CMS



FORTRESS EUROPE?

The Risk of Rising Protectionism in Europe

In association with:

Oxford Analytica

series

CMS Lawyers for Business

Foreword by Cornelius Brandi – Chairman of the CMS Executive Committee

This report on "The risk of Rising Protectionism in Europe" is the first in a series which CMS will be publishing in conjunction with Oxford Analytica on topics which should be of interest and significance to all commercial enterprises operating in the important European market. The report has two sections; first, a commentary from the CMS team involved in the initiative and then the main body of the Oxford Analytica study. As lawyers we will naturally be looking at the issues concerned from a legal perspective but not exclusively so; our intention is also to examine and, we hope, throw some light on the broader commercial, regulatory, fiscal and political aspects of our chosen topics.

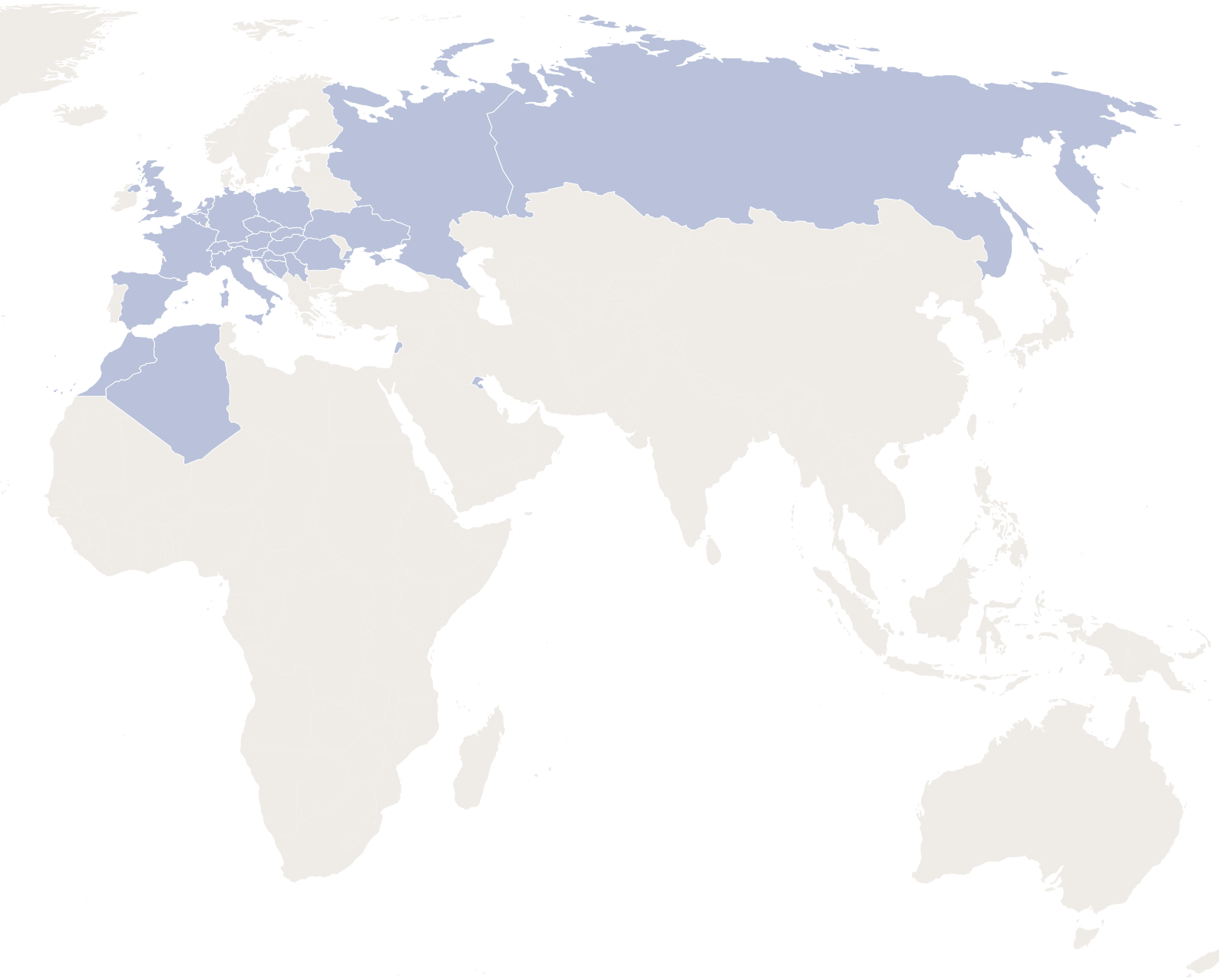
Some of the issues we will be discussing will have geographical implications which extend beyond Europe. At CMS, however, we think of ourselves very much as citizens of Europe since, of our 2,200 plus lawyers operating from 48 cities around the world, the substantial majority is based in and is offering practical legal advice from within Europe. Our main aim, therefore, is to consider the relevant issues with a European focus and to assess their likely impact on the future development of Europe, particularly as they affect the commercial and corporate environment in which all of our clients have to manage their own businesses with a view to profitability.

CMS has chosen Oxford Analytica as its partner for the proven quality of its research and analysis. We are confident that in doing so we will be able to publish a series of reports which will have the scope and rigour necessary to stimulate a healthy and productive debate within your own organisations and possibly more widely. In some areas which are still evolving there will as yet be no right or wrong answers. In relation to those, we would not be so presumptuous as to claim that the views we express or the conclusions we reach are likely to be any more accurate than your own. However, by creating the framework and forum for the debate we hope to be able to educate and perhaps encourage others to find the right solutions.

This is a challenging time economically and politically for Europe. But we should not discount Europe's continuing position at the centre of the world stage, notwithstanding the emergence of future economic powerhouses in countries such as China and India. In spring 2007 the value of all Euros in circulation exceeded for the first time the value of US dollars in circulation and the outlook for the Eurozone for 2008 at least is looking more healthy than in some other major economies or regions. So finding the right answers in Europe to the various issues confronting the business community is likely to have benefits and consequences further afield. CMS and Oxford Analytica hope that this and subsequent reports might make some contribution to the wider debate.



Cornelius Brandi
Chairman CMS Executive Committee
T +49 69 71701 522
E cornelius.brandi@cmslegal.com



Our opinion
Fortress Europe – The risk of rising protectionism in Europe

Our conclusion is that it is rising – both in terms of rhetoric as well as action. It is affecting both investment and trade, and our expectation is that this will continue to get worse. That said, there is at least some optimism that the scope for protectionism is constrained by the international nature of trade and capital, together with the impact of new technology.

This is particularly the case as our experience is that numerous innocuous activities can often inadvertently be hit by heavy-handed legislative swipes – both through direct prohibition and indirectly by creating a climate of uncertainty. To assess the impact of an apparent trend towards protectionism, CMS has commissioned this report from Oxford Analytica, an international, independent consulting firm that draws on a wide global network of experts, mainly from academia. The report considers whether protectionism is rising in Europe, the forms it is taking, and its likely effects on businesses and investors.

Investment protectionism

EU member states cannot enact national legislation that restricts the free movement of capital, whether within the EU or with non-EU members.

However, some member states want to enshrine greater protectionist measures in their national legislation. Last year the European Commission launched infringement proceedings against Poland, and this year against Portugal and Spain.

Notably Germany, a country whose economic success is underpinned by its export success and international expansion by its leading businesses, is tightening its Foreign Trade Act (Außenwirtschaftsgesetz) to further limit ownership by companies outside EU or EFTA within certain sectors.

The negative reactions from Brussels towards Germany's proposals highlight the difficulties faced by member states in creating protective measures which comply with EU law. Such measures will be challengeable through the courts, but they may nonetheless achieve, and probably exceed, their objective. This is because many overseas investors might find the prospect of uncertainty and years of protracted legislation so off-putting that they might think twice when contemplating sensitive acquisitions in Germany.

Certainly, our experience from working on numerous deals for businesses and investors of all sizes is that what they want from governments is:

1. Clear legislation;
2. Precise and useful guidance on what investments are permitted;
3. What criteria need to be met.

Sadly such legislation is hard to find.

Sovereign wealth funds

While SWFs have been around for several decades, their recent rapid growth and relative lack of transparency has generated particular hostility from many commentators who fear that they will become tools of foreign policy, perhaps also grabbing strategically important technologies to transfer to their own country.

