VOX

A European framework for foreign investment

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European security concerns about foreign investment have produced opaque and inconsistent responses by national governments. This column makes the case for establishing a EU authority to address the issue in an open, comprehensive and sustainable manner rather than allowing the proliferation of disparate national regulatory initiatives. The openness of the EU investment environment is at stake.

Europeans have long prided themselves of their ability to remove border signs. For themselves, they have achieved the EU's own internal market, first for coal and steel and then for all other goods – even though the job remains to be finished on certain services – as well as, increasingly, for labour and capital. On the global scene, both EU institutions and EU participation in global institutions have been instrumental in pushing common norms to liberalise investment flows, as Rawi Abdelal has documented in his intriguing *Capital Rules*.[1] A 'world without borders' is a mainstay of what world-war-scarred Europeans consider inspirational rhetoric.

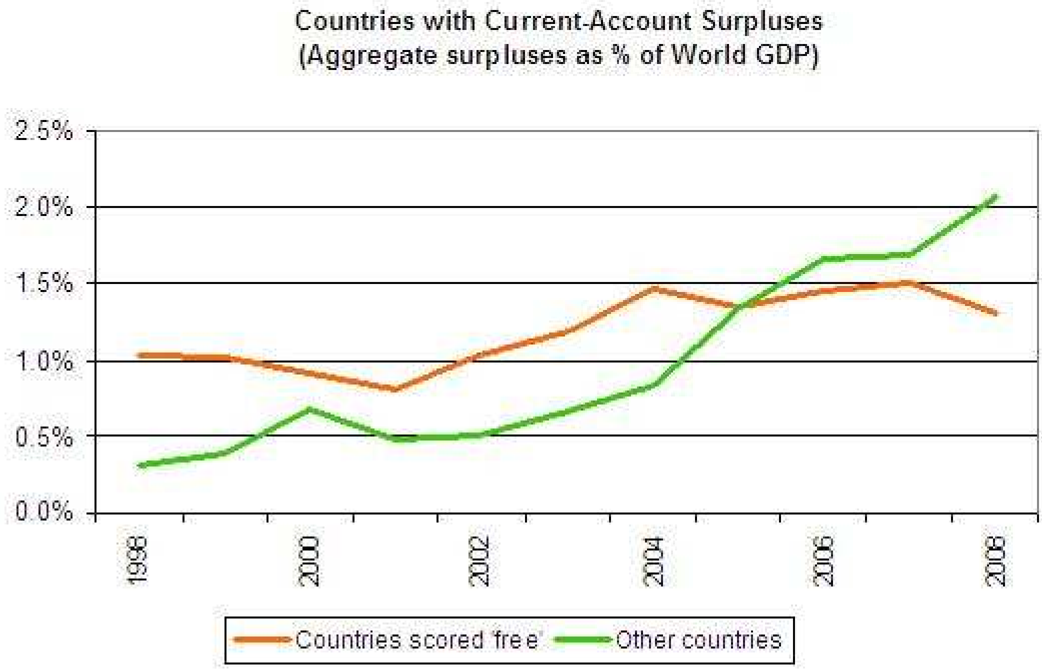
But the same Europeans have also lately often displayed scepticism bordering on hostility towards foreign investment. Franz Müntefering, the German centre-left leader, in April 2005 famously compared (implicitly foreign) private equity funds to locusts. The slogan of 'economic patriotism' has been officially embraced by France in 2005 to promote the defence of 'national champions' against 'foreign predators'. Nicolas Sarkozy has expanded this rhetoric since his election last year.

In a series of highly publicised and often embarrassing cases, governments have attempted – sometimes successfully, sometimes not – to prevent iconic companies from being taken over by non-domestic players: names that spring to mind include Beiersdorf, Danone, Antonveneta, BNL, Arcelor, Suez, Autostrade, Endesa, or Société Générale. More recently, the emergence of sovereign wealth funds as global financial players, increasingly identified as a distinct category since the spring of 2007, has been met with concern in many European debates.

Is the defensive mood correlated with actual changes in patterns of investment? And what should Europeans do about it? In a paper[2] recently published by Bruegel, we use political regime analysis by Freedom House, a respected international NGO, to analyse which type of countries currently hold most investment capability.

Seen through this lens, there has been an astounding rise of countries with illiberal political regimes in terms of current-account balances over the past decade. Over a few years, these countries have become by far the largest holders of surpluses, and therefore the largest potential investors internationally.

Figure 1.



