★ CENTRE FOR EUROPEAN REFORM
essays

State, money and rules: An EU policy for sovereign investments

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★ Lower oil prices and the unwinding of global imbalances will slow the growth of sovereign wealth funds (SWFs). Nevertheless, these state-controlled vehicles will remain major players, with trillions of dollars to invest in companies and markets in Europe and elsewhere.

★ European businesses and banks have generally welcomed the prospect of long-term investment from SWFs. But politicians and the media have expressed concerns about their close links to governments that do not necessarily believe in liberal democracy and open markets.

★ The European Union has been right not to rush into new legislation to control SWF investments. Instead it has supported multilateral efforts under the auspices of the IMF and the OECD. These initiatives will set standards of accountability and transparency for SWFs and aim to make the investment environment in rich countries more predictable.

★ The risk that individual EU countries will erect new barriers against outside investment remains, however. The EU should resist any new moves towards protectionism. These undermine the functioning of the single market, deprive European companies of fresh capital and damage the credibility of the EU in the international arena.

Introduction: A muddled debate

In October 2008, Nicolas Sarkozy, president of France and holder of the EU rotating chairmanship, suggested that European countries should set up their own 'sovereign wealth funds' (SWFs) to secure stakes in strategic local companies and prevent them from falling into foreign hands. Most of his EU colleagues were not enthusiastic about the idea. But his proposal refocused European minds on an issue that had dropped off the agenda during the worst days of the financial crisis. Between early 2007 (when the term SWF first caught on) and the summer of 2008 (when the global financial crisis worsened dramatically), Europe had a lively debate about how to react to these state-owned investment vehicles mainly found in oil producing countries and fast-growing Asian economies. Although pre-crisis predictions of SWF growth have probably been exaggerated, these funds still hold trillions of dollars. Many of them are looking to diversify their investments away from their traditional focus on the US. Will Europe welcome them as saviours in an environment where capital is scarce? Or will it seek to fend them off through existing rules or new and inherently protectionist measures?

European countries are bound by EU rules to allow free movement of capital. Although these rules (and many national laws) allow governments to restrict this freedom, most European politicians have pledged to keep their economies open to all investors, sovereign or otherwise. Efforts to construct some kind of international framework for SWF investments have been remarkably swift. Although EU countries see the SWF 'threat' very differently, they quickly managed to agree on a number of principles to guide their policy reaction. Crucially, they decided against new rules at the EU level. Instead, they pledged to support the

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multilateral processes underway at the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD).

The international working group (IWG) on SWFs under the auspices of the IMF has been one of the more remarkable episodes in multilateral rule-making in recent times. Within less than a year, the IWG came up with a set of principles and standards on the transparency and accountability of SWFs. Meanwhile, the OECD has harnessed its existing rules on investment to construct guidelines for the countries at the receiving end of SWF investment.

Nevertheless, some European politicians and experts still claim that the EU should do more to erect defences against potentially harmful SWF bids. There are fears that SWFs could use control of European companies for political purposes or to skew the commercial playing field. After all, most SWFs are located in countries that do not fully share the West's democratic and liberal values. If the EU does not come up with new rules, individual countries might. While Europeans' fears about SWFs should not be dismissed out of hand, new investment restrictions entail several risks: they could lead to a fragmentation of the single market; they could put off potentially long-term investors at a time when fresh capital is increasingly hard to come by; they could hamper the integration of the SWF-owning countries into the world economy; and, more broadly, they could make the EU look insincere: it cannot preach about the importance of economic openness and adherence to multilateral rules to the likes of China and Russia while EU member countries are closing their own markets to investments from the outside.

In this essay, we analyse the trends that underlie the emergence of SWFs. We look at available evidence of their investment strategies and ask whether concerns about SWFs as tools of foreign policy or mercantilist strategies are justified. We outline how individual EU countries have so far reacted to the emergence of SWFs and what the EU's common approach looks like. We discuss the various proposals that are now being discussed to take the EU's SWF policy further, from 'golden shares' to 'reciprocity'. However, we recommend that the EU and its member-states should stick to their current approach of supporting the multilateral efforts of the IMF and the OECD, while resisting any moves towards investment protectionism at home.

What are sovereign wealth funds?

SWFs are government-owned investment funds that are managed separately from official reserves. Most SWFs are funded from the receipts of commodities exports, in particular oil, or from foreign exchange interventions in countries with large external surpluses. Sometimes the money also comes from fiscal surpluses or privatisation revenue. Countries establish SWFs for numerous purposes. They can act as macroeconomic stabilisation funds to insulate a country's public finances against unpredictable swings in commodity prices. They can serve as savings funds for future generations, or as pension reserve funds. And they can function as investment vehicles to increase returns on a country's official foreign exchange holdings. These objectives are not fixed. They can – and do – change over time. For example, in countries which have benefited from rising commodity prices, some funds initially set up for the purpose of fiscal stabilisation now double up as inter-generational savings funds.

SWFs are usually accountable to the government that owns them. Many are run by career officials although they usually employ professional fund managers. A growing number are entrusting at least a part of their money to US and European banks and fund managers to manage it on their behalf.

SWFs share certain common features, but they are not a homogeneous or clearly defined group. It is sometimes hard to distinguish SWFs from other state-controlled pools of money, ranging from state pension funds to the private wealth of ruling families. Some experts count public pension funds as SWFs, but others do not (on the grounds that active pension funds have short-term liabilities while most SWFs do not).[1] Confusingly, some so-called 'pension funds' do not immediately pay out pension money and should therefore be counted as SWFs. The best example is Norway's $400 billion Government Pension Fund-Global, which is really a future generations fund financed by oil money. Moreover, the line between foreign exchange holdings and SWFs can sometimes be blurred. Strictly speaking, China has only one SWF, the $200 billion China Investment Corporation (CIC). But the State Administration of Foreign Exchange (SAFE), which operates under the central bank, has been acting like an SWF by buying stakes in western companies – and it has more money to play with than the CIC. Some observers prefer to call entities like SAFE diversified monetary authorities (DMAs).[2] DMAs raise similar issues as SWFs in terms of transparency and accountability.

[1] *For definitions see United States Government Accountability Office, 'Sovereign wealth funds', September 2008.*

[2] *For a list of DMAs see for example Alastair Newton, 'Sovereign wealth funds and the Santiago principles', Nomura, October 2008.*

