TESTIMONY OF PATRICK A. MULLOY
BEFORE THE SENATE COMMITTEE
ON BANKING, HOUSING & URBAN AFFAIRS
HEARING ON
"SOVEREIGN WEALTH FUND ACQUISITIONS AND OTHER
FOREIGN GOVERNMENT INVESTMENTS IN THE U.S.:
ASSESSING THE ECONOMIC AND NATIONAL SECURITY IMPLICATIONS"

NOVEMBER 14, 2007

Introduction

Chairman Bayh, let me begin by thanking you, Chairman Dodd, Ranking Member Shelby and Senator Webb for providing me the opportunity to speak before you today on the economic and national security implications of sovereign wealth funds and other foreign government investments in our nation.

My name is Patrick Mulloy and I served as a member of the twelve person, bipartisan, bicameral United States-China Economic and Security Review Commission from its creation in early 2001 through the end of 2006. I presently serve as the Washington representative of the Alfred P. Sloan Foundation and also teach International Trade Law and Public International Law as an Adjunct Professor at the law schools of Catholic University and George Mason University.

I should note that the views I will present today are my own and not necessarily those of any of my present employers nor the U.S.-China Economic and Security Review Commission. I do want to assure the Committee that I have no client except the public interest on these matters and have never been paid by any company or any other entity to advise it on foreign investment matters.

I commend the Committee for holding this important hearing and I am honored by the invitation to testify. It is a source of enormous personal satisfaction for me to have served on the staff of the Committee from 1983 to early 1998 when I left to take a position as Assistant

Secretary in the Commerce Department's International Trade Administration. During the period of 1987-1988 when the provisions of the Omnibus Trade Act of 1988 dealing with "exchange rates" and "foreign investment reviews" were being formulated by the Committee, I served as the Committee's General Counsel and was directly involved in the discussions that led to their formulation and enactment into law. The sovereign wealth fund and other foreign investment issues we are discussing today are directly related to those two sections of the 1988 trade bill.

Prior Oversight Hearings

In October 2005 Chairman Shelby and Ranking Member Sarbanes invited me to testify before the Committee on the background of the foreign investment provisions enacted in 1988 and amended in 1992 and how they were being implemented by the Treasury Department chaired Committee on Foreign Investment in the United States or CFIUS. I am delighted that some of the concerns I expressed at that hearing were taken into account by the Committee in the CFIUS reform legislation entitled the "Foreign Investment and National Security Act of 2007" which you formulated on a bipartisan basis and got enacted into law just a few months ago.

In May of this year, International Finance Subcommittee Chairman Bayh and Ranking Member Martinez invited me to testify on the "exchange rate" provisions of the 1988 Omnibus Trade Bill and the performance of the Treasury Department in carrying out the statutory obligations given it by that law to identify and report to Congress the names of countries that were manipulating their currencies to gain trade advantages with the United States. In my May testimony I told the Subcommittee that the Treasury Department had failed to carry out the responsibilities given to it by Congress in that 1988 law. That failure is at least one reason we are here today to discuss the issue of sovereign wealth funds and increased foreign ownership of the United States economy. I will explain in my testimony why I make that direct link.

I am pleased, however, that the Committee subsequent to the May hearing did formulate and report out for consideration by the full Senate legislation to address some of the measures that were advocated by me and others to address exchange rate manipulation by other nations including China.

Sovereign Wealth Funds

As I begin my discussion of sovereign wealth funds, and knowing that many officials in the Executive Branch along with some business leaders will not be sympathetic to the concerns I will raise, let me remind the Committee that under Article I, Section 8 of the Constitution it is the Congress, not the Executive Branch, which is charged with the regulation of foreign trade, foreign investment and the value of our nation's currency. Our Founding Fathers knew such matters directly impacted people's lives and wanted them under the control of the branch of Government closest to the people. The rise of "sovereign wealth funds" and the increased foreign ownership of our economy are directly related to our mismanaged trade policies which have failed to take into account the government-directed mercantilist trade policies of many of our trading partners.