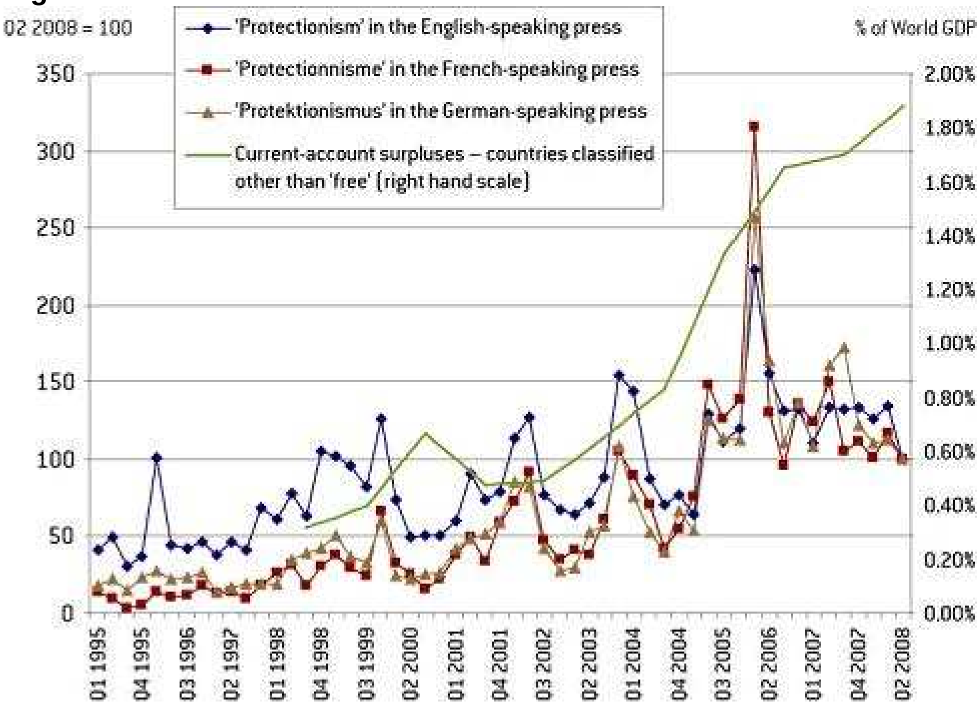
Source: IMF (current-account balances), Freedom House (country classification)

This rise cannot continue indefinitely, but illiberal countries' surpluses are likely to stabilise at a high level and to result in significant investments in the years to come, including in developed countries which hold about four-fifths of global financial assets.[3]

There are good reasons to think that the rise in defensive or protectionist attitudes, and the concern about sovereign wealth funds, is directly linked to this new dominance of countries with illiberal regimes on the global investment scene. The situation of the cold war and post-cold-war periods, when almost all inward investment into the EU came from countries which could be safely assumed to be long-term 'friends', no longer holds.

A rough indicator of public attitudes, the frequency of the word 'protectionism' in the press in three major European languages (measured from the Factiva database), illustrates a marked step up exactly at the same time when investment from illiberal countries started to emerge in the West, with a spike at the time of the Dubai Ports World controversy (early 2006) and a permanently high level since then.

Figure 2.



Under a rational risk analysis, there can indeed be situations in which foreign investment creates a security threat, either by wrecking entire economies – say, through a currency shock – or by leveraging the acquisition of a specific company. Conversely, inflated or misinformed perceptions of threat create the risk of a protectionist drift, especially in the EU where protectionist attitudes of individual countries can impair the integrity of the internal market as a whole.

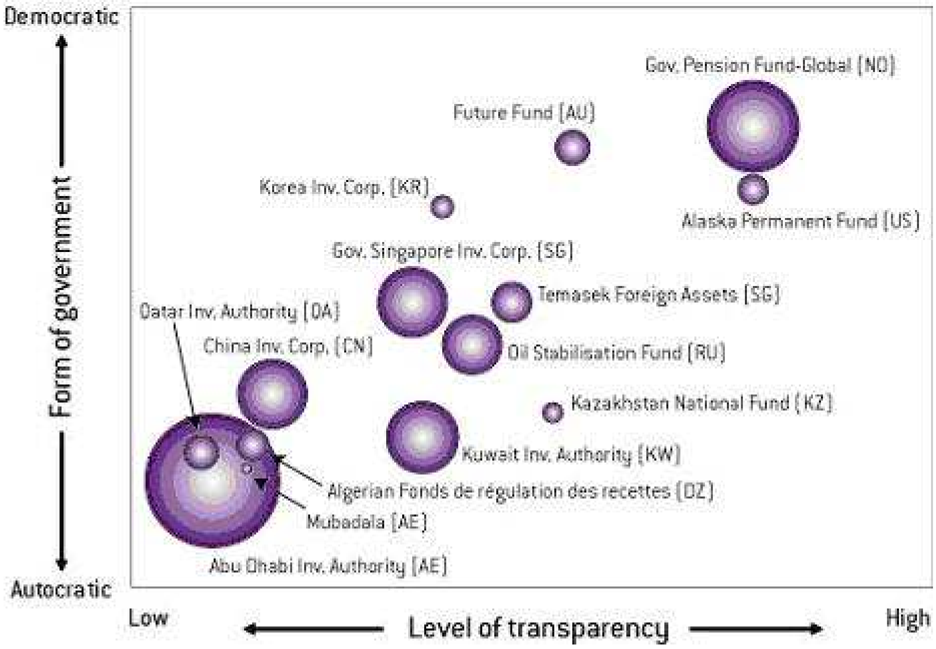
Specifically looking at risks resulting from acquisitions and the corresponding possibility of protectionist backlash, the investment patterns resulting from the new global current-account landscape warrant a re-examination of existing policies that cover foreign investment.