Sovereign wealth funds: Some of the biggest players

Country	Name	Established	Assets, $ billion
UAE	Abu Dhabi Investment Corporation, ADIA	1976	875
Norway	Government Pension Fund (administered by Norges Bank Investment Management)	1990	401
Saudi Arabia	Various funds	N/A	350
Singapore	Government of Singapore Investment Corporation, GIC	1981	330
Kuwait	Kuwait Investment Authority, KIA	1953	264
China	China Investment Corporation, CIC	2007	200
Hong Kong	Hong Kong Monetary Authority Investment Portfolio	1998	152
Russia	Reserve Fund	2008	141
Singapore	Temasek Holdings	1974	131
Libya	Libyan Arab Foreign Investment Company, LAFICO	1981	100
UAE	Investment Corporation of Dubai	2006	82
Qatar	Qatar Investment Authority, QIA	2005	60
Australia	Australian Government Future Fund, AGFF	2004	59
Russia	National Wealth Fund	2008	49
Algeria	Fonds de Régulation des Recettes de l'Algérie	2000	47
US	Alaska Permanent Reserve Fund Corporation	1976	40
Brunei	Brunei Investment Agency, BIA	1983	35
Ireland	National Pensions Reserve Fund, NPRF	2001	31
South Korea	Korea Investment Corporation, KIC	2006	30
Kazakhstan	Kazakhstan National Fund, KNF	2000	26
Venezuela	National Development Fund of Venezuela	2005	21
Chile	Economic and Social Stabilisation Fund	2007	17
Nigeria	Excess Crude Account	2004	17
Canada	Alberta Heritage Savings Trust Fund	1976	17
Malaysia	Khazanah Nasional Berhad, KNB	1993	16
US	New Mexico State Investment Office Trust Funds	1958	15
Ireland	Foreign Exchange Reserve Fund	1999	15
Taiwan	Taiwan National Stabilisation Fund	2000	15
UAE	Abu Dhabi International Petroleum Investment Company	1984	12

Source: Deutsche Bank Research. Data reflects latest available figures as reported by individual entities or other authoritative sources. Various reporting dates between 2004 and 2008.

Finally, the debate about SWFs cannot be disentangled from that about state-owned or controlled enterprises (SOEs). In countries where the state plays a big role in the economy (which happens to be the case in most countries with SWFs), even companies that are not state-owned in the strict sense may be subject to certain political imperatives. Most of the big controversies about foreign investments in recent years have been sparked by SOEs, not SWFs: examples include the attempted acquisition of a US oil company by CNOOC, the state-owned Chinese oil giant; the foiled bid by Dubai Ports World for the management of various US port assets through its takeover of a UK-based port operator, P&O; the controversial build-up of a 5 per cent stake in EADS, the European defence conglomerate, by a Russian state-owned bank; or the various investments of Gazprom, the Russian gas monopoly, in the energy sectors of EU countries. Concerns about SOEs have set the scene for the debate about 'sovereign' investment more generally. "Europe's debate about sovereign wealth funds is really a debate about Gazprom", says one European official. To many, it makes little sense to impose limits on SWF investments while not doing so for SOEs or vice versa.

SWFs in the global spotlight

SWFs are not new actors in the international financial system. Indeed, a number have been around for several decades. The most venerable SWF of all, the Kuwait Investment Authority (KIA), was established as far back as 1953. Two of the other major SWFs, the Abu Dhabi Investment Authority (ADIA) and Temasek (Singapore), were set up in the 1970s. Why, then, have rich countries only started to focus on SWFs over the past two years or so? Broadly speaking, there are three reasons.

First, SWFs have been getting larger, and hence more visible. Following explosive growth over the past decade, assets managed by sovereign funds now account for an estimated $3 trillion – about the same as the total assets managed by hedge funds and private equity combined.[3] The total assets managed by SWFs worldwide are still modest compared with those managed by pension funds, mutual funds and insurance companies. Individually, however, some SWFs are now massive players on international financial markets. The world's largest SWF, ADIA, is estimated to manage assets worth around $875 billion.

[3] *All data are estimates as at mid-2008.*

Second, the number of SWFs has proliferated as more and more countries have set up such funds. Traditionally, SWFs were to be found mainly in Gulf states such as the United Arab Emirates (UAE), Kuwait and Oman, and in a handful of richer Asian countries, such as Brunei, Malaysia and Singapore. However, since 2000 the number of SWFs worldwide has more than doubled. Even if a strict definition is adopted and institutions such as active state pension funds and DMAs are not counted, there are now around 50 SWFs worldwide. New SWFs have sprung up in countries such as China and Russia. It is the emergence of these new players that has raised concerns in Europe and the US.

Third, the proliferation of SWFs reflects a shift towards more 'aggressive' investment strategies by countries with large current-account surpluses. Until recently, many of these countries were content to hold low-yielding, liquid assets such as US Treasury bonds. However, a growing number of countries with external surpluses have started to diversify into higher-risk, higher-yielding assets such as equities. Although most equity stakes taken by SWFs remain fairly small, the number of large stakes has been rising. Some SWFs have been moving into foreign direct investments (taking stakes of 10 per cent or more) or outright acquisitions. UNCTAD reports that 20 years ago there was only one large cross-border acquisition by an SWF. In 2007, there were 30.[4]

[4] *United Nations Conference on Trade and Development, 'World investment report 2008', September 2008.*

Why are recipient countries worried?

By and large, the West has viewed the rise of SWFs with equanimity. The US has been happy for SWFs to help finance its large external deficit, while the United Kingdom has welcomed the capital and lucrative business links that have come with SWF investments. Businesses and banks have also welcomed SWFs – partly because they hope that stronger links with state-owned vehicles in, say, China or the Arabian Gulf, will give them better access to these lucrative markets; and partly because they see SWFs as a stable source of long-term capital. Unlike hedge funds or private equity firms, SWFs do not usually borrow to invest. As a result, they are not forced to withdraw their money at short notice to meet margin calls if markets dip. In theory, therefore, they should be able to withstand the 'herd behaviour' that drives other investors, and have a stabilising impact on the share prices of the companies they invest in and on financial markets overall.

Many European politicians have also welcomed SWF investments. They know that SWFs are often important tools of economic stabilisation in oil-producing countries, and that they are suitable vehicles for channelling some of the oil wealth and excess savings in emerging markets back into the mature economies of Europe

and the US. Some also argue that giving oil-producing countries and emerging Asian powers a stake in the economies of Europe and the US will help to align their interests more closely with those of the West.

Nevertheless, there has been growing unease in Europe as SWFs have diversified their investments away from government bonds and into equity stakes. These concerns are often inchoate, but usually revolve around the following considerations:

★ **Ownership:** most European countries have privatised most of their previously state-owned industries, convinced that private owners make for better management. They do not want other governments to take control of such companies now.

★ **Geopolitics:** new SWFs are emerging in countries that have difficult relations with the West, such as Russia, China or Venezuela. Such countries could use their control of local companies to put pressure on the host governments.

★ **Policies:** SWFs are the offspring of policies that many Europeans resent – particularly efforts by the OPEC cartel to keep oil prices high, and interventions by countries such as China to maintain artificially weak currencies in order to boost their exports.

★ **Competitive distortions:** SWFs could be investing in firms not only to maximise their returns but to achieve certain commercial advantages for companies from their own country.

★ **Transparency:** few SWFs disclose what they invest in, what their strategy is or how they are managed.

★ **Governance:** the links between the SWFs and the governments that own them are often opaque. This makes them look unpredictable.

The growth of SWFs overturns one of the central assumptions that accompanied the new phase of globalisation that began in the early 1990s – namely, that global economic integration would be driven by 'de-politicised' market forces. The growing prominence of SWFs looks like a harbinger of a new era of state capitalism. What worries European countries is not only that governments appear to be playing a bigger role in economics, but that many of these governments do not fully (or even partially) sign up to the democratic and liberal principles on which Europeans want the international order to be based. Very few of the countries that have been exporting capital to the developed world via their SWFs are pluralist democracies.[5] SWFs, therefore, are not just the symbols of a shift in power from the West to the East and South. There is also a fear that they could become tools in a growing strategic rivalry between a declining West and a rising China, a more assertive Russia or a more self-confident Arab world.

