potential they will be used to apply political pressure, manipulate markets, gain access to sensitive technologies, or undermine economic rivals.

Some observers have argued that the primary goal of sovereign wealth managers will almost always be to produce a good return on invested assets. Consequently they are unlikely to engage in political or economic manipulation. Yet, producing a good return on investment is often stated as the primary goal of state-owned energy companies, but we have witnessed in recent years numerous instances of nations using or threatening to use their energy assets for political purposes.

In this context we must examine whether United States agencies have the resources and the expertise necessary to effectively respond to the policy complexities inherent in sovereign wealth funds. We also need to study how the United States, working with like-minded nations and international institutions, can promote transparency in sovereign wealth funds to reduce concerns about political and economic manipulation.

The high level of transparency demonstrated by the sovereign wealth funds of some countries, such as Norway, has shown that transparency can be internally beneficial. The Norwegian fund's transparency helps maintain public support for its investment strategy.

In addition, our government must find the right balance between promoting investment in the United States and safeguarding security interests through regulation. The United States rising government debt and continued dependence on foreign oil have intensified our reliance on foreign investment. We certainly do not want to

discourage healthy investments in the United States. As we have seen, some sovereign wealth fund investments helped provide potential stability to a number of United States banks.

The Treasury Department has undertaken efforts designed to balance our need for foreign investments with prudent safeguards. Domestically it has been working to improve accountability within the Committee on Foreign Investment in the United States for review of foreign government-controlled transactions and it is creating a working group on sovereign wealth funds.

Globally, the Treasury Department is supporting the International Monetary Fund and the World Bank in their development of voluntary best practices for sovereign wealth funds. It has also proposed that the Organization for Economic Cooperation and Development identify best practices for countries that receive foreign government-controlled investments.

In addition, the Securities and Exchange Commission requires that sovereign wealth funds disclose holdings of 5 percent or more in a public company and the Federal Reserve imposes a number of regulations on sovereign wealth fund investments in United States banks.

I look forward to this opportunity to discuss the foreign policy consequences of sovereign wealth funds, to examine with members here whether additional public policy responses are necessary. I thank the chairman again for the hearing and look forward to hearing the witnesses.

The CHAIRMAN. Thank you, Mr. Chairman.

A more detailed background about your careers will be placed in the record. I didn't want to take the time to do it now. Professor Bhagwati, it's an honor to have you here and why don't you begin, and then we'll work down the line, Dr. Drezner. The floor is yours, sir.

STATEMENT OF JAGDISH BHAGWATI, PROFESSOR, LAW AND ECONOMICS, COLUMBIA UNIVERSITY, AND SENIOR FELLOW IN INTERNATIONAL ECONOMICS, COUNCIL ON FOREIGN RELATIONS, NEW YORK, NY

Dr. BHAGWATI. Chairman Biden, Ranking Member Senator Lugar, and members of the committee, it's a pleasure and a privilege to be before this distinguished committee. As both of you pointed out, these are not, sovereign wealth funds, are not a new phenomenon, but they are new in the sense of the very rapid acceleration with which they've arrived and the speed at which things happen can of course create anxiety.

We have underlying reasons why we have got these SWFs, which Senator Biden referred to, and I think I want to turn to that a little bit toward the end, because you're dealing with a surface phenomenon, but we still have to regulate the surface phenomenon and react to the anxiety which is created by these.

Now, in the United States in particular, though you find some bit of this anxiety also in the European countries, but in the U.S. the political anxiety really comes from a variety of reasons other than the sudden acceleration of these phenomena which are so new in our public consciousness. One of course is it represents a dramatic reversal of the role which we have played, because we are

so used to investing abroad ourselves and being the top dog, the Rotweiler on the block, and suddenly we find ourselves in a state of what looks like dependence on foreign funds, particularly controlled by governments. So that's a double whammy, which I think naturally creates some anxiety.

When we teach in the classroom, we always say trade creates some political problems. Investment creates even more in terms of being able to sell it to the people and to allay anxiety. And immigration, particularly illegal, we know is a most acute problem. So I think we have to confront that particular fact.

The second reason why we have these—these anxieties—of course, is these are not transparent, as Senator Lugar in particular was pointing out. The nontransparency comes because several of the funds actually belong to countries which themselves are not democracies in the sense in which we are used to it, because good practices tend to spread. When you have good governance, democratic governance, you're accountable, like the hearing here and so on. But where you have authoritarian or sheikdoms and so on, there you don't have the transparency. It just runs right through the system.

Of course, it offers certain advantages, which I'll mention later, in terms of how to handle the SWF anxiety. But basically there's a good relationship, which I have a chart which I borrowed from one of my CFR friends, Brad Setzer, which shows the level of transparency as measured by an agency and the governance in terms of authoritarianism. It's amazing how good that fit is. So it's entirely understandable that you would have that.

But that, plus the fact that you are dealing with the UAE, China, Russia, which has sort of fallen out of favor, I think probably excessively so, all of these make you feel these are not countries which are really allies or sympathetic to our aims, and that is yet another factor which makes us worry, because if it was coming from Norway we wouldn't really bat an eyelid.

So I think all of this creates the worry that we're going to be dealing with governments and their funds which are actually—may be used for strategic noncommercial, political objectives. It's a perfectly reasonable worry in my opinion to think like that.

Now, of course we need to have a little perspective, which I say in my testimony, which is we normally don't have government investments abroad. We, of course, have aid programs and so on and so forth, but mostly we are into private investment abroad. But that doesn't mean that we leave politics out of it, because we have other instruments by which all of you actually try and influence political and economic and social objectives. Think of Helms-Burton, think of the free trade agreements, which are all in deep trouble because we want to advance social agendas, rightly or wrongly, but that is our objective.

So we have other sets of instruments, given the way we are set up in our system economically and politically, by which we actually advance the state agendas, while leaving direct private flows more or less alone. Now these other countries seem to be using—certainly through social welfare funds, sovereign wealth funds, we are actually—those countries are not using a multiplicity of instruments to advance their strategic objectives. So I think we need to

have a little bit of perspective on this in the sense that politics and economics cannot be divorced altogether, and not in our system either.

As Peter Mandelson wrote recently, one more perspective, which is that we've had them around for 50 years, not in the same degree, and there's very little evidence that actually, even from the Middle East and so on, people have actually used the SWFs in order to advance any real strategic political objectives. So the track record is something which is a little bit more comforting, if you want to say, look, does the past tell you anything about the future.

But let me now come just very quickly to why I'm not terribly worried about these in particular, because I feel that they're going to be very practical in terms of the way they invest. I was at a meeting in Florence with Tony Blair being in the chair and Joe Ackerman and others, a small group, and a big Chinese guy, high up, was there. He said—you know, Ackerman and Tony Blair both asked: What are you going to do about the SWFs and all the political anxiety? He said: Oh, we're just thinking now very seriously about simply handing over our investment portfolio to Goldman Sachs. Which means it takes the politics, the worries right out, aside from pleasing our Wall Street firms actually, so killing two birds with one stone.

The Chinese are a very practical lot and I suspect that model will probably work out with the UAE and others, because they don't want—they do want to invest abroad. We have to remember that, because they've got all these enormous funds, and they want to invest. When they see that we are worried about how it might be misused for strategic and political purposes, they'll try, regardless of cost and so on, try and do what is in fact necessary to make these palatable to us.

At the same time, right now we need the funds. You just have to talk to the former Secretary of the Treasury, who is now running Citigroup. He clearly is happen to get some infusion of funds. There's competition for these funds.

So we also I think are going to be not going off the some extreme measures and so on. So I think on both sides there is likely to be convergence toward a reasonable way of dealing with this particular anxiety. In my view, therefore, we don't need any codes. Of course, there's no harm in keeping all these economists and others occupied in the international agencies doing something useful. But I think essentially a code is necessary if you think the system really requires a whole lot of guidelines and so on and so forth. And I'm not a libertarian; actually I'm a Democrat. And I feel——

The CHAIRMAN. It's obvious from how well you speak. I knew that right off the bat. [Laughter.]

Dr. BHAGWATI. So I would say you need intervention when it is useful, but I don't think it's really necessary and you might just gum up the works, and this might resolve itself.

But we still have to do something at our end because, just remember the Dubai fiasco. I think we need to tell our committee in case it doesn't have it—all of you are lawyers and so you know about critical scrutiny, but you can have enhanced scrutiny for certain sectors. Now, of course the French would do it for Danon's Yogurt, which we are more sensible than that. But we could do it for

seaports, airports, and a variety of sectors where we think handing over the equity to a foreign power which might be hostile, which might be unstable, and so on—but I think it should be done across the board, not to provoke—not to fix on one particular country and so on. But it should be sectorially done, and there you could have enhanced scrutiny and Congress being involved right at the beginning, so we minimize the possibility of a Dubai kind of situation.

So that would be my recommendation that we really need to do. A final word on why this happened, and I think Senator Biden was absolutely right to say this is a surface phenomenon and we have to deal with it, with the political anxiety in the system, and you can't just take a purist attitude saying it'll solve itself and so on. I think the underlying problem is in fact the huge imbalances in the world economy right now and the food crisis has compounded it. But there's also a plus side too to the food crisis, foolish as it may seem, because countries like India, which has also accumulated large reserves, and we are more transparent in India, but the reserves are going to be used up to import the food.

So it's something where you're going to get a redistribution of surpluses and deficits and so on. So there might be some bright side to it.

But in the end I would say that unless you take some more fundamental measures like on oil, like you were suggesting, Senator Biden, that you really have to get at the dependence on oil, which means going very intensively into the substitutes, R and D financing, and so on, and even I think we've got to work hard at actually selling GM foods and so on, because in so many countries, because of the Europeans and the NGO concerns and so on—we talk of Frankenstein foods as soon as you get out of the United States, but on the one hand you've got Frankenstein looming large in the imagination, and if you indulge him, if you feed him, indulge him, then you've got the grim reaper facing you, and also the enormous amounts, amount of dependence on these.

So I think we have to take a fresh look at the underlying problems. It spills over to the environment as well. But I think we need a holistic approach to how to handle the underlying problems which are giving rise to these enormous funds in places where we're not entirely happy, that they're not the areas where you want these surpluses to arise. But I think that needs to be looked at, so the hearing cannot just be detached from the basic issues which you are raising, Mr. Chairman.

So that's mine.

[The prepared statement of Dr. Bhagwati follows:]

PREPARED STATEMENT OF DR. JAGDISH BHAGWATI, PROFESSOR, LAW AND ECONOMICS, COLUMBIA UNIVERSITY SENIOR FELLOW, INTERNATIONAL ECONOMICS, COUNCIL ON FOREIGN RELATIONS, NEW YORK, NY

Permit me to start with a few salient observations about Sovereign Wealth Funds (SWFs) before I proceed to policy implications.

SOVEREIGN WEALTH FUNDS

Sovereign wealth funds are over 50 years old, not an entirely new phenomenon. What is new is their rapid growth and the fact that they have spread almost worldwide, spanning many different countries. There are the so-called "Super

Seven" SWFs, each with assets of over $100 billion. They are in: Singapore (two), Abu Dhabi, Norway, Kuwait, Russia, and China.

By most estimates, SWFs recently exceeded $2 trillion already. Some forecast, using current trends, that they could exceed today's U.S. GNP by the end of 2020. Still, the overall world stock of financial assets is estimated variously in the range of $165 trillion and up, so that the SWF assets, while "large," are also "small."

What exactly are they? They represent government-controlled funds. So, typically (but not exclusively) they reflect either (i) monetary authorities' foreign investments (traditionally, central banks invested their reserves in foreign treasuries, rather than in equity) or (ii) more typically (in areas such as the Middle East) the funds that government entities have earned through exports of oil and other commodities (and which are typically beginning to invest in equity in the U.S. and other rich countries).

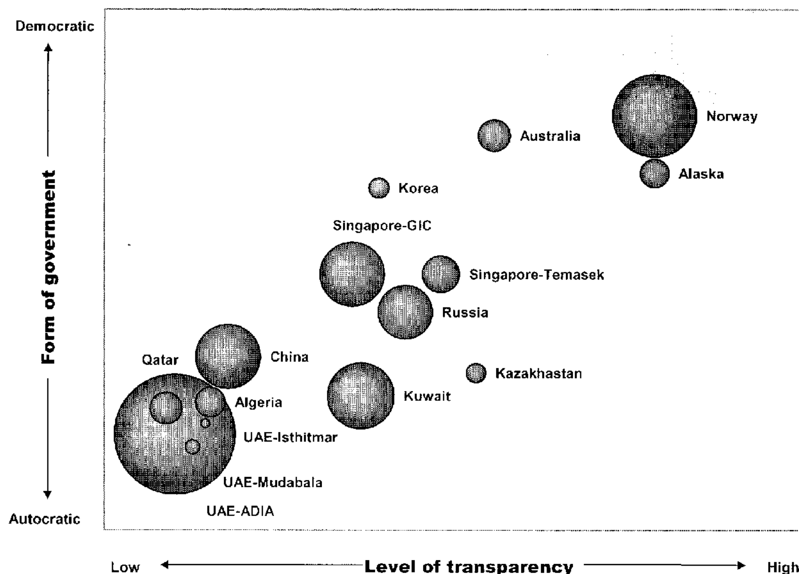
ANXIETY OVER SWFS

A general anxiety over SWFs has arisen for several reasons. First, we confront the sheer speed at which these funds have increased. The "role reversal" where we have others buy into our banks and businesses instead of being the top dogs ourselves, is a painful reality which makes many of our citizens uncomfortable. Second, many Western governments (including France and Germany) and their publics are worried about the "nontransparency" of these funds' investment strategies. With some, we know that they invest here; but we have little clue about their governance and decision criteria in any form or degree whatsoever. So, the fear has grown about their pursuing noncommercial criteria in investing their funds (sometimes referred to as "strategic" investing). In particular, the potential noncommercial aspect of the investment strategy by SWFs, has created a general anxiety that we are laying ourselves open to political exploitation by the governments that own these SWFs. Third, this fear is particularly likely to arise because the politics of these countries is not one that excludes potential rivalry and even political instability and/or hostility. Thus, in the United States, Chinese and Middle Eastern (SWF) investments have attracted particular opprobrium especially because these are areas where there is feared political instability (the Middle East) or even potential hostility (China and the Middle East). Even in regard to Russian SWFs, the continual Putin-bashing that has afflicted most of the media, and the hostile and jaundiced coverage of Gazprom, has added to the fear that somehow we are laying ourselves open to exploitation by a Russia that is undemocratic and moving away from us in democracy and from international policy convergence. Again, in regard to China, their equity investments lead to the fear, voiced daily by Lou Dobbs, that China is out to get our technology and to spy on us. He and his likes influence and feed uninformed public opinion on trade, immigration, and now China, with hardly any politician daring to take him on frontally: Only Senator Obama, to his credit, has denounced him in no uncertain terms while others have had their allies and spokesmen appear on his show without any sense of embarrassment or shame.

Let me elaborate on some of these observations; and then turn to the question of how to deal politically with this general anxiety over SWFs.

First, it is indeed true that many SWFs have limited or no transparency. The lack of transparency happens to have some correlation with whether the government controlling these funds is democratic or autocratic (i.e. "nondemocratic" in one way or another). In the chart below, my CFR colleague Brad Setser and his research associate, Arpana Pandey, have plotted the form of Government on the vertical axis and the Level of Transparency on the horizontal axis, showing how nontransparency and lack of democratic governance tend to go more or less together. This is not surprising. Democratic governments typically have to meet, in their governance and in their institutions, transparency standards that dictatorships and sheikhdoms do not have to. But because a fair number of such SWF countries are nondemocratic (e.g. UAE and China for sure), the nontransparency makes recipients of these funds afraid that noncommercial "strategic," political and social factors would prevail in the making of their investments.

SWF: Relationship between transparency and form of government



But remember that even transparency does not ensure that the SWF will not be used to promote noncommercial, noneconomic objectives. Thus, the Norwegian SWF proudly refuses to invest in sectors and countries which do not satisfy Norway's own menu of social responsibility criteria. Is it alright for Norway then to be influencing other countries' social policies while it would not want other countries to influence (in however limited and paltry a fashion) Norwegian politics? In fact, before outlining my views on what the U.S. needs to handle the anxiety over SWFs, let me proceed to put the SWF question in the context of the U.S. itself using private investment, aid and trade, among other phenomena to advance U.S. political and social objectives.

PUBLIC POLICY ON SWFS: PUTTING IT INTO CONTEXT

In deciding on Public Policy to address the anxiety over SWFs especially concerning their possible use of "noncommercial," "strategic" objectives, it is necessary to put the matter into context. Our own policies on private investment outflows and on trade, for example, are not free from attempts at advancing our political and social, broadly "noncommercial," agendas. At the same time, there is little evidence that SWFs have been used significantly for "strategic" investments.