Our report finds no clear examples of SWFs being used to further foreign policy goals, or of SWFs transferring particularly sensitive technologies. On the contrary, it highlights their importance in being able to move swiftly over the last year to give much-needed investment to troubled financial institutions, something which no doubt averted much bigger problems in the banking sector.

However, SWFs need to change quickly. Poor governance is a weakness of many large ones: typically they do not publish data about their investment portfolios; their available data is usually very out of date; and their annual reports fail to give insight into their investment strategies. Indeed, it is sometimes not clear if they are using external fund managers (most are) let alone which ones.

There is no reason why SWFs cannot provide this information in a regular and timely manner, while doing so will help to disarm their critics. If they do not change voluntarily, they will be likely to have more onerous restrictions imposed by Brussels or national governments.

However, other investor classes should also be concerned about the debate over SWFs. Organisations such as national level pension funds may well also be adversely affected by legislation directed at SWFs.

Existing investment protectionism across Europe

There is a minefield of legislation that non-EU investors need to take into account when buying stakes in European businesses. CMS has surveyed the legislation across 17 European countries. In all of these – except for the United Kingdom and the Netherlands – rules exist which discriminate against foreign investors (although in the majority of these, investors from other EU countries are treated like national investors). For comparison the different approaches to protectionism can be grouped into five broad categories:

Group 1

Traditional "old fashioned" protectionism preventing, in particular, the acquisition of land by foreigners. Countries with such an approach are: Austria, Poland, Romania, Russia, Switzerland, Ukraine and Bulgaria.

Group 2

Security protectionism preventing acquisitions of defence-related companies. This is by far the largest group and includes the Czech Republic (military weapons), France (military weapons, nuclear energy, private security services, encryption technology), Germany (military weapons, encryption technology, operation of certain satellites), Italy, Romania, Russia, the Slovak Republic, Spain and Ukraine (all military weapons).

Group 3

Legislation preventing acquisition in other strategic industries. This group includes industries which are not directly relevant for security purposes but which are regarded in the respective countries as being of specific national importance. These are: Energy (Italy, Ukraine, Spain), pharmaceuticals industry, (Romania, France), financial services (Switzerland).

Group 4

Legislation preventing acquisition in industries to protect the public interest.Industries are protected due to fear of foreign political influence or to protect citizens against the dangers of gambling. The broadcasting industry is protected in certain countries (Austria, Poland, Slovak Republic, Ukraine) and foreign investment in the lottery and gambling industry requires public consent in several countries (Czech Republic, France, Poland, Romania, Slovak Republic).

Group 5

No discrimination by law. The United Kingdom and the Netherlands do not have specific rules preventing the acquisition of shares or assets by foreigners. Nevertheless, those (and other) countries have regulations in certain sectors that require the consent of the regulator if there is any change of control or, sometimes, a substantial investment by a third party. In the UK, the government could generally intervene in cases of national security.

Proposed new German law

After the implementation of the new law (probably from January 2009 on), the German government could intervene in all acquisitions concerning at least 25% of the shares of any German company by any entities from outside EU and EFTA if such acquisition would endanger public order or security (as defined by the European Court of Justice). There is no filing requirement but if not cleared in advance, even finalised transactions could be redone within three months after closing. The German government claims that the change will only bring the (so far indeed very liberal) law up to international standards and that it will make use of it only under exceptional circumstances. Whether the latter holds true remains to be seen and depends a lot on the political development. In any event it will create uncertainty and put non-EU / EFTA investors at a disadvantage in time-critical situations.

Implications for M&A

We expect that the M&A regulatory minefield will get more complicated and restrictive for non-EU investors: certainly over the next few years and maybe for much longer. This will cause an inevitable lack of legal certainty as to whether a transaction will be prohibited on the grounds of national security. This will cause, at a minimum, delays in closing transactions and the increased need for advisory services.

As a consequence of current developments, investors must be particularly aware of political changes in the jurisdiction of the target company. Experience has shown that enhanced awareness of national interests can create resistance to cross-border M&A transactions, in some cases causing national governments to intervene.[1] This sentiment must not be underestimated.

[1] Various references to such deals being blocked on pages 5 & 6 of the report. Explicitly said on p25

Trade protectionism

Rising protectionism also includes measures to restrict the trade of goods and, to an extent, services.

Following the failure of the WTO's Doha round of talks (so called because they commenced at Doha, Qatar in November 2001), aimed at achieving multilateral reductions in protectionism, governments are likely to put more effort into negotiating specific country-to-country bilateral agreements.

Sadly, the failure of Doha may encourage protectionist elements within the European Commission, traditionalists in national governments, and anti-globalisation NGOs to exert more influence on trade policy.

We expect to see a rise of overt traditional trade protectionism, such as anti-dumping measures, together with tougher enforcement of product standards and intellectual property rights.

This will be supplemented with new measures. For instance, the imposition of 'carbon border taxes' on some imports to compensate for the disadvantage of domestic producers subject to taxes on their carbon emissions (when their foreign competitors are not).

In a worst case scenario the European Union will completely turn away from further multilateral trade integration and simply negotiate bilateral agreements. While CMS believes the overall benefits of multilateral deals far outweigh a series of bilateral ones, the benefits from bilateral agreements would be advantageous for those doing business in countries with which the EU concludes deals.

Our report finds plenty of reason to find at least some solace in the practical limits being placed on trade protectionism by our global economy. It concludes that despite rising protectionist sentiment, the barriers placed on many economic sectors run into countervailing forces. The cross-border exchange of services taking place over the internet grows steeply – despite potential protectionist measures, it has still become cheaper and easier than ever to trade across borders.

The service tier of the global economy will expand at a healthy rate, even under a worst case scenario. In this sector, the global trading system resembles the world economy of a century ago, when rapid technological advances caused trade flows to grow even as the major economies were erecting higher tariff barriers. Regardless of policy measures, and amid significant macroeconomic and political upheaval, the long-term trend is for trade to continue to grow – although at a slower pace than under a multilateral system.

Implications for business of rising European protectionism

This report is very much aimed at raising the debate on the impact of measures against foreign investment and trade, and we particularly hope it highlights to European businesses the negative effect such measures may have on a wide range of businesses.

The trends outlined in our report have implications for any business investing into Europe, any European business seeking non-EU investment and for all businesses trading across Europe's external frontier.

We conclude that SWFs not adopting good governance are certainly at risk of being excluded from certain sectors. Businesses that receive SWF investments may well find reputational risk from unwelcome political and media attention.

We believe that it is very unlikely that foreign non-SWF asset managers would be forced to divest from European industries where they have longstanding investment track records. Nonetheless there is a 'definitional' risk to other asset managers: how will any new regulations define SWFs? These organisations need to keep careful tabs of all legislative and regulatory developments involving the limitation of SWFs to ensure they do not get caught too.

The raising of trade barriers will cause particular difficulties for companies with long supply chains involving several countries, particularly where there may be the added complication of some of these having a preferential EU status.

For instance, the EU is hoping to conclude a bilateral free trade agreement with India. Such an agreement will give Indian suppliers some advantages over their Russian or Chinese counterparts.

CMS particularly highlights that businesses need to be particularly wary of, and be prepared to lobby against, adverse trade restrictions introduced for purported environmental and other reasons. They, or their trade association, will need to be prepared to challenge where the measure is unjustified or not proportionate.

However, it is easier to prevent such measures before they are announced than seek to change them afterwards. CMS expects that the businesses that will do best in this politically-charged emerging environment will be those that are active with national governments, Brussels and regulators in preemptively challenging measures at the earliest stages.