[5] *Of the ten countries with the biggest SWFs, only two are classified as 'free' by Freedom House, a US-based non-governmental organisation. Three are labelled 'partly free' and five 'not free'.*

Governments in the developed world also worry that SWFs could have a detrimental impact on their economies or on the integrity of their markets. Some countries with SWFs suffer from widespread corruption,[6] and many promote state monopolies at home rather than competitive markets. Some have engaged in practices that most Europeans would consider incompatible with the established international economic order. Examples include the violation of intellectual property rights, the expropriation of foreign companies' assets or the use of energy as a political tool. The growth of SWFs linked to such governments raises questions about their standards of behaviour. They could, in theory, use their SWFs to try and create advantages for their own national champions, via industrial espionage, insider trading or by stifling competition. European countries have laws and legal systems in place to clamp down on such misbehaviour, should it occur. But a lawsuit against an SWF could turn into a diplomatic incident with the government that owns it.

[6] *In Transparency International's 'corruption perception index, 2008', for example, China ranks 72 and Russia 147 out of 180 countries.*

Finally, even Europeans who worry little about the identity and motives of SWFs may have concerns about the impact that their growing size and appetite for risk will have on international financial markets. SWFs could have a stabilising impact on financial markets, for the reasons already explained. But this cannot be taken for granted. SWFs' investment strategies, insofar as they are published, tend to be vague. Their risk management practices may be weak. They are not regulated. Rather than acting as stabilising long-term investors, they could exacerbate swings in international markets if they acted quickly to unwind existing positions or dash into new growth markets. Some economists worry that SWFs could contribute to an abrupt and disorderly unwinding of global imbalances if they diversify too rapidly out of US Treasury bonds. Others fret that SWFs could distort asset prices if they invest for reasons that are not purely commercial.

Investment vehicles or geopolitical instruments?

Because SWFs are big, opaque and linked to non-western governments, it is easy to construct lurid scenarios about their motives and behaviour – and consequently about their impact on the economies of recipient countries. But is there much evidence to suggest that SWFs are geopolitical instruments dressed up as investment vehicles? To date, not really. Countries establish SWFs not for foreign policy reasons but for domestic ones, such as macroeconomic stabilisation or saving for future generations. Anxious observers may dismiss SWFs' advertised goals as window dressing. But these goals do place constraints on the way SWFs operate. Even in non-democratic countries with low levels of transparency and accountability, SWFs have attracted domestic criticism for 'wasting' national savings. China's CIC, for example, has been castigated for losing money by investing in US financial institutions.

The overwhelming weight of evidence suggests that SWFs are motivated by commercial, rather than political, considerations. Consider first the sectors that SWFs have invested in. According to data from the Monitor Company Group (MCG), some two thirds of the value of those SWF transactions that have been reported between 2000 and 2008 were in just two sectors: financial services and real estate. By comparison, less than 1 per cent was in strategically sensitive sectors such as defence, transport, aerospace and high technology.[7] Among the few 'sensitive' deals recorded so far were the acquisition of small stakes by China's SAFE in two oil firms, France's Total and British Petroleum; and the Investment Corporation of Dubai's purchase of a small stake in EADS.[8]

[7] *Monitor Company Group, 'SWF behaviour: The evidence of public transactions', 2008.*

[8] *In most western countries, investments under a certain threshold – usually 3-5 per cent – do not need to be disclosed.*

Between mid-2007 and the autumn of 2008, SWFs invested more than $90 billion in financial services, thus playing an important part in recapitalising ailing banks in the developed world in the early stages of the financial crisis.[9] Prominent deals have included the stakes taken by the Government of Singapore Investment Corporation (GIC) in UBS and Citigroup, by ADIA in Citigroup, by Temasek and the KIA in Merrill Lynch, and by the CIC in Morgan Stanley. There is nothing sinister about the rush by SWFs into this particular sector. Valuations of banking stocks looked appealing to SWFs when most of these investments were taking place. And some SWFs may have hoped that by appearing as 'saviours' of western financial systems they could dispel some of the concerns that had been publicly expressed about their investment strategies and motivations. Moreover, certain SWF-owning countries are themselves regional financial centres, such as Dubai and Singapore. They may have hoped that acquiring minority stakes in the world's leading financial firms would help them to gain access to expertise and to raise their profiles.

[9] *Deutsche Bank Research, 'SWFs and foreign investment policies – an update', October 2008.*

A look at the geographical distribution of SWF investments is also instructive. The belief that SWFs are scouring western markets for strategic assets is misplaced. Only a third of the SWF transactions identified by the MCG have been in OECD countries. True, the deals in developed countries have typically been larger, so by value they accounted for around 60 per cent of the total. Even so, it is clear that SWFs do not just target their investments at developed countries. They also invest heavily outside the OECD – often in countries located in their geographical neighbourhood – although they tend to place smaller sums at risk. Within the OECD, most SWF investments have gone to just two countries, the US and the UK. In part, this is because the UK and the US have been generally welcoming to foreign investment. But it is also because they happen to host the world's leading financial centres and SWFs have invested heavily in banks. It is striking, however, that the most heated debates about SWFs have been held in countries which have attracted very little investment from such funds. Economists expect SWFs to diversify their investments away from US assets and banks and more towards other emerging markets[10] – rather than to developed countries which are reticent towards them.

[10] *If SWFs allocated 10 per cent of their assets to emerging and developing countries (an allocation that would be in line with what many global investment funds are doing), this would generate inflows of up to $100 billion a year for the next ten years. Javier Santiso, OECD Development Centre, presentation at the Salzburg Seminar, September 2008.*

Although commercial motivations have been uppermost in SWFs' investments to date, this does not mean that political considerations will not become more influential in the future. Some observers fear that past behaviour may not be a guide to the future. The initial investment of, say, a Russian or Algerian SWF in Europe may be based on purely commercial considerations. But if relations between the recipient country and the SWF-owning country subsequently deteriorate, the investment may become a tool in a political game. Moreover, 'political' is not a straightforward term in this context. Norway's Government Pension Fund, for example, operates under strict ethical guidelines drawn up by politicians. It is not allowed to invest in a range of companies, from EADS to Wal-Mart. And in some instances, the fund has tried to influence the behaviour of the firm's management. For example, it worked actively with Monsanto to end the company's use of child labour in India (threatening to withdraw if it did not). Norway's

'non-commercial' investment guidelines worry few people in Europe because Norway is a liberal democracy and military ally with similar values. But Europeans might worry more about non-commercial guidelines if the SWF came from a country that was not a democracy or had a fundamentally different value system.

However, the biggest 'political' threat from SWF investments may not be related to these funds buying 'strategic' companies in Europe or the US, but rather to their impact on other emerging markets. OECD countries have well-developed legal and administrative systems that they can use to fend off unwanted investments or discipline unruly investors if need be. Moreover, the US and the EU are so important as markets, sources of capital and as investment destinations that SWF countries cannot risk spoiling their reputation there. By contrast, poorer countries – short of capital and with weak legal and administrative systems – may be more susceptible to SWF-owning countries playing politics. Most SWF investments in other emerging markets have been entirely benign. But there have been a few examples that give cause for concern. China's SAFE has reportedly agreed to buy $300 million worth of government bonds from Costa Rica, in return for that country shifting diplomatic recognition from Taiwan to the People's Republic. Hugo Chavez has ostentatiously used Venezuela's oil wealth to bankroll politicians of his choice throughout Latin America. If Europe and the US became more closed to SWF investments, one unintended consequence would be to divert more SWF money to poorer countries, where the risk of political mischief or uncompetitive behaviour is much larger. As we argue below, it is therefore important that the EU makes a real effort to construct the broadest possible framework for SWF investments, one that also includes other emerging markets.