Thus, we have used Preferential Trade Agreements (PTAs), such as Free Trade Agreements, to use our political and economic power to compel the smaller countries in one-on-one negotiations, to accept a variety of trade-unrelated, noncommercial objectives, ranging from environmental and Labor agendas to restrictions on the ability to use temporary controls during financial crises.[1] Important developing countries such as Brazil and India, both democracies, reject such PTAs with us, and with Europe, unless they are free from such political and social demands that piggyback on trade negotiations and advance unilaterally defined "noncommercial" objectives reflecting domestic politics and domestic lobbying agendas. I could also cite the deliberate use of trade retaliation under section 301 of the 1988 Omnibus Trade and Competitiveness Act to impose on others our own unilaterally defined views as to "unreasonable" practices which reflected our own political and social agendas: A practice that attracted worldwide opprobrium.

[1] These issues have been addressed fully in my book, "Termites in the Trading System: How Preferential Agreements are Undermining Free Trade," Oxford University Press, July 2008.

More importantly, the U.S. has often exercised pressure on private U.S. investors to conform, not to "commercial" criteria, but to national "noncommercial," "strategic" priorities and objectives. Most tellingly, the 1996 Helms-Burton Act was aimed at extraterritorial demands on foreign firms to advance the objectives of the Cuban embargo (which was operative in any event on U.S. firms). The act caused an uproar internationally, with the EU and Mexico denouncing the act and enacting counter-legislation, while the EU threatened to take the matter to the WTO. It is naive to believe therefore that we allow only strictly commercial objectives to guide the volume and direction of our private investment outflows. It would, in fact, be astonishing if politics were kept out of commerce in this pristine fashion in a constituency-and-lobby-responsive democracy like ours.

In fact, even private pension funds have been known to use political and other noncommercial agendas to seduce or intimidate foreign governments into compliance with these agendas, bypassing strictly "commercial" objectives. Thus my colleague at the Council on Foreign Relations, Ben Steil, has written in the Wall Street Journal (March 7, 2008) about such political investing by California's Public Employees' Retirement System, Calpers which has $259 billion in assets and "would rank fifth among the world's SWFs," and by the California State Teachers' Retirement System (Calstrs) which has $169 billion, the two together making California "the second largest SWF in the world, just behind the United Arab Emirates." Maybe foreign governments and impartial observers are not "anti-American" when they contrast our own behavior with U.S. anxiety over and demands on SWFs abroad.

By contrast, as Peter Mandelson (the EU trade commissioner) has written recently in the Wall Street Journal (June 7–8, 2008) that "In my meetings with them, sovereign fund managers have often bridled at being the subject of suspicion. They rightly point out that for more than five decades they have been quietly investing the proceeds of oil and gas wealth for future generations without raising the slightest concern. Some have standards of transparency that are exemplary."

WHICH WAY FOR U.S. POLICY ON SWFS

But U.S. policymakers cannot ignore the anxiety in the body politic, no matter how unjustified it may be. This became obvious during the uproar during February–March 2006 over the proposed purchase, after approval by the Committee on Foreign Investment in the United States (CFIUS), by DPW, owned by the government of Dubai, of 6 major U.S. seaports and takeover of management of 16 other lesser seaports. Dubai is an ally or a satellite, depending on your political viewpoint; but it is certainly not a hostile or unstable government. But the political uproar was quite enormous, accompanied by congressional hearings and widespread condemnation. My own view was that this fuss was entirely irrational. But, once the security issue had been raised, with sabotage feared from the Middle East, it made no sense to persist with it. Suppose that the sale had been approved despite the political tsunami. And then some sabotage had happened at one of the 6 ports (as is always possible). That would then have killed the possibility of a more enlightened policy in this regard.

To handle the politics of the issue, therefore, it is necessary now to develop a short list of sensitive sectors where "enhanced scrutiny" is exercised over inflows of funds, whether private or SWF, leaving all other sectors with free entry. The French do it and more for their "national champions" (which include, believe it or not, Dannon which produces yogurt). But we can be more sensible. Bipartisan involvement of congressional leadership on particularly sensitive investments (like seaport and airports) would also preempt later political surprises and embarrassments with political fallout in terms of our image abroad as champions of an open world regime on trade and investment. Indeed, we must recognize, and not compromise on, our openness which has been so rewarding to us (including to our workers as much empirical work shows that the pressure on our worker's wages cannot be attributed to trade and indeed some studies, such as mine, provide evidence that trade openness may actually have moderated the fall in real wages resulting from acute and repeated labor-saving technical change).

Do we also need an international, voluntary Code of Conduct on SWFs? This is the current thinking.

Mandelson states that the IMF is interested in masterminding such a code but that SWFs are suspicious of the IMF. We merely need to recall that, unlike the WTO which had an open and fiercely contested election where the Brazilian candidate was a close front-runner who lost to Pascal Lamy, the choice of the IMF Managing Director was basically regarded as a European prerogative. The newly emerging countries were denied the place, with the Europeans saying: Next time, not now.

It was reminiscent of the famous remark of St. Augustine in his bacchanalian youth: "Dear God, grant me chastity but not yet."

The OECD also wants to embark on formulating such a code. But its credentials are also weak: Except for Mexico and South Korea, it is a club of the rich countries who represent the countries receiving SWF funds, not the countries that own them. Unfortunately for the OECD, its attempt at formulating a code on multinationals revealed the flaw of such unbalanced representation. Its attempted code on multinationals failed because it contained mainly the rights of multinationals, and virtually nothing on their obligations (e.g. Corporate Social Responsibility) or on the rights of the receiving countries. The code should have been a tripod with all three legs; instead it had only one leg and the stool collapsed as critiques multiplied.

But, leaving aside the question of who oversees the formulation of a code, do we really need one? My view is that the problems currently about the SWFs will iron themselves out as both the SWF-investing countries and the investment-receiving countries have incentives to arrive at a workable solution without a bureaucratic code having to be formulated, with all the attendant compromises that leave behind much dissatisfaction.

First, the SWF owners have little incentive to get themselves shut out of desired investment outlets. So, they will surely hire Wall Street firms like Goldman Sachs to do their investing, for example: I heard a Chinese high official say precisely this when the SWF matter was raised at a small meeting I recently attended in Florence. [I might add that rewarding Goldman Sachs with a juicy contract would counter in the U.S. eyes the fear that the Chinese SWFs are going to be used for noncommercial purposes; it would also have the added advantage of pleasing Treasury Secretary Paulson.]

As for the U.S. and other rich countries, the enhanced influx of SWFs is, at least as of now, a matter of high priority. Where would Citigroup be without SWF infusion? Indeed, the competition for SWF funds is likely to be sufficiently intense for the U.S. and others to not create too many obstacles, and to put in place just a few procedures (such as the one recommended above for "enhanced scrutiny") to shield their political flank, in the way of the SWF investments.

Hence, the need for a code seems to be negligible; it is really a red herring.

The CHAIRMAN. Thank you very much, doctor. I read your statement and we probably all have. I'm going to, with your permission, have it placed in the record as if read because I think it's worth having in the public domain here, if you don't mind.

Doctor, the floor is yours.

STATEMENT OF DANIEL W. DREZNER, PROFESSOR OF INTERNATIONAL POLITICS, FLETCHER SCHOOL OF LAW AND DIPLOMACY, TUFTS UNIVERSITY, BOSTON, MA

Dr. DREZNER. Mr. Chairman, Ranking Member Lugar, thank you very much for allowing me to participate in this. Thank you also in particular, Senator Biden, for the kind words you had for political scientists. My profession is normally not praised so highly in this chamber.

The CHAIRMAN. I think very highly of it.

Dr. DREZNER. You're a wise man.

In the interest of time and keeping everyone awake, I'm not going to go into the background of sovereign wealth funds, which has been ably done by my distinguished colleague to my left, as well as by both the opening statements.

I would just give three take-away points from my testimony. The first is that, to use a health analogy, sovereign wealth funds are a symptom of much more serious health causes, crises affecting the United States. Sovereign wealth funds are fueled primarily by extremely high energy demand in the United States, which is giving rise to petrodollars in oil exporting and energy exporting economies.

It is also being driven by a large current account deficit, of which oil is obviously one part. There are a combination of factors driving this. Obviously one is the intervention in exchange rate markets by certain Pacific Rim economies that that will go unmentioned, and the other is a dramatically low U.S. savings rate, which is the fundamental way you're going to have to fix this problem.

In defense of these capital-rich economies, the reason you're seeing them develop sovereign wealth funds is that, frankly, they're sick of holding large amounts of dollar-denominated reserves. After you have a trillion of them it does make kind of sense to see if you can diversify your portfolio a little bit and try to earn higher rates of return. So it should be stressed that part of what they're doing is hardly malevolent in intention.

If you're really concerned about sovereign wealth funds, you need to address those fundamental problems. It should be pointed out that market forces to some extent are contributing in this direction. You're already seeing a devaluation of the dollar vis-a-vis the renminbi since early 2007 and the best way to create energy conservation is having oil prices at the rate they are now. It's painful, but it's also probably necessary.

The second point I would say is that as symptoms go sovereign wealth funds are relatively benign in their effects. In OECD economies, particularly the United States, the historic pattern of investments by sovereign wealth funds has been relatively passive and relatively long term in their intent. A study that was released this week by the Monitor Group showed that less than 5 percent of sovereign wealth fund investments in OECD economies have been intended—have been targeted for controlling interests in so-called strategic sectors; that on the whole sovereign wealth funds have been intended to pursue noncontrolling stakes or stakes that would not trigger the CFIUS process; and furthermore, that they were holding for the long term.

That's not terribly surprising. The comparative advantage of sovereign wealth funds in financial markets is that they can hold long positions. They presumably do not face the same pressure to maximize their short-term rate of return that private sector investment funds do. This is a good thing, I would add, because in the year to date I believe sovereign wealth fund investment in the United States has earned a negative 10-percent real rate of return. So it's probably a good thing, and the data suggest that the overwhelming majority of sovereign wealth funds, not all of them to be sure, but the overwhelming majority are interested in maximizing profit and not acting for geopolitical reasons, again for the reasons I was talking about before: They want to diversify their portfolios, they want to maximize the rate of return on their investment. So it's not terribly surprising that they're going to be interested in profits much more so than geopolitics.

Historically, the effect of having overseas investors controlling or having large investments in the U.S. economy has not in the end amounted to much in terms of the way of foreign policy influence. The reason is in times of crisis the assets are still physically in the United States. During World War II and other eras of crisis, foreign direct investment in the United States did not impair the functioning of the U.S. economy. So, although it is an interesting

specter to discuss, in the end in times of crisis the assets are here and that's not going to change any time soon.

Furthermore, I would add that prior waves of foreign direct investment by private actors, admittedly not public, there's been never any sort of suggestion that there's been any malevolent intent from those investments.

Furthermore, in this sense, once again due to the wisdom of the U.S. Congress, you already have an infrastructure in place to deal with concerns that sovereign wealth funds might bring up with regard to investments in strategic sectors and the fact that they are government-controlled entities, namely the FINS Act that you passed last year and the guidelines the Treasury Department is going to be issuing.

That combined with the regulatory procedures in place at the SEC and the Federal Reserve suggest that for once there is a problem that you actually have all of the institutions in place. I don't necessarily think you need to have further reform in the United States to deal with this kind of problem.

Now, all that calming logic said, let me offer one warning, which is in terms of foreign policy I think the one significant crimp that sovereign wealth funds pose to the United States is that they will retard significantly U.S. efforts at peaceful democracy promotion abroad. There are three reasons for this.

The obvious one is that most sovereign wealth funds are from nondemocratic countries and sovereign wealth funds presumably give these governments greater resources with which to maintain power, to buy off disaffected interests in their own country. It allows them to maintain state stability in their own country, not terribly surprising.

The less obvious reason is that the United States might not have incentive to want these countries to democratize. Here we're talking about the combination of anti-Americanism and nationalism in the countries that have the largest sovereign wealth funds, namely the Pacific Rim and the Middle East. This sort of combination will create if you have democratic governments, newly created democratic governments, they're not necessarily going to be big fans of the United States, and they might very well decide to take costly actions in order to punish the United States for what they see as past historical grievances.

While this would hurt their own economies, I would stress, it is a tendency of newly democratic governments to do things that might hurt themselves for costly political reasons.

Furthermore, it should be stressed that it is sovereign assets from democratic countries that are most likely to attach political conditions. All we need to look to here is our own country, where you see restrictions placed on, let's say, the California pension system in terms of investing in Sudan, or the Divest Terror campaign in terms of trying to place restrictions on investing in Iran.

One final point, which is that in the long term—and I don't think this is a huge possibility, but I do think you have to consider it—sovereign wealth funds are part of a component of a sort of state-led development approach, in which you're talking about sovereign wealth funds, state-owned enterprises, national oil companies, government regulations of the Internet, other extensive government

regulations, that appear to be succeeding in the short term at generating relatively large amounts of economic development.

The rest of the world is looking to see what is the best recipe for economic growth, and for decades we have told them the past is liberal free market democracy. If it turns out that sovereign wealth funds are a component of this alternative form of development, then suddenly our own sort of model is going to look less attractive and that's going to cause an erosion of American soft power. Fewer countries are going to want what we want.

Now, I should stress that I don't know in the long term if this model is viable. But if it is that is certainly a source of concern. Thank you very much.

[The prepared statement of Dr. Drezner follows:]

PREPARED STATEMENT OF DR. DANIEL W. DREZNER, PROFESSOR OF INTERNATIONAL POLITICS, FLETCHER SCHOOL OF LAW AND DIPLOMACY, TUFTS UNIVERSITY, BOSTON, MA

Sovereign Wealth Funds (SWFs) are government-controlled pools of assets designed to engage primarily in foreign portfolio investment. They are distinct from other sovereign assets—central bank reserves, state-owned enterprises and banks, and government pension funds—because of the emphasis on cross-border equity purchases. Their size, rate of growth, and national origins have raised concerns about whether and how SWF investments impact America's economy and foreign policy. This testimony focuses primarily on the latter.

In most respects, the growth of sovereign wealth funds has marginal effects on the contours of U.S. foreign policy. SWFs are, rather, a symptom of other national ailments—persistent macroeconomic imbalances and a failure to diversify America's energy supply. As symptoms go, sovereign wealth funds are relatively benign in their foreign policy effects. Indeed, SWF investment patterns have been less aggressive than the similar wave of Japanese foreign direct investment during the eighties. If anything, these investments demonstrate the ever-increasing interdependence of the Pacific rim and Middle East with the American economy. There is, however, one foreign policy wrinkle from the rise of sovereign wealth funds. Their growth will significantly impair America's democracy promotion efforts.

BACKGROUND

Sovereign wealth funds are not a recent invention—Kuwait created the first modern one in 1953. Nor are they un-American: The State governments of Alaska and Texas both have sovereign funds designed to manage the revenues that have arisen from their energy booms.

What is new is the size of recently created funds, their anticipated rate of growth, and their countries of origin. Over the past 3 years, these funds have been growing at a 24-percent rate. In 2007 these funds invested $48.5 billion globally; in the first 3 months of this year, they registered more than $24 billion in overseas investments. SWFs have been involved in high-profile equity purchases of high-profile financial institutions, lincluding Blackstone, Credit Suisse, UBS, Merrill Lynch, Morgan Stanley, Visa, and Citibank. The combined heft of sovereign wealth funds is currently estimated to be between $3 trillion and $3.5 trillion. To put this in the proper perspective, this is between 1 and 2 percent of global asset markets. Private sector analysts project that by 2015 their total valuation could range in size from $9 trillion to $16 trillion. In 2007, Russia and China created new sovereign wealth funds. Saudi Arabia created one this year, and press reports indicate that Japan and India might create their own funds in the near future.

Two kinds of governments are pumping the most money into sovereign wealth funds: Energy exporters and Pacific rim economies. For the oil exporters, the incentive to create a sovereign wealth fund is twofold. First, these economies want to create assets that ensure a long-term stream of revenue to cushion themselves against the roller coaster of commodity booms and busts. As many economists have observed, these countries are simply converting assets extracted from the earth into a more liquid form. Second, by focusing on foreign direct investment, these governments are attempting to forestall the Dutch disease of rapidly appreciating currencies. Overseas investment via sovereign wealth funds can accomplish both tasks simultaneously.

Export engines like China are also using sovereign wealth funds to keep their currencies from appreciating too quickly. As of 2007, China had accumulated more than $1.8 trillion in foreign assets in order to prevent the yuan from rising—and therefore keeping Chinese exports competitive in the United States. More than 80 percent of these assets exist in the form of foreign exchange reserves—safe investments with very low rates of return. As these reserves have accumulated, the Chinese Government has been willing to diversify its holdings into higher risk investments—hence the creation of the China Investment Corporation last year.

