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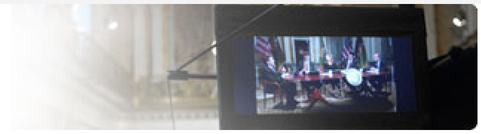

Under Secretary for International Affairs David H. McCormick Testimony

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Before the House Committee on Financial Services

Subcommittee on Domestic and International Monetary Policy, Trade and Technology and Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Washington − Chairman Gutierrez, Chairman Kanjorski, Ranking Member Paul, Ranking Member Pryce, Members of the Committee, good afternoon. I very much appreciate the opportunity to appear before you today to discuss sovereign wealth funds. This is a timely hearing on a very important topic. At Treasury, we have been increasingly focused on sovereign wealth funds for more than a year now. I am pleased to be able to share with the Committee some of our views.

Chairman Gutierrez, Chairman Kanjorski, Ranking Member Paul, Ranking Member Pryce, Members of the Committee, good afternoon. I very much appreciate the opportunity to appear before you today to discuss sovereign wealth funds. This is a timely hearing on a very important topic. At Treasury, we have been increasingly focused on sovereign wealth funds for more than a year now. I am pleased to be able to share with the Committee some of our views.

History and Context

Although the term "sovereign wealth fund" was coined just a few years ago, the funds it describes are not new. Sovereign wealth funds have existed in various forms for decades in places as diverse as the central Pacific, Southeast Asia, Europe and the Persian Gulf. At the turn of the century, there were about 20 sovereign wealth funds worldwide managing total assets of several hundred billion dollars.

Today, what is new is the rapid increase in both the number and size of sovereign wealth funds. Twenty new funds have been created since 2000, more than half of these since 2005, which brings the total number to nearly 40 funds that now manage total assets in a range of $1.9-2.9 trillion. Private sector analysts have projected that sovereign wealth fund assets could grow to $10-15 trillion by 2015. Two trends have contributed to this ongoing growth. The first is sustained high commodity prices. The second is the accumulation of official reserves and the transfers from official reserves to investment funds in non-commodity exporters. Within this group of countries, foreign exchange reserves are now sufficient by all standard metrics of reserve adequacy. For these non-commodity exporters, more flexible exchange rates are often necessary, and Treasury actively pushes for increased flexibility.

So what are sovereign wealth funds? At the Department of the Treasury, we have defined them as government investment vehicles funded by foreign exchange assets, which manage those assets separately from official reserves. Sovereign wealth funds generally fall into two categories based on the source of the foreign exchange assets:

- Commodity funds are established through commodity exports, either owned or taxed by the government. They serve different purposes, including stabilization of fiscal revenues, intergenerational saving, and balance of payments sterilization. Given the recent extended sharp rise in commodity prices, many funds initially established for fiscal stabilization purposes have evolved into savings funds. In the case of commodity funds, foreign currency typically accrues to the government and does not increase the money supply and create unwanted inflationary pressure.

- Non-commodity funds are typically established through transfers of assets from official foreign exchange reserves. Large balance of payments surpluses have enabled non-commodity exporting countries to transfer "excess" foreign exchange reserves to stand-alone funds. In the case of non-commodity funds, foreign exchange assets often derive from exchange rate intervention, which then increases a country's money supply. Monetary authorities take additional steps to lower the money supply and stave off inflation by issuing new debt, but there may be a cost associated with this if the cost of the new debt is more than the returns that the government earns on its foreign exchange assets.

In contrast to traditional reserves, which are typically invested for liquidity and safety, sovereign wealth funds seek a higher rate of return and may be invested in a wider range of asset classes. Sovereign wealth fund managers have a higher risk tolerance than their counterparts managing official reserves. They emphasize expected returns over liquidity, and their investments can take the form of stakes in U.S. companies, as has been witnessed in recent months with increased regularity.

However, sovereign wealth fund assets are currently fairly concentrated. By some market estimates, a handful of funds account for the majority of total sovereign wealth fund assets. Roughly two-thirds of sovereign wealth fund assets are commodity fund assets ($1.3-1.9 trillion), while the remaining one-third are non-commodity funds transferred from official reserves ($0.6-1.0 trillion).

To get a better perspective of the relative importance of sovereign wealth funds, it is useful to consider how they measure up against private pools of global capital. Total sovereign wealth fund assets of $1.9-2.9 trillion may be small relative to a $190 trillion stock of global financial assets, or the roughly $62 trillion managed by private institutional investors. But sovereign wealth fund assets are currently 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.