Thomas Meyding
Partner
CMS Corporate Practice Area Group Leader
T +49 711 9764 388
E thomas.meyding@cms-hs.com

Ernst-Markus Schuberth
Partner
T +49 211 4934 202
E ernst-markus.schuberth@cms-hs.com

In case of enquiries please contact any of the above or any member of the CMS Corporate Practice Area Group Management team as listed on the next page. More information can also be found on http://www.cmslegal.com/Fortress

Contact details of the CMS Corporate Practice Area Group Management Team are:

Austria
CMS Reich-Rohrwig Hainz
Peter Huber
T +43 1 40 443 0
E peter.huber@cms-rrh.com

Belgium
CMS DeBacker
Cedric Guyot
T +32 2 743 69 00
E cedric.guyot@cms-db.com

France
CMS Bureau Francis Lefebvre
Jacques Isnard
T +33 1 47 38 55 00
E jacques.isnard@cms-bfl .com

Germany
CMS Hasche Sigle
Thomas Meyding
T +49 711 97 64 0
E thomas.meyding@cms-hs.com

Italy
CMS Adonnino Ascoli & Cavasola Scamoni
Pietro Cavasola
T +39 06 478 151
E pietro.cavasola@cms-aacs.com

The Netherlands
CMS Derks Star Busmann
Roman Tarlavski
T +31 20 301 63 01
E roman.tarlavski@cms-dsb.com

Spain
CMS Albiñana & Suárez de Lezo
Carlos Peña
T +34 91 451 93 00
E cpena@cms-asl.com

Switzerland
CMS von Erlach Henrici Ltd.
Max Albers
T +41 44 285 11 11
E max.albers@cms-veh.com

United Kingdom
CMS Cameron McKenna LLP
Martin Mendelssohn
T +44 20 7367 3000
E martin.mendelssohn@cms-cmck.com

Oxford Analytica

FORTRESS EUROPE?

The Risk of Rising Protectionism in Europe

September 2008

A report produced for: CMS

Table of Contents

Introduction 3

1. European Investment Protectionism 4
   - I. Introduction 4
   - II. Investment From the Private Sector 4
   - III. Investment by State-owned Enterprises (SOEs) 6
   - IV. Sovereign Wealth Funds 8
   - V. Potential Policy Responses 12
   - VI. Restraints on Investment Protectionism 14

2. European Trade Protectionism 15
   - I. The WTO in 2008 15
   - II. Russian WTO Membership 16
   - III. Long-term WTO Problems 16
   - IV. WTO Disputes 17
   - V. Possible New Tariff and Non-tariff Barriers 18
   - VI. Pursuit of Regional and Bilateral Agreements 18
   - VII. Worst-Case Responses 19
   - VIII. Limits of Trade Protectionism 20

3. Implication for Business 21
   - I. Implications of European Investment Protectionism 21
   - II. Implications of European Trade Protectionism 22

Introduction

This report analyses the risks of rising protectionism in Europe, with the aim of preparing companies for a potentially more protectionist European trade and investment environment. Section 1 focuses on 'investment protectionism' and Section 2 on 'trade protectionism'. The former may encourage the latter, and vice versa. Section 3 draws together the implications that both types of protectionism have for businesses.

The risks of greater European 'investment protectionism' have, on the surface, increased significantly over the last year as awareness has deepened about the global investment activities of sovereign wealth funds (SWFs) from outside the European Union.

Investment protectionism also continues to be directed towards two other major categories of investors: state-owned enterprises and private sector companies – from both outside the European Union and from other member states.

Across all of these categories of investors, the common thread that runs through both the rhetoric and the practice of European governments is that some level of investment protectionism is warranted on 'strategic' grounds. In the current debate, this 'strategic' concern has become mixed up with questions about the governance structures and transparency of SWFs.

Following the collapse of the Doha Round of the WTO in July, there are signs of a trend towards greater European 'trade protectionism'. There is a danger that pressure in Europe for trade protectionism will increase over the next year if economic conditions remain unfavourable, if the United States continues to back away from support for free trade, and if diplomatic tensions with Russia do not improve from their current poor level.

The general outlook for deepening of multilateral trade relations is poor. In the aftermath of Doha, the whole future of multilateral trade rounds may be called into question. Instead, there are likely to be more limited trade agreements, often at a bilateral level. This does not mean that the current level of liberalisation will be rolled back; that is unlikely and in some cases close to impossible. However, it does mean that the pace of further liberalisation is likely to slow down.

1. European Investment Protectionism

I. Introduction

The current sovereign wealth fund (SWF) debate comes on top of the wider discussion about investment protectionism in Europe that has been going on for many years. Several European governments have, even over the last two to three years, put up barriers against specific cross-border M&A. Many of the high-profile cases have been intra-European, often accompanied by opposition from the European Commission.

European Commission President Jose Manuel Barroso has stated that "defending national champions in the short term usually ends up relegating them to the second division in the long term". The European Union authorities have been robust in attempting to limit both protectionist political rhetoric and government action in the area of takeovers by multinationals from other member states. For example, the European Commission launched infringement proceedings against Hungary and Poland (last year) and Portugal and Spain (this year) over legislation on golden share-type policies designed to block foreign takeovers. Also, the European Court of Justice has handed down rulings on significant cases, as it did for example on the 'Volkswagen law'.

Nonetheless, there is a core of sectors and countries where the impulse for EU member state politicians to intervene in the 'national interest' persists. For example, 'economic patriotism' is an important aspect in the policies of the current French government. President Nicolas Sarkozy has defended the government's right to block takeovers in strategic sectors, and criticised the activities of hedge funds and private equity.

The United Kingdom is one of the EU countries that, like many of the newer EU member states of Central and Eastern Europe, has generally taken a liberal view towards foreign investors. However, even there, takeovers of significant companies in sectors that may be considered strategic are likely to meet some level of resistance if the bidding company is state-owned and from a country whose government is not fully trusted.

In a climate of rising protectionist sentiment, future responses by EU member state governments are likely to be at least equally harsh as previous ones, and will probably be more frequent. It is possible to get a sense of how different European governments are likely to apply investment protectionism in the future by analysing past actions that have been directed not only at emerging market (and other foreign) investors but also at companies from other EU countries. But before examining the ways in which SWFs are now shaping this debate, it is worth considering the recent experiences of private sector and state-owned enterprises.

II. Investment From the Private Sector

The European Union remains a relatively attractive location for emerging market private sector companies that are seeking to conduct M&A in sectors that are not perceived as strategic. Among the major European countries, the United Kingdom's liberal investment policies and London's global financial leadership make it a particularly attractive destination for the 'new breed' of global private sector companies from emerging markets such as India.

Many Indian companies in sectors as diverse as IT, food and beverages use the UK as their European hub. For example, India's Tata group has been a leading emerging market investor in Europe, via the UK hub. Its takeovers in the United Kingdom have included chemicals company Brunner Mond and steel group Corus, and Tata Motors in March 2008 acquired Land Rover and Jaguar Cars. Even though the latter two were prestigious British brands, protectionism was not as significant an issue in slowing the deal as were purely business considerations related to employee remuneration, investment commitments and contractual obligations on intellectual property.

Private sector companies from emerging markets have also managed to complete significant takeovers in other European countries without triggering a decisive government block on the deal. Nonetheless, potential takeovers from both European and non-European private sector companies have in recent years been rebuffed (often decisively) on several occasions by Western European governments.

The sectors in which such protectionism has occurred are those that some governments might term 'strategic':

Telecoms

- In early 2007, Italian company Olimpia began negotiations with AT&T and Mexican operator America Movil to sell them Olimpia's stake in Telecom Italia. Despite working with local banks to give the deal a more Italian flavour, the political pressures to avoid such significant foreign investment in the former national monopoly operator were too great for the deal to succeed.
- German Chancellor Angela Merkel stopped Russia's Sistema holding company from acquiring a stake in Deutsche Telekom in 2006.

Transport

- In 2006, plans by Spanish firm Abertis to acquire the Italian motorway toll operator Autostrade were blocked by the Italian infrastructure minister.

Utilities

- Starting in 2006, the Spanish government repeatedly, and largely successfully, blocked E.ON's bid for Endesa. The European Commission found that the Spanish government had breached EU rules. The story gave considerable cause for concern over the way in which the Spanish government overruled or manipulated various regulatory authorities throughout the bid: the domestic competition authority's advice was ignored by the government; the energy authority was given emergency powers to block E.ON; and the stock market regulator was sidelined, prompting its chair to resign.

Financial Services

- In the wake of the rogue trading losses at Societe Generale, which came to light in January 2008, and ensuing speculation that the bank would be taken over, French Prime Minister Francois Fillon emphasised that "Societe Generale is a great French bank and will remain a great French bank". EU authorities immediately warned against any interference preventing a bid from another EU country. However, the French government appeared ready to intervene in support of keeping Societe Generale under French control.

