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SAFE AND SOUND: AN EU APPROACH TO SOVEREIGN INVESTMENT

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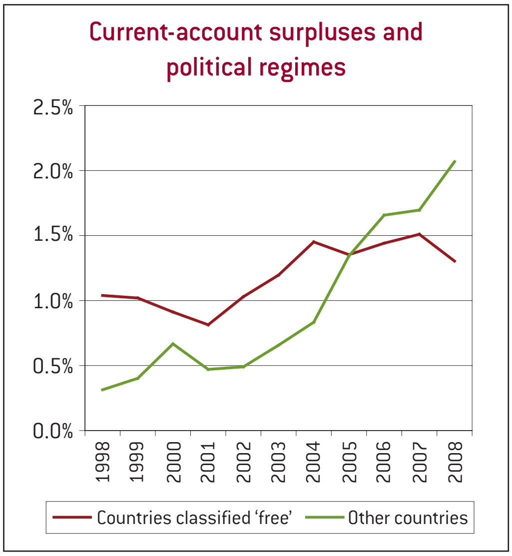
SUMMARY A growing share of inward investment into the European Union, including but not limited to sovereign wealth funds (SWFs), will come from countries with diverse political regimes with which Europeans may not always see eye-to-eye. **The current crisis may increase both Europe's need for such investment and its sensitivity to the non-economic implications**. New investor countries have incentives to refrain from political use of their assets, as illustrated by the recently published 'Santiago principles' for transparency and accountability of SWFs. But these incentives are not powerful enough to spare Europe its own assessment of security risks linked to new trends in foreign investment.

POLICY CHALLENGE

The EU should proactively address the increasing likelihood of mounting political tensions over foreign investment. It needs a comprehensive, open and sustainable framework to address the security aspects of foreign acquisitions, without which there is a risk of protectionist drift that could harm the economy and impair the integrity of the single market. We recommend anchoring the aims and mechanisms for review of foreign investments in a common EU legislative framework, while implementation, including security assessment of individual investments, would remain a national prerogative. This new approach would enable Europe to maintain its openness to investment while credibly addressing security concerns.



Cumulated current-account surpluses (countries with deficits not included) as a share of World GDP. Sources: IMF; Freedom House for country classifications.

EUROPE'S OPENNESS TO INVESTMENT can be maintained and increased only if its considerable economic benefits do not come at the expense of fundamental security concerns. The US responded to this challenge 20 years ago with the Exon-Florio amendment to the Trade and Competitiveness Act of 1988, which gave the Committee on Foreign Investment in the United States (CFIUS) an extensive mandate to review foreign acquisitions[1]. By contrast, the EU's approach to cross-border investment has been dominated by the drive to create a single internal market. But new global investment patterns and the current financial and economic turmoil are combining to increase both the need for inward investment and political sensitivity towards it[2]. In such a context, the ECOFIN Council's call in March this year for a 'European approach to sovereign wealth funds'[3] could be the starting point for a broader debate on the nexus between foreign acquisitions and security concerns, which is the focus of this policy brief.

1. A SHIFT IN INVESTMENT PATTERNS

The global economic imbalances of the past decade have given rise to a significant shift in wealth distribution. The current account of western economies has generally deteriorated. Emerging countries, such as China, the Gulf states and Russia, which until recently played no substantial role as international investors, have built up large surpluses linked to fossil-fuel production or high savings and exports. In these economies the state is a major force in both economic activity and outward investment[4].

Related policy debates have recently focused on sovereign wealth funds (SWFs), but these are only part of a larger picture. Their aggregate size is generally estimated at around $3 trillion in 2008 (comparable to public pension funds in the US[5]), while the total stock of sovereign investments from emerging countries, including central bank reserves, is estimated at around $9 trillion[6]. SWFs alone are estimated to have quadrupled in value between 2003 and 2007[7], and many expect them to grow beyond an aggregate $10 trillion over the next few years[8], even if the present recession prospects may slow down this growth somewhat. Total government surpluses available for investment will be larger still.

