

Monty Graham: Protector of National Security FDI Inflows to the United States and the Role of National Security Concerns

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I was privileged to be Monty Graham's colleague for six and a half years. I had had some contact with him before I joined the Institute, and of course I knew his work. What I did not know was that Monty was a renaissance man with a wide range of interests extending from mountain climbing and French cuisine, not only to mathematics but to astrophysics. Indeed, one of the last times we talked, he outlined the challenges and contradictions facing physicists today. A few weeks ago, I engaged an eminent astrophysicist at Harvard, as best I could, in a similar conversation. I will not attempt to repeat either conversation, but Monty was spot on!

Monty's many talents meant that he contributed constructively to multiple projects. Soon after joining the staff, following one of our frequent and inconclusive debates about models of exchange rates and exchange rate policies, Monty tried to interest me in the application of chaos theory to the behavior of exchange rates. He even lent me an issue of *Scientific American* to inspire me. I was flattered. I had read something about chaos theory, but I did not think that Fred Bergsten would permit me the time to tool up sufficiently on the subject to justify a collaboration with Monty—my regret.

More concretely, Monty gave me a piece of crucial advice during my first year at the Institute. I was struggling with a project on inflation targeting and frustrated that it was not progressing as rapidly or with the depth of insight that I had hoped. Monty said "take the time to do it right." Not that he was a perfectionist who was unable to let a project go into final production; rather, he was saying you have to satisfy yourself that you have done your best.

Monty Graham's own professional standards were impressive, demanding, and exemplary. They were *impressive* in that he did not shy away from dealing with messy topics that did not lend themselves to tidy analysis or yes-no answers. More often than not, his conclusion was "it depends," not only because many of the issues implicitly or explicitly involved second-best situations, but also because noneconomic factors were involved. His standards were *demanding* in the careful way in which he integrated theory, history, and facts.

(In how many policy analyses of foreign direct investment do you find a capsule history of a country, in this case China, covering more than two millennia [Graham and Marchick 2006, 96–100])? He marshaled his facts and grounded his analysis on history to answer basic questions and test hypotheses, not to support a preconceived thesis. Monty's work was *exemplary* in these respects but also because of his remarkable expositional skills. Perhaps this was one reason why he and Paul Krugman had such a successful collaboration.

These professional qualities were impressively demonstrated in Monty Graham's work on the vexed nexus of foreign direct investment and national security. In his work with Krugman (Graham and Krugman 1995) and with David Marchick (Graham and Marchick 2006), Monty identifies clearly the real national security issues with respect to foreign direct investment in the United States. They are issues that potentially threaten the capacity of the United States to defend itself with the necessary technology, products, and expertise. However, as Monty Graham demonstrated in his historical reviews, most of the issues are not new.

Moreover, many attempts to grapple with these issues in the past were either misguided, because they were grounded on an oversimplified view of the relevant alternatives and consequences, or motivated more by short-term commercial considerations than rational national security concerns. Consequently, the principal danger in addressing the very real national security issues raised by foreign control of particular investments in the United States is that policies will have large unintended negative consequences for US prosperity. The somewhat prosaic policy conclusion is to stay calm and avoid over-reaction. As Graham and Krugman (1995, 175) put it, "The United States must avoid hysteria."

In the post-9/11 environment, national security issues have taken on new dimensions and fresh prominence. Because of technological change and the dispersed nature of today's threats, the scope for mischief, including the self-inflicted variety, has greatly expanded. The concept of national security has been extended appropriately to incorporate critical infrastructure. The risk is that incorporating such real concerns in our framework of national security protection pushes us down the slippery slope of embracing so-called economic security concerns within that framework, via financial protectionism.

In my view, financial protectionism is a much greater risk than traditional trade protectionism because of the nature of financial markets and the scope for instantaneous retaliation without the constraints associated with the agreed (if imperfect) multilateral rules and institutions that exist in the trade area. This type of consideration led Monty Graham to advocate cooperative solutions and to bemoan failed efforts to establish international norms in this area such as the multilateral agreement on investment (Graham 2000).

As Graham and Marchick (2006, chapter 5) demonstrate, in the post-9/11 environment, reviews of foreign direct investment acquisitions in the United States by the Committee on Foreign Investment in the United States (CFIUS) have become increasingly politicized. We have a new, ill-defined set of adversaries, which only adds to existing forces inflaming political passions: foreign ownership and national security, high-profile transactions, and economic incentives of rival suitors.

Adding to these factors is the rediscovered phenomenon of sovereign wealth funds (SWF) and large hoards of foreign exchange owned by governments, including governments of countries whose economic philosophies, cultures, and political systems differ from our own. I have conservatively estimated that governments now manage at least 12 percent of all cross-border assets, and in some individual countries it is more than 60 percent. (These estimates generally do not include assets held by government-owned enterprises.) Moreover, the share is rising. Government ownership increases potential concerns about foreign direct investment because motivations may be political. Even when they are economic, motivations may involve the promotion of economic power, development of national champions, or an extension of crony capitalism, rather than the pursuit of economic profit. Thus, it is reasonable that CFIUS should pay particular attention to foreign government owned or controlled investments.

China poses a particular set of challenges for the United States because of its large size, the fact that it is not a strategic or political ally, the limited scope of true private enterprise in its economy, and its history of economic espionage and proliferation of sensitive technologies (Graham and Marchick 2006, 104). The fact that China has at least \$1 trillion in *excess* foreign exchange reserves that it could deploy in pursuit of its economic and political objectives raises the stakes further.

However, Monty Graham would be quick to qualify some of the concerns expressed about sovereign wealth funds. Even as the scale and the scope of such investments expand, only a relatively small portion is likely to take the form of full ownership or a controlling stake.

Nevertheless, as I have argued elsewhere (Truman 2006), sovereign wealth funds potentially involve a volatile clash of cultures and institutions. It is in the interests of the home countries as well as the host countries that government investors embrace best practice in the accountability for their activities; that accountability would be enhanced by greater transparency.

In the absence of a move in this direction, the risk of overreaction in the United States is palpable. A prominent example is provided by the recent piece by Jeffrey Garten (*Financial Times*, August 7). Garten is a sensible person whose name is not normally associated with protectionist positions. He explicitly denies any protectionist thrust to his proposals. Nevertheless, he states “The underlying premise must be that SWFs are political entities and should be treated as such.”

Consequently, Garten advocates regulation in the United States and Europe that would require countries whose sovereign wealth funds invest in the United States or European Union to grant reciprocity. We do not have sovereign wealth funds at the national level, aside from pension funds, so presumably Garten means reciprocity for our private investors, which as Monty Graham documented is a well-known can of worms of the poisonous variety. Moreover, such a proposal has no direct connection with sovereign wealth funds per se; it is an attempt to exploit leverage. Monty Graham would remind us that the focus should be on protecting national security, not bargaining for commercial advantage.

Garten also advocates a presumptive 20 percent cap on ownership of a company by sovereign wealth funds. Such a proposal, as with tougher proposals limiting investments to nonvoting equity, raises a host of technical implementation questions in addition to concerns about the sign of its economic effects, for example raising the cost of capital to US corporations.

In recent months, with the encouragement of Monty Graham, I have addressed some of these issues. Monty's death deprives me of his unique professional insights as well as his warm friendship, but at least I have the inspiration of his many contributions to this topic.

References

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