Investments and Acquisitions in the United States by Government Entities

Testimony by Alan Larson
Senior International Policy Advisor
Covington & Burling LLP

before the Senate Committee on Banking, Housing and Urban Affairs

November 14, 2007

Mr. Chairman, Senator Shelby and other distinguished Senators:

My name is Alan Larson. I am a Career Ambassador and former Under Secretary of State for Economic Affairs. In those capacities, I frequently dealt with inward investment and acquisitions issues. In my current position, I sometimes advise clients, including government corporations and government investment funds, on how to ensure that proposed acquisitions comply with the policies of the United States.

I am honored to participate in this important hearing. I hope that my public and private sector experiences will be helpful to the deliberations of the Committee.

The Benefits for Foreign Investment in the United States

This Committee is well aware of the benefits of foreign investment. Let me briefly summarize a few of them.

Financial investments from abroad add to the pool of capital available to support investment, economic growth and job creation in the United States. Investments in U.S. government and corporate bonds, for example, help keep interest rates low. Investments in the stocks of private companies help those companies finance their investment opportunities.

Direct investments, such as greenfield investments or acquisitions of existing assets or companies, contribute to the production base in the United States. They stimulate competition and support job creation. Often these investments bring technology and management techniques that sharpen American competitiveness.

In addition, foreign investments in the United States contribute to the efficient operations of the global economy, including through the recycling of surpluses generated abroad. At this time, the global economy is experiencing significant imbalances. Oil exporting nations and some Asian countries are generating large current account surpluses, while the United States and oil importing nations tend to have current account deficits. Foreign investments in the United States are one means to facilitate international adjustment to these imbalances.

There are broader political advantages to foreign investments and acquisitions. Countries who put money at work in the United States become stakeholders in the U.S. economy. Their economic interests are advanced if the economy of the United States thrives.

This Administration, and previous ones, have wisely pursued a policy that is based on openness to inward investment, while at the same time ensuring that the U.S. Government has the tools to deal effectively with the small number of inward acquisitions that might pose national security issues. I believe that the Foreign Investment and National Security Act of 2007, a law that benefited from strong leadership by this Committee, provides an effective framework for implementing this balanced policy.

Government Investment Entities: Not a New Phenomenon, a Variety of Shapes

The foreign government entities that invest abroad take many different forms. Some of them have familiar names and have been part of the economic landscape for a long time. Others are newer and less familiar.

Governments and government entities have several reasons for considering foreign investments and making acquisitions of foreign assets. Managers of government pension funds, for example, are responsible for ensuring that government revenues generate an adequate return to pay for the pensions of government workers or others who participate in government pension plans. In the United States, the Federal government and State governments have put in place such pension plans. The motivation is to accumulate resources sufficient to pay for the expenditure obligations of the future.

In some cases governments want to ensure that revenues associated with the production of depleting natural resources such as oil produce lasting benefits for their citizens over several generations. They may establish organizations that invest these revenues in a manner that generates returns for future generations, when the resources may have run out. In the United States, the state governments of Alaska and Wyoming operate such plans. Internationally, a number of oil producing countries operate such investment funds In many instances, these funds are directed by professional managers in accordance with broad investment strategies.

State-owned enterprises (SOEs) are a part of the economic fabric of most countries. In the United States, they include transportation companies such as Amtrak and electric utilities such as the Tennessee Valley Authority. In many other countries, government-owned companies operate internationally and are engaged in transborder trade and investment.

In some recent cases, countries' Central Banks have generated large foreign exchange reserves. These foreign exchange reserves traditionally have been held as cash or invested in foreign government bonds. In recent years, there have been vigorous discussions about the extent to which these foreign exchange reserves will be held in dollar-denominated assets (as a majority of them have been in the past) or Euro-denominated assets. The weakness of the dollar provides fuel for the debate. At the same time, some countries with large foreign exchange reserves have developed programs for converting a portion of these reserves into a wider range of financial assets that could earn a higher rate of return.

As this brief discussion makes clear, there is a wide range of reasons why foreign governments seek to invest foreign assets. In discussions of sovereign wealth funds and other government-owned entities, it is important to be specific about the type of government-owned entity, its investment aims and its operating methods.

<u>Reasons for Foreign Government Entities to Invest in the United States</u>

Foreign government entities have good reasons for considering investments in the United States as part of their portfolio.

Pension funds and commodity funds typically seek diversification and a reasonable balance of risk and return. Financial counselors advise American families to hold a mix of assets across different asset types, different economic sectors and different regions of the world. For the same reasons, foreign funds often want to have exposure to the dynamic U.S. economy as part of their investment portfolio. This appears to reflect the approach that many of the large sovereign wealth funds have followed during the last thirty years.

Many oil exporting countries have small populations. Even if they formulate large domestic investment programs, they cannot sensibly invest all of their oil revenues at home. In contrast, excessive domestic investment would tend to create asset bubbles, destabilizing local inflation or exchange rate appreciation that would cripple domestic exporters. The so-called “Dutch disease” is an example of the economic problems that well-managed commodity funds can mitigate. In addition, a well-managed fund allows a country dependent largely on one product to diversify away from a commodity that may be susceptible to boom and bust cycles.