The financial giants of tomorrow?

One of the reasons why people in the EU and elsewhere have become worried about SWFs is simply because they are big, and have been forecast to get ever bigger. The SWF debate took off in earnest in May 2007, when a Morgan Stanley analyst predicted that SWF assets would reach $12 trillion by 2015. Similarly, Standard Chartered projected them to expand to $13-15 trillion over the next ten years. The IMF was a little more cautious, forecasting that funds invested in SWFs would grow to $6-10 trillion by 2012. However, all these forecasts were carried out before the global economic crisis worsened in the autumn of 2008 and some of the key assumptions that underlie them may no longer hold true.

One of these assumptions was that the current-account surpluses of China and other East Asian countries would continue to grow, leaving governments there with ever bigger foreign exchange reserves to channel into their SWFs. But the huge external surpluses in Asia could only exist as long as some big western countries, such as the US and the UK, ran large external deficits. These deficits came at the price of unsustainable increases in public and household debt. Now that credit has dried up and households have started to rebuild their finances, domestic demand in the US and the UK is flagging – which means much less demand for Asian goods. It appears very unlikely that other countries can take up the slack. In the eurozone, domestic demand looks set to be weak for several years. And other emerging economies will not be able to expand their domestic demand significantly because large external deficits are hard to finance in an environment of scarce and volatile capital flows. This can only mean that China and the other Asian countries will be running smaller external surpluses – which means fewer foreign reserve assets to fund their SWFs.

A second assumption was that international commodity prices would remain high, thus channelling billions into the SWF-owning countries in the Gulf region and the former Soviet Union. Most private-sector projections of the future size of SWFs were carried out before the middle of 2008, when international oil prices were at their peak. Between June and November 2008, international oil prices fell by nearly two-thirds, dramatically reducing oil producing countries' revenues. Oil producing countries with small populations, such as the UAE or Norway, will continue to run large external surpluses even if oil prices stay low for a while. But a big resource-dependent country such as Russia will see its external surplus dwindle, and possibly turn into deficit. Commodity prices are unlikely to fall to the exceptionally low levels seen in the late 1990s, when oil cost just $10 a barrel. The industrialisation of China and other emerging markets, production cuts by OPEC and underinvestment in the exploration of new oil fields will put a floor under oil prices in the medium to long run. But for the next couple of years, energy demand in the industrialised countries will fall, while that from emerging markets will grow more slowly. So oil producers' revenues are likely to be lower than seemed likely a few months ago.

The third assumption was that emerging economies will continue to buy more equity stakes abroad to achieve higher returns. China alone sits on roughly $2 trillion of foreign exchange reserves – a huge pot of money potentially available for funding investments (either through SAFE or the CIC). In addition, other countries with substantial foreign exchange reserves, such as Taiwan (reserves: $280 billion) and Japan (almost $1 trillion), have been considering setting up their own SWFs. But the current economic and financial crisis will

have changed their considerations. Many SWFs have come under criticism for the heavy losses they have suffered since the start of the financial crisis, especially as they have invested so much in western banks, whose share prices have collapsed.[11] Global financial turmoil has also reminded governments in emerging economies that they are holding large reserves for a reason. Many emerging market currencies, even in countries with sound macroeconomic policies, came under pressure in the autumn of 2008. Several countries, from Kuwait to Russia, have instructed their SWFs to buy local shares to prop up domestic financial markets. With growth slowing in most emerging economies, the temptation to use SWFs for domestic purposes, such as recapitalising banks, helping small businesses or boosting domestic demand through infrastructure projects, will become stronger. Finally, countries with SWFs have also been called upon to make some of their foreign exchange reserves available for global rescue efforts, in particular by lending them to the IMF.

11 'Sovereign funds cool on rescue finance', Financial Times, November 9th 2008.

A balanced appraisal

Many of the concerns expressed in Europe about SWFs are understandable, given their lack of transparency and their opaque links to governments that are not democratically accountable. However, there is a risk that public discussions about SWFs will become distorted by myths. The evidence suggests that the overwhelming majority of SWFs are straightforward investment vehicles, not geopolitical tools in the hands of states that could become hostile to the West. Around three quarters of the funds under management are held by SWFs that have been around for quite some time – and most observers accept that their investments are commercial. Nor is there any evidence to suggest that SWFs invest in strategic (or even non-strategic) assets in the teeth of political opposition in the recipient country. SWFs tend to invest only where they find a receptive political climate. And while SWFs are likely to become more influential players in international financial markets over the years to come, they may not grow quite as rapidly as many independent forecasters initially assumed. Europeans should therefore rely on evidence and keep a sense of perspective when they ponder policy responses to the growth of SWFs. Otherwise, there is a risk that European countries will end up erecting new protectionist barriers against investments. These would raise the cost of capital, deprive many European companies of a source of stable, long-term financing and make the EU look unwelcoming to outside investors.

The EU's framework for SWF investment

Although there is little reason to assume that SWFs pose a threat to national security or the functioning of markets in the EU, several European politicians have called for new defences against SWF investments. However, European governments cannot easily put in place new restrictions without violating their legal commitments. EU countries are bound by a myriad of multilateral investment rules that they have signed up to, primarily through their EU membership, but also through the WTO, the IMF, the OECD and various EU agreements with other trade blocs or individual non-EU countries.[12]

12 European Commission, 'Provisions on capital movements in multilateral and bilateral agreements of the European Union with third parties', May 2007.

The investment policies of the EU member-states are primarily determined by the *acquis communautaire* (the Union's accumulated rulebook). The free movement of capital is one of the four fundamental freedoms of the single market: article 56 of the EC treaty prohibits any restrictions on capital flows, not only between EU countries but also from third countries. However, the treaty makes exceptions for national security, defence and property ownership (articles 296 and 295), and it allows the Council of Ministers to limit direct investments from non-EU countries (article 57). Moreover, the individual member-states retain the right to restrict capital flows "on the grounds of public policy or public security" (article 58) or in emergency situations (article 59). Other pieces of EU legislation also have a bearing on capital movements. For example, the EU merger regulation (article 21) allows EU countries to block mergers and acquisitions to "protect legitimate interests other than competition". The regulation mentions security, plurality of the media and financial stability.

Although the EU's legal framework offers some room for restrictive measures, in practice the law has been applied rather strictly. The European Commission has not been shy to take EU governments to the European Court of Justice (ECJ) for alleged infringements of the free movement of capital; and the ECJ has tended to interpret the EC treaty in a narrow sense, ruling against all sorts of national rules and practices that restrict the free movement.

Individual EU countries have their own ideas

Nevertheless, the specific legal and – it must be added – political frameworks for foreign investment differ between the member-states. Most EU countries have some special rules for investments in strategic sectors,

most notably defence, media and infrastructure. A small number have review procedures that can be used for any sector if an investment could entail a national security risk or, in some cases, if it exceeds a certain threshold (in terms of the money involved or the share taken). But some countries have no established legal and administrative framework that governments could rely on to fend off an unwanted bid from an SWF.