The political dimension of corporate governance and investment is not limited to state-controlled entities. To varying degrees, concerns privatised in the 1980s and 1990s in France and Italy, US defense contractors, Russia's oligarchic conglomerates, holdings of the Gulf states' ruling families, or Communist Party-linked Chinese businesses are all examples of economic actors that are technically part of the private sector but that are widely considered to be under at least the partial influence of political authorities in their home country. In this policy brief, we use the phrase 'sovereign investment' loosely to refer to investment ultimately controlled by governments, bearing in mind that this categorisation may not reflect a precise legal definition.

New investment patterns change political balances. An in-depth geopolitical analysis is beyond the scope of this policy brief, but it can be observed that many newly cash-rich countries have different political regimes from the countries that previously dominated international investment. This is illustrated using country scoring by Freedom House, a respected US-based NGO that publishes an annual assessment of all countries as 'free', 'partly free', or 'not free'. Since first publication in 1973, EU countries have always been 'free'. Using current-account surpluses as a measure of potential outward investment, Figure 1 illustrates how countries not classified 'free' have recently become significant potential international investors.

In spite of the dearth of relevant data[9], these trends seem to be mirrored by actual investments. 'Free' countries no longer hold the bulk of foreign assets[10]. Foreign direct investment (FDI) from countries not classified 'free' to the EU15 (EU members before 2004) reached an all-time high of nearly $14 billion in 2006[11].

These findings echo a broader global rebalancing of economic power. Figure 2 illustrates that a growing share of world GDP, and of headquarters of the world's largest listed companies, is accounted for by countries not classified 'free', even though their rise is less spectacular than that of current-account surpluses.

Developments in the years to come will depend on a number of factors, including fossil-fuel prices, exchange rates, growth and

[1] E. Graham & D. Marchick, *US National Security and Foreign Direct Investment*, Peterson Institute, 2006.

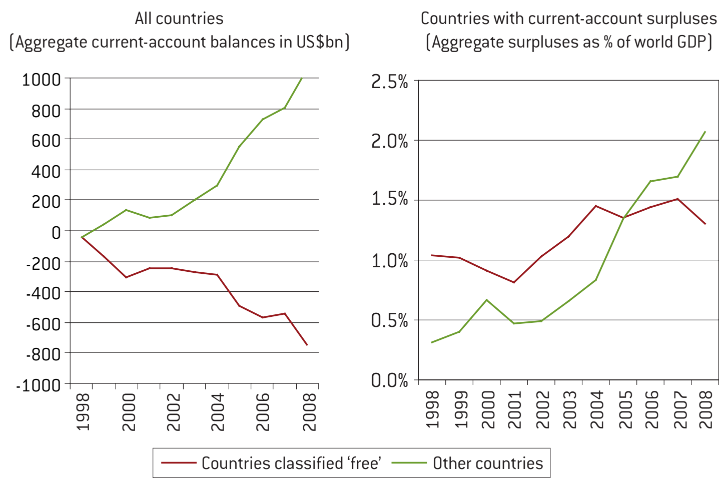
[2] In the US context, this tension was vividly summarised by Jim Cramer, host of *Mad Money* on CNBC on 17 January 2008: *"Do we want the communists to own the banks, or the terrorists? I'll take any of it, I guess, because we're so desperate."*

[3] Conclusions of the ECOFIN Council of 4 March 2008.

[4] The share of the state in GDP has been estimated at above 80 percent in the United Arab Emirates, 35 percent in Russia and 29 percent in China, compared with typically less than 10 percent in developed countries. Sources: CIA World Factbook 2008; EBRD; China's National Bureau of Statistics, World Bank Bureaucrats in Business Database 1971-1991.

[5] Pensions & Investment 1000 Report, January 2008.