In June of this year, then Acting Under Secretary of the Treasury Mr. Clay Lowery made a speech in San Francisco on "sovereign wealth funds". He said he would use the term to mean:

> "a government investment vehicle which is funded by foreign exchange assets and which manages those assets separately from official reserves"

He said such sovereign wealth funds typically fall into two categories based on the foreign government's source of foreign exchange assets. These are:

1. Commodity funds – which are established through commodity exports such as oil and gas. The tripling of oil prices since 2002 has created a windfall for oil-exporting nations such as Abu Dhabi, Kuwait, and Norway. McKinsey and Company in an October 2007 report entitled The New Power Brokers, which examines sovereign wealth funds, has estimated that investors from oil-exporting nations collectively owned between $3.4 trillion and $3.8 trillion in foreign financial assets at the end of 2006. That report also said many oil exporting nations have now set up state-owned investment funds, often called sovereign wealth funds, to invest **some** of the assets they have acquired through their oil exports. The October 2007 study done by McKinsey and Company tells us that "sovereign wealth funds", unlike "central bank reserves" (also known as "foreign exchange reserves"), have diversified portfolios that range across equity, fixed income, real estate, bank deposits, and alternative investments such as hedge funds and private equity. According to the McKinsey October 2007 study; the largest sovereign wealth fund among oil exporters is the Abu Dhabi Investment Authority which reportedly has total assets of up to $875 billion.

2. Non-Commodity Funds – which are typically established through transfers of assets from official foreign exchange reserves. Large balance of payment surpluses, according to the McKinsey Study, have enabled non-commodity exporters to transfer "excess" foreign exchange reserves to stand alone investment funds to be managed for higher returns. Most of the non-commodity holdings of foreign exchange reserves are held by the Asian central banks. **The October 2007 McKinsey study estimates that at the end of 2006**

Asian central banks had $3.1 trillion in foreign reserve assets. The study then stated:

> **"to put this in perspective, it is twice as many assets as global hedge funds manage and twice the size of global private equity**".

China's central bank had $1.1 trillion in reserves at the end of 2006 and the Bank of Japan had $875 billion. The central banks of Hong Kong, India, Malaysia, Singapore, South Korea, and Taiwan together have another $1 trillion.

Now how are these Asian central banks able to accumulate these vast and fast-growing amounts of "foreign exchange reserves?" The McKinsey study tells us on page 77 that:

> "…**exchange rate management has been key**. Since the Asian financial crisis, the region's economies have benefited from rapidly growing exports, and apart from Japan, have switched from running current account deficits to large current account surpluses. **The logical long-run corollary of these surpluses, combined with foreign capital inflows would be the appreciation of the currencies of the surplus countries**. **However to preserve the competitiveness of the region's exports, Asian central banks have intervened in the foreign exchange markets to prevent rapid appreciation, buying foreign currencies (mainly the dollar) while selling domestic currency.**

The McKinsey study on page 78 then explores the pros and cons of having the Asian central banks manage the value of the dollar in a system some economists called Bretton Woods II. The study states:

> "**For Asia the system has ensured the success of its export-led growth model and continuous and growing current account surpluses.** For the United States the benefit has been twofold. American consumers have the advantage of being able to bring in a huge range of cheap goods manufactured in Asia. But of even more importance is the fact that the United States has been able to maintain a large and growing current account deficit while at the same time maintaining significantly lower interest rates than would normally prevail with a large deficit position – because Asia has provided low cost funds to finance the shortfall".

The McKinsey Report then goes on to note that the Bretton Woods II system has two distinct disadvantages for the United States. A higher dollar (propped up by the Asian central banks) hinders our nation's ability to export (and harms import sensitive domestic industries) and there are hazards from an over-reliance on foreign capital.

Recently Asia's governments have begun to shift some of their foreign exchange assets into "sovereign wealth funds". The Government of Singapore Investment Corporation has around $150 billion under management. China has taken at least $200 billion of its foreign reserve assets and put them into its sovereign wealth fund the China Investment Corporation. It can always transfer more from its foreign exchange reserves into its sovereign wealth fund as it is accumulating foreign exchange at a rate of well over $300 billion annually. Its trade surplus with just the United States this year will be over $250 billion.