THE PATTERN OF SOVEREIGN WEALTH FUND INVESTMENTS

To date, the effects of SWF investment in the United States have been benign. The general consensus among financial analysts is that sovereign wealth funds have taken a long-term, passive approach to their American investments. The bulk of recent SWF investments has been for either nonvoting shares or stakes too small to trigger the CFIUS process—somewhat defusing concerns about foreign state control of the U.S. financial sector. A majority of sovereign funds have explicit policies preventing them from acquiring controlling interests, and most of the rest have implicit policies following the same course of action. Compared to the wave of private Japanese foreign direct investment during the 1980s, sovereign investments have been considerably less controlling. They have consciously avoided the purchase of "trophy assets" such as Pebble Beach or Rockefeller Center. The more mature sovereign wealth funds outsource the management of many of their assets to outside managers.

Indeed, the high-profile purchases of equity stakes have permitted firms like Citibank to recapitalize in the wake of the subprime mortgage crisis. The specter of China's SWF presence has also been exaggerated. While the China Investment Corporation (CIC) has $200 billion to invest, the bulk of its assets have been invested domestically. As of March of this year, CIC's overseas investment total less than $20 billion, though this is expected to grow. CIC's most notable foreign investment—Blackstone—was made by a subsidiary prior to its takeover.

The comparative advantage of sovereign wealth funds is that they can hold large positions for long stretches of time, weathering short-term panics and downturns (this is a good thing for them—between February 2007 and February 2008, high-profile SWF investments earned a real rate of return of negative 10 percent). If these funds are attempting to maximize profits, they would therefore function in a countercyclical manner akin to hedge funds. This kind of investment pattern does not pose a threat to American interests.

OVERALL EFFECTS ON U.S. FOREIGN POLICY

One foreign policy concern is that SWFs are sprouting up primarily in countries not commonly thought of as reliable U.S. allies. Could they use their stakes to exercise political influence over American firms? Testifying before the United States-China Economic and Security Review Commission in February, Alan Tonelson articulated this concern: "If, for example, the Chinese Government held significant stakes in a large number of big American financial institutions, especially market-makers, and if our Nation's current period of financial weakness persists, how willing would Washington be to stand up to Beijing in a Taiwan Straits crisis?" That same month, Senator Hillary Clinton observed: "You know, you cannot get tough with your banker. You cannot stand up if they have very different interests in the Middle East or in Asia than we do and they basically say, fine, you want us to dump dollars? Do you want us to pull our investments out?"

This fear rests on some tenuous assumptions. First, it presumes that foreign governments will know how to strategically invest so as to maximize foreign policy leverage. This might give governments too much credit. As Kenneth Rogoff pointed out in congressional testimony last year: "Governments have a long tradition of losing massive amounts of money in financial markets. This tradition is not likely to end anytime soon." Second, because of existing U.S. laws and guidelines, it is far from clear whether sovereign wealth funds could exercise malevolent control over firms even if they tried. The Foreign Investment and National Security Act of 2007 already requires heightened scrutiny when a foreign government-controlled entity acquires a controlling stake in a U.S. firm—and the Treasury Department's suggested guidelines suggest that CFIUS will investigate proposed acquisitions below the controlling level. Third, a cursory review of past waves of foreign direct investment reveals that in times of global crisis, what matters is the actual location of physical assets, not the identity of their owner.

Many analysts predict that capital exporters will possess bargaining leverage on regulatory questions. However, the tâtonnement process of bargaining currently

taking place between home and host countries of sovereign wealth funds suggests that concerns about transparency will be addressed. Last year the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD), in response to a G–8 request, initiated reviews of best practices for sovereign wealth funds appropriate inward investment regimes for recipient countries. Both international organizations have made reasonable progress in their remits, and experts in both organizations seem unperturbed by their investment patterns to date.

Individual sovereign funds are also adapting to the changed political environment. Two of the largest sovereign wealth funds—Singapore's Government Investment Corporation (GIC) and the Abu Dhabi Investment Authority (ADIA)—agreed to principles of transparency with the U.S. Treasury Department in March of this year. The head of CIC pledged on "60 Minutes" that his fund would match Norway's sovereign wealth fund in transparency. Singaporean officials have made it clear earlier this year that it recognizes the need for greater transparency in its investment plan. GIC's deputy chairman explained, "The greatest danger is if this is not addressed directly, then some form of financial protectionism will arise and barriers will be raised to hinder the flow of funds."

This last quote indicates why American foreign policy does not face significant constraints from SWF investment. The interdependence created by sovereign wealth funds cuts both ways. At present, the United States needs SWF investment to finance its large current account deficit. However, most other asset markets are neither big enough nor open enough to cater to large-scale sovereign wealth investments. Large market jurisdictions—the United States and European Union—should be able to dictate most of the rules and regulations regarding these funds. While the OECD economies—and prominent firms within these jurisdictions—might need SWF investment, it is equally true that capital exporters need America and Europe to keep their jurisdictions open to capital inflows. These two markets remain the only ones deep and liquid enough to absorb inflows in the trillions of dollars. Indeed, the very countries ginning up sovereign wealth funds at the moment are the most protectionist when it comes to foreign direct investment.

Sovereign wealth funds are unlikely to disrupt the functioning of the American economy. They are symptom of other problems. U.S. consumption is keeping energy prices high. A low U.S. savings rate, combined with the foreign manipulation of exchange rates, has allowed some Pacific rim economies to inflate their current account surpluses. Those are the macroeconomic forces that are causing foreign governments to expand their sovereign wealth funds. Addressing those problems sooner, rather than later, will go a long way toward eliminating sovereign wealth funds as a political hot potato. Improving the savings rate of Americans, for example, would help to reduce the large current account deficit that is fueling the growth of sovereign wealth funds in the Pacific rim. Reducing energy demand would also reduce the growth of sovereign wealth funds among energy exporters—though such a reduction would be partially offset by rising demand around the globe. Recent trends suggest that market forces are moving in the preferred direction. In recent years the Chinese renminbi has appreciated by 20 percent against the dollar. High prices will likely contribute to greater conservation efforts and reduced energy demand.

EFFECTS ON DEMOCRACY PROMOTION

The biggest effect of sovereign wealth funds on American foreign policy is their effect on democracy promotion efforts. These funds impact U.S. foreign policy in this area on several dimensions. SWFs aid and abet in the persistence of "rentier states"—governments that do not need their citizens to raise revenue. Democratization is a much more difficult policy for the United States to pursue when the target government is sitting on trillions of dollars in assets to buy off discontented domestic groups. Authoritarian governments in the Middle East and East Asia will be more capable of riding out downturns that would otherwise have threatened their regimes.

More generally, the growth of China's sovereign wealth fund belies the notion that as China grows richer it will become more democratic. Embedded within America's current national security strategy is the assumption that as China integrates itself into the global economy, it will face a growing demand from its own people to follow the path of East Asia's many modern democracies, adding political freedom to economic freedom. If the Chinese Government can blunt pressures toward democratization through its financial muscle, then the United States will need to recalculate its long-term approach toward Beijing.

More perversely, the growth of sovereign wealth funds, combined with rising nationalism and anti-Americanism in capital exporting countries, would give the United States even less reason to want democratic transitions in these parts of the globe. Consider the effect of a populist or fundamentalist revolution taking over in Saudi Arabia or the gulf emirates. Rampant anti-Americanism among the Arab populace could encourage a new government to purposefully sell off SWF investments in the United States in order to induce a financial panic. While such moves would also be economically costly to these countries, such actions are not inconceivable in the early stages of a revolutionary government.

Even if China or the Persian Gulf emirates were to democratize more gradually, one could easily envisage nationalist parliaments using their SWFs to constrain U.S. actions. Sovereign funds in democratic societies are more likely to inject political conditionality into their capital markets. In the United States, for example, interest groups have been eager to use America's financial muscle to alter the behavior of foreign actors in Sudan and Iran. There would be no reason to expect other democratic, capital-rich countries to behave differently.

Looking at the long term, sovereign wealth funds are one component of an alternative development path, suggests a possible rival to liberal free-market democracy. In state-led development societies, governments could use sovereign wealth funds, state-owned enterprises and banks, national oil companies, extensive regulation, and other measures to accelerate economic development, buy off dissent and promote technology transfer. If this model proves sustainable over the long run—and this is a big if—it could emerge as a viable challenger to the liberal democratic path taken by the advanced industrialized states. More countries might think of sovereign wealth funds as a signal of being a "successful" country. One could then envision the proliferation of such funds—even in situations in which there is no economic rationale for its creation. This would have corrosive effects on America's soft power. It would be an open question whether the rest of the world would look at the democratic development model as one to emulate. Crudely put, far fewer countries would want what America wants.

In conclusion, sovereign wealth funds have made headlines over the past year because of high-profile purchases of prominent firms. As long as global macroeconomic imbalances and demand for traditional hydrocarbon fuels continue to persist, SWFs are projected to grow at an accelerated rate over the next decade. Sovereign funds have, to date, played a constructive role in injecting liquidity into the global economy during the current period of uncertainty. There is little reason to believe that, on their own, sovereign wealth funds will exercise any significant constraint on most dimensions of U.S. foreign policy. Over the long term, the trouble with sovereign wealth funds is not that they will fail, but that they will succeed—in which case they pose a challenge to American national interests.

The CHAIRMAN. Thank you very much, Professor.

Sir, the floor is yours.

STATEMENT OF DAVID MARCHICK, MANAGING DIRECTOR AND GLOBAL HEAD OF REGULATORY AFFAIRS, THE CARLYLE GROUP, WASHINGTON, DC

Mr. MARCHICK. Thank you very much, Mr. Chairman, Senator Lugar. Thanks for the opportunity to participate. I will try to be brief for a couple reasons. One is that it is always the chairman's right to preempt and say what the witness was going to say and the chairman by definition always does it better.

The CHAIRMAN. No; that's not true, but I'm flattered you think I did. Thank you.

Mr. MARCHICK. So I think that you hit the nail on the head when you said let's focus on don't confuse the symptoms and the cause. All of this is driven by the huge and growing current account deficit that we are running, the combination of our trade deficit, our low savings rates, and our increasing dependence on oil combined with the high price of oil. Until we get those issues under control, which have huge public policy consequences and very difficult decisions, we're going to continue to see the changes that we're seeing today.

Part of this has resulted in the growth of sovereign wealth funds, which you and others have said are growing quite rapidly, $3.2 trillion today, going up to maybe 12, 13 trillion in 5, 6 years.

There is anxiety resultant from this because the investments are coming from nontraditional sources of investment in the United States. It's not just the U.K. or The Netherlands or Canada, which are traditional long-term investors, but it's now coming from China, the Middle East, Russia.

This reminds me somewhat of the situation 20, 21 years ago with Japan, where there was great concern on Capitol Hill. I think in July 1987 there was a press conference where Members of the House took sledge hammers to Japanese products. At that time there was great concern about whether Japan was going to buy up our assets, whether we were going to be eclipsed by the Japanese economy, and whether we were losing our leadership position in the world.

Well, what happened after that was that Japan went through a prolonged period of economic slump and the United States went through a period of great economic dynamism, where we were actually encouraging the Japanese to get their economy growing again. So none of the fears that occurred in the late 1980s actually came to pass. But today we're seeing some of the similar anxieties.

So the key issue for us I think as a nation is what do we do about this? It's been documented unequivocally by economists and others that foreign direct investment has a positive impact on the U.S. economy. It creates jobs, it creates high-paying jobs. There's a disproportionate investment in our manufacturing base, which is absolutely critical for our economy; that there's heavy investment in R & D; that overall it's a net benefit.

Most sovereign wealth funds are passive investors, so there shouldn't be any problem with passive investment. Senator Webb has done some I think very good work on this issue in the CFIUS context. If a company has a third party management, whether it's Fidelity or Goldman Sachs or like our 401ks, there's no control, there's no issue.

Then the issue is what if sovereign wealth funds take controlling stakes. In most sectors of the economy there should—there are no national security issues associated with investments, controlling investments in particular sectors—real estate, retail, most services, insurance, et cetera.

In a small subset of the economy, there are sensitive sectors where foreign investment does raise legitimate national security issues. Then the question is, Are our processes adequate and rigorous enough to address those threats? In my view they are and, thanks to the Congress, CFIUS has been strengthened and under the new law there is heightened scrutiny of any government-controlled investment.

Let me just give you 2 minutes on our own experience at the Carlyle Group. We have been around for 21 years. We invest in all sectors of the economy. We have two investments from government-affiliated organizations. One is CALPERS, which owns 5.5 percent of Carlyle, and the other is a company called Mubadala, which is based in the UAE, which owns 7.5 percent.

Both those investments are structured exactly the same. They invest in us, we have total control over how we invest, in what companies we invest, how we manage those entities, and when we exit, when we sell the companies. They have no seats on our board, they have no right to control our decisions. So they're completely passive investments, just like when you and I invest in Fidelity or our thrift savings plans.

They've been very positive investments and they've helped us expand our investment in the United States, which I think is a positive thing. What they're looking for is hopefully a good dividend, a good return, and hopefully we will do well with their money and meet their investment criteria. But they're completely passive and have no control over what we do or how we approach things.

So I think that overall we should welcome sovereign wealth fund investment in the United States. Most of it is passive, so there shouldn't be any concerns. And for those few investments where they do trigger national security issues, as Senator Webb has focused on this issue, there should be a very active, rigorous review by Federal authorities to determine whether there are any national security issues, and if there are CFIUS should either mitigate those concerns or block the investment. Otherwise, we should welcome the investments.

Thank you very much.

[The prepared statement of Mr. MARCHICK. follows:]

PREPARED STATEMENT OF DAVID MARCHICK, MANAGING DIRECTOR AND GLOBAL HEAD OF REGULATORY AFFAIRS, THE CARLYLE GROUP, WASHINGTON, DC

Chairman Biden, Ranking Member Lugar, members of the committee, thank you for the opportunity to testify, and for holding this hearing. I worked on foreign investment issues during my time in government and for the past 6 years before I joined The Carlyle Group, a global private equity firm. I am speaking as much from my previous experience as from my current perspective at Carlyle.

HISTORICAL CONTEXT FOR THIS DEBATE

Mr. Chairman, 21 years ago next month, seven Members of the House of Representatives held a press conference outside the Capitol where they smashed Japanese products with sledgehammers. At that time, there was great anxiety over the rise of Japan—over whether Japan was going to buy up our key assets, and whether Japan would eclipse the United States as the leading economy. None of those fears materialized. Japan subsequently went through a protracted economic slump where the United States was actually encouraging Japan to increase economic growth, and the United States entered one of the most dynamic periods in its economic history. Although Japanese investment stirred controversy in the 1980s, today, Japanese firms are part of the fabric of American society. In 2005, 613,000 Americans were working for U.S. affiliates of Japanese companies.

Today, similar fears are being raised about another growing source of investment—from Sovereign Wealth Funds (SWFs).

Just as with respect to Japan in the 1980s, a significant amount of today's anxiety exists because foreign investment is coming from new countries. For example, in 2006, the United Kingdom, Switzerland, the Netherlands, and Japan accounted for almost 60 percent of the cumulative stock (e.g. the cumulative amount of investment) of Foreign Direct Investment (FDI) in the United States but only accounted for 31 percent of the inward flow (e.g. the amount invested in that year). Other countries, including developing countries, are becoming much larger outward investors. This represents a dramatic shift in the paradigm that we have seen for many years—China, Brazil, India, and Russia have traditionally been large recipients of FDI; today, they are starting to be significant sources of investment. From 2000–2006, outward FDI from China grew 6.9 times, from Russia 5.9 times, and from some Middle Eastern states more than 35 times.

Also evident is the fact that investments from developing countries are more likely to be affiliated with government ownership than are cross-border investments from developed countries. Of the top 100 multinational companies in the world, only 5 are government-owned. By contrast, of the top 100 developing-country multinational companies, 25 are government-owned.

Sovereign wealth funds are also becoming larger sources of cross-border investments. Sovereign wealth funds have been around since 1953, when Kuwait, then controlled by the United Kingdom, established the Kuwait Investment Authority. SWFs invested either directly or through asset management firms in relative obscurity until the last couple of years, when the growing size and number of SWFs attracted the attention of the press and officials primarily in the United States and Europe.

There have been two predominant factors driving this growth: Higher commodity prices, primarily in oil; and growing current account surpluses, particularly in Asia. Much of the growth has occurred in the developing world, including China, Russia, and the Middle East, and there have been more high-profile investments from government-affiliated entities. The growth in SWFs has come at a time of overall growth in outward investment from developing nations.

While the number and size of SWFs has grown in the past few years, SWF investments represent a small slice of the global investment market: In 2007, the value of SWF mergers and acquisitions (M&A) activity represented only 1.6 percent of total global M&A volume. The percentage may be larger in 2008, but overall will still represent a small component of global investment.

Sovereign wealth funds have a lot of money—$3.2 trillion according to some estimates—but are tiny compared to the $52 trillion in global pension and mutual funds and even smaller when considered in the context of the more than $160 trillion in global financial assets. Further, while there have been a number of high profile investments, the vast majority of SWF investments are for passive, minority stakes. SWFs have, in fact, served as an important source of stability at a time of great uncertainty in financial markets.

