U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 2pm EST, November 14, 2007
CONTACT Ann Marie Hauser, (202) 622-2960

UNDER SECRETARY FOR INTERNATIONAL AFFAIRS DAVID H. MCCORMICK TESTIMONY BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Chairman Dodd, Ranking Member Shelby, 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

First, some history: sovereign wealth funds are not new. The oldest of these funds date back to the 1950s in Kuwait and Kiribati. Over the next four decades, their numbers slowly grew. Three of the largest and most respected funds – the Abu Dhabi Investment Authority, Singapore's Government Investment Corporation, and Norway's Government Pension Fund-Global – were founded in 1976, 1981, and 1990, respectively. By the year 2000, there were about 20 sovereign wealth funds worldwide managing total assets of several hundred billion dollars.

Today, what is new is the rapid increase in both the number and size of sovereign wealth funds. Twenty new funds have been created since 2000, more than half of these since 2005, which brings the total number to nearly 40 funds that now manage total assets in a range of $1.9-2.9 trillion. Private 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. It should be noted, that 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. [1]

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

[1] Russell Green and Tom Torgerson, "Are High Foreign Exchange Reserves in Emerging Markets a Blessing or a Burden?" Office of International Affairs Occasional Paper No. 6, U.S. Department of the Treasury, March 2007.

separately from official reserves.[2] 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 reserve. 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 $53 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, President Bush publicly reaffirmed in his open economies statement 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

[2] "Sovereign Wealth Funds," Appendix 3 of the Semi-Annual Report to Congress on International Economic and Exchange Rate Policies, June 2007.

markets should continue to make the United States the most attractive country in the world in which to invest.

Foreign investment in the United States, including from sovereign wealth funds, strengthens our economy, improves productivity, creates good jobs, and spurs healthy competition. In 2006, there was a net increase of $1.9 trillion in foreign-owned assets in the United States. Foreign direct investment (FDI) is particularly beneficial to our economy. FDI supports nearly 10 million U.S. jobs directly or indirectly, 13% of R&D spending in the U.S., 19% of U.S. exports, and pays 30% higher compensation than the U.S. average.

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. Primary among them is a risk that sovereign wealth funds could provoke a new wave of investment protectionism, which would be very harmful to the global economy. Protectionist sentiment could be partially based on a lack of information and understanding of sovereign wealth funds, in part due to a general lack of transparency and clear communication on the part of the funds themselves. Concerns about the cross-border activities of state-owned enterprises may also at times be misdirected at sovereign wealth funds as a group. Better information and understanding on both sides of the investment relationship is needed.

Second, transactions involving investment by sovereign wealth funds, as with other types of foreign investment, may raise legitimate national security concerns. The new Foreign Investment and National Security Act (FINSA) authored by the Chairman and Ranking members of this committee and signed into law by President Bush last summer, implemented through the Committee on Foreign Investment in the United States (CFIUS), ensures robust reviews of investment transactions, based on the consideration of genuine national security concerns, and requires heightened scrutiny of foreign government-controlled investments. CFIUS is able to review investments from sovereign wealth funds just as it would other foreign government-controlled investments, and it has and will continue to exercise this authority to ensure national security.

As we take our work forward on sovereign wealth funds, Treasury is also considering, non-national security issues related to potential distortions from a larger role of foreign governments in markets. For example, through inefficient allocation of capital, perceived unfair competition with private firms, or the pursuit of broader strategic rather than strictly economic return-oriented investments, sovereign wealth funds could potentially distort markets. 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.

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 could 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 FINSA through the CFIUS process. I want to be clear that CFIUS reviews the investment transactions of sovereign wealth funds, based on the consideration of genuine national security concerns, just as it would for any 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. We believe the U.S. investment security framework provides a good model for other countries where protectionist sentiment has been on the rise due to concerns about sovereign wealth funds, and we are actively engaged with these countries to help them avoid undue protectionist responses.

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

Third, we have proposed that the Organization for Economic Cooperation and Development (OECD) should identify best practices for countries that receive foreign government-controlled investment, based on its extensive work on promoting open investment regimes. These should have a focus on proportionality, predictability and accountability, and should be guided by the well-established principles embraced by OECD and its members for the treatment of foreign investment. It is important to address the growing importance of sovereign wealth funds, on both sides of the investment equation.

We have already seen meaningful progress along these lines. On May 12-13 of this 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 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. The next day, 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.

Fourth, Treasury has taken a number of steps internally and within the U.S. Government to enhance our understanding of SWFs. Treasury has created a working group on sovereign wealth funds that draws on the expertise of Treasury's offices of International Affairs and Domestic Finance. 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 also have initiated bilateral outreach to ensure an ongoing and candid dialogue with countries with significant sovereign wealth funds and their management.

Treasury is actively coordinating with Congress through staff briefings and committee hearings. As you know, we informed Congress in June of some of our initial thinking on sovereign wealth funds in an appendix to the Report on International Economic and Exchange Rate Policies, and 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 ensure the United States shapes an appropriate international response to this issue, addresses legitimate areas of concern, and ensures that the United States remains open to and welcoming of foreign investment.

-30-