<u>Problems for the U.S. with Sovereign Wealth Funds</u>

1. <u>Purchases of Strategic Assets and Technologies</u>

   Mr. Gerard Lyons, the Chief Economist of the Standard Chartered Bank, issued a paper on October 15, 2007 entitled "State Capitalism: The Rise of Sovereign Wealth Funds". In that paper he noted that sovereign wealth funds are presently valued at $2.2 trillion, but could reach $13.4 trillion in a decade. One concern he identified on page 9 of his paper is that these funds may make purchases (investments) for strategic, rather than economic purposes. He noted that through these funds foreign governments could acquire:

> "strategic stakes in key industries around the world such as telecommunications, energy, the financial sector, or even to secure intellectual property rights in other fields."

In 1992 the Treasury Department as part of its CFIUS responsibilities was tasked by law to report to Congress within one year and every four years thereafter whether any foreign government had a coordinated strategy to acquire U.S. companies involved in the research and development or production of critical technologies. In its 1993 report the Treasury said it could not find credible evidence of such strategies but said that "should not be viewed as conclusive proof" such strategies did not exist. It did indicate some governments did identify "technologies that are critical to national economic development and thus prime targets for acquisition through M&A's." In its first update to that report submitted to the Congress in September of 2007, the Treasury again reported it "did not find strong enough evidence to conclude that any individual company had a coordinated strategy or was acting on a coordinated strategy on behalf of its respective government." The Treasury report did note, however, that "there is significant evidence that foreign governments are involved in other efforts to acquire such technologies." That was in the Treasury's unclassified report. I understand that there is a classified version and I would urge you to have your staffs peruse that and brief you on it. It just seems reasonable to me to assume that if some foreign governments are using illicit means to acquire U.S. developed critical technologies, that they will probably buy companies producing them if they can utilize that means to access these critical technologies.

2. <u>Increasing Foreign Government Ownership of Our Market Economy</u>

Another concern was expressed by SEC Chairman Christopher Cox in an October 24th speech at the Kennedy School of Government at Harvard University. In that speech entitled "The Role of Government in Markets", Chairman Cox noted that sovereign wealth funds, which are already enormous in his view, could "grow as large as $12 trillion over the next eight years". He then went on to state:

> "The economic rationale for our legislative and regulatory deference to markets is called into question when the major marketplace participants are not profit-maximizing individuals but governments with national interests".

The SEC Chairman then went on to discuss why in the United States we have traditionally been against large government ownership of our economy, noting our emphasis on private ownership is directly tied to America's dedication to individual freedom. He stated:

> "…the fundamental question presented by state-owned public companies and sovereign wealth funds does not so much concern the advisability of foreign ownership, but rather of government ownership".

He then revisited the issue of foreign ownership later in his speech and noted that if ownership is held by our own government, we can at least influence it to use its ownership to "put our nation's interests first." If the owner on the other hand is a foreign government, he said,

> "the national interests a foreign government will advance will presumably be its own".

So there are, in Chairman Cox's view, legitimate concerns a nation must take into account when it considers whether to follow policies giving foreign owners and particularly foreign governments increasing amounts of control over its domestic economy.

Foreign Ownership and Trade Deficits

On October 26, 2003, Fortune Magazine carried an article by Warren Buffett entitled "Why I'm Not Buying the Dollar: America's Growing Trade Deficit is Selling the Nation Out From Under Us". In that article, Mr. Buffett noted that America's trade deficit exceeded 4 percent of GDP (it is closer to 5.5 percent now), and our nation owed the world $2.5 trillion from the cumulative effect of past trade deficits. He then wrote:

> "In effect our country has been behaving like an extraordinarily rich family that possesses an immense farm. In order to consume 4 percent more than we produce – that's the trade deficit – we have day after day been both selling pieces of the farm and increasing the mortgage on what we still owe".

He then said it was imperative that we take "action to halt the outflow of our national wealth" and advocated a plan to do so. I will discuss that plan later in my testimony.