The restrictiveness of an investment regime depends as much on political practice as on the specific legal framework. Most of the EU countries that have rules on strategic sectors or investments with national security implications have hardly used these laws. Nevertheless, instances of investment protectionism abound. Various governments have foiled bids for 'national champions' – bids that have mostly come from other EU countries or the US.

One reason why there has not been a high-profile case of an EU government blocking an SWF investment may be that both recipient countries and investors usually try to avoid public controversy. SWFs (and other state-connected foreign investors) often contact the relevant authorities in the target countries well before any review process is even triggered. When the government, parliament or central bank of that country indicates that the investment may be unwelcome, the investor may retreat rather than risk a public showdown. SWFs know that politics ultimately trumps any legal review process. For example, the Committee on Foreign Investment in the United States (Cfius) had already cleared the bid of Dubai Ports World for the US ports portfolio of P&O when it started to attract political opposition in the US Congress. The Dubai company had to sell its US port assets despite official clearance.

This essay cannot describe the investment regimes of all 27 EU countries, some of which are in a state of flux. But a quick glance at the policies of four of the bigger ones illustrates the breadth of the approaches taken.[13]

[13] US Government Accountability Office, 'Foreign investment: Laws and policies regulating foreign investment in ten countries', February 2008; news reports.

★ **Netherlands:** Unusually, the Netherlands does not have a review process which would allow the government to reject a bid for a Dutch company on national security grounds. Most sectors of the economy are open to foreign investment. The only exceptions are state monopolies, such as the power grid. Despite the Netherlands' openness to foreign investment, mooted cross-border takeovers of Dutch firms occasionally spark domestic political debates. In July 2007, for example, Barclays Bank increased its bid for ABN Amro after the state-owned China Development Bank and Singapore's Temasek had taken a large stake in the UK bank. Barclays' bid was ultimately unsuccessful. But the spectre of China Development Bank indirectly controlling a stake in the Dutch financial giant triggered a debate on whether the Netherlands needed stronger defences against sovereign investments. In April 2008, the government rejected a plan from the Socialist Party to bar SWF investments in certain sectors, such as media and energy. But it promised to consider another proposal to allow a judicial review of investments that pose risks to national security.

★ **UK:** The 2002 enterprise act gives the government the right to block transactions that could threaten the public interest or security. Several sectoral laws (defence, finance, media) have specific clauses that can be used to ward off unwanted bids. In practice these laws have hardly been used as the UK has generally been very open to foreign investors, sovereign or otherwise. In the late 1980s, the British authorities told the Kuwait Investment Authority (KIA) to reduce its stake in BP from 22 per cent to below 10 per cent (it still holds around 3 per cent). But since then various SWF investments in British companies – from the Government of Singapore Investment Corporation's (GIC) stake in British Land, the UK's second biggest quoted property company, to Qatar Investment Authority's purchase of 20 per cent of the London stock exchange – have aroused little public concern. Politicians and officials from the prime minister down have repeatedly stressed that the City of London and British industry will continue to welcome investment from SWFs.

★ **Germany:** Traditionally, defence and encryption have been the only sectors where outside investments required a formal review. But in 2007 the government started drafting a new law to set up a Cfius-style review process that could be applied to all sectors of the economy. The cabinet adopted a final draft in August 2008, although parliamentary ratification was still pending at the time of writing. The law will give the economics ministry – in consultation with other ministries – the right to review and block any acquisition (from an SWF or any other fund or company) of more than 25 per cent in a German company if it is deemed a threat to "national security" or "public order". The new law will only apply to non-EU/EFTA countries. German business federations have warned that the new law could put off foreign investors and encourage countries such as China to close their markets to German companies. But the economics ministry has promised that the new rules will be used sparingly. There have been a small number of long-standing SWF investments in Germany, such as the KIA's 7 per cent stake in car-maker Daimler since 1969. Some recent bids have triggered more debate. For example, when Neptune

Orient Lines, which is controlled by Temasek, attempted to buy TUI's shipping business, Hapag-Lloyd, in 2008, workers went into the streets to demonstrate against feared job-losses. Hapag-Lloyd was then sold to a German consortium.

★ **France:** A 2005 decree restricts investments in 11 strategic sectors, mainly in defence and dual-use industries. The rules are stricter for non-EU companies than for those from the EU. The European Commission has taken the French government to the European Court of Justice over the law, and France has promised to bring it in line with EU requirements. France also has special investment rules for the media, the financial sector and public monopolies, such as nuclear power stations. Despite its reputation for being closed to foreign investors, France is actually one of the world's top five destinations for foreign direct investment and over 40 per cent of the stockmarket capitalisation of the CAC-40 index is owned by foreign investors. The single largest foreign investor on the CAC-40 is an SWF, the Norwegian Government Pension Fund. Other sovereign investors with stakes in French companies include China's SAFE (which has a small stake in the French oil giant, Total) and Qatar's QIA (which has a stake in Cegelec, an electrical engineering company). France, in short, is slightly enigmatic. It attracts significant foreign investment. But government statements on SWFs are often ambiguous and not always welcoming.

Cfius

The Committee on Foreign Investment in the United States (Cfius) is the US's main tool for reviewing foreign investments with national security implications. Cfius is an 'inter-agency committee', meaning it is made up of representatives of various ministries (defence, state, commerce, homeland security), under the chairmanship of the treasury secretary. It has been in existence since 1975, and since 1988 the president has been able to block mergers and acquisitions on national security grounds (the so-called Exon-Florio amendment). Usually it is the companies that seek to invest in the US that apply for a Cfius review. But the body can also take the initiative to review any acquisition of a stake of more than 10 per cent. The vast majority of applications have not been followed by a formal investigation and only a handful have actually resulted in a presidential decision.

The Bush administration reformed the Cfius process twice in 2007-08. First, it made an investigation quasi-automatic in cases where the investor is controlled by a foreign government or when it is aimed at critical infrastructure. Second, it allowed Cfius to also review transactions that fall under the established threshold of 10 per cent. The number of cases under review has risen considerably since 2007.

The EU's response

With some EU governments rethinking their investment laws in response to a perceived SWF threat, the European Commission feared that protectionist reflexes could damage the integrity of the single market. The Commission therefore sent a communication to the Council in February 2008, which suggested that the EU should:[14]

14 European Commission, 'A common European approach to sovereign wealth funds', February 2008.

★ **Keep markets open for foreign capital,** to avoid a negative spiral of protectionist reactions.

★ **Support multilateral efforts**, in particular through the IMF and the OECD.

★ **Rely on existing laws** to deal with SWFs rather than drawing up new ones.

★ **Respect EC treaty and other international commitments** on the free movement of capital.

★ **Ensure proportionality and transparency** in any responses to SWF investments.