SWFS AND FOREIGN POLICY

The regular flow of investment from SWFs does not, in my view, give rise to foreign policy concerns for the United States. The U.S. benefits from foreign direct investment—it creates jobs and fosters growth. SWFs have been investing in the United States for decades without any problems. To my knowledge, no sovereign wealth fund investment has compromised the United States' or any other country's national security.

In fact, most SWF investment is completely passive and/or managed by third party investment managers. For these investments, it is hard to even create a hypothetical foreign policy or national security concern that could arise. Even where SWFs take controlling stakes in companies, most transactions do not raise any national security or foreign policy concerns. For example, there should not be any national security concerns associated with investment in most sectors of the economy, including the retail, real estate, or hospitality sectors, each of which have been the focus of SWFs. For those investments in more sensitive sectors, the United States has a robust, layered set of laws and regulations that protect important governmental interests associated with any investment, sovereign or otherwise. Last year, Congress passed the Foreign Investment and National Security Act, which strengthened the foreign investment review process in the United States. FINSA protects against threats to national security, and CFIUS has demonstrated its willingness to block or mitigate problematic investments. Other laws and regulations are in place to address other government interests, including antitrust, consumer welfare and safety and security. Even if there were cause for concern associated with sovereign wealth funds, our existing legal and regulatory structure should capture and fix—or block—any problematic investments. Bottom line: When foreign entities invest in the United States, the U.S. is sovereign, not them.

By contrast, official or even informal actions to restrict SWF investment in the United States could cause foreign policy problems, or at a minimum, create unnecessary tensions with our allies and nonallied sources of investment. Legislative or regulatory steps to restrict SWF investments will not only cause harm to the U.S. economy, but also alienate countries which are critical allies on a variety of issues that are core to U.S. interests. Actions to curb SWF investment would not only impact China and Russia, it would also negatively impact Australia, one of our closet allies; Singapore, with whom we have a strategic defense alliance; and the UAE, which has troops in Afghanistan and is a critical ally against extremism in the Middle East. Even unofficial actions—including politicization of investments—can have a

negative impact on the U.S. economy and U.S. national interests. Several significant sovereign wealth funds have recently stated that they will look to invest outside the United States or Europe because of the political environment. This unfortunate development harms our economy and potentially causes unnecessary tensions with other countries. Finally, if we start blocking investments in the United States, we can be certain that other countries will retaliate against U.S. investment abroad. Since the U.S. is the largest source of FDI in the world, we have more at stake than any other country in the world.

Mr. Chairman, SWFs are growing fast because of high energy prices and our large current account deficit. American dollars are going overseas, and SWFs are one important way that foreign countries can recycle these dollars. I would much rather have SWFs invest in the United States than abroad—their investments creates jobs, economic activity, and opportunities for American firms and workers. Their investments further integrate these countries into the global economy, and align their interests with those of the United States. These investments also could help create economic security and a stronger middle class in the source countries, and as we know well, a vibrant middle class is an important source of stability.

In my view, a more important foreign policy and national security concern is the United States' growing dependence on foreign countries to finance our current account deficit. At $738.6 billion in 2007, our current account deficit now accounts for about 70 percent of the world's total across all deficit countries. Beyond traditional surplus countries like Japan, fast-growth countries such as China, Russia, and Saudi Arabia have assumed a larger financing role. There is nothing unhealthy about foreign financing of deficits. However, the unprecedented size, trajectory, and sustained nature of our deficit, combined with growing structural imbalances, does raise concerns.

We have little control over some of the factors leading to these structural imbalances. For example, some countries are clearly intervening at significant levels in order to lower the value of their currency. And the U.S. is uniquely positioned to continue to attract large amounts of investment to finance our deficit. But we can and should take steps to reduce the growth of our fiscal deficit, to encourage greater private savings rates in the United States, and to reduce demand for oil.

CARLYLE'S EXPERIENCE WITH GOVERNMENT INVESTMENT ORGANIZATIONS

I'd like to take a moment to explain The Carlyle Group's positive experience with two investments from government-affiliated entities. First, the California Public Employees Retirement System (CalPERS), the largest public pension fund in the world, acquired a 5.5-percent interest in Carlyle in 2000. Second, the Mubadala Development Company, a firm that invests funds on behalf of the government of Abu Dhabi, purchased a 7.5-percent stake of Carlyle in 2007. The terms of these investments are pretty simple: CalPERS and Mubadala acquired passive stakes in Carlyle. They exercise no control or influence over our investment decisions. Their investments have allowed us to create strong U.S. companies, grow jobs and spur innovation. CalPERS and Mubadala each receive a quarterly or annual financial report, and we will work hard to produce an attractive rate of return for both entities. Both CalPERS and Mubadala are sophisticated investors, and we are grateful for the confidence they have shown in us.

SUMMARY

In summary, SWFs are having a positive impact on the United States and international economies. They have proven to be a source of capital for the U.S. at a time of volatility in our financial markets. Indeed, if some of our largest financial institutions did not receive large infusions of capital from SWFs late last year and early this year, it could have led to economic disorder, which itself conveys a sense of weakness and vulnerability.

To date, SWF investments have been typically passive, minority stakes. For active, controlling investments, the United States has a proven set of laws and regulations that protect our national interests associated with any foreign investment. Barring a particular problem with a particular transaction, our doors should be wide open to foreign investment. Formal or informal steps to close our economy or restrict investments would not only harm U.S. interests but also unnecessarily cause tensions with our allies and other countries with which we have important strategic objectives.

The CHAIRMAN. Thank you very much. Thank all of you.

Mr. Chairman, 7-minute rounds?

Senator LUGAR. Yes.

The CHAIRMAN. We have good attendance and we'll do 7-minute rounds.

To state the obvious, there's a number of questions I'd like to ask, but I'm sure that my colleagues will ask them as well. I'd like to focus on something and maybe go to you, doctor, the political scientist in the group here. There's something that I'm a little more concerned about that's a more subtle influence. The subtle influence, quite frankly, that I focused on, and none of my colleagues nor any of you may think is worth the concern and I'd be anxious to hear if it's not and it would allay my concerns. But I think there is a subtle impact on our conduct of foreign policy when investments in the United States affect the powerful groups in which the investments are made, for them to determine and put impact on the Congress and the President ought curtail and/or enhance a certain foreign policy action.

So that, let me overstate the case for a minute. One of the things that's become clear to all—I'll speak for myself—clear to me is that our overwhelming dependence on imported oil, coupled with our low savings rate and coupled with particularly the Chinese, at least in my view, policy of mimicking what Japan did and expanding it multifold in the first decade of the 20th century regarding exports, has put us in a position where those nations whose conduct we wish to influence toward a more benign or, how can I say it, to be more responsible actors in the international community have no reason to have to listen to us. They're floating in a sea of oil.

I mean, can you imagine Putin's circumstance in Russia in terms of the impact of any pressure relating to his de-democratization of that country were he not floating in a sea of oil? If oil had gone down, as predicted by the administration, to $10 a barrel after we went into Iraq, where would Putin be at this moment? In a very different position, to take one example.

Conversely, it has profound impact, as the Chairman has pointed out, on the willingness of our friends to act in my view responsibly, because they are held hostage by oil. I'll make a very subjective comment. I think the Chairman and I both agree that the expansion of NATO, including the preliminary steps for Ukraine, would have been a positive thing. Well, Russia used oil as they used their 40 divisions prior to the collapse of the Soviet Union to basically in my view say to the Germans: You've got a real problem; you go ahead and vote to expand NATO by bringing the preliminary steps for Ukraine, we may, figuratively speaking, cut off the spigot.

So it has profound impacts on our foreign policy. I'm not picking on Russia, doctor. I am not one who views they should be kicked out of the G–8. I'm not—if you know, any of you know a little bit about me, I am not saber-rattling about it. But I think it's a statement of fact that there's real impact, that is subtle and not clear to the average American or European or anyone.

So, having said that, I think you add on top of that, if there is an overall by the year 2012 or 2015—if you have an $8, $10 trillion investment benefiting—benefiting the United States economic growth engine—but particularly benefiting those who control the growth, I think it becomes much harder and divides us up here when the President would come along and say: We're taking the

following action against Saudi Arabia for reasons unrelated to sovereign wealth funds, or Russia or China or whatever.

You see the pushback—let's argue that it's totally legitimate. You see the pushback that comes from American manufacturers. You see the pushback that comes from IT companies when we say to them, whoa, what the hell are you doing turning people over to Chinese authorities for violation of human rights—I mean, for violation of Chinese law? What are you doing? They say, whoa, hey, man, you guys shouldn't be legislating in this area; it will cost us a lot of money.

You saw the impact when they sent us dogfood. If that dogfood had come from France, we'd have cut off that brand like bang. It'd be done, finished, gone, over. It would have been done within 2 days. But it was China and there's a whole hell of a lot of American investors who view, as the overused phrase, why invest in China, why Willy Sutton robs banks, robbed banks? That's where the money is. That's where the people are.

So I'm sure, as an old friend of mine used to say, you understand my point. I'd like you to comment on it. What about the subtle impact on domestic American pressure from major patriotic—I'm not making any claims about patriotism, whether they are labor or business—on impacting upon the conduct of U.S. foreign policy when they, the beneficiaries of America investments, which I agree with you, Dr. Drezner, is most times fairly benign.

I was going to ask—my very first question was about, remember Japan Incorporated was going to—that was my first question. You've mentioned it already. It didn't have much of an impact, but it went to our pride. It went to our sense of ourselves. But it also now seems to me to go to the conduct of foreign policy in terms of legitimate interest groups in the United States, able to, and appropriately, putting pressure on the United States Government in the conduct of foreign policy.

It's a very broad question. Would you please respond, and I invite either of the other two to respond as well if you'd like to after Dr. Drezner does.

Dr. DREZNER. Thank you, Mr. Chairman. There's no question that the most effective kind of power you can exercise is the power that you never see, is the power that's sort of implicit in the other person's mind. So to some extent you're correct in terms of saying that if these interest groups, recognizing that they owe their livelihood in part to the ownership by sovereign wealth funds from overseas, would implicitly affect their behavior—in fact, I'm sure if you gave them a lie detector test and asked them, is it affecting your behavior, they'd pass it saying no. But it might have some sort of implicit awareness of the extent to which they're relying on foreign investment.

So might that happen? It's certainly a possibility and if you look particularly at, let's say, the Senators from New York and what their attitudes are going to be after sovereign wealth funds investments into the U.S. financial sector, that might be an interesting political science exercise.

Now, that said, I do think you're overstating the situation a little bit in a couple of ways. First, this kind of power cuts both ways. The more sovereign wealth funds investment there is in the United

States, it doesn't just increase our dependence on foreign capital; it also increases the dependence of these other governments on our economy functioning relatively well.

So in that sense I would argue this is an increase in interdependence, not an increase in asymmetric dependence.

The CHAIRMAN. It may be an increase in economic interdependence, but that doesn't necessarily comport with the promotion of human rights. That doesn't necessarily comport with our view of where our strategic interests lie unrelated to our economic concerns. I mean, I would argue the President did not make the judgment to go into Iraq, notwithstanding what people think, based on oil. I would argue he made that judgment based upon what he thought the national security interest—I think he's wrong, but the national security interests of the United States were in the region.

So I don't doubt for a moment the interdependence that it breeds. But what I do wonder about—and you've answered the question—is whether or not it has the effect of having economic policy in effect trump other legitimate, legitimate foreign policy and national security concerns in terms of our action. What is economically in our interest is not always necessarily strategically in our interest, I would argue, unless you are a political science professor who's gone over to the economists, and then what the hell, you're lost.

Dr. DREZNER. I have to confess, I also have a master's degree in economics.

The CHAIRMAN. I knew you were suspect. [Laughter.]

Dr. DREZNER. I have consorted with other known economists, sir.

I think in the long term the pursuit of wealth and the pursuit of power tend to go hand in hand. So it's not clear to me—while there might be some short-term conflicts, I think in the long term the sort of issues you're raising do not fundamentally impair U.S. foreign policy.

As I said in my testimony, I agree that the promotion of sovereign wealth fund investment is going to retard the promotion of democracy and human rights abroad. That has to do with the origins, the countries of origin. But that said, these countries now have a greater stake in making sure that the U.S. retains its economic growth and the stability of the global system, and that's not for nothing.

The CHAIRMAN. I'm not suggesting it is. I appreciate your answer.

Do either one of you like to comment? I'm over my time, but if it's brief.

Dr. BHAGWATI. Yes, sir, very quickly, Mr. Chairman. With China it's really our investment there——

The CHAIRMAN. I agree.

Dr. BHAGWATI [continuing]. In the provinces, rather than their investment with us——

The CHAIRMAN. No; I absolutely agree with that.

Dr. BHAGWATI [continuing]. That's constraining us. And as far as Russia is concerned, it's just the luck of the draw that the oil price increases have actually made them so much better off. I mean, they've gone from being a superpower to what I call a super-beggar, when they were completely flat out. Now, thanks to oil, they've risen up again. I think it's just getting a little hard for us to accept

that in the sense that they're now speaking their minds, following their interests as they see relevant, and so a divergence is opening up.

But I think as far as sovereign wealth funds are concerned, I would be inclined to agree with my political science friend that it really doesn't amount to a hill of beans right now. But there's a subtle influence which you were talking about, like when they start buying up Citigroup and so on and so forth. These are not—Senator Obama is not here, but these are not exactly innocent, poor, ineffective lobbies. As far as their influencing what the firms will say and do in Washington, I think there may be—I mean, that's something we need to think about.

I don't know which way it would go, but certainly it's an important point which you're raising. I think at the moment I don't see any clear pathway which would be followed, but certainly when the going gets tough on some issue you can be sure that the financial firms which have been bought into a little bit are going to be more cautious compared to NGOs and others who want to push human rights, and so on and so forth. So I think you've got a good point there.

The CHAIRMAN. I've not reached any judgment on it, but I do think we don't talk about it much and that's why I wanted to raise it, because it's just not in the line of questions my incredibly competent staff has prepared for me. I just wanted to because others will ask those questions as well.

David, would you like to make any response?

Mr. MARCHICK. Just very briefly, these are age-old issues. I dealt with them when I was in the administration, where business or agriculture wanted one thing and there were other interests. Good policymakers have to balance the various interests and make the judgment on what they think is the best interest of the United States overall.

But I agree with my colleague that sovereign wealth funds' impact on that is probably negligible.

The CHAIRMAN. Thank you.

Mr. Chairman.

Senator LUGAR. Thank you very much, Mr. Chairman.

One of the good things about discussing the sovereign wealth funds is it brings to the fore a host of other questions other committees and the whole Senate is dealing with. For example, Mr. Marchick, you mentioned that one problem that we have is that we're running a very large trade and current accounts deficits. We are also running a large fiscal deficit of $400 billion. There are plans in 10 years of how that might get down to zero or so, but these are not altogether credible, given what we're doing.

So as a result we have a need for a lot of money. We've been borrowing through our Treasury bonds from all these countries quite apart from sovereign wealth funds for a long time. There are disagreements as to how many trillions of dollars other countries have, but it is a large sum.

It would appear that our low savings rate, which some estimate at sort of a net zero after credit cards and everything else are factored out, is not going to change very rapidly, especially given the stresses on families and on mortgages. So these things are not

inevitable, but these would appear to be trends that are intermediate in our own future and maybe even fairly long-term that dictate a lot of policies that we may have.

Now, they may verge, as you point out, Dr. Drezner, into foreign policy in this sense, that the President in his second inaugural address stressed democracy, said it was demeaning to suggest any country was unprepared for democracy. Yet others are noting, not necessarily cynically, that our emphasis upon human rights and democracy, has been in decline, in some cases hardly spoken. This may have to do with strategic problems with regard to war and peace, but it also may be related to, as the chairman pointed out, oil and natural gas and other resources, and maybe even ultimately the sovereign wealth fund issue.

This is more than a subtle change in terms of our own outlook or, as you pointed out, Dr. Drezner, the suggestion that some countries might adopt the so-called Chinese model, in which you have an authoritarian government, but a lot of market activity, investment, and prosperity. It's a very, very dynamic situation.

So somebody looking at this might say that for some developing countries that this model may be the best way to go, given the per capita benefits.

But that runs aground to some fundamental thoughts in our country about democracy, human rights, market economics, freedom of world trade altogether, although the Chinese don't necessarily restrict that. They want money coming in. We've certainly accepted their money going out. I just mention these not subtle changes.

When I was in Azerbaijan last year, the gentleman running their sovereign wealth fund—it's a much smaller one right now—was stressing the transparency. I thought that was admirable, and they claim they're going to use the Norwegian model.

This country, like many countries, has a lot of money accumulating pretty fast. But the fact that they're going transparent is a benefit to their citizens. Now, this is hardly a democracy, but it's moving in that direction. In other words, if we were to encourage some models that's a pretty good one to take a look at and to at least congratulate people when they do the right thing. I think this is an example of that.

