

Meltdown—European Response

Kavaljit Singh

In a hard-hitting speech to the European Parliament in Strasbourg (France) on October 21, French President Nicolas Sarkozy proposed that European countries should create their own sovereign wealth funds to protect national companies from foreign "predators."

"I'm asking that we think about the possibility of creating, each one of us, sovereign funds and maybe these national sovereign funds could now and again coordinate to give an industrial response to the crisis," he told members of the European Parliament.

On October 23, while addressing business leaders in Annecy (France), Mr Sarkozy announced that France would establish a sovereign wealth fund (SWF) which would support companies of national strategic importance. "I will not be the French president who wakes up in six months time to see that French industrial groups have passed into other hands," he remarked.

Both speeches were made at a time when the financial markets in Europe and elsewhere had plummeted due to ongoing financial meltdown.

As of now, the details of new French SWF (such as asset size, sources of fund, investment policies, etc.) are not publicly available. It is also not clear how the new SWF would be different from the existing one, Caisse des Depots et Consignations (CDC), that was established way back in 1816. With (60 billion of funds, CDC undertakes investments in local development projects, equity markets, real estate and private equity. It is expected that the new SWF would be managed by CDC and become operational by the end of 2008. The media reports suggest that the new sovereign fund would actively invest mostly in strategically-important industries of France.

The concerns expressed by Mr Sarkozy over non-European SWFs are not new. Across the Western world, politicians, business leaders and commentators are bemoaning the rapid rise of SWFs, particularly from the Middle East and Asia.

With an estimated \$3 trillion in assets, sovereign wealth funds are large pools of assets and investment funds owned and managed (directly or indirectly) by governments. They may be funded by foreign exchange reserves, commodity exports, the proceeds of privatizations and fiscal surpluses. The SWFs manage foreign exchange assets separately from official reserves. To a large extent, SWFs are set up to diversify and improve the return on foreign exchange reserves or commodity revenue, besides protecting the domestic economy from fluctuations in international commodity prices.

Much of the controversy on SWFs is centered on political questions. The Western policy makers fear that the operations of SWFs are largely influenced by strategic policy objectives rather than commercial interests. They suspect that investments by sovereign wealth funds are meant to secure control of strategically-important industries (such as telecommunications, energy and banking) for political ends, in particular, the paranoia is centered on the multi-billion dollar investments in international banks by leading SWFs in the wake of credit crisis which began in mid-2007.

These fears have sparked a heated debate within the developed world about the extent to which SWFs should be allowed to invest in national markets. A protectionist backlash against sovereign wealth funds is fast emerging in the developed world.

Countries such as the US, Canada, Australia and Germany have recently introduced substantial legislative changes in order to screen and restrict investments by SWFs and other state-owned entities. In August 2008, Germany enacted a new legislation which allows the authorities to review and prohibit a non-EU company from acquiring German companies "on grounds of public policy or public security." The legislation would come into application where the foreign investor seeks to acquire directly or indirectly 25 per cent or more of the voting rights in a German company. Some European governments are considering the use of "golden shares."

In early 2008, the Australian government introduced new guidelines to enhance the screening of investments made by foreign state-owned entities. The guidelines contain six principles by which investments by foreign state-owned entities will be measured. One of these principles states that the country will consider whether "an investor's operations are independent from the relevant government."

Mr Sarkozy's proposal for creating European SWFs is flawed on many counts. The objective conditions for establishing SWFs are squarely missing in Europe. The East Asian and Middle East countries established them on the basis of higher current account surpluses and strong commodity exports. Unlike China and Singapore, the overwhelming majority of European countries are running persistent large current account deficits. This includes the UK, Italy, Spain and most countries of Central and Eastern Europe. A number of European countries such as Italy, Hungary and Romania are also running large fiscal deficits.

Unlike the Middle East, most European countries (barring a few) do not have any dominant exportable commodity (such as oil or gas) so as to generate significant surpluses.

The main policy rationale behind setting up sovereign wealth funds is not to support or bailout domestic companies, as proposed by Mr Sarkozy. Rather, these funds are set up to diversify and improve the return on foreign-exchange reserves or commodity revenue, besides insulating the domestic economy from volatile international commodity prices. That is why the overwhelming majority of sovereign wealth funds invest globally, not domestically. Establishing sovereign wealth funds to protect domestic companies is nothing but a non-commercial, political motive which, hypocritically, the European countries such as France strongly detest such funds.

Much of the paranoia in Europe over SWFs is based on false assumptions. To date, not a single incident of SWFs destabilising financial markets or pursuing strategic policy objectives has come to public notice.

Since SWFs have no explicit liabilities, they are patient investors with long-term investment horizons. Nor are SWFs prone to withdrawals by investors that could force them to liquidate their market positions quickly.

The overwhelming majority of sovereign funds are passive investors. The bulk of their money is invested in fixed-income instruments such as government and agency bonds. The foreign direct investment component of their total investments is not even 1 percent of assets in 2007.

In rare cases where SWFs undertake direct investments, they do not seek controlling interests. Even the direct investments in the ailing US and European banks during 2007-08 are minor in ownership with no special rights or board representation. These direct investments were not hostile in nature and involved convertible bonds which would be converted into equity stakes in the future, further, the investments were made in a transparent manner with the approval of banking regulatory authorities in the host countries.

It also needs to be emphasized here that the investments in Western banks were made at time when they were facing a severe liquidity crisis. The stakes in UBS, Citigroup, Merrill Lynch and Credit Suisse were bought when their credit default swap (CDS) spreads were very high. The higher the CDS spread, the higher the perceived risk. By injecting billions of dollars into ailing banks, the SWFs acted as counter-cyclical investors and enabled banks to continue their business. By and large, most SWFs have suffered losses on their investments in the Western banks. The value of stakes of most sovereign wealth funds have plummeted with the spread of credit crisis.

Not long ago, the EU gave a call for "Global Europe" with much fanfare and avowed commitment to open economy. Why double standards? □□□