The Commission argued that it would be easier for EU countries to stick to those principles if the SWFs agreed to sign up to certain commitments on governance and transparency. The communication listed some requirements, such as publication of the rules governing the relationship between the fund and the government that owns it, the development of a risk management system, and the disclosure of the size, currency composition and asset allocation of the fund. But it stressed that these should be seen as input for the IMF-led process of drawing up guidelines rather than EU-specific demands. EU leaders welcomed the Commission's paper at their March 2008 summit. They warned that "the emergence of new players

with a limited transparency regarding their investment strategy and objectives has raised some concerns relating to potential non-commercial practices". But they also stressed that "SWFs have so far played a very useful role as capital and liquidity providers with a long-term investment perspective". And they endorsed the Commission's five principles on open markets, the importance of existing rules and support for multilateral efforts.[15]

[15] *European Council, 'Council conclusions March 13th-14th', March 2008.*

The EU's response was remarkably swift, given that there were significant differences between the member-states – France wanted a strong EU response, the UK insisted on maintaining the free movement of capital, and Germany was wary of ceding new powers to the EU. Although the differences were not fully overcome before the March summit, Commission officials say that there is now a strong sense that the EU is approaching a common position. The EU's response was also measured and sensible, in particular in light of the rather more protectionist comments of some EU politicians before the March summit.

The EU is right to support multilateral efforts rather than draw up its own rulebook for SWFs. This decision partly reflects the insight that issues connected to SWFs need to be dealt with in the widest possible format: countries that own SWFs and the largest possible number of recipient countries should be involved. If western countries started to strike bilateral deals with SWF countries, the international investment regime would fragment and SWFs could start to play recipient countries off against each other. The EU is also right to support a voluntary code of conduct as an important first step towards building trust between the SWFs and the recipient countries.

What next for the EU?

Although the EU's initial reaction to SWFs is to be commended, it would be naïve to think that the threat of investment protectionism in the EU has gone away. The economic crisis has changed the debate on SWFs. On the one hand, in an environment where capital is extremely scarce, European companies, and some governments, may welcome SWF investments even more than before. On the other hand, some politicians have started worrying openly that the collapse in market valuations will allow SWFs to acquire important European companies 'on the cheap'.

These different attitudes were already apparent in the European debate about SWFs in the autumn of 2008. Germany and the UK, for example, reiterated their commitment to openness to foreign investors. Spain was actively encouraging SWFs from the Gulf states to buy the bonds that the Spanish government was issuing to fund its bank bail-out. In Italy, on the other hand, Foreign Minister Franco Frattini suggested that SWF investments should not exceed 5 per cent in a given company. Greece was resisting Commission demands to modify its new law on investments in strategic companies that set up an ill-defined (in the opinion of the Commission) approval requirement for private investments in network industries. And France's president, Nicolas Sarkozy, announced that a government-controlled entity would take stakes in important companies to prevent them from falling into the hands of foreigners. Some commentators urged the EU to build stronger defences at the EU level. But none of the proposals put forward looked particularly convincing.

★ A European vetting mechanism

There have been some suggestions that the EU should enact new legislation or establish a Cfius-like vetting mechanism at EU level to assess the security and public policy implications of SWFs and other investments from non-EU countries.[16] Such an EU procedure could help to safeguard the integrity of the single market. Individual EU countries would feel less inclined to erect national defences if they knew that an effective EU procedure was available. An analogy may be EU countries' reliance on EU anti-dumping procedures in the common trade policy. An EU mechanism may also be welcomed by the countries that host SWFs. It might provide them with a degree of clarity about the investment regime applicable in all 27 countries.

[16] *Laurent Cohen-Tanugi, 'Euromonde 2015: Une stratégie européenne pour la mondialisation', Centre d'Analyse Stratégique, April 2008.*

If current multilateral processes in the IMF and OECD fail to produce results, the EU may want to consider the idea of enacting a framework directive which leaves the actual review processes to the member-state governments, as suggested by Bruegel, a think-tank.[17] We agree with Bruegel that proposals for enacting detailed new laws and setting up an EU-level mechanism appear neither realistic nor desirable. Under current EU law, the Commission does not have competences to negotiate investment-related agreements with non-EU countries (in the same way as it

[17] *Lars-Hendrik Röller and Nicolas Véron, 'Safe and sound: An EU approach to sovereign investment', Bruegel policy brief, November 2008.*

concludes trade agreements on behalf of the member-states).[18] Even if the Commission acquired new competences in this field, EU governments are very unlikely to delegate decisions related to national security to any EU body. Moreover, if the EU tried to define national security or public interest it may end up with either a definition that is too strict for the taste of the EU's more liberal countries, or with a clause so vague that it does not add much to the implicit protection already contained in the EC treaty. Similarly, if governments sought to draw up a list of strategic industries at the EU level, the list may turn out to be a rather long one.

18 The Lisbon treaty – if it was ratified by all EU countries – would transfer such competences to the Commission as part of the common commercial policy (new article 188). Commission officials say that these new powers would be used "extremely cautiously" in the beginning.

★ State shareholdings and golden shares

In a speech to the European Parliament on October 21st, Sarkozy (who held the EU presidency in the second half of 2008) suggested that EU countries should set up their own "sovereign wealth funds" to prevent foreigners from buying European companies at a depleted asset value. The funds would be established at the national level but could then "co-ordinate to form a business response to the crisis". Although Sarkozy did not spell out the idea, it seems what he had in mind was EU governments using state money to acquire stakes in certain strategic companies and so prevent them from falling into foreign hands. Mr Sarkozy did not state explicitly whether these stake would amount to 'golden shares' (that is, preferred stock holdings that accord the owner special rights, such as influencing key management decisions or blocking takeovers and mergers).

Although the French proposal met with opposition from various EU governments, most notably Germany and the UK, Sarkozy announced shortly afterwards that France would convert its Caisse des Dépôts et Consignations (CDC, a state-owned financial institution that carries out a number of public interest functions, such as managing state pensions) into an SWF-like vehicle and "a powerful arm of industrial policy". The idea that CDC should build up stakes in strategic French companies is not new[19] but, depending on how it is executed, it may put France into conflict with the European Commission. The Commission has generally considered golden shares incompatible with EU laws on the free movement of capital and freedom of establishment, although it has allowed for certain exceptions on the grounds of public policy or security. In various rulings, the ECJ has applied a narrow definition of such exemptions, and it has declared golden shares illegal in numerous EU countries, with the ongoing row about Germany's Volkswagen law being one of the better known instances.[20]

19 It dates back to at least 2005, when the then prime minister, Dominique de Villepin, argued that CDC should be used to prevent foreign takeovers. Sarkozy took it up in January 2008 when he argued that CDC should be part of France's defence against "the increasing power of extremely aggressive speculative funds and sovereign funds". It was also included in the expert report on SWFs for the French government (see footnote 21) where it was, however, envisaged that SWFs and the French state would form partnerships to take long-term stakes in French companies.

20 For example, the ECJ ruled against France and Portugal in 2002, the UK government's golden share in airport operator BAA in 2003, the Dutch government's holding in postal and telecoms groups in 2006 and Germany's Volkswagen law in 2007. http://ec.europa.eu/internal_market/capital/framework/court_en.htm.

★ Reciprocity

Most SWFs are located in countries that themselves have rather restrictive investment environments. The United Arab Emirates, for example, confine foreign companies to minority shareholdings in all sectors of the economy. China strictly controls foreign involvements in many industries, through a plethora of laws and regulations or pure political obstruction. And Russia in 2008 passed a law that limits foreign investment in 42 strategic sectors, in some cases to shares as low as 10-25 per cent.