On the other hand, what I wonder in Azerbaijan, as well as in any of the countries that have the sovereign wealth funds, is it likely that sovereign wealth fund holdings may go from $3 trillion to $12 trillion or higher. Also, when do governments in order to either pacify their populations or because they do run into difficulties—it might be a world food shortage or something else—have to use the money?

The demand, whether it's transparent or not, the suggestion in our press that somehow trillions of dollars are coming here to satisfy our lack of saving and our deficits, and back in the oil producing countries people are saying, why aren't the roads any good or how about the schools, or so forth. What is your prediction in terms even of the immediate trend, as well as the long, as to whether there really will be great sovereign wealth funds? Or is this a trend that is spurred by the particular energy evolution of the moment and that we are simply witnessing in that form?

Do you have a thought, doctor?

Dr. BHAGWATI. If I may just to respond to that, I think it's a very important point. I think the other witness actually pointed out that we were so concerned about Japan at one time and Japan went into a tailspin. So I think it's a very good question because typically we, economists included, tend to extrapolate from whatever is going on. And there's no reason to think, as I was hinting at from the point of view of the Indian experience, to think that these funds are going to keep growing at the same rate, because, take China and India both. Both of them badly need infrastructure investments at home. They're talking about it. There's big discussion in India on using reserves for infrastructure. And China as well, as doubtless you know, Senator Lugar.

As a result, a lot of those reserves are going to disappear. And now, with the food crisis the Indian ones are going to go fast because they won't be able to go and borrow from the Fund and the Bank when they have so many reserves already to be able to spend on that.

So I think these things come and go. I think currently if we keep at our oil policy of trying to create substitutes and so on and hopefully the environmental policies reinforcing our security concerns, so if we finally mean business on this issue and really move into that, I think that will certainly depress the price of oil down the road, there's no question about it. Right now, of course, the weak dollar is in fact extending to the notion that all currencies are likely to be weak and therefore people are moving, hedge funds included, from currencies into commodities. This has happened before. So commodity prices are moving up.

But that's a temporary phenomenon. It's not a long-run phenomenon if you're looking at the future. So I think the huge oil price increase I think certainly is, you might call it speculative, but it is just portfolio diversification by people who are holding assets. They think commodities are the place to go.

So I think it cannot be expected to continue. There are some long-run factors also why food prices might keep increasing, but that's where you have to take decisions on GM foods and a variety of things like that. But I don't see this particular distribution of surpluses and deficits continuing.

We are also—we're going to enter into a new administration, whether it's Republican or Democratic, and the rather profligate policies on the budget, et cetera, will be put in line, because that can be brought in line a little more quicker than getting people not to—to increase savings in a dramatic fashion. So there are possibilities, and I would say I'm not concerned that much about the underlying trends unless people don't take fairly straightforward decisions which I think are obviously in need of being taken. And I don't see any fundamental problems about these decisions being taken right now.

So I think we should not get too carried away by the current situation.

Senator LUGAR. Dr. Drezner.

Dr. DREZNER. Senator, as a well-trained academic I can provide at least 30 answers to a single question. Let me try to do that here in terms of sort of contradicting what I said a little bit on terms

of how sovereign wealth funds might actually help democracy promotion. There are a few countertrends, particularly if there's adroit uses of policy.

As you suggested, one of the ways in which this can promote democracy in some countries is the transparency of sovereign wealth funds and whether this information gets to the citizens of those countries. You're correct that there is resentment in some countries where there is significant amounts of poverty and yet you read about trillions of dollars being invested in the richest country in the world. So there is no doubt that sovereign wealth funds have to tread carefully and governments have to tread carefully in terms of managing domestic discontent.

Another way in which they can potentially contribute to at least democratization or rule of law is that by operating in financial markets, reputation matters and the rule of law matters a great deal. So as a result the governments that run sovereign wealth funds have to learn to play by Western rules to some extent. I think you're starting to see that with the IMF process of trying to develop more transparent voluntary codes of conduct by sovereign wealth funds.

I think the fact that you got a commitment from Singapore's Government Investment Corporation and the Abu Dhabi Investment Authority that transparency is important suggests that they are slowly recognizing the political problems they're going to have to face. So that in some ways could contribute to greater transparency in these nondemocratic countries.

That said, there is one concern, which is if you actually have a crisis take place I think the last thing you would want from a U.S. perspective is for these governments, for these sovereign wealth funds, to precipitously withdraw significant amounts of money from the United States in order to fund crises at home.

To repeat what my colleague said, dealing with the current situation we've got now is kind of like turning the battleship *Missouri.* It's going to take a little while and the last thing you want is for the turn to be too precipitous. So to some extent if you have a crisis in these countries and you have sort of a change in government, as I said, a more populist revolution, you don't want to do terribly rash actions.

So just as you don't want rash actions by this distinguished chamber, I also think you don't want rash actions by the home country governments of these sovereign wealth funds.

Senator LUGAR. Mr. Marchick.

Mr. MARCHICK. I'll be very brief because I know there are a lot of Senators here looking to engage.

Two points. The first point that you raised is kind of the macro issue: Will this continue and what does it mean for the United States? In my view, running a—having a balanced, perfectly balanced budget is not essential—and running a deficit has traditionally not been problematic for the United States. Having a current account deficit has not been particularly problematic. But the trend lines are stark and accelerating. This year it'll improve a little, basically because the economy is slowing.

But I think that in the next Congress, with the next President, with whomever it is, hopefully some of the actions that you can

control, there will be action in terms of improving the deficit, improving savings rates, and getting a handle on the energy situation. And hopefully that will create a trend line more toward balance, even if it's never going to be perfectly balanced.

Second is, Azerbaijan is a good example. It is a small country seeking to become more independent from Russia, that suddenly found itself with huge amounts of oil and natural gas, where if they took that money and invested it back in their economy there would be hyperinflation and the oil curse, which would basically wreck the entire economy and make all of the nonoil parts of the economy noncompetitive.

So the United States and the IMF and Europe encouraged them to set up a sovereign wealth fund, to invest abroad. They invest through third party, mostly mutual fund type management, and they have one of the big accounting firms audit them to create transparency.

So I think that it would be hard to criticize Azerbaijan for essentially doing exactly what the United States asked them to do for so many years, when all of a sudden there are concerns about sovereign wealth funds.

Senator LUGAR. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Before I yield to Senator Menendez, I'm going to submit a question on behalf of Senator Nelson, who had to go to another hearing regarding the CSX Railroad, a Jacksonville-based railroad that stretches 21,000 miles, 23 States, connects 13 military bases and 70 ports, shipping more military equipment than any other railroad in the country. It's currently the target of a hostile takeover by an investment group called The Children's Investment Fund, which includes unknown sovereign wealth funds among its investors. CFIUS review of this potential takeover at the request of the Department of Defense is currently under way.

The question he asked, not to be answered now, but I hate to ask you to do it in writing: Is the Committee on Foreign Investment in the United States within Treasury an effective means to safeguard the interests that he's concerned about? That's the question.

[The information referred to above was not available at press time.]

The CHAIRMAN. I yield to Senator Menendez.

Senator MENENDEZ. Mr. Chairman, Senator Webb has another pressing engagement and I'd be happy to yield.

The CHAIRMAN. Senator Webb?

STATEMENT OF HON. JIM WEBB, U.S. SENATOR FROM VIRGINIA

Senator WEBB. I appreciate both my colleagues over here yielding to me. I have 175 10-year-olds waiting on the Capitol steps to get a picture taken. It would be very difficult to explain to them if I was too much later.

Gentlemen, we have a clear picture obviously of why there seems to be so much incentive toward moving toward these sovereign wealth funds. It's liquidity, partly because of bad investments here, and partly because of tremendous transfer of wealth outside of this

country as a result of oil policies on the one hand and trade policies on the other.

Just very quickly, Dr. Drezner, I would like to agree with your comment, which is something that has concerned me. That is what we're seeing here with this new form of government and economic cooperation inside these countries, many of which are not democracies that could down the road actually solidify the political systems that we have an interest in changing because they are able to benefit from a free market system. It's something of an irony, but that's what's going on here.

Mr. Marchick, on your comment, and others, about the situation in Japan in 1987 and shortly thereafter, I think the distinctions that we need to make now when we're looking at sovereign wealth funds is, first of all, this was a compatible political system. The Japanese political system is compatible to our own. They're an ally. And the challenge at that time was an economic challenge and, most importantly, this was not government investment. Other than T-bills—and ironically, I wrote a novel, published in 1991, where one of the assumptions was that if there had been a confrontation, a serious political confrontation on a specific issue—the issue in the novel was if they had withdrawn the T-bills—how would that affect our economy at a time that would illuminate the political issues. So this has been around.

But this situation here is to me quite a bit different. Foreign direct investment can be individual, it can be company, it can be investment in T-bills, it can be direct foreign government investment, which we are talking about here, into a free market economy. Then, much more troublesome, it can be direct foreign investment from nondemocratic regimes that could have strategic interests that are different than our own. That really is the question that we're facing.

We can only deal at present in a limited way with the CFIUS process because it's an individual process. The difficulty that we're going to be facing here is the cumulative process—the process of cumulative investments with the potential for manipulation or withdrawal, implicit, the nondiscussed ways of influencing an economy and as a result a government.

So let me just throw one question at you. Why is it that the United States Government does not directly invest in our own economy, and why are we so comfortable with other governments investing directly in our economy?

Dr. DREZNER. Thank you, Senator. To respond to your question, let me quote Ken Rogoff inform his congressional testimony last year: “Governments have a long tradition of losing massive amounts of money in financial markets and this tradition is not likely to end any time soon.” That likely answers your question, which is the belief is in this country that governments are not necessarily adept at picking winners and losers in terms of buying companies.

I should point out again, the government invests massive sums in the United States economy. It just doesn't do so by buying equities. It invests in education, it invests in infrastructure, it invests in technology, and so on and so forth, and these are all appropriate investments.

One of the problems with extrapolations of sort of current trends is the belief that foreign governments are somehow going to be incredibly adept at picking winners in terms of their investments in the United States. As I said before in my testimony, to date these investments have earned a negative 10-percent real rate of return over the past year. So do not underestimate the ability of foreign governments to screw up in terms of choosing which their investments will be.

Senator WEBB. If I may, because I only have a minute and 40 seconds left and I've got 175 kids waiting for me. I respectfully disagree. I don't think that the reason that the United States Government has declined to invest in the free market elements of our economy is because it won't make money. I believe it's because of the nature of our governmental system. I keep hearing about the fact that the Chinese lost money in their original investment. If there is a continued interest, and there will be, it's probably beneficial, fortunate in a way, because if they had made a huge amount of money right at the beginning we'd have a different view of this.

But the question we have to address is a systemic question. The United States Government doesn't invest in the stock market because it would be viewed as picking sides, picking winners and losers. That's a totally different thing than financing governmental programs.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Senator Corker.

STATEMENT OF HON. BOB CORKER, U.S. SENATOR FROM TENNESSEE

Senator CORKER. Thank you very much, Mr. Chairman. I think our witnesses have been outstanding and also have a sense of humor, which is greatly appreciated.

I would say that, just to follow on to Senator Webb's line of questioning, though, that I would also add a minor detail. We have no money to invest, so that is also a pretty limiting factor that I think is pretty relevant.

I think I like the perspective in the long-term views that you're sharing with us. I think it's fair to say that relative to other countries today at this moment in time, at this brief period of time in history that we're a part of today, that we are relative to them presiding over a weakening of our country as it relates to their relative strength.

I think that's a fair assessment of where we are, and I think maybe the most important thing to take away from this hearing and other hearings of this type. I think that's a fact and I'd just like to ask the three contestants to yes or no that one.

Dr. BHAGWATI. Certainly other countries have grown the required surpluses and so on, which is an added element.

But I would just like to say one more thing in relation to this whole question of whether sovereign wealth funds are going to give an added advantage to the authoritarian governments as against our model, which relies more on markets and human rights and so on. I think the way I read the evidence on India and China comparisons, which have been with us ever since President Kennedy's

time and so on—the two countries have always been compared—many seers I've talked to said that they would invest in China now, but not 10 years from now relative to India, because democracy really is the surefire way to have sustained development. Actually, if you look at China, the sinologists themselves are deeply worried about the fact that they don't have a democratic government. This is why people take to the streets when you have takings. We have takings in a judicial fashion, but when the commissars take your land away. You don't have NGOs, no civil society really. You don't have an independent opposition party. You don't have an independent judiciary. You don't have an independent press, the four elements of a functioning democracy.

So people take to the streets, and it's a highly unstable system actually in China. And if you look at the environmental damage and if you adjust the Chinese growth rates, as we should, for the damage they're doing to the environment, and there are well-established ways of doing it, people bring down their growth rate by about 3 percent actually. I've seen estimates to that effect.

So they're not doing all that well. They might go down, again the same point as Senator Lugar was making.

Senator CORKER. That was a pretty long yes or no and I appreciate it.

I would just—I would say that the other point I was getting ready to make, and I think you just made it for me, is that while they are investing in our country today, they are not investing in themselves. I think that there can be some long-term bigger issues that they will be dealing with down the road because they are not investing in infrastructure, they are not investing in education, they're not doing some of the basic things that need to happen.

So I do think that the issue of oil—I just want to get to that. I am not one who believes that—I believe that our future here as it relates to energy is through technology and changes. I do think it's interesting that we continue to talk about oil in the Middle East and yet would not even consider using the reserves that we have here in our own country.

At the end of the day I would also say, though, that even if we used our own reserves here, is it not fair to say that these countries are still going to be awash in cash because other countries are going to be buying from them? I'd like just a brief comment if I could from the witnesses on that. The fact is the imbalances are going to continue either way because of the high price of oil and their ownership of it; is that correct?

Mr. MARCHICK. Yes, sir; it is. The fundamentals are in place, going back to Senator Lugar's statement. Oil prices are high. A number of countries are maintaining very high levels of current account surpluses, which means that they're earning more than they can consume. And the money has to go somewhere. The money can either be invested domestically, which some of it is, but not too much of it can be because then you get into inflationary situations.

So some of it has to go overseas. It can either go overseas and buy T-bills, which a lot of foreign countries are doing right now—we're financing our deficit through basically foreign borrowing—or it can go into direct investment. In my view it's better to have direct investment because it's longer term, it's less liquid, and it's an

investment in the United States. It's essentially a sign of confidence in the United States.

Senator CORKER. Let me follow up with that quickly. I would just—it seems to me that in many ways we're more fragile as it relates to our relationships with other countries with them having tremendous investments in our debt than we are with them having investment in equities. A change of policy, a concern about the value of the dollar, sudden desires to be in other currencies could have, it seems to me, a more immediate destabilizing factor on our country than investment in equities spread throughout our country.

I'd just like brief answers or thoughts as it relates to that.

Dr. DREZNER. Just briefly, Senator. There's an old adage that if you owe the bank $1,000 that's your problem; if you owe the bank a billion dollars, that's the bank's problem. To some extent, you're seeing that with respect to the large amount of U.S. debt being held by central banks overseas, which is it's so large that they don't want the U.S. economy o collapse. You're correct, in theory they could do this sort of thing, but it would be just as disastrous for them as it would be for us. So I don't think that's a terribly realistic scenario, and I'll just leave the answer there.

Senator CORKER. I do hope—and I know my time is up. I do hope that these types of hearings that we're having—and I agree, doctor, that we should not become too alarmist, that we need to have perspective about where we are, and I know that many of these countries will even more so be investing through investment entities, if you will, and not taking as much direct ownership possibly because of some of these issues we're talking about.

But the fact of the matter is that the policies that we are carrying out today in our country today, just at this moment in time—and this is a great country and we can redirect ourselves hopefully—and just the sort of the culture that we have in our country as it relates to consumption beyond the ability to pay, that today these types of meetings point out the fact that we need to drastically change the policies that we have in this country today to cause us to be stronger in the future. Is that a fair assessment?

Dr. BHAGWATI. Yes.

Senator CORKER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Menendez?

STATEMENT OF HON. ROBERT MENENDEZ, U.S. SENATOR FROM NEW JERSEY

Senator MENENDEZ. Thank you, Mr. Chairman. I appreciate the witnesses.

From what I understand of your testimony, you are all basically in agreement that we have not much to fear from sovereign wealth funds. Is that a fair statement? Yes.

So let me ask you in a different context, Hugo Chavez. We think that countries will respond based upon their financial interests and so they won't be looking at other political dimensions. Yet here we have Hugo Chavez, maybe not through a sovereign wealth fund, but nonetheless using the national patrimony of Venezuela in a way that is not being promoted for the financial benefit of its citizens, but ultimately to promote his foreign policy. Citgo here in the United States puts out oil to communities that are underserved or

have needs. He does that in promotion of his policy. He uses his oil throughout Latin America to promote his policies.