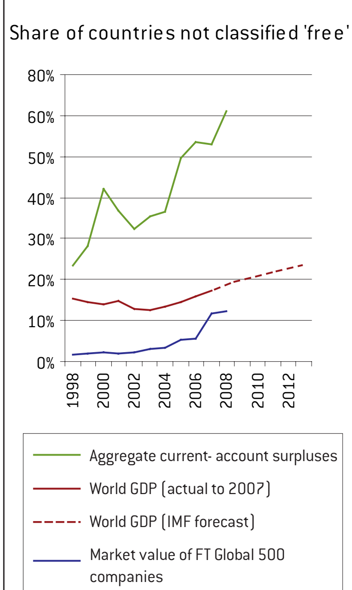
Figure 1: Current account balances and political regimes



Country scoring: Freedom House, Freedom in the World Report 2008. Current-account data: IMF World Economic Outlook, October 2008. The left-hand chart is not symmetrical because of measurement errors.

savings and political changes, all of which will be affected by the financial crisis. But in virtually all scenarios, countries not classified 'free' will continue for the foreseeable future to have significant financial capacity for international investment.

Figure 2: The changing distribution of global economic power



Sources: IMF; FT Global 500 rankings (as of 30 September of each year), www.ft.com; Freedom House; authors' calculations, assuming unchanged political regimes in the forecast years from their scoring in 2008.

2. EUROPE'S OPPORTUNITIES AND RISKS

The rise of investment from countries with different political regimes is largely an opportunity for Europe. Cross-border investment creates a powerful alignment of interests between such countries and the EU, which could play a big role in defusing potential tensions. Sovereign investment could also have a stabilising effect if it is long term-oriented and insensitive to market volatility, even though evidence to this effect remains controversial[12]. In any case, Europe's ability to attract investment will be of particular value in the years to come in the context of possibly severe economic hardship.

But there are also new risks for Europe. Then Trade Commissioner Peter Mandelson expressed this at an OECD conference on 28 March 2008:

> *"Why are we having this debate at all? Looking coolly at the question the answer is – and I will put this as diplomatically as possible – that the biggest new funds are in economies which have raised some sensitivities in our own politics. No one is worried about Norway's plans for global domination. Chinese investment vehicles and the Russian stabilisation fund on the other hand are new investors, with huge reserves, backed by governments with mixed democratic credentials, substantial foreign policy projection and no track record as investors."*

Two broad categories of concern can be distinguished: 'macro' risk, or the possibility that entire economies might be disrupted by the actions of sovereign investors; and 'micro' risk, or the possibility that individual acquisitions might be abused for political purposes. Our choice to focus on the latter in this policy brief should not be understood as playing down the 'macro' risk category, which is too serious a possibility to be dismissed, even if there are only few examples of it in history[13] and the EU may be less vulnerable than other economies. 'Macro' risk from sovereign investment merits extensive future policy research, which should obviously be linked with the broader policy debate on financial stability as it unfolds from the ongoing financial crisis.

The 'micro' security risk tends to be smaller than perceived in many European countries, where acquisitions by non-western actors are often attributed to dark motives. The vast majority of foreign investments are innocuous[14].

[6] This in turn compares to $28 trillion for pension funds worldwide, $26 trillion for mutual funds, $19 trillion for insurance assets, and $2.8 trillion for the sum of private equity and hedge funds. D. Farrell, S. Lund & K. Sadan, *The New Power Brokers*, McKinsey Global Institute, July 2008.

[7] Testimony of Scott Alvarez (Federal Reserve Board) before the US House Committee on Financial Services, 5 March 2008.

[8] eg Stephen Jen, *How big couldsovereign wealth funds be by 2015?*, Morgan Stanley, 3 May 2007; Steffen Kern, *Sovereign wealth funds – state investment on the rise*, Deutsche Bank Research, 10 September 2007.

[9] See US Government Accountability Office, *Sovereign Wealth Funds: Publicly Available Data on Sizes and Investments for Some Funds Are Limited*, September 2008.

[10] Brad Setser, *Sovereign Wealth and Sovereign Power*, Council on Foreign Relations, September 2008 (Figure 9).

