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Testimony of Matthew J. Slaughter for Joint Hearing,
"Foreign Government Investment in the U.S. Economy and Financial Sector"

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Committee Chairman Frank, Congressman Bachus, Subcommittee Chairs Gutierrez and Kanjorski, and fellow members, thank you very much for inviting me to testify on these important and timely issues regarding Sovereign Wealth Funds.

My name is Matt Slaughter, and I am currently Associate Dean and Professor of International Economics at the Tuck School of Business at Dartmouth, Research Associate at the National Bureau of Economic Research, and Senior Fellow at the Council on Foreign Relations. From 2005 to 2007, I also served as a Member on the Council of Economic Advisers, where my international portfolio included Sovereign Wealth Funds and related topics.

Let me start by making three points about the economic benefits of Sovereign Wealth Funds.

First, many Sovereign Wealth Funds were created as legitimate stewards of national economic welfare. Many of today's most prominent Funds hail from countries with surging fiscal revenues from production of oil and other natural resources, and many funds aim to manage these revenues for sound goals such as intergenerational transfers. Here, it is important to remember that the United States itself is home to such Funds; for example, the Alaska Permanent Reserve Fund.

Second, to the extent that Sovereign Wealth Funds invest for commercial motives of high risk-adjusted rates of return, the overall U.S. economy benefits from their investments into the United States. This is true of both foreign direct investment that brings managerial control and portfolio investment that does not. America's commercial and investment banks are a prominent recent example of these gains. Funds' investments provided these world-class companies with much needed capital to stabilize their near-term performance and thereby benefit the overall U.S. economy. The United States has long benefited from open global capital markets, of which these Funds are now an important part.

Third, to date the magnitude of Sovereign investments into the United States remains quite small. At year-end 2006, the rest of the world owned $17.4 trillion of American assets. The recent surge of investments into the United States by Sovereign Funds is large to you and me, but it is still a tiny fraction of American's gross international investment position—a fraction of one percent. Globally, these Funds are estimated to control between $2 and $3 trillion in assets: again, a lot to you and me but only somewhere between one and two percent of the world's tradable securities.

These economic benefits aside, the "S" in Sovereign Wealth Funds presents a legitimate policy concern. Were these funds to operate for non-commercial reasons, they could damage the United States. Some of this damage could be economic, such as poorly run companies aiming at goals other than maximizing shareholder value. But much more importantly, some of this damage could be to national security, were these funds to use their investments in American companies to further their political or strategic interests in conflict with those of the United States.

So, what to do about this legitimate policy concern? Let me answer this question in two parts. First, let me list three important costs to the U.S. economy that we run the risk of incurring should excessive constraints be placed on these Funds in an attempt to address this concern.

First, we could incur economic damage to U.S. companies at home. American companies have historically been strengthened by foreign investment—both controlling and passive stakes, by private and government-related investors alike. A tangible example of this is employment and earnings at insourcing companies. In 2005 there were 5.1 million Americans working for U.S. affiliates of foreign multinational companies, earning an average annual compensation of $66,042—31.8 percent above the average for the rest of the private sector. At a time today when many are rightly concerned about the labor-market fallout of the economic slowdown, these tangible benefits of inward investment to American companies are well worth remembering.

Second, we could incur economic damage to U.S. companies abroad. In a forthcoming Council of Foreign Relations report, David Marchick and I have documented a new protectionist drift in inward-investment policies around the world. In the last two years, at least 11 major countries, which combined received 40.6 percent of all world inflows of foreign direct investment in 2006, passed or debated new laws to restrict or refine rules governing certain types of FDI. In this environment, new U.S. restrictions on inward investment may well be met by similar restrictions against U.S. companies abroad that would harm their competitiveness.

Here, it is very important to remember that U.S. multinationals serve foreign markets mainly by host-country affiliate sales, not by exporting. In 2005, U.S. parents of U.S. multinationals exported $456 billion in goods to foreign markets. But that same year their majority-owned affiliates sold nearly $3 trillion in goods--$6.58 in affiliate sales for every dollar in parent exports.

Third, we could incur economic damage to the overall U.S. economy by raising the risk of a disorderly adjustment to the chronic U.S. current-account deficits of recent decades. In 2006, the U.S. current-account deficit reached a record high of $811.5 billion. The main economic cause of this deficit is low U.S. national savings relative to U.S. national capital investment. To finance the excess of imports over exports of goods and services that underlies these current-account deficits, each year the United States must, on net, sell an equivalent amount of assets to the rest of the world. So, in 2006 the United States needed to sell $811.5 billion worth of U.S. assets to foreign investors.

In current discussions of international economic policy, there is much concern about the future path of the U.S. current-account deficit. The likelihood of a gradual, orderly evolution of the U.S. current-account deficit—and of the value of the U.S. dollar—will be higher the wider is the range of U.S. assets the rest of the world can reasonably purchase and the wider is the range of foreign investors—including Sovereign Wealth Funds.

Let me close my testimony with the second part of my reply to the question, "What to do?" For now, I recommend two strategies.

One is diligent U.S. participation in ongoing multilateral dialogues with Sovereign Wealth Funds to generate more and more-transparent information about their governance, goals, and strategies. Recent interest in these Funds has revealed that for many there are some clear gaps in what we know. Like in so many other areas, here, too, sound public policy is best founded on complete and robust information. With the support of the U.S. Treasury Department and others, the International Monetary Fund has launched a discussion with several Funds to create and follow a set of best practices. These discussions are well underway and should be supported. The resulting increase in quality and quantity of information about Sovereign Funds should help allay many concerns about the likelihood of these Funds operating for non-commercial reasons that could threaten U.S. security.

The second strategy is to urge support by all interested parties in the continued non-political operation of the Committee on Foreign Investment in the United States. Last year's Foreign Investment and National Security Act was the outcome of a robust, bipartisan discussion that aimed to build on the many already-sound CFIUS practices. Today, the reforms of FINSA and its related Executive Order need to be implemented without undue political interference. CFIUS is well suited to address any legitimate national-security concerns raised by U.S. investments by Sovereign Wealth Funds—or, let me remind everyone, by any other foreign investor as well. One important reason for this is that CFIUS does not have any statue of limitations. Any inward transaction can be brought to CFIUS not just before but also after closing, should any concerns arise after the fact. During my time serving on the Council of Economic Advisers, I had the privilege of working on CFIUS first-hand with the sound leadership of colleagues at the Treasury Department and many other government agencies. Let the CFIUS process work.

Let me thank you again for your time and interest in my testimony. I look forward to answering any questions you may have.