In sum, sovereign wealth funds represent a large and rapidly growing stock of government-controlled assets, invested more aggressively than traditional reserves. Attention to sovereign wealth funds is inevitable given that their rise clearly has implications for the international financial system. Sovereign wealth funds bring benefits to the system but also raise potential concerns.

Benefits

A useful starting point when discussing the benefits of sovereign wealth funds is to stress that the United States remains committed to open investment. On May 10, 2007, President Bush publicly reaffirmed, in his Statement on Open Economies, the U.S. commitment to advancing open economies at home and abroad, including through open investment and trade. Lower trade and investment barriers benefit not only the United States, but also the global economy as a whole. The depth, liquidity and efficiency of our capital markets should continue to make the United States the most attractive country in the world in which to invest.

In 2006, there was a net increase of $2.5 trillion in foreign-owned assets in the United States, while U.S. net international investment abroad increased by $2.2 trillion. International investment in the United States fuels U.S. economic prosperity by creating well-paid jobs, importing new technology and business methods, helping to finance U.S. priorities, and providing healthy competition that fosters innovation, productivity gains, lower prices, and greater variety for consumers. Over five million Americans –

4.6 percent of the U.S. private sector – are employed by foreign-owned firms' U.S. operations. Over 39 percent of these five million jobs at foreign-owned firms are in manufacturing, a sector that accounts for 13 percent of U.S. private sector jobs. These five million jobs pay 25 percent higher compensation on average than jobs at other U.S. firms. Another roughly five million jobs are indirectly supported by foreign investment. Additionally, foreign-owned firms contributed almost six percent of U.S. output and 14 percent of U.S. R&D spending in 2006. Foreign-owned firms re-invested over half of their U.S. income – $71 billion – back into the U.S. economy in 2006. A disproportionate 13 percent of U.S. tax payments and 19 percent of U.S. exports are made by foreign-owned firms. Without international investment, Americans would be faced with painful choices regarding taxes, spending on government programs, and their level of savings and consumption. Another benefit of FDI is that foreign investors' economic interests become more dependent on the health of the U.S. economy – giving the investor an incentive to support U.S. economic interests.

As many observers have pointed out, sovereign wealth funds have the potential to promote financial stability. They are, in principle, long term, stable investors that provide significant capital to the system. They are typically not highly leveraged and cannot be forced by capital requirements or investor withdrawals to liquidate positions rapidly. Sovereign wealth funds, as public sector entities, should have an interest in and a responsibility for financial market stability.

Potential Concerns

Yet, sovereign wealth funds also raise potential concerns.

First, transactions involving investment by sovereign wealth funds, as with other types of foreign investment, may raise legitimate national security concerns. The Committee on Foreign Investment in the United States (CFIUS), which is chaired by Treasury, conducts robust reviews of certain investments that could result in foreign control of a U.S. business to identify and resolve any genuine national security concerns. The Foreign Investment and National Security Act (FINSA) became effective on October 24, 2007, and strengthened the CFIUS process. CFIUS is able to review investments from sovereign wealth funds, just as it would other foreign government-controlled investments, and it has and will continue to exercise this authority to ensure national security. CFIUS reviews are of course limited to identifying and resolving genuine national security concerns.

Separately, Treasury is also considering non-national security issues related to potential distortions from a larger role of foreign governments in markets. Through inefficient allocation of capital, perceived unfair competition with private firms, or the pursuit of broader strategic rather than strictly economic return-oriented investments, sovereign wealth funds could potentially distort markets. Sovereign wealth funds may also indirectly invest abroad through domestic state-owned enterprises. However, such action by a SWF is more likely to be viewed as a direct extension of government policy. Clearly, both sovereign wealth funds and the countries in which they invest will be best served if investment decisions are made solely on commercial grounds.

The investment policy issues I have just described – both the national security and non-national security issues – have the potential to provoke protectionist responses from recipient country governments. It is my view that protectionist sentiment stems partly from a lack of information and understanding of sovereign wealth funds, which in turn is partly due to a lack of transparency and clear communication on the part of many of the funds themselves. Further, concerns about cross-border investment by state-owned enterprises are often misdirected at sovereign wealth funds as a group. Better information and understanding on both sides of the investment relationship is therefore needed.

Finally, sovereign wealth funds may raise concerns related to financial stability. Sovereign wealth funds can represent large, concentrated, and often non-transparent positions in certain markets and asset classes. Actual shifts in their asset allocations can cause market volatility.

In fact, even perceived shifts or rumors can cause volatility as the market reacts to what it perceives sovereign wealth funds to be doing.

Policy Response

Treasury has taken a number of steps to help ensure that the United States can continue to benefit from open investment while addressing these potential concerns.