[11] Source: OECD.

However, some risks can be real, especially when the market power or access resulting from an acquisition can be abused by the government that controls the acquirer. In particular, harm can be inflicted or influence exerted in order to advance political or redistributional goals. Box 1 shows a classification of how such risks might emerge. It is taken from the US context, but it could equally apply to the EU. Europe currently has friendly relations with most of the world, but scenarios of future political tension with major investing countries could include, to name only three, crises with Russia over Ukraine, with China over Taiwan, or with Gulf states in the event of their overthrow by forces hostile to the west, as happened in Iran in 1979.

A counterpart to the potential security risk is the risk of protectionist drift. In the US, the proposed takeover of Unocal by China National Offshore Oil Corporation (2005) and the purchase of US port facilities by Dubai Ports World (2006) were memorable cases. Europe offers fertile ground for protectionist sentiment because of its historical legacy of wars and state intervention.

Figure 3 shows the frequency of use of the word 'protectionism' in the press in three major western languages. The curves show short-term fluctuations from specific news events, but also a marked step-up in the 'floor' level, which roughly doubles in 2005 compared to the previous ten years. Remarkably, this effect is simultaneous in the three languages. Protectionism has never been absent from Europe, but this rough indicator would suggest its presence in public discussion has increased in step with the emergence of countries not classified 'free' on the global economic stage, as detailed in the previous section.

Protectionism can create its own security risks. The US veto to CNOOC's acquisition of Unocal may have contributed to persuading the Chinese leadership that US advocacy of an open global market for fossil fuels is insincere and that what counts is direct ownership of reserves, a belief that is plainly not in US security interests. But the most obvious negative effect of protectionism is the economic harm it inflicts on countries that adopt it. Moreover, in Europe national protectionism threatens the single market, and thus is of concern for the entire EU. And historical experience suggests that when protectionism is embraced in one country, it tends to shift the political balance towards protectionism in neighbouring countries as well.

The security risk from foreign investment and the risk of protectionist drift are at least to some extent negatively linked. Complete investment autarky would eliminate the security risk at enormous economic cost; unrestricted openness to foreign investment leaves the security risk unchecked.

BOX 1: A FRAMEWORK FOR ASSESSING RISK FROM FOREIGN ACQUISITIONS

The potential threats that a foreign acquisition of a US company might pose fall into three categories.

- The first category of threat is that the proposed acquisition would make the United States dependent upon a foreign-controlled supplier of goods or services crucial to the functioning of the US economy (including, but not exclusively, the functioning of the defense industrial base) who might delay, deny, or place conditions upon provision of those goods or services.
- The second category of threat is that the proposed acquisition would allow transfer of technology or other expertise to a foreign-controlled entity that might be deployed by the entity or its government in a manner harmful to US national interests.
- The third category of threat is that the proposed acquisition would allow insertion of some potential capability for infiltration, surveillance, or sabotage – via a human agent, or non-human agent – into the provision of goods or services crucial to the functioning of the US economy (including, but not exclusively, the functioning of the defense industrial base).

Quoted from Theodore H. Moran, 'Three Threats: An Analytical Framework for the CFIUS Process', unpublished draft, Peterson Institute for International Economics, forthcoming 2009.

[12] See for example Brad Setser: Follow the Money (blogs.cfr.org/setser).

[13] Benn Steil & Robert E. Litan, *Financial Statecraft: The Role of Financial Markets in American Foreign Policy*, Yale University Press, 2006.

[14] John Kay, 'Sovereign wealth is a force for stability', *Financial Times*, 27 February 2008.

[15] International Working Group of Sovereign Wealth funds, 'Santiago Principles', October 2008 (www.iwg-swf.org).