Many Europeans ask why they should welcome investments from Asian, Arab or former Soviet countries if European companies do not enjoy the same welcome there. Demands for equal access, or reciprocity, have therefore become an integral part of the debate about SWFs and SOEs. A report on SWFs commissioned by the French government in 2008 states "European regulation on foreign investment should be founded on the principle of reciprocity".[21] There is, of course, a certain irony in France's enthusiasm for reciprocity, because the country would fail such a test if it were applied within the EU: even as French energy companies have made acquisitions in other EU countries, the state has made it all but impossible for foreign energy firms to acquire their counterparts in France.

21 Alain Demarolle, 'Report to the government of France on sovereign wealth funds', May 2008.

Even if there was political agreement on the need for reciprocity, this principle would turn out to be anything but straightforward. What most Europeans have in mind when they talk about reciprocity is a level playing field in terms of rules and regulations. In other words, they would like the legal and

administrative framework in SWF home countries to be as open as in the EU. Since this is not the case, some European politicians say that the EU and its member-states should use access to their markets as leverage to prise open the markets of China, Russia and other countries. This strategy entails several risks and many practical difficulties, however.

First, reciprocity – rather than being a tool for mutual market opening – could result in a spiral of new protectionism. If, say, Beijing or Moscow decided that protecting their strategic industries was more important than being able to invest abroad, the EU could be tempted to close its markets to show that it was serious about reciprocity. Second, defining what 'equivalent' market opening means would be very difficult in practice. When exactly would the EU declare that Abu Dhabi or Kazakhstan had done enough to fulfil the reciprocity criterion? Some countries, such as Russia, have a more transactional approach to reciprocity. What they have in mind is not so much reciprocal deregulation but asset swaps of equivalent market value.[22] Thirdly, EU laws and OECD agreements explicitly state that the free movement of capital should apply to all investors, whether they come from countries that are liberal or those that are not. The EU is right to push its partners around the world for greater market openness. But using access to its own market as a lever is not the best way to go about this. It would be much better to cajole emerging markets to sign up to international agreements, and in an ideal scenario these agreements would come with a dispute settlement mechanism, such as that administered by the WTO.

22 *Russia's gas monopoly, Gazprom, has done a number of deals whereby it has allowed European energy companies to get involved in big oil and gas fields in Russia while Gazprom was allowed to take stakes in distribution assets in the EU to get access to European energy consumers.*

A case study in reciprocity

The debate about reciprocity for SWFs has become entangled with that over other state-owned enterprises, in particular the politically charged discourse about energy. The EU's first and so far only attempt to make reciprocity operational was in its third energy liberalisation package, which was winding its way through the European Parliament and Council in the winter of 2008. The Commission originally wanted vertically integrated energy companies in the EU to sell off their pipelines and power grids to give a boost to energy market competition – so-called ownership unbundling.

Some governments raised concerns that their unbundled infrastructure could end up in the hands of state-owned energy giants from abroad. Some of the new member-states in Central and Eastern Europe were particularly scared that Gazprom, the Russian gas monopoly, could abuse its ownership of local energy assets to engage in political or commercial arm-twisting. The Commission therefore inserted a 'third party clause' into the draft directive. This stated that only companies from countries that have themselves unbundled would be allowed to buy pipelines and power grids in the EU, and only after they have struck a special agreement with Brussels. Some Europeans were hoping that the 'Gazprom clause' (as it came to be known) would not only protect Europe from the possible anti-competitive practices of foreign monopolies, but also that it could persuade Russia to give European energy companies better access to its lacklustre oil and gas sector.

In the end, an alliance of EU countries led by Germany and France watered down the liberalisation package. Since ownership unbundling will no longer be compulsory, the case for the third party clause has also been weakened. Germany eventually insisted that it should be up to each member-state to decide which bits of its energy infrastructure it wants to sell and to whom. Several German companies have close ties with Gazprom and would not like to be forced to unwind them. The failure of the Gazprom clause gives an indication of how difficult it would be for the EU to agree on, and implement, clauses on reciprocity in new investment legislation.

Multilateral efforts

Rather than setting up new restrictions at the EU level, the Europeans should stick with their agreed approach of supporting the multilateral efforts of the IMF and the OECD. These efforts have already made remarkably swift progress. And they seem to be mutually reinforcing. Recipient countries insist that they will only be able to keep their markets open if the SWF-owning countries adhere to well-defined standards of transparency and accountability. Conversely, the governments that own SWFs have argued that they should not be expected to accept new rules unless western countries themselves make an effort to offer an investment environment that is open, transparent and predictable.

The EU has taken an active role in both the IMF and the OECD discussions on SWFs. European governments have co-ordinated their positions ahead of multilateral meetings. And they have usually allowed the Commission to speak first in these meetings – although individual governments still insist on making their own statements afterwards.

The Santiago principles for SWFs

In October 2007, the finance ministers and central bank governors of the G7 first called for the identification of "best practices for SWFs in such areas as institutional structure, risk management, transparency and accountability". This call was echoed by the (much broader) executive body of the IMF, the International Monetary and Financial Committee (IFMC). An international working group (IWG), composed of 26 countries with SWFs, was set up in response in late April 2008, with the IMF offering administrative support and expert advice. The IWG has worked with commendable speed. On October 15th 2008, just six months after it was established, it published a set of 24 generally accepted principles and practices (GAPP), which have become known as the 'Santiago principles'.

The Santiago principles aim to assuage concerns about the motives and behaviour of SWFs by increasing their transparency and accountability, and ensuring that they are run to meet the objectives for which they were set up (such as macroeconomic stabilisation or inter-generational saving). The idea is not only to reassure recipient countries, but also to increase public confidence in SWFs' home countries that public money is not being squandered – an often neglected but important consideration. By and large, the Santiago principles address most of the issues that recipient countries had raised. Some of the principles are arguably superfluous. For example, the SWF countries have committed themselves to complying with the laws and disclosure requirements of the countries in which they invest. However, they would hardly announce their intention to flout the laws of the recipient country. And in any case they would face consequences there if they did so.

But the Santiago principles are not just a collection of empty declarations aimed at pacifying recipient countries. They set verifiable targets in terms of governance, transparency and accountability. Principles 6, 8 and 9 of the GAPP are designed to ensure that SWFs are operationally independent of the governments that control them, and that their investment decisions are free of political interference. Principles 11 and 12 commit the signatories to publishing annual reports that meet internationally recognised accounting standards, and to commissioning annual audits of operations and financial statements. And principles 18 to 22 cover detailed aspects of governance and risk management. The Santiago principles cover all the essential elements that experts identified before the IWG got down to work.[23] They contain substantive commitments that will alter the way a large number of SWFs are run. Since levels of disclosure among SWFs are low, the GAPP should make many SWFs more transparent actors than they are at present.

[23] *Edwin Truman, 'A blueprint for sovereign wealth fund best practices', Peterson Institute, policy brief, April 2008.*

This supposes, of course, that countries adhere to the principles to which they have signed up. It is a good sign that the countries with the largest SWFs – China, Kuwait, Qatar, Russia, Singapore and the United Arab Emirates – all participated in the IWG and committed themselves to the GAPP.[24] Sceptics will no doubt point out that the GAPP are voluntary guidelines, and that since there is no enforcement mechanism, compliance is bound to be low. But they should give the GAPP a chance to work. These principles are not a set of ideals that SWFs will struggle to reach, but an inventory of best practices that already exist. This means that the GAPP do not require SWFs to do anything that is not already being done by at least one other SWF. It should therefore be harder for SWFs to argue that they cannot live up to the GAPP's standards of accountability and transparency. Now that SWFs have signed up to the GAPP, there may even be a process of competitive emulation.