There is a perfect example of what in that country is the sovereign wealth being used for a political purpose. So why is it that we cannot foresee the possibility of sovereign wealth being used in a way that doesn't look at strictly the financial rewards, but at rewards that may very well promote the foreign policy of another country?

I look at Dr. Drezner's testimony and, while a hypothetical, in a post-September 11 world I think we have to think about what things that may seem hypothetical actually take place. You cite, for example, to consider the effect of a populist or fundamentalist revolution taking over in Saudi Arabia or the Gulf Emirates, and that a rampant anti-Americanism among the Arab populace could encourage a new government to purposely sell off sovereign wealth funds in the United States in order to induce a financial panic.

Now, that might not be inconceivable, as you say, in a revolutionary stage. I think that when we saw an airplane turned into a weapon of mass destruction or a simple envelope laced with anthrax into a deadly weapon, that using financial instruments in a way to undermine the national interests or security of the United States is not farfetched. That doesn't mean you stop all sovereign wealth funds or investments, but I think we have to do a better job of looking at how these investments take place.

So my first set of questions is: Why do we not envision that and how can we just be so sure that only financial interests of sovereign wealth funds will be pursued? Second, in my other assignment as a member of the Banking Committee we had some of these hearings and I believe some of you have been testifying before the committee. It's interesting to see that they always seem to keep the threshold below the trigger threshold necessary for review of CFIUS, the Committee on Investments of Foreign Assets in the United States. It throws a little red flag up to me and says, well, why, if this is so good, why do you always keep below the threshold, number one?

No. 2 is, I look at what Chairman Cox said in reference to sovereign wealth funds, the chair of the Securities and Exchange Commission, and he said when it comes to transparency the track record to date of most sovereign wealth funds does not inspire confidence. How is it that we work around the paradox that is supposed to uphold investor protection, yet it depends upon the disclosure of governments that are not subject to their own regulations?

How is it, for example, if we believe that there are violations of U.S. securities law, we can do very little and we get no cooperation from the very governments that are under investigation?

So these are paradigms that I think are of concern and I'd like to hear your responses to some of that.

Mr. MARCHICK. Let me take a crack at that. Senator, I think you raised some very good points, and I don't think there is, at least from my perspective, much, if any, daylight between what you're saying and what we're saying. The first thing to say is that these funds have been around for 50 years and to date I'm not aware of any that have compromised either U.S. or any other country's national security.

Second is, Is it in the United States interest to have investment from these entities or not? Broadly speaking, I think the answer is yes. Most of their investment is passive. It's managed by third parties and they have no control.

Then you take the other investments, where they have controlling stakes, whether it's a small investment where they have 11 percent, 15 percent, or even a 6-percent controlling stake if they have rights on the board, et cetera. Most of that investment shouldn't be problematic for us either in real estate, in retail, in sectors that don't have security consequences.

For the sectors where we have essential security interests or any other interests, then the U.S. Government should be very vigilant in protecting our interests, whether it's national security, competition, chemical security, chemical safety, across the board. The question is are our laws and regulations adequate to address whatever risks there are?

Senator MENENDEZ. What's your answer to that question?

Mr. MARCHICK. My answer is that overall the answer is yes and that we have—we obviously have room to improve in some areas that are unrelated to whether an investor is a sovereign wealth fund or not. Obviously, some of the issues concerning toys and pet food and consumer safety are troubling to anybody in the United States, particularly people that have kids. But that's an issue that we need to deal with from an overall framework.

Senator MENENDEZ. With respect, that's a different issue. The reality is that it is not about investment in potentially critical assets of the United States by a foreign government who you can't get under the existing Securities and Exchange Commission law to respond to inquiries if there is an investigation.

Mr. MARCHICK. Let me answer it this way, then. For any issue where there is a delta in the risk between a domestic investor and a foreign investor and a delta in the risk between a foreign private investor and a foreign government investor, my view is that the CFIUS process and other regulatory processes are adequate to deal with those risks.

Senator MENENDEZ. Can I hear from the rest of the panel?

Dr. DREZNER. Senator, I think you started talking about Hugo Chavez. It's not clear to me that Hugo Chavez's throwing around money has actually achieved all that much, and if anything it's increased his unpopularity at home. I think that's a worthwhile parable to consider in terms of the more dangerous scenarios you're talking about.

Senator MENENDEZ. It may not be the result, but it's the intent that I am worried about. You can't just look at negative results and say, well, it didn't prove well for him. It doesn't mean that if someone else couldn't be using it more intelligently and provide a positive result.

Dr. DREZNER. Again, never underestimate the ability of governments to screw things up in terms of their intent. So I'm actually not sure that you're going to have a Machiavellian government successful at potentially accomplishing this.

I agree, however, that certainly there's the 1-percent possibilities that you're talking about. You need to have constant vigilance, and I would again agree with Mr. Marchick, we have a regulatory

process and we have the legal institutions in place to guard against those very kinds of concerns. As I said, the promotion of transparency among sovereign wealth funds by the IMF process I think would also add an extra level of assurance to deal with the kind of concerns that you've just raised.

Senator MENENDEZ. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

The Senator from Georgia.

STATEMENT OF HON. JOHNNY ISAKSON, U.S. SENATOR FROM GEORGIA

Senator ISAKSON. Thank you, Mr. Chairman. Very helpful hearing and I appreciate the witnesses and their testimony today.

I'm not a lawyer, so I'm a real estate broker, and in the 1980s I was in the real estate business when Japan Inc. became the popular fear in the United States of America. I'd point out that they crashed for three or four reasons. One is they bought at 100 percent. Second, they bought real estate; they weren't buying companies. Third, they had no transparency at home and the banks kept the assets at the purchase level when the U.S. economy went in the tank in 1990–1991 and the assets plummeted in value, and eventually they had to recognize that.

The reason I make that point is this. Maybe the sovereign wealth funds looked at that experience with foreign investment in the United States and said: Hey, controlling interests might not always be good and the strength of the United States economy's going to make this investment a good or bad investment. So they're a passive investor, in smaller amounts, spreading their risk over a larger number of investments, and have a vested interest in the economy being good. Is that a fair judgment?

Dr. BHAGWATI. I think it is a fair judgment, and I think all experience even with private investment, as you were pointing out by the Japanese, they bought into the Empire State Building and they were taken by Hollywood basically, rather than the other way around. So I think in many cases even not having an experience of our system, they actually really were moving into areas where they didn't have any comparative advantage in terms of investment know-how. They really came a cropper.

I think it's the same thing. I think they're much more cautious as a result of that past experience. Like the Chinese put their foot wrong on the Blackstone Group. They virtually transferred a lot of money to our people. So they've learned from that as well. So I think they're going to be very cautious, and I don't think the Chavez model is a particularly relevant one. Chavez is just throwing money around, like we sometimes do with our foreign aid to achieve objectives.

Senator ISAKSON. We haven't always achieved ours either.

Dr. BHAGWATI. It's a tricky business, but I think it's not particularly appropriate to link that one with the sovereign wealth funds thing.

Senator ISAKSON. Given what we're debating on the floor of the Senate right now and the concurrent concern over gas prices, 20 years ago my son wrote a master's thesis in economics on the

Dutch disease and its impact on Middle Eastern countries, their sole dependence on one source of wealth, a rich natural resource.

We're talking about oil running out in 40 years or going on a decline. We've got a 40-year period of time to get off of petroleum and onto whatever the new new thing is. I notice five of the big seven sovereign wealth funds are obviously getting their money from oil and selling it to us. Are they in the process through these wealth funds of reinvesting the money we're paying them for the foreign oil so that when it does run out they've got an investment basis to continue to sustain their type of a society, but with a different singular source of wealth, that being those pools of investments versus the oil they had for so many years?

Dr. BHAGWATI. I think some of them are. I think countries like China are going to be investing in their own system increasingly, I feel. And countries like India are going to be using it up to meet the food crisis. So it's not a situation which is going to be extrapolated into the future.

I think the oil, people deriving money from oil, certainly are making a calculated decision that the internal rates of return from internal investments, meaning social investments, infrastructure and so on, don't offer as much prospect as investing it in our system. I think this is why they are going to be much more pliable to accepting rules and being obliging in the way in which they do it.

But I think that is clearly the decision they're making, I think, that they're better off coming here rather than putting more money into their own investments. So I think that also suggests that we need not be too alarmed in the sense they're simply interested in the rates of return, essentially. I think they're going to learn from past mistakes like the Japanese investments, some recent Chinese investments, and I think we expect to do—I think one thing we need to remember is that there's been debate, is the current deficit being driven by the fact that people want to invest money here or the other way around?

I think to some extent we're still a safe haven, we're still the smartest economy in the world. We go through problems like everybody does. But essentially, if you ask people, not to look at arbitrage operations between the euro and us and the yen, for example, but if we say, look, if you had a pot of gold where would you put it on a sustained basis, I think almost everybody would agree. Everyone I've ever talked to says this is the country they want to invest in.

So I think fundamentally that's a decision even the oil guys are making, that this is where they want to be. I think it is going to be reasonably steady. They aren't going to fool around trying to use it for political purposes. So I'm reasonably optimistic on that front.

Senator ISAKSON. Well, the reason I brought those two things up, I was in Iraq the day the Dubai Ports deal broke and they diverted us to Dubai to try and talk to the government over there and settle everybody down. I realized what a problem lack of knowledge is. I think, Mr. Chairman, your having this hearing and subsequent hearings we would do on understanding sovereign wealth funds will help us to get the information out on what they are.

Second, if we can have a good system of transparency we can raise the level of confidence, but also reduce the risk of some of the fears that you see out there in these investments. After all, in the end these countries are governments in many cases different than ours, that are not necessarily democracies, but they're investing in a democracy. If we maintain its strength—and we have some things we need to do—this can be good for us as a country and good for the "world is flat" era that we're going into, where we're so close and so interconnected.

I just want to echo what Senator Corker said, that our savings rate, our spending habits, and our dependence on imported oil are three contributors to our current problem. Every time we can improve our situation vis a vis oil, create mechanisms where savings become something the American people do, we can go a long way towards being an even more attractive place for the world to invest its assets and want America to do well.

Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Senator Cardin.

STATEMENT OF HON. BENJAMIN L. CARDIN, U.S. SENATOR FROM MARYLAND

Senator CARDIN. Thank you very much, Mr. Chairman, and I very much appreciate you holding this hearing. I think it's extremely important and I think we all agree on the fundamental issues in this country that we need to deal with that have added to the growth of the sovereign wealth funds and the diversity of the sovereign wealth funds and the potential for impact on our own country.

We need to deal with the realities of the balance of payments deficit in the United States. As our panel has indicated, a deficit is not always bad, but the uncontrollable deficits are bad, and the trend lines are problematic. We need to deal with our own operating budget deficit, our own savings deficits in this country. A lot of that are issues that we need to deal with internally.

But when you take a look at whether we have a level playing field with our major trading partners and you look at some of the manipulation that's been done, for example China and the manipulation of currency, that impacts the surpluses that China has versus the United States, adds to their ability to grow their wealth funds, and can become an issue for our own country.

Clearly, the sovereign wealth funds that are operating as stabilization for the economy of a country that is focused on a particular natural resource, that makes sense. I don't think any of us disagree with having that type of a stabilization fund. However, when these funds grow at such a level or where a country can potentially use those funds for a strategic purpose, not having the same pressure that investors have on the managers of funds, then it can become an issue that we should be concerned about.

I think about China and I think about the fact that they've made strategic decisions to invest in countries where they need natural resources, which clearly give them leverage over that other country's decision as to how they use their natural resources. I think of our own relationship with China and the fact that we have more

limited options against China today than we had 10 years ago because of the ability of China to—their market impact in the United States.

So let me just challenge our panel if I might. Let's assume we disagree with your overall conclusions that our current economic and regulatory system in the United States is strong enough to protect us against potential harm from sovereign wealth funds. Let us say that we want to act now while we can act, looking at the trend lines, concerned about the potential strategic impact that these sovereign wealth funds could have on U.S. interests.

My question to you is, Can you tell us whether we can focus our legislative actions to the areas of potential harm to this country, those funds that are not transparent, those funds that are operating with strategic interests rather than pure economic interests? Is there a way that we could either strengthen our Committee on Foreign Investments in the United States Act or look at legislation or regulation that is targeted to the types of fund activities that we think could be abusive to U.S. interests?

Is there a way that we can be surgical as we look at ways of better defining U.S. areas of concern as we go forward?

Mr. MARCHICK. Senator Cardin, I think it's a very good question. My view is that the Congress just acted in a surgical way, thanks to the leadership of Senator Dodd and others, by passing a new amendment to Exon-Florio, which I believe passed unanimously last year, and which the administration is currently implementing with a series of regulations which I know Senator Dodd, Senator Webb, and others have weighed in on.

That law basically addresses problems that became apparent during the Dubai Ports issue, which is, whether you agree or not that Dubai Ports' investment in the United States was a security risk—in my view it wasn't—the fundamental issue was that the Congress lacked confidence in the strength and the transparency of an administrative process. CFIUS didn't provide Congress with the reports they were supposed to provide. They didn't adequately brief Congress.

So when you had difficult facts in this case, which made a political stew, the systems that were in place didn't stand up to the scrutiny. So that's what the legislation that Senator Dodd so ably got put into law I think addressed. It strengthens the communications with Congress. It requires heightened scrutiny for any government-linked investment, requiring the Deputy Secretary—requiring much higher levels of engagement and basically signatures to the Congress that they personally have looked into the issue and do not find national security issues. Before it could be done at a much lower level. So you're going to have much more exacting scrutiny.

It created a much broader and more appropriate criteria for examining investments in a post-9/11 world.

Senator CARDIN. I would just point out, I strongly supported that effort and it dealt with the port issues, which were pretty transparent as to its potential impact on the United States. But when we're dealing with perhaps natural resources or dealing with areas that are not as directly related, it may be more difficult under the current regulatory and statutory arrangement.

My issue is is there ways to strengthen those types of provisions.

Mr. MARCHICK. Again, we should always look to find things that we can do to improve our national security. It's a constant effort. But the law that was put in place dramatically expands the scope of inquiry to critical infrastructure. The previous law focused on defense assets and a traditional, very narrow definition of security. The new law that Senator Dodd led broadly defines much broader subsectors of the economy and requires exacting scrutiny of those investments.

So the Congress should be vigilant in oversight and I'm sure that this committee, I think which has jurisdiction, and Senator Dodd, which has jurisdiction, there will be hearings to make sure that CFIUS is doing its job. But my view is the legislative framework is in place for it to be effectively implemented, and then the question is are they effectively implementing it. And that's something that Congress should pursue through oversight.

Dr. DREZNER. Just a quick add-on, Senator. First, I believe the legislation that was passed also has a provision specifically for government-controlled entities if they purchase U.S. assets, to address the question about sovereign wealth funds to some extent. You've already got it in the legislation.

It should be pointed out that, since Treasury has yet to finalize, I believe, the implementing regulations, my tendency is to apply a Hippocratic oath to new policy innovations, which is, first do no harm. Let's see what the existing process does, I think, before adding onto it.

Senator CARDIN. I'm just going to make a very brief comment. There was significant concern about moving forward with that legislation last year. It was clearly in my view the right thing to do and I congratulate Senator Dodd on his leadership. My concern is that, while we have the opportunity to act now and use that model to deal with the realities of what some of these sovereign wealth funds may be getting into, it may be the time is right to take a look at that model to expand its potential areas of interest as to what sovereign wealth funds may be getting into that could affect the security of our country that's not currently covered by the act. That was just my point that we should be doing.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Marchick, my staff tells me you may have a plane you have to catch, and if you do——

Mr. MARCHICK. Yes, sir. I've already missed one. I apologize.

The CHAIRMAN. No, no, no. There's no need to apologize. We apologize to you.

Mr. MARCHICK. Thank you very much. I'm very sorry I have to run if you don't mind. Senator Dodd has already heard from me many times. He's probably sick of hearing from me.

The CHAIRMAN. Well, thank you very much for being here, and Chairman Dodd is never tired of hearing.

STATEMENT OF HON. CHRISTOPHER DODD, U.S. SENATOR FROM CONNECTICUT

Senator DODD. As you are walking out the door, an issue I was going to raise with you was the new regulations implementing FINSA, which remove any doubt, I think, that if a foreign entity

holds less than 10 percent of voting interest it may still exercise control and thus prompt a CFIUS review. I think the word "control" obviously is the operative word; but moving clearly in the right direction on all of that.

So I know that you're packing up. We'll send a letter.

Mr. MARCHICK. My view is that—and you and Senator Webb have done a lot of work on this. My view is that the regulations tighten the focus on transactions that are less than 10 percent. So you could have a 1-percent interest but control the board of directors and you're right in the CFIUS.