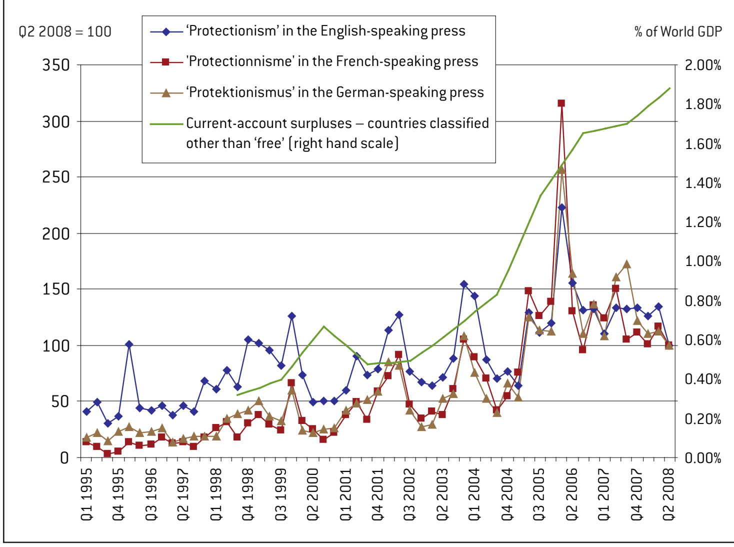
Between these extremes lies a thorny policy trade-off.

3. THE PERSPECTIVE OF INVESTING COUNTRIES

In general, sovereign investment in recent years has not raised security concerns , with the possible exception of Russian acquisitions of a stake in EADS in 2006 and of energy companies in eastern Europe. The investments by SWFs in several large banks in late 2007 and 2008 have benefited western economies by providing temporary relief to a strained banking system. Some sovereign investors, such as the Government of Singapore Investment Corporation, have attracted high respect for their professionalism.

Indeed, there are powerful incentives for sovereign investors not to take initiatives that might stoke security concerns. Given the size and growth of their assets, and their long-term horizon, they need continued access to recipient countries' markets and are careful not to attract criticism. This was illustrated when a group of 26 investing countries recently adopted a set of 'generally accepted principles and practices' – known as the Santiago principles – with coordination provided by the International Monetary Fund[15]. Given strong initial doubts about such common norms in some countries[16], the adoption of these principles demonstrates the strength of the incentives for cooperation. Together with ongoing discussion at the OECD, they embody the hope of a 'grand bargain' in which foreign investment is accepted in return for a pledge of 'good behaviour'.

Figure 3: A change of tone



Source: Factiva, IMF and Freedom House.

However, three important factors limit the scope for such a bargain and suggest that the corresponding discussions will not eliminate all recipient countries' security concerns.

- Emerging sovereign investors may find it politically difficult to meet developed countries' criteria for governance and accountability if these run contrary to features of their domestic system. In regimes where a single family or party controls virtually all institutions, it is unreasonable to expect a state fund's operations to be truly independent. In such a context, transparency can create problems of its own, specifically where ties to the west are controversial and not well accepted in the body politic[17]. Figure 4 (overleaf) shows there is a strong correlation between SWF transparency and the respective countries' political regime.

- While investing countries have economic incentives to accept 'rules of the game', they can also have political, economic or financial incentives not to. Politics sometimes runs contrary to economic interest, as was shown when Russia's invasion of Georgia in August 2008 contributed to wiping hundreds of billions of euros off domestic equity wealth. Also, sovereign investors' legitimate willingness to maximise investment returns can frustrate recipients' wishes for, say, specific disclosures[18] or restrictions on direct investment in companies[19], on the size of equity stakes[20], on the exercise of shareholder rights[21], or on the use of derivatives and leverage. Figure 5 (overleaf) illustrates how long-term investors generally tend to diversify asset allocation over time. Sovereign investors are likely gradually to expand into the full range of investment possibilities, including direct equity stakes and all sorts of alternative investments[22].