To be sure, sovereign investment – including that from sovereign wealth funds but also other government-controlled investment, e.g. by state-controlled enterprises or public bodies such as China's State Administration of Foreign Exchange or the Saudi Arabian Monetary Agency – has been benign so far, and worries about security implications have not been substantiated. Such investment helps recipient countries by bringing much-needed capital, especially in the current context, and also creates beneficial economic interdependencies between different parts of the world.

Moreover, investing countries increasingly recognise the need to proactively allay the fears that their newfound wealth may stoke in recipient countries. In the most meaningful step so far, even though it remains unfinished business, 26 countries with sovereign wealth funds last month endorsed the so-called 'Santiago principles' or 'generally accepted principles and practices' prepared during the previous few months by an international working group under the aegis of the International Monetary Fund. Under this process, we will gradually know more about how sovereign wealth funds are governed and, to a limited extent, about the nature of their investments.

But such initiatives, constructive as they are, will not be sufficient to address Europe's policy challenges. First, investment transparency can go only so far in countries where government is otherwise generally opaque and unaccountable. Brad Setser and Arpana Pandey at the Council of Foreign Relations have built a remarkable image of the correlation between the democratic nature of a political regime (measured by the Economist Intelligence Unit) and the transparency of corresponding sovereign wealth fund (measured by the gauge created by Ted Truman at the Peterson Institute for International Economics).

Figure 3.



Source: Brad Setser, "Sovereign Wealth Funds: New Challenges from a Changing Landscape", Testimony before Subcommittee on Domestic and International Monetary Policy, 10 Sep 2008

Second, while investing countries have strong economic incentives to 'play by the rules' of international investment as embodied in the Santiago principles, they can also be sometimes tempted to act otherwise, for a variety of political, economic or financial reasons. Third, the developed world's leverage in this game is limited, as it generally needs the investing countries' money and cannot realistically impose a specific behaviour upon them. Thus, relying on investing countries' initiatives alone is not enough to respond to the emerging new picture of foreign investment.

Today, each EU member state has its own policy as regards the security consequences of foreign investment. Some countries, such as the UK, or Germany following the recent adoption of new legislation, have adopted policies which, if reasonably implemented, provide the government with the means to mitigate the risks in the national space. In others, such as France, the existing regulatory framework covers only a limited sectoral scope, but the state sometimes intervenes outside of a formal process to ward off foreign acquirers. As a whole, this policy area is not dealt with consistently in the EU.

EU-level competencies such as competition and trade policies are unsuited to the consideration of security aspects. Nor is there an EU-level intelligence community that could support relevant security assessments. The upshot is policy instability at member state level, an inability to address certain risks on some member states, and an overall investment environment which offers insufficient clarity and predictability to foreign investors.

Twenty years ago, the US had a similar debate and created a policy framework for the assessment of foreign acquisitions for security purposes with the Exon-Florio amendment to the Trade and Competitiveness Act of 1988, which created a formal review process carried out by a Committee on Foreign Investment in the US (CFIUS) chaired by the Secretary of the Treasury. Without copying CFIUS, which has shortcomings of its own, Europeans should develop a policy framework that is at least as open, comprehensive and sustainable. For this, it needs to provide a common legislative framework, while recognising that implementation, including individual security assessments of foreign acquisitions and the corresponding link with the intelligence community, has to remain national as it cannot be credibly carried out by the EU institutions in their current form.

Such legislation would include a common objective of defending national and European security, as well as a harmonised process to significantly reduce the legal uncertainty that may be associated with fragmented national approaches. It would also introduce exchanges of information and best practices at EU level, which does not currently exist. It would thus provide a more robust structure than that currently provided by the Treaty on the European Community, which in the current global context does not go far enough to anchor member states' investment review policies and prevent a protectionist drift.

European debates have long focused on removing any controls of cross-border investment, and discussing such a review process beyond the national level would be something new. But in view of the rising prospect of investment from illiberal countries, the alternative is a proliferation of disparate national regulatory initiatives rather than a benign status quo. It is high time for Europeans to initiate serious discussions among themselves about security risks, if they are to maintain, and hopefully even improve, the openness of their investment environment.

Footnotes

1 Rawi Abdelal, *Capital Rules: The Construction of Global Finance*, Harvard University Press, 2007
2 'Safe and Sound: An EU Approach to Sovereign Investment', Bruegel Policy Brief 2008/08, November 2008 (http://www.bruegel.org/9146)
3 McKinsey Global Institute, *Mapping Global Capital Markets*, January 2008