Senator DODD. I appreciate that immensely, because that is the kind of flexibility. And while he's had to leave apparently, to Senator Cardin, my sense is too as well that I don't think you need to necessarily expand the areas covered. I would suggest that under existing law, unless you tell me otherwise, that if you start talking about some of these other investment areas, for someone to suggest that a natural resource were going to be acquired in some way here, I still believe CFIUS applies. I don't think because the area that he's raised is not mentioned specifically it would deny the kind of operation to examine that to determine any national security implications.

Senator CARDIN. I think one of the positive elements, many positive elements, of the law you wrote is that it gives CFIUS incredible flexibility. So in 3 years, if there's a new national security threat that we don't know about today, CFIUS covers it. Cyber security is covered now; 4 years ago, 5 years ago, that wasn't a concern.

Senator DODD. And if it's not, I presume you'd be back up or someone would be back up here, from this administration or the next administration, suggesting that we need to have an additional authority granted if there's some question about it.

Anyway, I know you've got to run. I apologize.

The CHAIRMAN. Thank you.

I thank the Senator from Wyoming for his indulgence. The floor is yours, sir, and then we'll go to Chairman Dodd.

STATEMENT OF HON. JOHN BARRASSO, U.S. SENATOR FROM WYOMING

Senator BARRASSO. Thank you very much, Mr. Chairman.

If I may as you leave, Mr. Marchick, there'll be a couple questions. I may want to just submit them to you in writing, because I am interested in your thoughts on some of these things. Thank you very much.

Mr. Chairman, we heard a little earlier that Goldman Sachs had concluded that, while concern about politically motivated acquisitions in the West might be justified, so far there's no evidence of this becoming an issue with the sovereign wealth funds and in their view there wasn't a serious prospect of it becoming one. But I agree with Senator Menendez that you don't worry about someone's intention; you worry about the possibilities and the potential to create problems.

I am concerned, Mr. Chairman, that there is the potential or the possibility to create problems. I look at this in terms of nations where they may have an interest in high oil prices and they at the

same time have a sovereign wealth fund and the possibility of using them—through speculation or manipulation—to bid up the price of oil on the futures market; using the sovereign wealth fund to then bid up the prices as they then sell their product, the oil, to the United States or to the rest of the world.

I don't know if that's something that you'd given any consideration to, but I'd be most interested in your comments on that potential, which would drive the cost of oil even further up than we're dealing with now.

Dr. BHAGWATI. But that possibility, Senator, would be independent of whether there were any sovereign wealth funds. They could be doing it right from Riyadh or anywhere in the Middle East and so on. So I think the possibility of this kind of deliberate speculation, as it were, to try and raise the returns to you, if it works it doesn't require them to be present here in any particular form. So I think it's just not related really to the sovereign wealth fund issue, but it's a possibility certainly. If you've large amounts of funds, like when George Soros was accused by Malaysia of speculating against the Malaysian currency prior to the East Asian financial crisis, he was supposed to be such a big player that when he started speculating against the currency they thought he was undermining the currency. Maybe he should speculate on something else.

So I think it's exactly the same point. If you're a major player you can have—you can actually manipulate prices and have other lemmings follow you, and then you really have a high rakeoff. So I think it's certainly possible. Whether it's likely in this particular case, is that really happening now, I'm not sure.

Senator BARRASSO. I don't know if you want to comment, Dr. Drezner. I was going to ask you about just the transparency in a global market, to know if it is happening, even separated from the sovereign wealth funds?

Dr. DREZNER. Just to add, if you're talking about hypotheticals, there are so much better ways of jacking up the price of oil. All Mahmoud Ahmedinejad needs to do is issue some sort of fiery denunciation of the United States and Israel and oil prices go up by $10 a barrel. That's much more effective and much more direct than the sort of indirect route which you're talking about.

It also should be pointed out that, while some actors want oil prices to simply go up and up and up, the major oil producers, particularly Saudi Arabia, there is a downside to oil prices being prohibitively high, which is obviously it puts political heat on them, and also it can cause a global economic downturn, which eventually diminishes demand for their production.

Senator BARRASSO. Could I move a little bit to the issue then of U.S. foreign aid. I look at the fact that the United States, a major funder of activities around the world, some to countries perhaps that have sovereign wealth funds. How do we balance that, where we are as a nation investing, giving money to foreign countries and they have sovereign wealth funds, and should that money not be used instead for them to invest in their own country.

You talked about hyperinflation, if too much money went into their own countries. But I have a concern about the United States and the taxpayers of America sending money overseas while they're

just continuing to do well and investing with sovereign wealth funds.

Dr. BHAGWATI. I think it's the general state of development which you may be interested in, because sovereign wealth funds may be there, but you may want to give foreign aid just with a view to promoting health care and all sorts of things. Now, whether in fact those sovereign wealth funds themselves should be used for that, it depends on the magnitude of these funds. You might as well say, look, private investment funds should not flow out from there. So you're then taking a position on where people should be investing their money. I think if we start getting into that kind of comparison I don't think it really is very helpful, because then you'll wind up doing micromanagement, as it were, of how a country's resources are going to be used.

So I think sometimes you just have to take their portfolio of choices and what they decide as given, and if there are countries you want to assist with development, then I think you should just throw it out of the window and really focus on whether the moneys you're going to provide are going to do things like affect malnutrition and a variety of other things, promote liberty, et cetera.

So my choice would be to say, look, unless it's a gigantic SWF with gigantic reserves—I think this is the sort of issue which would come up with China. There, would you really want to put moneys into assisting with development? I doubt it, I doubt it.

Dr. DREZNER. Just to add, I don't think there's a terribly strong correlation between where our foreign aid is going and the size of sovereign wealth funds in those countries. So I don't know how large a concern it is. Certainly I understand why you would be concerned about the overlap.

It also depends on the reasons for the aid, of course. For example, given the earthquake in Chungdu, I don't think you would assume that the United States would not want to participate in humanitarian efforts because they have a large sovereign wealth fund. Obviously, this serves our own interests, not to mention ethical concerns.

Also, a lot of the reasons for the U.S. aid overseas is to promote democracy, to promote human rights, and it's not terribly shocking that some of these governments might be reluctant to invest their own money in such efforts. But I don't think that should therefore prevent us from at least trying to nudge these countries in the direction we want to see them going.

The CHAIRMAN. Thank you very much.

Chairman Dodd?

Senator DODD. Well, thank you very much, Mr. Chairman.

Let me thank our witnesses and our colleagues as well. I know you've been here a long time this morning and I apologize for not getting over here at the outset of the hearing.

Let me thank Senator Biden and Senator Lugar for holding this hearing. It's very appropriate that the Foreign Relations Committee examine this issue as well and, as you've heard and obviously because of your awareness of the issue, you're conscious very much of the fact that the Banking Committee as well has obviously jurisdiction over a good aspect or part of this. But the foreign policy

implications are significant and so it's very appropriate that this committee be listening to witnesses as well.

Over the last 18 months, actually we've had markups of bills and hearings along this area. We held the first congressional hearing last November on sovereign wealth, affirming Congress's legislative approach to addressing national security concerns. Based on these hearings, the Banking Committee has undertaken several oversight initiatives, including a forthcoming Government Accountability Office report—and we conducted an April hearing evaluating the regulatory authorities over these funds and closely monitoring efforts to establish a set of best practices for sovereign wealth funds by the United States and international bodies, including the Treasury Department, Securities and Exchange Commission, the International Monetary Fund, and the Organization for Economic Cooperation and Development.

Today, as you probably heard already—and I'm repeating myself to those who were talking about this. I'm sure the chairman may have noted this. The IMF estimates that 20 sovereign wealth funds, largely financed by petrodollars and excess foreign exchange reserves, manage somewhere between $2 and $3 trillion globally, and they're anticipating those assets to climb to around $12 trillion by 2012. I don't know if you agree with those numbers or not, but those are the numbers we've been given.

So with that kind of financial muscle and the extensions of foreign governments, their operations in U.S. markets have raised questions, obviously, of political intentions, transparency, and the security of critical U.S. industries.

At the same time, in recent months sovereign wealth has provided a much-needed source of capital. Without them we'd be in a very different situation in this country. So it's one of those issues here. Be careful because without sovereign wealth funds we would have some serious problems in the country. So as we look at these issues, maintaining that balance.

Fortunately, I believe the United States can continue to enjoy an open investment climate while protecting economic and national security, and I appreciate the generous comments the chairman tells me you made about CFIUS, the legislation we crafted, and the very balanced way to deal with those issues. But CFIUS is only one tool and we're examining obviously the roles of other agencies in light of this influx of investment, from the Federal Reserve and the SEC to agencies governing specific industries like defense, energy, and telecommunications.

Many questions remain. I mentioned one here already and that is the control issue and to what extent Treasury can respond. I appreciate very much Mr. Marchick's response about the flexibility of the legislation, so we need not necessarily jump in. And obviously we want to examine through oversight how this is all proceeding in the coming weeks and months and years.

How can we ensure sovereign governments cooperate with the United States in enforcing our laws, including insider trading protections? Chairman Cox I think had a pretty good quote in this area. He said: "The same government from whom we sought enforcement assistance was also the controlling person behind the entity under investigation. It creates some inherent potential con-

flicts." So we need to examine that and how we can make certain that sovereigns operate in the United States market strictly according to their commercial rather than foreign policy interests is obviously an overriding issue.

Perhaps most important to this hearing on foreign policy, is how can we address concerns over reciprocity. So if I may, let me ask you about the reciprocity issue if I could, and ask both of you professors, Dr. Bhagwati and Dr. Drezner. The reciprocity questions are: How might promoting reciprocity support such mutual economic interests? What sorts of forums exist to advance such an agenda, and would demanding such reciprocity damage foreign relations with any of these other countries as well?

Dr. Bhagwati, do you want to start?

Dr. BHAGWATI. If by reciprocity you mean what they expect of us when we deal with sovereign wealth funds in their countries?

Senator DODD. Uh-hmm.

Dr. BHAGWATI. We should also follow the same transparency—I mean, we are kind of state of the art anyway, and we also don't use sovereign wealth funds particularly. So I think in a way it's a moot issue, if that's what you mean. It would be automatically——

Senator DODD. There's also other questions, access to markets, how investments are treated, how private investments are treated. So I'm not looking for sovereign wealth fund versus sovereign wealth fund, but giving access to that capital.

Dr. BHAGWATI. OK. That gets back into the problem you always have with devising a code on investments in general, foreign investments, which would consist of private and the governmental ones, the sovereign wealth funds. We haven't really made much progress. The OECD tried it, as you know, and the NGOs objected in a big way, the developing countries objected.

I think if you're going to do that you would have to make it stand on sort of three legs, as it were. It'll have to be a tripod where you have the rights of the funds, of the people who are doing the investments, and the rights of the people receiving these funds, then the obligations of whichever entity in terms of corporate social responsibility and so on. The OECD code, being at the OECD, which is a rich countries club as you know, was entirely on the rights of the corporations. But I think we could expand the whole thing, now that we're taking up the matter again at the OECD and the IMF, into looking at in a very comprehensive way to include things like CSR, corporate social responsibility, and what should be the rights of the countries which are receiving these funds.

It shouldn't be just a matter of—I think having the sovereign wealth funds would automatically bring in the focus on the obligations to be transparent and so on and so forth. But I think it could be expanded in that direction if by reciprocity you mean a more comprehensive thing which really looks into all these different dimensions. I think it's time to look at the entire investment flows in the modern context, in a much richer way than we have traditionally done in relation to an investment code.

Senator DODD. Any comments, doctor?

Dr. DREZNER. Senator, Mr. Chairman, first let me preface my remarks. Having grown up in the State of Connecticut, it's an honor

to be speaking with you, and I can assure you that you've made my mother very happy by the fact that I'm able to——

The CHAIRMAN. Let's not get carried away here. [Laughter.]

Senator DODD. Where are you living now?

Dr. DREZNER. I live in the State of Massachusetts.

Senator DODD. Well, come on back. All is forgiven. We'll take you back. [Laughter.]

Dr. DREZNER. They have to hire me there.

The CHAIRMAN. Hire him at Yale.

Dr. DREZNER. Yes; exactly.

I don't disagree—I would say I agree fully with Dr. Bhagwati. I would point out that one of the reasons why sovereign wealth funds probably have less leverage than we think they do vis-a-vis the United States is precisely because most of the developing world has the kind of investment protectionism that you're talking about and therefore there's not a lot of opportunity for them to invest in those places. Not surprisingly, I think something like 60 percent of sovereign wealth fund investment is in OECD countries.

Interestingly enough, this might be in essence where a sovereign wealth fund from one country might actually be acting in our interests by trying to pry open other developing country markets as well. So this might be a situation where the sort of natural trend line works in our favor, and I'm not sure stressing reciprocity is necessarily going to be a necessary part of U.S. policy.

Senator DODD. Let me ask you on a related matter of the enforcement issues, the question of the importance of diplomatic arrangements with foreign governments and with sovereign wealth funds to ensure cooperation with American authorities, the SEC and others, in the course of criminal or civil legal proceedings. Can you give us some sense of where you think that is and to what extent we can be demanding more of that? Do you have any sense of that?

Dr. DREZNER. I'm going to have to plead ignorance.

Senator DODD. I was going to ask Mr. Marchick more. It's an area I presume he'd probably have a bit more——

Dr. DREZNER. It's not my area of competence, I'm afraid.

Senator DODD. We will submit the question to him.

As I pointed out, if you end up with the some governments from whom we're seeking enforcement is also the very entity making the investment, you've got sort of an inherent problem here. That very government willing to be supportive of enforcement areas if in fact they're the provider of the sovereign wealth——

Dr. DREZNER. There is one thing I can say on this. I think there might be a tendency on the part of the United States to overestimate the sort of unitary nature of authoritarian governments, the belief that if there exists a sovereign wealth fund and it's controlled by an authoritarian government then surely the government is strategically micromanaging the sovereign wealth fund. The fact is that you have bureaucratic politics in those countries just as you do in the United States. So even though we might think that there's going to be a direct line of access from the government to the fund, if you take a look at sort of closer analysis, for example CIC, it seems pretty clear that there is actually a fair amount of

bureaucratic squabbling going on there about how appropriately to manage the CIC.

This isn't to say that these issues aren't—I agree with Commissioner Cox that these are an issue of concern, but they're not necessarily—it would be dangerous to overstate them, I guess.

Senator DODD. He poses a good intellectual question.

Dr. DREZNER. Right.

Senator DODD. And I'm waiting to get some specific examples of where maybe this has happened, where you're finding lack of cooperation which would warrant maybe considering something else.

I thank you both and thank Mr. Marchick. Of course, in these debates I always find it somewhat interesting. Some of the strongest supporters, of course, of investments by sovereign wealth funds are the private sector in the country, and I just find it somewhat of a contradiction when you suggest the investment of governments, their own government. Yet when it comes to this government making investments we find some of the same constituencies rather antagonistic to the idea. So it's somewhat amusing to me that the very people who are the strongest supporters of governments investing here are some of the strongest opponents of our own government making some investments in certain areas. But that's my own sort of inside private smile I have from time to time on these issues.

But I thank you immensely, both of you, and I'm sorry again I wasn't here to hear all of your comments in response to questions that others raised. But this is a very important area and a growing one. As I point out, if the numbers are correct it's even going to get larger, and it offers some tremendous opportunities.

We're going to have hearings tomorrow, Joe, on the infrastructure bill that Chuck Hagel and I have authored trying to create an infrastructure bank idea, that attracting private wealth into these—because we're not going to do what we need to be doing. We've got a $1.6 trillion shortfall just in maintenance of existing physical infrastructure in the country—waste water treatment, water systems, roads, bridges, and the like. This is not going to be done out of the appropriation process. You're going to have to attract private wealth to come in and do it.

So sovereign wealth funds become an incredible source of potential liquidity for us dealing in this area. For those who are worried about this, I always say you can't pick up a transit system or bridge and take it back to the country who's helped you build it. So there's some wonderful attractions of having private wealth come into this area, which we need desperately for economic growth in this century. So they're very important related issues and an area we want to continue to support, and I thank you.

The CHAIRMAN. Maybe they can pick up I–95 as it goes through Delaware and Connecticut, which are parking lots.

Senator DODD. We'd be willing to give that up.

The CHAIRMAN. We'd be willing to give them those two.

Gentlemen—Mr. Chairman, do you have any further questions?

Senator LUGAR. No, thank you.

The CHAIRMAN. Thank you for your time and your input. With your permission, we don't want to make a lot of extra—a little extra work for you. I have half a dozen questions that I'd like to

submit in writing. There's no time frame on them. With your permission, we'll leave the record open for a day to see if some of our colleagues who had other business might have some questions. But you've covered the waterfront very well. We appreciate it a great deal.

The only part of this whole exercise that Senator Lugar and I found difficult was the consistent praise for Chairman Dodd and the Banking Committee.

Senator DODD. I'm glad I showed up. [Laughter.]

The CHAIRMAN. That's right.

But seriously, thank you very, very much. It was very helpful, and we are adjourned.