First, we are aggressively implementing reforms that strengthen the CFIUS process, reflected in FINSA and Executive Order 11858, issued by the President on January 23. We are proceeding steadily through a vigorous drafting process for new regulations which will become effective later this Spring following public notice and comment. One of the reforms codified by FINSA, which we have already implemented, is an elevated level of accountability within CFIUS for review of foreign government-controlled transactions. I want to be clear that CFIUS has – as early as 1989 – and will continue to review the investment transactions of sovereign wealth funds, based on the consideration of genuine national security concerns, just as it does for other foreign government-controlled investment. FINSA protects our national security while keeping investment barriers low and reaffirming investor confidence and the longstanding U.S. open investment policy. CFIUS will continue to vigorously implement this law.

Second, we have proposed that the international community collaborate on the development of a multilateral framework for best practices. The International Monetary Fund, with support from the World Bank, should develop voluntary best practices for sovereign wealth funds, building on existing best practices for foreign exchange reserve management. These would provide guidance to new funds on how to structure themselves, reduce any potential systemic risk, and help demonstrate to critics that sovereign wealth funds can be responsible, constructive participants in the international financial system.

Here, I would note that the logic of voluntary best practices for sovereign wealth funds is to create a dynamic rise to the top. International agreement on a set of best practices will create a strong incentive among funds to hold themselves to high standards. Sovereign wealth funds themselves are increasingly aware that the increase in the number and size of these funds has, rightly or wrongly, raised reputational issues for them all.

Third, we have proposed that the Organisation for Economic Co-operation and Development (OECD) should identify best practices for countries that receive foreign government-controlled investment, based on its extensive work on promoting open investment regimes. These should have a focus on avoiding protectionism and should be guided by the well-established principles embraced by OECD and its members for the treatment of foreign investment.

We have already seen meaningful progress along these lines. On May 12-13 of last year, Treasury hosted a G-20 meeting of Finance Ministry and Central Bank officials on commodity cycles and financial stability, which included perhaps the first multilateral discussion of sovereign wealth funds among countries with these funds and countries in which they invest. Following a period of extensive direct bilateral outreach with sovereign wealth funds, Secretary Paulson hosted a G-7 outreach meeting on October 19, 2007 with Finance Ministers and heads of sovereign wealth funds from eight countries (China, Korea, Kuwait, Norway, Russia, Saudi Arabia, Singapore, and the United Arab Emirates) to build support for best practices.

On October 20, 2007, the International Monetary and Financial Committee – a ministerial level advisory committee to the IMF – issued a statement calling on the IMF to begin a dialogue to identify best practices for sovereign wealth funds. On November 15-16, 2007, the IMF hosted a roundtable meeting for sovereign asset and reserve managers. In response to the IMFC statement, the IMF added a special session on policy and operational issues relating to SWFs for official sector delegates. This marks the beginning of an important process in the IMF. IMF Managing Director Dominique Strauss-Kahn opened the roundtable meeting and underlined that some form of agreement on best practices for the operations of SWFs could help maintain an open global financial system.

A separate dialogue is well underway in the OECD on investment policy issues with regard to SWFs, building on the discussions on Freedom of Investment, National Security, and "Strategic" Industries. Later this month, the OECD Investment Committee will discuss an interim report on broader investment issues that will also cover SWFs. The OECD expects to issue a "special statement" regarding investment policy principles and sovereign investment at its June Ministerial.

Fourth, Treasury has taken a number of steps internally and within the U.S. Government to enhance our understanding of sovereign wealth funds. Treasury has created a working group on sovereign wealth funds that draws on the expertise of Treasury's offices of International Affairs and Domestic Finance. Treasury's new market room is ensuring vigilant, ongoing monitoring of sovereign wealth fund trends and transactions. Through the President's Working Group on Financial Markets, chaired by Secretary Paulson, we continue to discuss and review sovereign wealth funds. We have also engaged sovereign wealth funds directly on numerous occasions, at numerous levels within our government and at numerous forums.

Treasury is actively coordinating with Congress through staff briefings and committee hearings. As you may know, I testified on these issues before the Senate Banking Committee in November. Also, in June and December of last year we provided Congress with updates on our sovereign wealth fund-related work in an appendix to the Report on International Economic and Exchange Rate Policies, and we will continue to provide updates on a semi-annual basis.

The Treasury Department will continue its work on sovereign wealth funds through sound analysis and focused bilateral and multilateral efforts to help ensure the United States shapes an appropriate international response to this issue, addresses legitimate areas of concern, and together with other countries, remains open to foreign investment.

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