Construction Materials

- Mittal Steel's eventual takeover of the European conglomerate Arcelor in 2006–07 became a landmark case, after Mittal raised its offer to exceed that of Russia's Severstal. The losers in this deal were Severstal and its Kremlin backers, who blamed the failed deal on "double standards" and "certain attitudes" towards the expansion of Russian companies abroad. There had clearly been fears within the governments of France and Luxembourg that the Kremlin would have sought to leverage its influence over the new company as an instrument of foreign policy.

Central and Eastern European (CEE) countries have generally adhered to very liberal policies towards foreign investors from the private sector – most of which have been from Western Europe. In most countries of CEE, many key companies are now foreign-owned (eg in the banking sector). Despite frequent populist political rhetoric and negative public attitudes towards some large foreign companies (eg in the retail sector), in practice the CEE countries are likely to remain generally less protectionist than many Western European countries.

III. Investment by State-owned Enterprises (SOEs)

European Soes

Negative reactions in Western EU member states to proposed takeovers are magnified when the company concerned is a state-owned enterprise (SOE), particularly if there is a lack of trust between the European country's government and the SOE's home government. For example, in Central and Eastern Europe, history dictates that Russian SOEs are treated with far greater suspicion than non-Russian SOEs.

There have been several cases of such protectionism towards SOEs among Western EU countries. For example, former French Prime Minister Dominique de Villepin helped to engineer a merger between Suez and Gaz de France in order to prevent a takeover of Suez by Italy's (now partially privatised) energy company ENEL.

In some cases, national legislation is cited. For example, Spanish legislation protects the country's energy sector. It can be applied with considerable discretion by the Spanish government, and might well have been used to protect Spanish electricity company Iberdrola from a potential takeover bid by France's EdF, had the latter followed up the initial interest it showed in early 2008 rather than turning its focus towards UK nuclear energy company British Energy.

Non-European Soes

It is in the area of M&A by non-European SOEs (or, at least, state-controlled enterprises) that the debate about foreign takeovers of Western European companies becomes most sensitive. Many of the concerns currently surrounding SWF investment in Europe also apply to non-European SOEs. For example, in late 2007, Borse Dubai's attempt to acquire a controlling stake in Sweden's OMX exchange (now part of the NASDAQ OMX Group) met with sceptical Swedish public opinion. Gazprom is the leading example of a state-controlled company from outside Europe that is seeking large stakes in companies within the European Union. For example, there was intense political and public debate surrounding Gazprom's interest in Centrica (the largest gas distributor in the United Kingdom) in 2006-07. The episode suggested that some political pressure may have been applied to prevent a takeover by Gazprom if it had actually made a bid, although then prime minister Tony Blair expressed his support 'in principle' for the potential bid. Gazprom has also been very active in seeking energy sector assets in Germany, and has met with resistance.

Other SOEs are beginning to make inroads into strategic sectors of the European market. These include China Development Bank (CDB), which in July 2007 purchased 3.1% of Barclays plc, and Russia's Vnesheconombank (VEB, often referred to as the Russian Development Bank), which in December 2007 acquired the 5% stake held by Russian VTB Bank in EADS. The French and German governments would be unlikely to agree to any higher stake, should VEB seek one in EADS.

As has happened with Gazprom, European government positions towards these and other SOEs are likely to harden if they begin to seek large stakes in companies that might be classified as strategically significant. There are several current examples. The speculation surrounding a possible takeover of German shipping group Hapag-Lloyd by Singapore's Neptune Orient Lines (which is majority-owned by one of Singapore's SWFs,

Temasek) is leading to protests by workers and some concern among politicians. The potential takeover of Dresdner Bank by CDB is generating a mixed reaction: many Dresdner Bank employees expect their jobs would be safer if the company is purchased by CDB than under any of the alternative options; however, questions remain about whether a deal would be politically acceptable. As a result of the latter, the more likely outcome is that the purchaser will instead be CDB's main rival for the deal, Commerzbank.

Western European protectionist attitudes towards SOEs from Russia, Asia and the Middle East are unlikely to subside until greater trust is established between the countries at the highest levels of government. However, in the case of Russia, the country's growing tensions with the West, following the war between Georgia and Russia, and Russia's subsequent recognition of South Ossetia and Abkhazia as independent states, suggest that the short-to-medium term trend of worsening relations between Western Europe and Moscow.

Furthermore, powerful national security arguments will prevent takeovers in sectors that are deemed strategic. India's democratic credentials may give it slightly more leverage in this regard than Russia, China and some Middle Eastern countries, but its SOEs will be subject to a similar response from some Western European governments if they pursue takeovers in strategic sectors.

Central and Eastern Europe

With some exceptions (eg Bulgaria) concerns run extremely high in Central and Eastern Europe (CEE) about the risk that Russian investment may bring with it unwanted political influence. The Baltic countries (especially Estonia) and Poland are the most concerned about this, and would lead the region in resisting any potentially significant investment by a Russian state-linked entity. SOEs from India, China, the Middle East or even former Soviet states such as Kazakhstan are viewed far less critically across the region.

For example, Kazakhstan's state-owned oil company Kazmunaygaz (KMG) last year purchased 75% of Romanian privately held company Rompetrol Group (TRG). By buying a controlling stake in TRG – which is the 25th largest oil group in the EU, owning two refineries in Romania and a significant network of petrol stations in Romania, Moldova, Bulgaria and France among other countries – KMG is establishing a presence in the EU. It hopes to use TRG as a base for further expansion in Europe and to create a bridge between the oil resources of Kazakhstan and the West's increased demand for refined oil products.

IV. Sovereign Wealth Funds

Recent Activity

While SWFs have existed for decades, at least a dozen have been established since 2005, and they are more in evidence in the liberal investment environment of today. Attention has been drawn to them as a result of the steep rises in official currency reserves held by many of the major exporters of commodities and manufactures over the last several years, and the potential for more of these reserves to be channelled into SWFs. Some of the major SWFs are held by states that have become geostrategically very important. Estimates place the current level of assets under management by SWFs at between 1.2 and 2.0 trillion euros[1].

[1] *An exchange rate of 1 US dollar = 0.67 euros has been applied throughout this report.*

Top 5 Sovereign Wealth Funds
(Assets under Management, estimates in billion euros)

Abu Dhabi Investment Authority	410
Government Pension Fund - Global (Norway)	251
Kuwait Investment Authority	177
Government Investment Corporation (Singapore)	140
China Investment Corporation	130

Source: Oxford Analytica

In 2007–08, SWFs have invested over 50 billion euros in some of the largest financial sector companies in the world. More of these SWF investments have been in the United States than in Europe; within Europe, the major investments have been in Western countries.

The sudden and intense debate about European policy towards SWFs was triggered in May 2007 when the China Investment Corporation (CIC), a new SWF, took a stake worth approximately two billion euros in the US private equity company Blackstone. At the same time, there was news that the Chinese government was placing some 130 billion euros into CIC. The discussion among European policy makers is focused on two different, but linked, issues:

1. SWFs present a strategic challenge to European countries in terms of national security and technological competition (if SWF investments result in technology transfer to the SWF's home country).

2. Many large SWFs have suboptimal levels of governance – including a lack of transparency – which makes it difficult to assess their motives and activities. This in turn raises questions about whether their access to European companies is acceptable.

'Strategic' Investors?

On the positive side, SWFs can be a source for stability within financial markets, since they are unleveraged and well capitalised long-term investors. This has been particularly relevant as liquidity has become the main concern in financial markets over the last year. SWFs also usually are passive investors, and long-term return maximisation is arguably their primary aim.

On the negative side from the point of view of many European policy makers, some SWFs seem to be becoming more 'activist'. As SWFs are ultimately owned by foreign governments, this activism raises the potential that they may become new and powerful foreign policy tools. There is also concern about the nature of the sponsoring governments, as nine of the ten largest SWFs are in countries that do not possess full democratic rights. A related concern is that SWFs will be used to secure strategic investments in important industries, acquiring technologies for home countries in fields such as telecommunications and other infrastructure, energy resources, and financial services.