16 Only six months ago the president of the China Investment Corporation commented about calls for increasing SWF transparency requirements: *"Why do you need a law like that? That law will only hurt feelings. It is not economic. It does not make sense. Politically it is stupid"*, and the head of the Kuwait Investment Authority said: *"Recipient countries are placing handcuffs on sovereign wealth funds in the form of regulations termed – in the best traditions of George Orwell's Newspeak – 'codes of conduct' or 'principles of operation' or 'best practices'. These regulations will not solve or prevent any future financial crises"*. Sources: interview with Gao Xiqing on '60 Minutes', CBS, 6 April 2008; A. Newton, 'The Politics of Sovereign Wealth: An Overview', Lehman Brothers, 10 April 2008.

17 S. Schwarzman, 'Reject sovereign wealth funds at your peril', *Financial Times*, 19 June 2008.

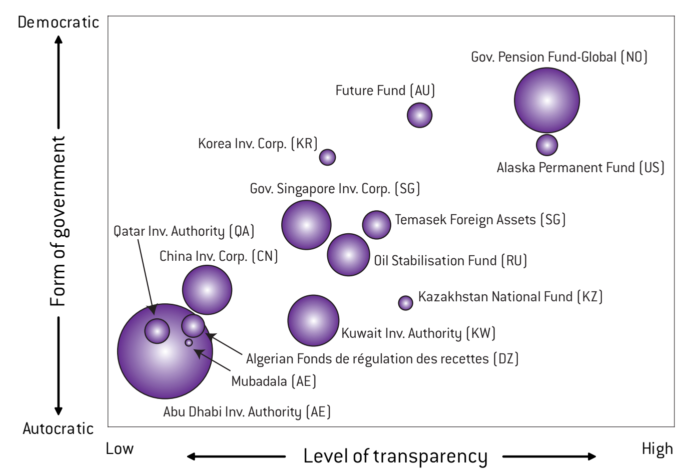
18 European Commission, 'A common European approach to Sovereign Wealth Funds', 27 February 2008.

- Developed economies' leverage to impose and enforce desired standards on sovereign investors is limited. True, they represent around four-fifths of global financial assets[23]. But they are unlikely to maintain a common restrictive front given that each of them wants to attract investment; and any rules imposed unilaterally would be resented as patronising by emerging investing countries, many of which are former European colonies, and would ultimately prove counterproductive. Moreover, even when common norms are accepted, as with the Santiago principles, enforcement will remain dependent on each country's goodwill and is likely to be imperfect.

Specifically, the idea that sovereign investment in the EU should be subject to a condition of reciprocity[24], while seductive, should not be pursued. Because many reforms cannot be forced on emerging countries whose levels of economic development remain diverse and different from those of recipient countries, the main effect of reciprocity would likely be to import legal uncertainty and suboptimal practices from less developed economies into the EU.

Overall, it seems reasonable to hope that sovereign investors will make progress towards more transparency, but this progress will be gradual and incomplete, its pace will vary among countries, and it will not eliminate recipient countries' concerns about their security[26].

Figure 4: Political regimes and transparency of SWFs

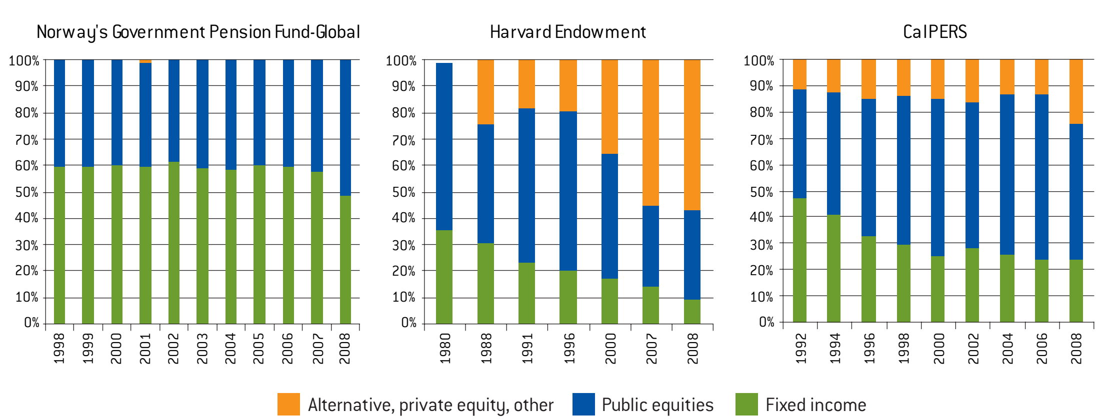


Source: Brad Setser and Arpana Pandey. Transparency is measured using the scoreboard developed by Edwin Truman[25]; the form of government index is from the Economist Intelligence Unit.