Even if they compile big shopping lists that include large amounts of imports, some resource rich exporters cannot spend all their current revenues in a prudent manner. Making investments abroad is a sensible strategy for putting these earnings to work rather than dissipating them in unproductive expenditure. The Government of Australia, for example, has established a “Future Fund” for investing budget surpluses related, in part, to revenues generated by commodity production.

In other cases, a foreign investment fund may have financial objectives that go beyond mere diversification or saving for the future. In some cases, a foreign fund with substantial financial resources may calculate that certain U.S. assets have been undervalued by markets. The fund managers may believe that they are more patient than the market and see the potential for financial gain in making a longer-term investment in an undervalued asset.

In some cases, a fund or an SOE may have still broader economic objectives. Some funds pursue domestic and regional investment policies designed to establish a position as a financial and transportation hub. In some cases, those domestic and regional investments generate expertise that creates a business interest in investing in similar sectors in the United States.

In other cases, an SOE may seek to grow by making investments at home and abroad in its core business or related businesses. For example, when the Saudi firm SABIC acquired earlier this year the plastics business of General Electric, that investment was motivated by SABIC's interest in using its expertise in the production of petroleum based plastics to broaden its international footprint.

<u>The Demand for Investments and Acquisitions in the United States Is Likely to Grow</u>

It is likely that government-owned entities will be interested in making a growing number of investments and acquisitions in the United States during the next decade, so long as our market is open.

The McKinsey Global Institute has estimated, for example, that oil exporting nations already hold $1.5-1.8 trillion dollars in assets. McKinsey calculates that at current oil prices, petro-dollar resources are likely to double by 2012. In light of the limited absorptive capacity of many oil producing countries, large increases in the financial surpluses available to be invested abroad are likely.

It is possible that oil prices will slump, but in my view this is highly unlikely. Demand growth remains strong, including growing demand from fast growing economies such as China and India. As the oil intensity of our economy has been slashed, consumers and businesses seem to have become less sensitive to high prices and our economy has become less susceptible to recessions induced by high oil prices. At the same time, supply uncertainties in a number of oil producing countries raise continuing worries about disruptions, and there are limited prospects for supply growth during the next five years. On balance, I believe it is more likely that prices and petro-dollar investments will rise rather than fall during the next five years.

I am not an expert on government pension funds and I do not have studies of the subject to cite. Nevertheless, I offer the hypothesis that, seeing the growing budgetary demands created by retiring workers and ageing societies, many governments are likely to try to put more government revenues into pension funds and that they will try to make this money work harder. If so, that is likely to mean that these funds will be larger players in international investments and acquisitions. Certainly at my firm, we are seeing evidence of this phenomenon from individual pension funds.

As countries like China and Russia achieve higher levels of economic development, more of their companies will be interested in "going global." For companies that have this aspiration, there is, in my view, no substitute for having a presence in the United States, the most dynamic large developed economy in the world. For a number of historical reasons, China and Russia are home to a number of SOEs. I believe that many of these SOEs have good economic reasons to aspire to be significant investors in the United States.

Policy Issues: Global Imbalances and Transparency

If there is growing interest for investments and acquisitions in the United States by foreign government-owned entities, what would this mean for public policy in the United States?

The fundamental policy issue is whether these trends create new national security risks that require new policy approaches. Are these entities controlled by foreign governments? Are they pursuing economic objectives or political objectives? Are the tools now available to the government sufficient?

Most of these entities, and all of the ones with which I have worked, are responsible organizations pursuing business and economic objectives and doing so in a responsible manner consistent with U.S. law and policy. So a fundamental implication is that the policy response of the United States should be generally to welcome this interest, while having the tools to scrutinize acquisitions that pose national security issues. As discussed at the beginning of this testimony, investments and acquisitions by these entities can support investment, economic growth, innovation and job creation in the United States. They can support our competitiveness and make these firms and their governments stakeholders in the U.S. economy.

At the same time, policymakers should be attentive to the questions and concerns that increased investments and acquisitions may raise. Some part of this concern is related to the international imbalances that contribute to the growth foreign of government assets. Some part of the concern is related to the unfamiliarity of certain of the entities.

It is important, for a number of reasons, that the United States and other countries do what they can to address the underlying imbalances in the global economy. We should be honest in accepting that the large oil imports and the large current account deficit of the United States are a mainspring that is contributing to the accumulation of large surpluses of investment capital abroad. Tackling the root causes of these imbalances, including through more effective energy policies, is a crucial national priority in its own right. Nevertheless, my assessment is that there is no sensible energy policy that is going to decrease dramatically the accumulation of petro-dollars over the next decade.