Governance Weaknesses

Good governance in SWFs begins with mission clarity, translation of mission goals into investment strategies, and transparency. It also requires governments to stay out of internal decision-making processes, and supports the creation of a board of trustees capable of managing billions of euros. Good governance gives outsiders confidence that investment decisions are not being made to pursue particular 'political' government agendas. Poor governance is a weakness of some of the largest SWFs. Many of these SWFs also fail to publish data about their investment portfolios, including, in several cases, lists of specific investments. Available data can be out-of-date, and annual reports can lack insights into the nature of investment strategies being adopted.

External Fund Managers

An important area of governance involves making data publicly available about the delegation of investment decisions to external fund managers (such delegation is common practice among most large global pension funds). In many cases these fund managers are well-known international brands, and there can be no doubt that their investment decisions are based on commercial considerations rather than political or other factors. However, in the cases of some of the largest SWFs, it is not even clear whether external fund managers are being used, let alone which ones. As a result, direct government influence over investment decisions is made more likely.

1. European Investment Protectionism

Selected major SWF Investments in Europe in 2007–08

Date of Deal[2]	Stake purchased by	Stake purchased in	Size of Stake
August 2008	Qatar Investment Authority[3]	Cegelec (France)	1.76 billion euros (takeover)
July 2008	Qatar Investment Authority	Barclays plc	1.4 billion pounds sterling (6.2%)
February 2008	Qatar Investment Authority	Credit Suisse	Less than 3%
January 2008	Temasek (Singapore)	Standard Chartered	19% (increased from 18%)
December 2007	Government Investment Corporation of Singapore (GIC) and unnamed Middle Eastern investor	UBS	11.5 billion Swiss francs (9% stake)
December 2007	Qatar Investment Authority[4]	Cadbury Schweppes	5%
November 2007	Qatar Investment Authority	London Stock Exchange	Approx. 15%
November 2007	Dubai International Capital	Alliance Medical (UK)	600 million pounds sterling (takeover)
July 2007	Temasek[5]	Barclays plc	1.4 billion euros (2.1%)[6]
July 2007	China Investment Corporation7	BG Group plc	125 million pounds sterling (0.46%)
June 2007	Dubai International Capital	Mauser AG (Germany)	850 million euros (takeover)

Source: Oxford Analytica

[2] *Many other negotiations have made headlines over the last year without ultimately leading to deals. An example is Qatar Investment Authority's failed bid to buy UK retailer Sainsbury, through its Delta Two Fund. In recent days, executives from Siemens have confirmed that they have held talks with SWFs about stakes being purchased in the engineering group. As the SWFs (or other state-owned entities) in question are believed to be from the Middle East and Russia, this could become one of the most politicised cases so far.*

[3] *The purchase was made by Qatar Investment Authority's subsidiary, Qatar Diar.*

[4] *Qatar Investment Authority partially financed US investment firm Trian's expansion of its stake in Cadbury Schweppes to almost 5%.*

[5] *In parallel, China Development Bank purchased 3.1% of Barclays plc for 2.2 billion euros, as discussed above.*

[6] *This stake was increased to 2.5–3% in July 2008.*

[7] *The People's Bank of China bought this stake, but it is rumoured to have done so on behalf of the China Investment Corporation.*

Comparison to Pension Funds

The 1.6 trillion euros managed by national level pension funds at the end of 2006 was a sharp increase from the 0.7 trillion euros managed by those funds three years previously, and illustrates the large and rising scale of these funds. The largest national and subnational level pension funds (there are many more of the latter than the former) rival the largest SWFs in terms of the value of assets under management (AuM).

Among European countries, the Netherlands, Denmark, Sweden and Finland all have pension systems that are very well funded. The Netherlands' ABP is the largest of the European pension funds[8], administering some 200 billion euros, while the values of the AuM in the other cases do not exceed 100 billion euros. France's state-owned bank Caisse des Depots et Consignations (CDC), which administers public sector pensions as part of its remit, has AuM of at least 200 billion euros.

However, most of the largest national and subnational pension funds are non-European. These include Japan's Government Pension Investment Fund, with about 650 billion euros of AuM, and South Korea's National Pension Fund, with about 130 billion euros of AuM, as well as many North American subnational level funds (eg the California Public Employees' Retirement System, CalPERS).

Pension funds are usually financed by employer and employee contributions, whereas SWFs are established to invest a country's foreign reserves or commodity revenues. Unlike many of the large SWFs, most large national and subnational pension funds can point to rigorous governance models, which engender transparent, cautious, long-term investing. These pension funds typically publish a wide range of data about their investment portfolios, including, in several cases, lists of specific investments. This should continue to be sufficient to give outsiders, including European authorities, confidence that investment decisions are not being made to pursue particular political or strategic government agendas.

Swfs and Private Equity

SWFs are already having an impact on the private equity market – particularly in the United States – as competitors, but also as investors. The Abu Dhabi Investment Authority purchased a small stake in Apollo Management in July 2007; China Investment Corporation (CIC) purchased 10% of Blackstone Group in May 2007; and Dubai's Mubadala Development Company invested 7.5% in the Carlyle Group in September 2007.

One of the largest deals so far came in June 2008 with the 1.72 billion euro investment by China's State Administration of Foreign Exchange (SAFE) in US private equity firm TPG. Until earlier this year, SAFE had not been considered a SWF, but its recent equity investments abroad – including stakes in BP and Total – are leading it to be reclassified as one. There is considerable current discussion about whether the Chinese authorities – through either through CIC or SAFE – will soon invest significant further sums in private equity companies. US private equity firm JC Flowers has been widely cited as one of the leading candidates.

The founder of UK private equity firm Terra Firma, Guy Hands, has predicted that SWFs, and in particular the Abu Dhabi Investment Authority, will "effectively replace Wall Street" as lenders to the private equity industry as a consequence of the unfolding credit crunch leading banks to restrict lending to private equity. His comments have been echoed by some other leaders in the private equity industry, for example Blackstone Chairman and Chief Executive Stephen Schwarzman and Carlyle Group Co-Founder David Rubinstein, who also cites the growing importance of hedge funds, mutual funds and even pension funds in lending to private equity. However, this trend (which is more pronounced in the United States than in Europe) is likely to be rebalanced in the medium term, as Wall Street recovers and bank credit again becomes more readily available.

[8] *Norway's Government Pension Fund – Global is larger, but in this report is counted as a SWF.*

Investing in private equity is attractive to some SWFs as it can shield them from the limelight, and so generates less pressure to reform governance structures. However, a bill – the Responsible Private Equity Investment Act – was sent to the California legislature on February 14, 2008 that sought to prohibit the state's two large pension funds, CalPERS and the California State Teachers' Retirement System (CalSTRS) from investing in private equity companies that are partly or wholly owned by SWFs from countries with poor human rights records. The bill was withdrawn in April follow lobbying by the pension funds, and seems unlikely to regain traction. Nonetheless, the episode highlights how pension fund legislation could potentially be used in future to limit SWF investment in private equity and potentially also other asset classes. However, on balance it seems improbable that this will occur, but it remains an area worth watching.

V. Potential Policy Responses

Responses from European Governments

In many recent statements by EU member state politicians, comments about SWFs have been prefaced by references to the positive contribution of SWFs and foreign investment more generally. For example, the joint statement issued by the US and German governments in the context of the Transatlantic Economic Council in May 2008 criticised barriers to foreign investment – but nonetheless highlighted that "an open investment environment is compatible with policies that address genuine national security concerns." This statement captures the developing consensus in European Union countries and the United States following over a year of intense debate on the appropriate policy responses to foreign investment. However, this consensus position is still solidifying and significant risks remain for foreign investors.

In some European countries, positive comments towards foreign investors reflect more solid support than in others. For example, the United Kingdom retains a generally positive attitude toward SWFs. The government is acutely aware that the City of London stands to benefit enormously from the financial services business that would accompany any increase in SWF activity in Europe. A similar line is taken by some smaller countries, for example Sweden, whose Finance Minister Mats Odell on February 26 clearly stated that SWFs are "welcome" in his country. In some other European countries, most notably in Central and Eastern Europe, SWF investment has not yet become a significant issue.

However, senior members of several Western European governments, including those of Germany and France, have suggested that more restrictive policies are needed in response to SWFs. French President Nicholas Sarkozy in early 2008 suggested using CDC, the state-owned bank, to defend French firms against hostile takeovers. CDC (or part of it) may even be established as a large SWF itself, following a recent proposal by French government advisors. This idea appears to be a direct response to the activities of SWFs. In Germany, a legislative amendment was sent in August 2008 by the government to the legislature.