4. POLICY OPTIONS FOR EUROPE

As the crisis reinforces the need for Europe to attract foreign investment, it also may exacerbate defensiveness and economic nationalism[27]. In this context, Europeans need credible policy instruments of their own to ensure that inward investment does not put their security at risk. The EU's trade and competition policies, which are sensibly designed to address economic concerns only,

Figure 5: Gradual asset diversification of long-term investors



Source: Websites of HMC and GPF-G; CalPERS Investments Department.

[19] Lawrence Summers, 'Funds that shake capitalist logic', *Financial Times*, 29 July 2007.

[20] Philipp Hildebrandt, 'The Challenge of Sovereign Wealth Funds', speech on 18 December 2007 (on www.snb.ch).

[21] Evan Bayh, 'Time for Sovereign Wealth Rules', *Wall Street Journal*, 13 February 2008.

[22] Knut Kjaer, "Do not regulate wealth funds, improve them", *Financial Times*, 13 April 2008.

[23] McKinsey Global Institute, *Mapping Global Capital Markets*, January 2008.

[24] See for example Alain Demarolle, *Report to the French Government on Sovereign Wealth Funds*, May 2008.

[25] Edwin M. Truman, *A Blueprint for Sovereign Wealth Fund Best Practices*, Peterson Institute, April 2008.

[26] W. Miracky *et al*, *Assessing the Risks: the behaviors of sovereign wealth funds in the global economy*, Monitor Group, June 2008.

[27] Martin Wolf, 'Financial crisis tests durability of globalisation', *Financial Times*, 10 October 2008.

cannot and should not be used to address security concerns. We identify three main requirements for the corresponding policy framework:

- It should be **open**, and ensure that the EU remains among the world's most attractive places in the global competition for capital. Any investment review proceedings must offer legal predictability (including through guarantees that the security objective is not invoked for non-security motives), due process, and empowered jurisdictions.

- It should be **comprehensive** and credibly address the whole gamut of potential security risks, in the defence and security industry but also potentially in other sectors crucial to the functioning of the economy, including some energy facilities and critical physical and/or electronic infrastructure.

- It should be **sustainable** and provide a stable framework for policy. Steadiness is required both because of the need for long-term predictability, an essential factor of attractiveness to investment, and because political tensions from sovereign investment are more likely to increase than decrease in the near future.

We consider that these three requirements are broadly met by the CFIUS framework in the US, and by legislation in some EU countries. But looking at the EU as a whole, they are not fulfilled. The openness criterion is not met, since the diversity of national approaches to foreign investment is a barrier to the internal market in the defence/security industry. Current policies also fail to address the security risk comprehensively, as in many member states there is no consistent framework to review foreign investment outside of the defence industry. This gap can be exploited by populist politicians to push for protectionist moves or the abuse of other regulatory instruments, including in cases where no real security risk exists. Moreover, national frameworks fail to address cross-border security spillovers that arise in an integrated EU market: for example, if a contractor in one European country critically depends on a near-monopoly supplier from another European country, then a foreign takeover of the latter may have security implications for the former's home country, and the review process should allow adequate coordination. Finally, current policies are not sustainable. Many current investment control regimes are legacies of the cold war, a time when virtually all FDI came from long-term allies. These do not provide a stable policy framework in the current investment context, as is evidenced by a flurry of legislative initiatives since 2005 in countries including France, Germany and Greece.