In the winter of 2005 Mr. Buffett in his annual letter to the shareholders of his company Berkshire Hathaway, stated that our country's continuing and massive trade deficits are leading us in the direction of becoming a "sharecropper society", not an ownership society. In July of 2005 a debate raged in Washington about whether the Chinese National Offshore Oil Company (CNOOC), which was 70 percent owned by the Chinese government, should be prohibited from purchasing UNOCAL, a privately owned American company. During an interview on CNBC Mr. Buffett was asked to comment on the matter and stated:

> "If we are going to consume more than we produce, we have to expect to give away a little part of the country".

Associated with the same debate about the CNOOC/UNOCAL merger, the Washington Post published an editorial which appeared on August 7, 2005 entitled "A Sharecropper Society". In it the Post expressed concern that Mr. Buffett's vision of where the United States was headed was "distressingly plausible." The editorial noted that "the country is living beyond its means, spending more than it earns, and relying on foreigners to supply the difference." **On October 24th of this year the Washington Post published an editorial entitled "Countries Buying Companies" about sovereign wealth funds.** The editorial stated:

> "**Sovereign wealth funds, however, offer governments a way to take over businesses for political as well as economic purposes**. That's a benign prospect if the buyer is Norway, a member of NATO. It is more troubling if the government behind the money is that of China, Russia, or Venezuela **…** the **accumulation of so many dollars in foreign hands is the result of years in which the United States has imported more than it exports."**

The fast-increasing surge of sovereign wealth funds are just another indicator that the country is living beyond its means, spending more than it is earning, and relying on foreigners to purchase our assets to supply the difference. Most of the so-called foreign investment in this country is not "green field" investment whereby new assets are being created, but rather the sale of existing assets to new foreign owners. This is what Warren Buffett means by the "sharecropper economy reference. In allowing this to happen on our watch we are not doing well for future generations of our citizens.

What is to Be Done: Immediate Steps

America's political leaders must realize that the United States is part of an increasingly competitive global economy in which many of our trading partners, such as China, Korea, Japan and Taiwan have national goals and strategies to move their economies forward. Under pricing their currencies to achieve trade surpluses and attract investment is just one part of their economic strategies. Our nation must begin to develop our own national goals and a strategy to accomplish them to ensure that the Asian countries do not achieve their economic goals at our expense. Some elements of our own "national strategy" or if you prefer "business plan" might be:

1. The development of an energy policy that promptly begins to reduce our reliance on imported oil and gas. Spending on the technologies to accomplish this, which means investing in America, would create new high tech jobs in our nation and in time reduce the speed by which oil and gas exporters are building their sovereign wealth funds with our own dollars.
2. The development of policies to aggressively address the mercantilist trade practices (being used by China and many of our other Asian trading partners) such as currency manipulation, barriers to imports, illegal export subsidies, forced technology transfers, subsidies to attract investment ,and the massive theft of intellectual property. This Committee has already developed and reported to the Senate legislation to begin to address currency manipulation. I hope that additional measures can be added to that legislation when it is taken upon the floor, such as a provision to make an under-priced currency an illegal export subsidy that can be addressed by our countervailing duty laws.

It would also be good public policy to include measures to stop the influx of contaminated toys, foods and other items that threaten the health and welfare of our citizens.

3. A third element of such a strategy is to have in place a CFIUS process for reviewing foreign acquisitions of U.S. companies that ensures our Government does not permit the selling off of assets that are critical to our national security. The CFIUS legislation enacted this summer goes a long way in doing that. It gives the intelligence agencies a key role in the review process and ensures closer scrutiny of purchases made by foreign government-owned corporations.

Under the new statute, however, the more searching CFIUS review process for a foreign government acquisition only takes place if the foreign government acquires "control" over the American assets and it leaves the word "control" to be defined by agency rulemaking. The Treasury Department, which will pursuant to the Administrative Procedures Act engage in "**notice and comment**" rulemaking, is likely to receive more comments to be lenient in defining control than strict. It was thus reassuring to see that Senators Dodd, Shelby, Bayh and Webb have written to Secretary Paulson on that matter. Their September 27th letter urged the Treasury in its rulemaking process to take account of the fact that:

> "…in some cases passive foreign ownership interests in assets in the United States, including through sovereign investment funds may have national security implications".

It will be very important for this Committee to continue its recent close oversight of the CFIUS process to ensure that the Treasury implements the new statute in the manner intended by its Congressional authors. You can be sure interests representing foreign investors, including foreign government investors; will be active participants in the rulemaking now underway at the Treasury Department.