German Legislation

The German government on August 20, 2008 sent to the legislature a proposed amendment to the Foreign Trade Law. The amendment, which is likely to come into force in 2009, applies to investors from outside the EU and EFTA. It appears to have been softened compared to earlier drafts, following pressure from the European Commission.

The bill is clearly a response to the public outcry about SWFs over the last year. The law would allow the government to veto a foreign investment that amounts to a stake of 25% or more in a German company, in the interests of 'public security and order'. The bill does not specify particular sectors, although defence and encryption already were incorporated in the previous version of the Foreign Trade Law. It is widely perceived that the revised legislation may be applied in sectors such as energy and telecommunications, although the government will decide on a case-by-case basis.

The re-emergence of protectionist tendencies in Germany reflects genuine fears of politically motivated acquisitions from outside the OECD, as well as electorally useful rhetoric that has become more strident. It is also partly a reaction to the French government discouraging several acquisitions by German firms in recent years. German supporters of countermeasures to the potential 'invasion' of SWFs have also highlighted the contradiction of a state utility, such as Deutsche Telekom or a power company, being painstakingly privatised by the German state, only to fall under the control of a foreign government.

Germany's corporate sector has become increasingly concerned that the revised legislation could generate negative perceptions of Germany as an investment destination. This has been highlighted by the Federation of German Industry and the Chambers of Trade and Industry, which have warned against raising anxiety about globalisation. Both stress Germany's export dependence and the need to attract inward investment to sustain industrial competitiveness.

Response from International Organisations

The topic of SWFs has been debated heavily at many major international meetings this year, including the World Economic Forum in Davos. No coordinated international policy towards SWFs is yet on the horizon. However, the IMF's International Working Group of SWFs is currently preparing a set of voluntary principles that is scheduled to be ready in October 2008. The Group is co-chaired by the IMF and an Abu Dhabi Investment Authority representative; the aim is to gain input from all sides, in order to ensure that the set of principles is acceptable both to recipient market governments and to the SWFs.

The OECD continues to take the lead on encouraging a positive policy stance towards SWFs. OECD Secretary-General Angel Gurria on March 25 announced that "there should not be any legislation or any regulation or any code applied that unduly restricts the freedom of [SWF] investment". However, he accompanied these comments with an insistence that SWFs pursue commercial interests only, adopt high levels of transparency, and have good management.

The fact that so many key international players are involved in the debate surrounding SWFs has led to suggestions that eventually some global set of norms or regulations could be agreed upon that would go beyond the IMF's current work. A potential accord might be some form of 'grand bargain', according to which SWFs from China, the Middle East, Russia and other developing countries agree to improve their governance in return not only for continued access to western markets (excluding strategic sectors), but also for concessions in the management of 'Western' international organisations, such as the World Bank/IMF (which in turn might then play a leading role in regulating SWFs). However, establishing such a 'bargain' will be a long and difficult task.

European Commission

The European Commission on February 27 adopted a communication, subsequently endorsed by EU finance ministers, proposing "a common EU approach to increasing the transparency, predictability and accountability of SWFs". The objective of proposing this common approach is to help to facilitate global agreement on the voluntary set of principles being prepared by the IMF.

European Commission President Jose Manuel Barroso and Commissioner for the Internal Market and Services Charlie McCreevy have both highlighted on several occasions the positive effects of SWF investments – noting in particular the banking sector, arguing that SWFs provide systemic stability. Brussels is keen to avoid a plethora of divergent national measures, and emphasises that it may propose EU-level legislation if member states insist on pursuing divergent measures and/or if implementing a voluntary set of principles proves unsuccessful.

The election of French President Nicolas Sarkozy increased the topic's sensitivity. However, his initially very defensive stance towards SWFs appears to have given way to a more conciliatory tone. While many argue that his advocacy of protectionism was more symbol than substance, it may have already had some deterrent effect – particularly in combination with the poor current returns available to foreign investors in European markets.

The French government may ultimately take a case-by-case stance. This was indicated earlier this year by French Ambassador for International Investment Philippe Favre, who stated that Singapore's two SWFs, Temasek and GIC, are welcome in France. He lauded their track records as good examples for other SWFs.

Nonetheless, given the difficulty of agreeing on a global resolution to the SWFs issue, the most likely course for the European Union may well ultimately be to engage in bilateral negotiations with the major sources of these funds – Russia, Asian countries and the Gulf states. An early example of such a negotiation may prove to be the agreement on a set of principles, reached on March 20, between US authorities and ADIA and the GIC. These two SWFs committed in principle to invest in the United States purely for commercial, not political reasons, while the US authorities agreed in principle not to erect unnecessary protectionist barriers. However, full agreement on wider transparency and governance issues appears not to have been reached.

VI. Restraints on Investment Protectionism

Investment Hunger

Against the background of national imperatives to maintain stable growth and reduce unemployment, individual European states will find it more difficult to resist the advantages of openness to SWFs and to takeovers by foreign state-owned enterprises or multinationals. The acceleration of tax competition among newer EU member states is sufficient evidence of the hunger to attract foreign investment.

Corporate Activity

If European countries do impose stricter controls on foreign investors, they would face criticisms of hypocrisy. Germany and other EU member states have actively promoted acquisitions of strategically key elements of the economies of CEE countries. Deutsche Telekom, for example, dominates the telecoms sector in the Balkans and much of Central Europe; several German banks have been actively acquiring privatised assets in CEE states, as have energy and transport companies, and Deutsche Post.

2. European Trade Protectionism

I. The WTO in 2008

Failure to make progress at the WTO is likely to perpetuate current protectionist elements of European trade policies. Moreover, it is also likely to help create the conditions for new protectionist policies to emerge. Therefore, understanding what is likely to happen next at the WTO is at the heart of forecasting how European trade policies might become more protectionist.

Doha Breakdown

Talks aimed at brokering agreement on the Doha Round of global trade talks broke down on July 29, 2008, principally because differences could not be bridged on the rules of a 'Special Safeguard Mechanism'. This would have allowed developing countries facing a surge in imports to raise import duties to levels even above those already in force in order to protect vulnerable farmers and industries.

The failure of those talks marked a significant and possibly lasting shift in the positions of major trading countries. For the first time, the WTO encountered the combined economic weight of China and India, which were allied in resisting pressure for greater liberalisation.

Next Steps

The WTO's reputation as a forum for negotiation will suffer from the Doha breakdown. Immense effort and political commitment have been invested in the Round over nearly ten years. No early decisions are likely on whether, how, or when to re-start negotiations. Initial reactions suggest that:

- the tentative Doha package contains much that is worthwhile and should not be lost;
- no re-launch will be possible until well after the US and Indian elections; and
- all agree that at least six months' further work would be needed to complete the Round after re-launch.

The implication is that a resumed Doha Round negotiation could not be completed until late 2009 or early 2010. This might permit entry into force of the first instalments of liberalisation from January 2011. Possible alternatives are:

- picking out less controversial elements of the Doha package for earlier action, such as duty- and quota-free treatment for imports from the poorest countries, and easing of border formalities that hamper trade;
- a new initiative, including Doha elements still judged desirable and feasible but perhaps covering issues such as labour standards and the environment (if developing countries could be persuaded to accept this);
- indefinite postponement of new multilateral negotiations until a more favourable time;
- resort to self-contained 'plurilateral' negotiations on particular issues, the results of which need not necessarily be accepted by all WTO members; or
- abandonment of WTO negotiations in favour of negotiations among bilateral, regional or other 'like-minded' groups of countries. In the longer run, WTO rules could become increasingly irrelevant if this trend continues to accelerate.

2. European Trade Protectionism

II. Russian WTO Membership

One of the main ongoing debates surrounding the WTO, since well before the recent collapse of the Doha Round, is about Russian membership, which has been under negotiation for some 15 years. Remaining US and EU concerns include protection of intellectual property, trade in energy, and agricultural subsidies. Issues of this kind are usually handled through undertakings on future policy, which are addressed in multilateral negotiations in the WTO accession working party and are spelled out in the working party's report. Accession is possible only when all interested WTO members are satisfied with the outcome of the negotiations.