[Whereupon, at 11:47 a.m., the hearing was adjourned.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF DOUGLAS REDIKER, CO-DIRECTOR GLOBAL STRATEGIC FINANCE INITIATIVE, THE NEW AMERICA FOUNDATION, WASHINGTON, DC

Over the past several months, few issues in international finance have generated as much discussion and comment as have Sovereign Wealth Funds ("SWF"s). This committee deserves enormous credit for recognizing the potentially significant foreign policy consequences of the rapid accumulation by foreign governments of enormous, growing pools of capital. These large concentrations of government-controlled wealth raise complex issues that transcend traditional boundaries between foreign policy, financial markets, international economics, and national security.

It is my belief, however, that too much focus on SWFs may, in fact, divert attention from the more fundamental foreign policy issue that these funds have come to represent—that of the rise of "state capitalism" and the broader use of finance as a tool of foreign policy. These, I believe, are increasingly important 21st century phenomena.

SWFs are simply a particular type of global financial market investor.[1] They should not automatically trigger foreign policy concerns. Too much focus on SWFs as potential tools of political influence fails to take into account that the world's more than 50 SWFs are very different in terms of the origin of funds, size, structure, investment philosophy, and motivation. Other than the commonality of government ownership, they are really not a definable class of either political or financial actors. But it is specifically foreign government ownership and the possibility that these increasingly wealthy foreign governments may use finance as a tool to advance their national interests abroad that makes them of interest as a matter of foreign policy.

In many cases, SWFs are neither the major repositories of government controlled wealth, nor the financial tool through which a country might seek to exert financial influence for political gain. While SWFs are believed to control approximately $3 trillion of assets, foreign government-owned central bank assets are estimated to exceed $7 trillion. State-owned-enterprises ("SOE"s) represent an additional distinct investment vehicle. There is greater likelihood that, if a country sought to use financial tools to advance foreign policy goals, it would do so either through the use (or threat of use) of central bank reserves to impact currency markets or via an SOE. For example, it is generally taken for granted that central bank interventions in currency markets have at least some element of political rather than pure financial motives. Likewise, foreign policy considerations are very much involved in potential investments by SOEs. For example, past rumors of interest in acquisitions by Russia's Gazprom have caused great consternation in many European countries for fear of the political motivation and impact of such an investment. Such issues are less likely to be raised by means of an investment by an SWF.

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[1] There are also definitional questions as to what constitutes a SWF. For example, some analysts include in SWF calculations part or all of the $327 billion held by the Saudi Arabia Monetary Authority ("SAMA"), while others exclude these funds, classifying them as central bank reserves instead. Similarly, the China Investment Corporation ("CIC") is that country's acknowledged SWF. But, China's State Administration for Foreign Exchange ("SAFE"), which manages China's central bank reserves and is not generally considered an SWF, has recently made significant investments in international equities.

We should be cautious about finding common denominators among the motives and actions among widely differing governments based on the particular financial structure through which they hold and invest their wealth. This is why the U.S. and international community have struggled to put in place criteria by which to judge SWFs, as well as appropriate rules and responses to govern their actions. There is little in common between the risks posed by SWFs of strong democratic allies like Canada and Norway and those whose political systems and motivations are more worrying, like those of China and Russia.

I believe the criteria by which many suggest we judge the risks posed by SWFs has resulted in an overemphasis on transparency and disclosure, while ignoring the more subjective, but more valuable, assessment of the political risk that a particular government owner poses. This is dangerous. While increased transparency and disclosure should be encouraged, such an overemphasis on transparency of SWFs alone may, in fact, lead to unnecessary conflict with allies, which, for a multitude of reasons may fail to meet the requisite level of transparency. Likewise, we may take false comfort from those SWFs that comply with transparency rules, but whose government owners' use of a broad array of other financial tools to advance foreign policy interests and which should warrant closer attention.[2]

It is important to note that a comprehensive review of relevant legislation and regulation already in place in this country should provide this committee with comfort that we are already well protected from market-based threats that SWFs may pose to our national or economic security. Last year's revised CFIUS/FINSA legislation, as well as existing protections afforded by the SEC, Federal Reserve, Antitrust authorities and other relevant legislation and regulation, provide a high degree of protection from improper takeover approaches or unwanted material investments from SWFs.

But we must acknowledge that over the past several years, many of the world's emerging nations have accumulated capital at an unprecedented pace.[3] At the same time, we have witnessed the rise of competing centers of global finance not only in Europe but also in Asia and the Middle East. While the U.S. remains the world's sole military superpower, we can no longer claim the same level of financial dominance. While the U.S. is, of course, still a financial powerhouse, we are no longer the only game in town. This shift has significant foreign policy and political consequences. We should expect that certain other countries may seek to further their national interests by using the financial tools that they increasingly have at their disposal. In their minds, finance and foreign policy are increasingly intertwined.[4]

Independent of their commitment to SWF best practices, countries like China, Russia, and Venezuela can be expected to selectively use finance as an instrument of power and influence. They have already begun to do so. For example, last year U.S. financial markets reacted to veiled threats that China might resort to the "nuclear option" of dumping U.S. dollars. At the same time, Russia called for a new "balance of power" by seeking the support of emerging market countries for their proposals to a new global financial architecture and Venezuela tried to win some "hearts and minds" by refinancing other nations' IMF debt through its participation in capital market transactions. None of these initiatives involved SWFs, and yet they are clear examples of the attempted use of increasing financial might to exert strategic influence over foreign affairs.

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[2] For example, the Abu Dhabi Investment Authority ("ADIA"), the largest SWF with assets estimated to approach $875 billion, has been a responsible investor in the U.S. and global markets for over three decades. In financial circles, ADIA is considered a high quality investor and has never been accused of acting in a manner inconsistent with international political or financial norms. Yet, ADIA consistently receives failing grades as an SWF because it does not publicly disclose information about its holdings, investments, or governance structures. In fact, ADIA, which, along with Singapore, recently agreed to improve its disclosure practices, if judged against its financial peer group of large international hedge funds and private equity funds, rather than against its political ones, is in line with the industry norm. By contrast, Russia's National Wealth Fund, established in February of this year, has announced that it intends to disclose its financial holdings in a transparent manner, leading to high marks on the various SWF transparency indices. However, Russia, through various non-SWF entities, has demonstrated a willingness to use its recently acquired financial heft to advance its national interests abroad.

[3] Over the first half of 2007, central banks in the world's emerging economies accumulated over $600 billion of new reserves—an amount that is double the total reserve position of the IMF—whose mission used to include preventing the collapse of many of these same governments.

[4] In fact, traditional foreign policy phrases like "nuclear option," "balance of power," "mutually assured destruction," and other similar terms are now embraced by many financial, as well as military, strategists.

From Britain's use of financial tools to expand its empire in the 18th and 19th centuries to the U.S. threat in 1956 to wreck havoc on Britain's currency if it did not end its occupation of the Suez, history is replete with examples of the use of finance and financial markets as tools of foreign policy. It is, I believe, important to recognize and address as a top priority the foreign policy consequences raised by the increasing wealth of other nations. But I do not believe that we achieve any meaningful economic, foreign policy, or national security benefits by targeting SWFs with additional burdens. As significant providers of capital to our markets, SWFs have thus far been a positive influence on the U.S. and global economies.

RESPONSES OF DAVID MARCHICK TO QUESTIONS SUBMITTED BY SENATOR BIDEN

Question. How would you assess the level of regulatory protection in the U.S. versus other regions, such as the EU. Are our regulations comparatively stronger? Can they be improved? Are they sufficient?

Answer. While I am not an expert on the regulatory regimes in every country within the EU, I believe that the laws and regulations in the United States give the executive branch adequate and authority to protect U.S. national security and/or other important government interests. FINSA protects against threats to national security, and CFIUS has demonstrated its willingness to block or mitigate problematic investments. DOD has its own set of regulations to protect the defense supply chain and classified information. Hart-Scott-Rodino triggers antitrust reviews for any significant acquisition. And in any sensitive sector, there are a host of laws and regulators that provide additional protection. In the chemicals industry, for example, there are five federal regulators focused on safety, security, transportation and other issues; several state-level regulators; and more than a dozen Federal statutes that impose various, wide-ranging controls on chemical investments and operations. The Fed, Treasury, OCC, and OTS scrutinize investments in the banking sector. Similar laws and regulatory oversight exist in the telecommunications, energy, pharmaceutical, and transportation sectors, among others. Even if there were cause for concern associated with sovereign wealth funds, our existing legal and regulatory structure should capture and fix—or block—any problematic investments. Bottom line: When a foreign entity invests in the United States, the U.S. is sovereign, not them.

Several countries in Europe and around the world have recently amended their laws to strengthen scrutiny of foreign investments. France, for example, recently issued regulations that require additional reviews for investments in a number of sectors of the French economy. Hungary passed a new law that raises obstacles toward foreign acquisitions of companies that affect "the security of public supply." Germany is considering new legislation to increase scrutiny of investments by sovereign wealth funds.

In general, I believe that countries have both a right and obligation to protect national security, including with respect to foreign investments. At the same time, national security should not be a guise for protecting domestic companies or national champions from economic competition.

Question. Robert Zoellick, President of the World Bank, has called on sovereign wealth funds to take an active role in investing in the development of sub-Saharan Africa. What do you see as their role in the economic development of these countries? Can they have a positive effect? What are the downsides?

Answer. Foreign investment is absolutely key to the economic development in Africa, and Africa has traditionally been a location of under investment with the exception of investments in national resources and extractive industries. Sovereign wealth funds are an important and growing pool of capital, and hopefully SWFs can increase their investment in Africa.

At the same time, the United States, European governments and various international institutions, including the IMF, have been putting pressure on SWFs to invest only for commercial reasons, as opposed to political reasons. I therefore note the irony that the IMF's sister institution, the World Bank, is calling for increased investment in Africa by SWFs for development purposes, as opposed to commercial purposes.

Question. Dr. Edward Truman of the Peterson Institute has devised a "scorecard" for sovereign wealth funds that ranks the funds according to a set of best practices criteria. Does this scorecard represent a useful analytic tool to rate sovereign wealth funds? Does it measure the right factors? Or is there little correlation between national security risk and a fund's scorecard rating?

Answer. I support the transparency initiatives being pursued by the Treasury Department and the International Monetary Fund, and hopefully additional transparency can ease some of the concerns that exist about SWFs. At the same time, transparency is not a proxy for the existence or absence of national security risks. One can imagine an investment in the United States by a completely transparent SWF that triggers national security concerns. One could also imagine an investment by a completely nontransparent SWF that does not implicate national security concerns.

Instead of transparency, one needs to look at the country making the investment, the asset being acquired, and the sensitivity of the asset to determine the national security risk associated with an investment.

Question. Recently the Kuwait Investment Authority asked companies seeking money from it to "clear our name with politicians before you talk to us." Lehman Brothers is also said to be looking to raise capital from sovereign wealth fund sources. From your perspective as a senior executive in The Carlyle Group, are you concerned that the current political environment in the U.S. is dissuading outside investors from putting money in U.S. assets? Do we need to consider sending a different political signal?

Answer. Yes; I know from my experience as an attorney before joining The Carlyle Group and from discussions I have had with foreign investors that the political environment in the United States is dissuading certain investors from investing here. Certain foreign investors worry that their investments will trigger political backlash in the United States, either putting their investment or their reputation at risk. Other foreign investors worry that about the CFIUS process, either with respect to the timing required to clear CFIUS or with respect to the conditions imposed by CFIUS. Some investors have publicly announced that they will look outside the United States and Europe to invest because of the political environment. Lower investment volumes by definition lessens economic activity in the United States, potentially costing jobs and economic opportunities for Americans.

In my view, both the President (and the new President in 2009) and the Congress need to make clear that the United States remains open to foreign investment. In addition, both the executive branch and the Congress (in its oversight role) should work to ensure that regulatory processes are predictable and nondiscriminatory. The hearing that Senator Biden held, and the opening statements by Senators Biden and Lugar, set exactly the right tone, in my view.

Question. To what extent is past behavior of certain sovereign wealth funds a better indicator of national security risk than transparency? For example, the Abu Dhabi Investment Authority generally has a solid investment reputation in the United States, but it is also one of the least transparent funds. Should this matter when it comes to national security?

Answer. See above.

Question. Many commentators have expressed specific concern toward Russia's Sovereign Wealth Fund—the Russian National Wealth Fund. It has already raised concern with its disclosure that it owns a 5-percent stake in the European Aeronautic Defense and Space Co. (which owns Airbus) and is considering increasing its stake to 25 percent. This has prompted Germany to consider new laws restricting sovereign wealth funds. Should we be concerned about Russia's SWF in particular? Is the German response the appropriate one? Should we consider other policy responses when it comes to Russia's SWF?

Answer. I believe that the FINSA creates an effective, adequate, and balanced mechanism to ensure that foreign investments do not risk U.S. national security. The new law and regulations require heightened scrutiny of acquisitions by government-owned companies, including SWFs, and require additional reporting to Congress to ensure that Congress can effectively execute its important oversight role.

The draft German law creates a number of uncertainties for foreign investors, including uncertainty with respect to whether the government will act to block or mitigate a transaction for up to 3 months after the transaction has been completed.

RESPONSES OF DAVID MARCHICK TO QUESTIONS SUBMITTED BY SENATOR LUGAR

Question. You noted in your testimony that a more important foreign policy concern is the "United States growing dependence on foreign countries to finance our current account deficit." Could you please outline in more detail how our government's fiscal deficit connects to the need for foreign financing?

Answer. By definition, if the United States spends more than it saves (both in terms of public and private savings), it needs to finance that spending. As a result, the United States requires investment from abroad through a variety of means, including foreign direct investment.

Question. What does the growth of sovereign wealth funds mean for the United States? If sovereign wealth funds reduced their investments in the United States, what would be the impact on our economy?

Answer. The growth of SWFs has a number of implications for the United States. First, it points to an unhealthy current account imbalance, combined with high energy prices, which has led to a dramatic rise in the accumulation of official reserves in a number of countries around the world. Second, just like any other investor, SWFs have many choices with respect to deployment of their capital. So long as a SWF investment does not create a national security risk to the United States, we should welcome SWF investments. If the United States created an unwelcome environment for SWFs, it would ultimately harm US economic and strategic interests. Just like any other investment, SWF investments can help create economic activity, jobs and opportunity for American firms and workers.

Question. What policy proposals would you recommend, if any, to improve sovereign wealth fund transparency?

Answer. I believe that the proposals outlined by the IMF, with support from the Treasury department, are generally pointed in the right direction. Transparency will help reduce concerns and fears about SWFs; at the same time, even a perfectly transparent SWF might seek to buy U.S. assets the sale of which would present national security concerns.

Question. The President of the World Bank, Robert Zoellick, has suggested that sovereign wealth funds actively invest in the development of sub-Saharan Africa. What do you see as the role of sovereign wealth funds in the economic development of poor countries?

Answer. SWFs can and should play an important role in investment in sub-Saharan Africa but the United States and International Financial Institutions should not press SWFs to make non-commercial investments in the region. The U.S. and other countries can and should play an important development role in sub-Saharan Africa. However, it would be counter-productive and confusing if the U.S. and International Financial Institutions call on SWFs to make investment only for commercial reasons, on the one hand, but then call for development-related investments on the other.

Question. Should we treat sovereign wealth fund investments differently than other types of foreign holdings of U.S. assets? Do U.S. national security concerns differ for sovereign wealth funds versus other types of foreign investment and foreign purchase of U.S. debt?

Answer. The recently passed CFIUS reform bill requires heightened scrutiny of foreign acquisitions of U.S. companies by government-controlled entities, including Sovereign Wealth Funds. In my view, the legislation strikes the right balance between encouraging foreign investment and protecting national security. To date, most SWF investment have been small, passive stakes which have not implicated any U.S. national security interests.

Question. Despite concerns about sovereign wealth funds, it is also possible that they can support U.S. foreign policy and development goals. Some oil and gas rich countries with surging export revenues struggle with weak domestic economies. For example, Angola, which reportedly received $44 billion in oil revenues last year, has the10th largest amount of arable land in the world but has been unable to revive its agriculture sector and imports half of its food. How can the U.S. encourage governments to form well-managed funds? Are our foreign assistance tools equipped to provide this sort of technical expertise?

Answer. The United States has—correctly in my view—for many years encouraged small, resource-rich developing countries to take steps to avoid the so called "Dutch disease," which has undermined the economies of many oil-rich countries. One of the big challenges that resource rich countries face is that the dramatic in-

crease in fiscal revenues at times of high energy prices increases inflation, creates upward pressure on their currency and make non-energy sector exports uncompetitive. One way to reduce risks of Dutch disease or the "oil curse" is to set aside revenues and invest them abroad. In doing so, countries can maintain discipline on spending and reduce upward pressure on their domestic currency. Both the Treasury Department and the IMF have done good work in providing technical assistance to developing countries on these issues but perhaps more could be done at this time given the extraordinary growth in revenues in a large number of resource-rich countries.