In the case of China, it is perhaps understandable that investments and acquisitions will spur attention to the issues of exchange rate inflexibility and lack of market access that are seen as contributing to the accumulation of foreign exchange surpluses in China. It is important that China and the United States make progress on these issues, including in the Strategic Economic Dialogue. It would not serve U.S. interests, however, to establish policies of linkage or reciprocity that would make U.S. investment policy contingent on progress in these other policy areas. And I believe that Chinese entities, including government entities, will have growing interest and growing capacity to make acquisitions in the United States, even if exchange rate and market access issues are fully resolved.

It also is important that the United States deal with transparency concerns that have been raised recently by sovereign wealth funds and the increased flow of investment and acquisitions by government controlled entities.

In this regard, it is useful that the Treasury Department has launched an international process of deliberation on good practices for sovereign wealth funds. Some of these funds do not publish financial figures nor provide an overview of broad investment strategies. Greater disclosure would be a service to their shareholders, the citizens of their own country. At the same time, greater communication on these issues would dispel many concerns in countries that benefit from investments and acquisitions from these entities.

It also can be useful for government entities to elucidate their governance structure, so it is clear whether investment and acquisition decisions are being driven by economic objectives and professional managers, or by political objectives and political figures. A fund or enterprise that invests government money on the basis of a transparent and clearly elucidated investment strategy, whose objectives are purely financial and economic rather than political, which is operated by professional managers and which has a governance system that restricts or removes the scope for governments influence raises far fewer concerns than government entities that are pursuing political goals. Foreign government ownership or partial ownership does not necessarily result in foreign government control.

At the same time, the Treasury Department has called for dialogue within the OECD to promote policies in investment receiving policies that are transparent and non-protectionist. There are serious pressures in Europe and Canada for revision and strengthening of investment screening laws. In my judgment, some of these laws already tilt too far in the direction of investment screening. They place limitations on inward investment and acquisitions based not on national security reasons, but rather on fuzzy rationales such as economic security or maintaining the dominant position of national champions. There is a real risk that new laws and regulations will go too far in restricting investment.

Policy Issues: The Foreign Investment and National Security Act of 2007 (FINSA)

In the United States, Congress has enacted legislation (FINSA) that updates and improves a framework that has served the United States well. I would like to congratulate this Committee for its leadership in shepherding sensible legislation to the finish line. Let me highlight a few features of FINSA that are of critical importance in ensuring that the U.S. economy remains open to foreign investments and acquisitions, while ensuring that the government has the tools it needs to deal with any national security issues.

FINSA retains a focus on those acquisitions that raise threats to national security, and where other laws and regulations are not sufficient to deal with the issue. It is important that FINSA remain focused on this relatively narrow class of acquisitions and does not dissipate its efforts in attempting to screen acquisitions on the basis of vague criteria.

Second, FINSA sensibly retains a focus on acquisitions that establish control. Acquisitions in which foreign persons gain control--essentially the ability to direct, determine and decide major business issues--could, in certain circumstances, raise national security issues. It is important that agencies focus on such acquisitions, and do not dissipate scarce resources in examining acquisitions that create minority, non-controlling positions.

Third, FINSA focuses government scrutiny on those acquisitions where a foreign entity is controlled by a foreign government, where that entity makes an acquisition that would create control over a U.S. company, and where that acquisition raises national security concerns. In such cases there is a presumption that the transaction will be subject to a second stage review, otherwise known as an investigation. This presumption of an investigation can only be overturned if the Deputy Secretary of the Treasury and the Deputy Secretary of the relevant security agency agree that an investigation is unnecessary. This provision provides confidence that acquisitions by foreign government controlled entities will receive thorough review.

Fourth, FINSA retains the longstanding provision that one CFIUS agency, on its own, is sufficient to ensure that there is an investigation of a proposed transaction. This provision ensures that security agencies have a strong voice. In addition, one CFIUS agency, on its own, is sufficient to require that a transaction go to the President for review even if other CFIUS agencies are prepared to approve it. This ensures that any transaction where security concerns have not been resolved reaches the President, the executive branch official with the ultimate responsibility for protecting national security.

Fifth, FINSA provides the Administration with flexibility in determining when national security concerns are raised by a proposed transaction. The working practice of CFIUS has made clear that national security concerns may be raised, inter alia, when acquisitions involve assets in the defense industry sector, in critical infrastructure and in telecommunications. But CFIUS does not define national security nor does CFIUS limit it to specific sectors. In my view, it is correct policy, however, not to try to define or limit national security.

For these and a host of other reasons, FINSA provides a robust tool for the Government in dealing with any potential national security issues. Congress should encourage the Administration to take a thoughtful and deliberative approach toward writing and implementing regulations.

Congress should continue to monitor the operation of FINSA and the progress of transparency work in the IMF and the OECD. Congress should continue to observe developments as government entities make additional investments in the United States. The United States should continue to be open to foreign investment, including investment and acquisitions by government-controlled entities.

Conclusion

FINSA provides an effective tool that has benefited from a recent and thoughtful tune up. FINSA offers an effective safety net for dealing with any issues that may arise, including issues related to acquisitions by foreign government-owned entities. Now the most important thing for Congress and the executive branch to do is to stay cool and use the tool that you have crafted. Thank you.