One of the international political consequences of the recent conflict between Russia and Georgia may be significant further delay in WTO acceptance of Russian membership. The European Union and the United States are likely to make use of their leverage by insisting that Russia fully responds to all their concerns about its trade policies. As regards bilateral concerns, even prior to the war, Georgia had been dissatisfied with Russian restrictions on imports of Georgian wine, and Ukraine, which acceded to the WTO on May 16, 2008, had become in a position to put demands to Russia.

III. Long-term WTO Problems

The collapse of the Doha Round highlights general weaknesses in the present approach to negotiations. Five factors are contributing to the apparent breakdown of the 'round' model:

1. Too Many Subjects

In theory, inclusion of many subjects in a negotiation can give every participant an interest in overall success. However, this approach can force countries to accept a bad agreement on one subject in order to obtain a good result on another. One consequence is growing interest in plurilateral agreements that not all members would be required to accept.

2. Too Many Participants

The WTO's 153 members all participate in the Doha Round. Formal meeting of WTO negotiating groups are thus ill suited to real negotiation, which instead migrates to restricted groups.

3. The Consensus Rule

The consensus rule requires that decisions be taken only if no member actively objects. This effective veto adds to the challenge of negotiating multilateral agreements and increases the attraction of resorting instead to dispute procedures, plurilateral agreements or free trade agreements (FTAs) to solve trade problems.

4. MFN Rules

The most-favoured nation (MFN) principle requires that any trade advantage granted to one member be extended to all others. One effect of the MFN-rule is the 'free rider' problem: trade negotiators are reluctant to offer concessions unless all the countries that benefit agree to 'pay' by making concessions in return.

5. North-South Differences

Brazil, China and India are now major partners in the multilateral trading system, yet they and other developing countries have adopted an essentially defensive stance throughout most of the Doha Round. Although Brazil sided with the United States during the collapse of talks on July 29, 2008, India enlisted widespread developing-country support with its insistence on protecting 'livelihood security' over commercial interests. China – brought for the first time into the inner circle of WTO negotiators during the recent talks – emphasised domestic priorities in refusing tariff cuts for rice, cotton and sugar.

IV. WTO Disputes

Following the collapse of the Doha Round, the WTO's role in settling trade disputes will become more important than ever. Negotiation is generally preferable to litigation, since it can open up trade opportunities where none existed. However if there is no choice, resort to the WTO's binding dispute procedures can show impressive results. For example, China has just suffered its first defeat in a dispute with a ruling that it has treated imported car parts unfairly.

Contrary to the impression given by press reports, most WTO disputes concern very specific (and often minor) problems. The parties usually accept the ruling on the matter by the WTO dispute panel. If the complaint has been upheld, the offending measure or action is withdrawn, or amended to make it compatible with the rules.

If a government fails to withdraw or amend policies or actions found inconsistent with the WTO rules, the injured country can demand compensation equivalent in value to the injury. This happens fairly often, and resolves the dispute. Disagreements about whether the original trade measure has been made fully consistent with the rules, or whether the compensation demanded is appropriate, can result in long delays, and occasionally in award of further compensation for the continued injury. But 'tit-for-tat' disputes in this framework are unlikely.

Agreement can be most difficult in industries or sectors that are politically or economically sensitive. Major disputes remain outstanding at the WTO that are unlikely to be settled soon. Examples include:

- **Airbus and Boeing**
  There remain mutual US and EU objections to subsidies to Airbus and Boeing. A key ruling from a WTO dispute panel is expected soon.

- **Other Chinese restrictions**
  There are current US and EU complaints concerning Chinese import restrictions in areas other than car parts, and concerning export refunds and subsidies, and failure to protect intellectual property. Complaints against China are at relatively early stages, but could become a serious flashpoint in trade relations.

- **US and EU agricultural policy**
  Australia and Brazil continue to attack US and EU sugar policy. Canada is objecting to US subsidies for corn and other products. Some Latin American countries remain dissatisfied by the European Union's import regime for bananas. (A tentative settlement reached in July collapsed with the Doha negotiations.)

2. European Trade Protectionism

V. Possible New Tariff and Non-tariff Barriers

If trade protectionism rises, it could take the form of many tariff and non-tariff barriers. One possibility is that 'traditional' barriers will be revived; another is that new issues, eg carbon emissions, will lend themselves to protectionist policy.

Revival of 'Traditional' Barriers

Use of safeguard, anti-dumping and countervailing measures has declined overall, but could revive. Problems in 2007–08 with defective Chinese-made toys show the potential for trade disruption if trade restrictions linked to the enforcement of product standards and intellectual property rights become more common.

Carbon Border Taxes

A looming issue is the potential imposition of 'carbon border taxes' on some imports. These would compensate for the disadvantage of domestic producers that are subject to taxes on their carbon emissions when their foreign competitors are not. France favours such action.

VI. Pursuit of Regional and Bilateral Agreements

The European Union is turning increasingly to regional and bilateral agreements, in which European concessions on agriculture can be kept to a minimum through the European Union's greater bargaining power, and by excluding from such agreements countries whose exports might disrupt the CAP. Examples include:

India-EU ETA

Indian and EU leaders earlier this year stated that they were optimistic about the prospects of reaching a free trade agreement by the end of 2008. Both sides are keen to reduce trade barriers and deepen commercial ties. The EU is India's largest trading partner, accounting for 20% of India's total trade, and its biggest foreign investor. India is the second-fastest growing source of imports to the EU and an export destination for EU products (both grew by some 20% last year). India is the eighth most important EU export destination and the tenth-largest importer into the EU. The new trade agreement might include up to 90% of trade, but exclude contentious agricultural products. The objective of reaching an India-EU free trade agreement within the next twelve months is very ambitious, given continued differences over Doha and EU demands for more investor transparency.

Other Examples

Apart from the India-EU agreement, and those with the African, Caribbean and Pacific (ACP) countries, the main EU FTA or other trade agreements are:

- Association agreements with Mediterranean countries (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco and Tunisia).
- FTAs with Chile, Mexico and South Africa.
- Prospective FTAs with ASEAN, the Gulf Cooperation Council, India, South Korea and Ukraine (the latter an agreed EU aim, but with negotiations only now able to start following Ukraine's completion of negotiations for accession to the WTO).
- More limited agreements with Kazakhstan (textiles and steel), Vietnam (textiles) and Russia (steel). Proposals have been made for a 'comprehensive framework' for EU-Russia relations, but these are likely to be delayed as a result of diplomatic tensions between the European Union and Russia following the recent war between Russia and Georgia.

VII. Worst-Case Responses

In multilateral trade negotiations, experience has shown that little can be achieved without the active cooperation of the European Union. The same holds true for the United States. At the same time, the European Union (and the United States) can and will, more easily than other trading nations, act in disregard of the trade rules. There is a risk that this tendency could return, potentially undermining the strong WTO dispute settlement procedures, if there is a period of 'standstill' in multilateral trade rounds, as now looks likely.

The European Union is very unlikely to abandon the WTO, in which it is a dominant player. However, the huge amount of time, talent and political effort involved in the Doha negotiations may reduce its faith in the organisation. The collapse of the Doha Round will encourage protectionist elements within the European Commission, traditionalists in national governments, and anti-globalisation NGOs to exert more influence on trade policy. WTO rulings against the European Union on food disputes, for example, could further antagonise the public against the trade body.

Although responsibility for setting the European Union's trade strategy rests with the member states, the European Commission has the lead role in negotiating trade agreements and conducting trade policy. In a worst-case scenario, the European Commission may turn hostile towards the WTO and promote a new post-Doha trade strategy that includes the following two elements:

1. Social Nullification Vis-a-Vis the WTO Dispute Settelment Systems

If the European Commission deems that a trade-restricting measure reflects a broad social consensus of the EU population, then the Commission might seek to reject the right of the WTO to rule against that measure. The European Union might seek to apply some form of 'social nullification' principle to all trade-related agricultural issues.

However, 'social nullification' is not a concept recognised under the rules that bind WTO members, and thus as such provides no justification for the EU to reject the right of the WTO to rule against that measure. While the GATT Article on 'General Exceptions' and some other provisions provide a possible defence, the outcome of a dispute concerning an EU 'social nullification' trade measure would be hard to predict.