To improve the policy framework for the review of foreign investment in Europe, three options can logically be envisaged. The first option consists of specific legislation and implementation in each member state, as is currently the case. A second option would involve common legislation at the EU level, with implementation (review of actual acquisitions) carried out at national level. A third option would consist of EU-level legislation and implementation, the latter by the Commission or a newly created *ad hoc* EU agency.

The first option's above-mentioned shortcomings are only likely to worsen over time, because of the probable increase in protectionist tendencies in many member states as a reaction to the changing global investment patterns, and in spite of the countervailing incentives to loosen controls arising from regulatory competition to attract inward investment. The third, federalist option has been advocated[28] but we see it as unrealistic and undesirable in the current make-up of EU political institutions. It appears to us that neither the European Commission nor any other EU institution can be entrusted with ultimate responsibility for security assessments, now or in the foreseeable future. Unlike essentially economic policies such as trade and competition, security policy involves a broad range of considerations which cannot in practice be delegated by national governments to the EU.

The second option better reflects the policy trade-off highlighted at the end of Section 2. It could take the form of an internal market directive (Article 95 of the Treaty) establishing a framework and process for the security review by member states of foreign acquisitions within the EU. The objective should be limited to 'hard' security, both national security of the country in which the investment takes place and security of the EU as a whole. The scope should be

[28] Laurent Cohen-Tanugi, *Euroworld 2015: A European Strategy for Globalisation*, report to the French Government, April 2008.

purchases of assets resulting in transfer of their ultimate control to non-EU investors, when this transfer creates a credible risk to security. Under the Treaty's provisions on free movement of capital, investments with no impact on corporate control would not be included in the scope. Nor should there be discrimination against state-owned investors. Governments should commit to adapt existing national security-related investment control regimes to the new framework.

'Denying the possibility of security risks would be a poor way to defend economic openness.'

The legislation should set out rules of due process, including on the maximum duration of the investment review; a definition of what is considered 'control' and how it should be assessed; and a framework for the negotiation of 'mitigation agreements', or modifications to be made to acquisitions in order to render them compatible with the security objective. It should create an EU committee, possibly coordinated by the High Representative for the Common Foreign and Security Policy, to ensure mutual information and coordination, especially in cases of cross-border security spillover even though the ultimate decision would remain with the relevant member state. Appeal would be possible to the court system, including the European Court of Justice. The European Commission could initiate infringement procedures if a government's practice is found to be in breach of the Treaties.

Such EU legislation would provide a robust anchor to prevent the proliferation of ill-coordinated national control regimes. It may be argued that the legislative process to adopt it risks being derailed, resulting in a more restrictive investment framework than the one we advocate. To address this risk, EU leaders should start the process by solemnly committing to openness towards foreign investment and emphasising the legislation's focus on 'hard' security, which minimises the possibility of its use for other purposes. The legislation's wording should not allow member states to block acquisitions which make business sense and entail no security risk such as, say, the purchase of Arcelor by Mittal Steel in early 2006, which several EU governments tried but failed to impede.

There are obviously other possible dimensions to a European approach to sovereign investment. More stringent transparency requirements on all (sovereign and other) investors in public equity, as well as active competition policy and, more generally, policies that encourage more vibrancy of European markets would also constitute appropriate responses. That said, the framework we propose for the review of foreign investment would be a key step for the EU to adapt to the new multipolar investment world, in which diverse political regimes coexist. Europe's response must be grounded in economic openness and legal predictability. The US had this policy debate in the 1980s. Its response, the CFIUS process under the 1988 Exon-Florio legislation, is certainly not perfect. But it has effectively contributed to America remaining one of the world's most attractive economies for foreign, including sovereign, investors, and it has remained essentially unchanged in spite of dramatic geopolitical changes since its inception.

In the EU, denying the possibility of security risks arising from foreign investment would be a poor way to defend economic openness. It is now time for Europe to tackle this difficult policy area, in which economic and strategic viewpoints must be combined to sustain an open investment environment.

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