What is to Be Done: Further Steps

1. Emergency Trade Summit

During the period of August 2006 through January 2007, I had the opportunity to participate as a senior staff member on the Horizon Project, which was established by the Democratic Policy Committee to develop proposals to address America's economic prosperity and security. At the conclusion of their work the leaders of the Project briefed both the Democratic and Republican Policy Committees about their recommendations.

The Horizon Project group of CEOs and policy experts, which included the President of the Sloan Foundation with whom I work, was very concerned about our nation's massive and ongoing trade deficits and recommended, among other things, that:

> "An Emergency National Summit on the Trade Deficit be convened to be attended by relevant Cabinet officers, the bipartisan leadership of both Houses of Congress and a small number of top corporate and labor leaders".

The Project report stressed that capping the size of the trade deficit had to be a top national priority. One method the report advocated be considered was the so-called Buffett proposal which was put forth by Warren Buffett in the May 2003 edition of Fortune Magazine which I referred to earlier in my testimony. Under the Buffett plan our nation's trade account could be balanced through a system whereby the Federal Government would issue import certificates to exporters of goods in the amount equal to the dollar value of their exports. Such a system could be phased in over a period of time.

The Alfred P. Sloan Foundation has recently funded a proposal submitted by a group of trade economists and lawyers to examine how the Buffett proposal could actually be implemented. The Horizon Project noted that Senators Dorgan and Feingold encapsulated the Buffett proposal in S.3899, a bill they introduced in the last Congress, which would phase in balanced trade for regular commerce over five years and for petroleum trade over ten years.

Another way to reduce the trade deficit considered by the Horizon Project was to use unilateral emergency tariff increases as President Nixon did in August of 1971. Either the Buffett proposal or the tariff increases could be justified under Article XII of the GATT/WTO agreement which permits parties to take measures to deal with serious balance of payment difficulties. The fast declines of our currency against the currencies of nations which do not prop it up are evidence of our balance of payments problem. Serious discussion in the Congress of either proposal would give us much needed leverage to deal with China and the other Asian countries which under-price their currencies and utilize other mercantilist practices to achieve massive trade surpluses at our expense.

2. Align Corporate and National Interests

America's political leaders must understand that other countries such as China have instituted policies, including subsidies and an under-priced currency, to give incentives to U.S. and other multinational corporations to help them grow their own economies. Our corporations are operating in a system that compels them to focus on making profits for their shareholders. Top corporate officials get significant financial rewards for achieving these objectives. Public officials, who are accountable to

America's citizens, must develop policies to counter foreign practices designed to entice our corporations to serve their interests. We must find the means to align the interests of American based multinational corporations with the national interest which includes keeping and creating well-paying high tech jobs in this country and not transferring huge chunks of our productive capabilities out of the country.

3. Craft an Omnibus Globalization Bill

Over 20 years ago the joint House and Senate leadership, acting in a bipartisan manner, decided to craft an omnibus trade bill to address some of the competitive challenges then facing the nation. Each relevant Committee of the Congress was charged to conduct hearings and to elicit ideas and concepts that could be encapsulated into one Omnibus bill. This process began in 1986 and continued in 1987 and resulted in the Omnibus Trade and Competitiveness Act of 1988.

As one who participated in that process and found it exhilarating, I urge the Congress to again institute such a process and use the year 2008 to lay the groundwork through comprehensive hearings for an Omnibus Globalization bill. Such a Bill would be designed to shape our nation's participation in the globalization process in a manner that reduces our current account deficits and lifts the living standards for our citizens. Any new Administration that comes to power in January 2009, will, I am sure, welcome a cooperative relationship with the Congress in crafting such a bill.

Conclusion

The rapidly-rising status of sovereign wealth funds, which the Committee is examining today, are just one more sign that our nation is not doing well in the global economic competition that will only intensify as we move forward into the 21st century. While it is very useful to examine proposals to make such funds more transparent and to establish behavioral guidelines for them, the real lesson we should take from their rise is that we must take action now to forthrightly address our massive trade deficits which are feeding the growth of these funds.