2. Tie Non-Trade Provisions to New FTAs

The European Union would be likely to attach non-trade provisions to its FTAs. Such provisions could include:

- Acceptance of the 'precautionary principle' as a legitimate regulatory standard for all traded goods involving potentially hazardous products or processes.
- Adherence to core labour standards for all production processes involving exports.
- Respect for data privacy.
- Abolition of the death penalty.
- Implementation of environmental provisions.

All of these features would have the additional effect of weakening the WTO itself. The European Union's interest in following the bilateral route in trade relations would be strengthened by its success in achieving results that are impossible under the WTO consensus requirements.

2. European Trade Protectionism

VIII. Limits of Trade Protectionism

Despite rising protectionist sentiment, the fears voiced by many free traders that the world might slide into a replay of the 1930s are misplaced. Even under a worst-case scenario, key players recognise the folly of encouraging trade breakdown. Also, the protectionist barriers placed on many economic sectors run into countervailing forces – the progress of globalisation (albeit slowed) and the reduced transportation and communication costs of international trade. The cross-border exchange of services taking place over the internet continues to grow steeply. Regardless of government policies to the contrary, it has still become cheaper than before to trade across borders.

The service tier of the global economy will expand at a healthy rate, even under a worst-case scenario. In this sector, the global trading system resembles the world economy of a century ago, when rapid technological advances caused trade flows to grow even as the major economies were erecting higher tariff barriers. Regardless of policy measures, the long-term trend is for trade to continue to grow – although at a slower pace than under a multilateral system, and amid significant macroeconomic and political upheaval.

3. Implications for Business

European 'investment protectionism' has implications for foreign companies that invest in Europe or plan to do so, and for European companies that might be recipients of such investments.

European 'trade protectionism' has implications for non-European companies supplying the European market, or planning to do so. It also has implications for European companies that trade with non-EU companies, as that trade might become more complicated.

Some of the implications identified in this section have direct or indirect implications for both trading companies and for investors, but they are listed according to the category in which their direct impact is likely to be greatest.

I. Implications of European Investment Protectionism

1. Governance Improvement

There will almost certainly be increased pressure for SWFs and any other foreign investors with poor governance to alter their governance structures. This pressure could be formal, following the introduction of new legislation, but in most cases is more likely to be on a voluntary basis initially.

2. Politics Can Trump Regulation

Examples of some European governments' protectionism concerning takeovers by multinationals have shown that political considerations can override regulatory frameworks. Companies (whether EU or non-EU) contemplating takeovers in Europe (outside their home country) need to analyse political trends in the country in question and understand which politicians will wield particular influence.

3. Lobbying and Public Relations Costs

SWFs, foreign state-owned enterprises and other foreign companies may need to engage more in lobbying or public relations campaigns in order to persuade policy makers and relevant stakeholders about the nature of their activities and objectives. This could entail a significant, long-term cost.

4. Risk of Spillover to Other Asset Managers

It is very unlikely that non-SWF asset managers would be forced to divest from European industries where they have longstanding investment track records. Perhaps the major regulatory risk to other asset managers will be 'definitional': how will any new regulations define SWFs? Some other asset managers, notably national pension funds, might get caught up in such definitional issues.

5. Reputational Risks

European companies might increasingly face a reputational risk if they accept investments from SWFs or foreign state-owned enterprises that are deemed by European governments (and/or general publics) to have poor standards of governance. This risk exists even in the absence of any new legislation directed at these foreign investors.

6. Russian WTO Accession and Investment

As far as Russian investors are concerned, WTO membership is significant mainly because it would entitle them to benefit from the treatment that the European Union has undertaken – in its General Agreement on Trade in Services (GATS) commitments – to provide to WTO member country service suppliers seeking to establish their companies in the EU market. Therefore, access by Russian investors to the EU would be eased, even if in many cases only marginally. If greater European protectionism contributes to the indefinite delay of Russian WTO entry, as looks increasingly likely, these benefits to Russian investors will be lost.

II. Implications of European Trade Protectionism

1. Market Access and Competition

Even with progress at the WTO at a standstill, existing WTO rules and trade commitments stand. However, prospects of desirable rule changes and greater market access or competition are likely to be deferred for several years.

2. Supply Chain Complications

The raising of trade barriers and trade discrimination will generate more uncertainty for foreign companies supplying the European market, and for European importers, eg in the area of differing rules of origin according to supplying country. Particular difficulties face companies with a supply chain involving several countries, some of which are entitled to preferential treatment for their exports to the EU while others are not.

3. Country Differentiation

A key theme is differentiation among countries. Suppliers in WTO member countries not benefiting from EU preferences will continue to benefit from WTO-bound MFN rates, which in respect of many industrial products are very low or even zero. However, country differentiation through FTA agreements will alter the competitive situation in favour of suppliers enjoying EU preferences and against suppliers excluded from preferences. For example, the FTA with India will restrain protectionism from the EU towards India, giving Indian suppliers some advantages over their Russian or Chinese counterparts. Appropriate strategies for Chinese and Russian companies would include:

- lobbying their governments to seek similar agreements with the EU;
- manufacturing in a country that has an FTA with the European Union so as to have access to the EU market; and
- exploring possibilities under the FTA's rules of origin to supply components to an EU FTA-based producer that could incorporate them into products qualifying for preferential entry into the European Union.

4. More Frequent Formal Dispute Proceedings

Without the leverage provided by an ongoing trade round, it will be harder to seek multilateral solutions to general trade issues raised by individual bilateral disputes. This will leave formal dispute proceedings as the only way of seeking solutions.

5. Environmental Barriers

With progress at the WTO stalled, members will have little appetite for tackling newer issues on a multilateral basis. Such issues will include, but not be limited to, trade restrictions introduced for environmental reasons.

6. Russian WTO Accession and Trade

If Russia were to join the WTO, it would assume the same basic rights and obligations as any other member, except to the extent that the terms of its accession (spelled out in the Accession Protocol) may set out some exceptions that would normally apply only during a transitional period. Apart from these exceptions, Russia would be entitled to receive from the European Union the same MFN status and national treatment for its exports of goods and services that must be given to any other WTO member with which it does not have a preferential arrangement. If diplomatic tension and greater European protectionism contribute to the indefinite delay of Russian WTO entry, these benefits to Russian companies will be lost.

© Oxford Analytica 2008
This study is intended for the use and assistance of CMS. It should not be regarded as a substitute for the exercise by the recipients of their own judgment. Oxford Analytica Ltd and/or any person connected with it accepts no liability whatsoever for any direct or consequential loss of any kind arising out of the use of this study or any part of its contents.

© CMS Legal Services EEIG (October 2008)

CMS is the network of European law and tax firms of choice for organisations based in, or looking to move into, Europe. CMS provides a deep local understanding of legal, tax and business issues and delivers client-focused services through a joint strategy executed locally across 28 jurisdictions with 56 offices in Western and Central Europe and beyond. CMS was established in 1999 and today comprises nine CMS firms, employing over 2,200 lawyers and is headquartered in Frankfurt, Germany.

CMS nine member firms are: CMS Adonnino Ascoli & Cavasola Scamoni (Italy); CMS Albiñana & Suárez de Lezo (Spain); CMS Bureau Francis Lefebvre (France); CMS Cameron McKenna LLP (UK); CMS DeBacker (Belgium); CMS Derks Star Busmann (Netherlands); CMS von Erlach Henrici Ltd. (Switzerland); CMS Hasche Sigle (Germany); and CMS Reich-Rohrwig Hainz (Austria).

CMS offices and associated offices: Amsterdam, Berlin, Brussels, London, Madrid, Paris, Rome, Vienna, Zurich, Aberdeen, Algiers, Antwerp, Arnhem, Beijing, Belgrade, Bratislava, Bristol, Bucharest, Budapest, Buenos Aires, Casablanca, Cologne, Dresden, Duesseldorf, Edinburgh, Frankfurt, Hamburg, Kyiv, Leipzig, Ljubljana, Lyon, Marbella, Milan, Montevideo, Moscow, Munich, New York, Prague, Sao Paulo, Sarajevo, Seville, Shanghai, Sofia, Strasbourg, Stuttgart, Utrecht, Warsaw and Zagreb.

The members of CMS are in association with The Levant Lawyers with offices in Beirut, Abu Dhabi, Dubai and Kuwait.

www.cmslegal.com