[24] *The exception was Saudi Arabia, which chose to be an observer, arguing that its Monetary Authority (SAMA) is not an SWF.*

There is another reason for optimism. This is that participants in the IWG have recognised the need to keep the Santiago principles under review, to discuss implementation and to facilitate discussions with recipient countries and multilateral institutions. They are considering setting up a standing group for this purpose – a step that the EU's finance commissioner, Joaquín Almunia, said he would welcome. The establishment of a standing group should help to ensure that countries with SWFs follow through on their commitments, that the Santiago principles are updated in light of new developments, and that disputes between SWF-owning countries and recipient ones can be addressed in a constructive manner. A standing group would also provide a useful forum for countries with SWFs to learn from each other. SWFs may be more inclined to increase their levels of governance and transparency by working with their peers than by responding to pressure from the West.

That said, the Santiago principles are certainly not a panacea. The European Commission says they could have gone further on transparency, for example by asking SWFs to commit to greater disclosure of their investment positions and currency exposure, as well as of their voting behaviour on the boards of the companies they invest in. Moreover, some institutions which have SWF characteristics, such as SAMA or SAFE, will not adhere to them. But it would be foolish not to recognise the progress that the GAPP represents. And as long as the IWG work continues – as is suggested by the idea of a standing group – calls for protectionism at the national level should be easier to deflect.

The OECD framework for recipient countries

The process of drawing up guidelines for recipient countries has been entrusted to the OECD, the rich countries' think-tank and standard-setter based in Paris. This makes sense since all the big economies that are likely to be the main targets of SWF investments are members of the OECD; and because it has a long track record of working on investment rules.

All 30 OECD member countries – and quite a few non-members – have signed up to various codes and declarations on how to treat foreign investments.[25] The OECD also provides a forum for its members to discuss their respective national investment regimes, and it claims that it helps to prevent protectionism through peer review and pressure.

[25] *The OECD investment principles are not law in the sense that they can be enforced in a court but they have a "legally binding character" for those countries that sign up to them. Neither the OECD nor the WTO (which has also tried) has managed to get its members to commit to detailed, binding rules on investment, which shows how politically and commercially sensitive this area still remains.*

The OECD has always acknowledged that its members may have legitimate concerns when it comes to outside investors, in particular state-linked ones. Therefore, all OECD investment codes allow governments to make exceptions on national security grounds, and two-thirds of the signatory countries have rules to this effect. All OECD countries are free to define what national security means for their country, and the OECD is not entitled to review or criticise these definitions. But now the organisation is working harder on drawing up guidelines on how national security exemptions should be used without serving as an excuse for investment protectionism.

At a ministerial meeting in June 2008, OECD members agreed on their first declaration on how to deal with SWFs. They committed themselves to making "best endeavours" to apply the basic principles that guide their investment strategies towards each other to all investors, from OECD and non-OECD countries, state-linked or private.[26] The OECD investment principles are: non-discrimination (treat domestic and foreign investors equally); transparency and predictability (make investment-relevant laws public; consult about changes if possible); progressive liberalisation (work towards a more open regime); and no reciprocity (liberalise unilaterally, do not wait for others to do the same).

[26] *Some countries with sizeable SWFs, such as Norway and Korea, are members of the OECD, which means that OECD investment principles apply to both their investment regimes and outward investments. However, most SWF countries in the Arab world and many in Asia and Eastern Europe are not members.*

With a particular view to SWFs, OECD members promised to aspire to:

★ **Proportionality:** if recipient countries draw up lists of strategic sectors or set other criteria to prevent harmful investment, they should make these rules concrete and targeted, to avoid abuse. Governments should only block a sovereign investment as a last resort. If the investment raises security concerns, the government in question should instead renegotiate the terms of the investment.

★ **Accountability:** recipient countries should make decisions about blocking or limiting SWF investments at a high political level. They should discuss these decisions publicly. And they should make sure that the people involved in the review process really understand national security concerns (rather than being guided by, say, fears of job-losses or competition for national champions).

The OECD's declaration sounds sensible enough. And the organisation is also to be congratulated for trying to work with SWF-owning countries as closely as possible (the OECD has participated in the IMF's work on SWFs, and it has invited SWFs to take part in its own discussions, although only two have done so). However, the June 2008 principles are still too vague to constitute a proper framework for SWF investment. For example, proportionality and accountability need to be more clearly defined for the SWFs to be satisfied.

The OECD has also been slower to produce results than the IMF-led process. A final report is not expected until the middle of 2009, and observers are sceptical whether OECD members will make commitments that go beyond what they backed in the June 2008 declaration. For the SWFs to be satisfied, the OECD should

make bigger efforts to involve them in the deliberations about the final report. It should also reach out to non-OECD countries that are likely to receive SWF investments in the future, in particular in the developing world. And it needs to be prepared to give SWF countries a role in ascertaining whether recipient countries stick to the principles that they have signed up to (just like the recipient countries want a role in monitoring SWF compliance with new principles on transparency and accountability).

Conclusion: Beware of investment protectionism

The EU's official response to the debate on SWFs has so far been commendable. Rather than rushing into new legislation, it has supported parallel multilateral efforts in which recipient countries have committed themselves to keeping their markets open and SWFs have pledged to improve their governance, transparency and domestic accountability. It is too early to tell whether this 'grand bargain' will work. The EU should allow time to find out. If the countries participating in the IWG take steps to ensure that SWFs are independently run, properly audited, and transparent, many of the concerns expressed by recipient countries will fall away. If, on the other hand, the Santiago principles do not produce any noticeable changes in SWF management and behaviour, recipient countries will be entitled to ask why. Meanwhile, efforts to agree on principles for recipient countries need to go further. Since all EU countries are OECD members, there is a lot they can do to drive forward the process of strengthening the principles of openness, transparency and predictability that the SWF-owning countries want to see in the recipient countries. And they can push for the OECD to draw developing countries into the discussions on how to deal with SWF investments.

Although the EU has stressed the importance of openness, national politics may yet trump international commitments. There is still a risk that EU countries may invoke the growing size of SWFs and uncertainty over their motivations to justify new barriers against outside investment. The history of the EU's single market is replete with examples of countries impeding cross-border investments, in most instances without national security being threatened or outside investors being suspected of political motives.

Many of the concerns that politicians, experts and the media in Europe have voiced about SWFs have some legitimacy. Fears that state-connected entities from, say, Algeria, China or Russia could clash with European interests are not completely groundless. And even if these countries do not use their investments to pursue political goals, SWFs may still raise legitimate concerns about corruption and market integrity in host countries. So EU member-states are entitled to scrutinise closely such countries' investment strategies and to vet investment bids from them. However, existing laws and administrative procedures in most EU countries should be sufficient to repel investments that raise concerns about competition, intellectual property or political impact. Formal moves to erect new barriers to the free flow of capital into the EU would be interpreted as investment protectionism and could encourage or implicitly justify the erection of similar barriers elsewhere.

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