A POLITICAL MENACE OR COMMERCIAL OPPORTUNITY? CHINESE SOVEREIGN WEALTH FUNDS' INVESTMENTS IN THE EUROPEAN UNION[1]

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ABSTRACT

With an estimated total of US$1.2 trillion under management, the two top Chinese sovereign wealth funds (SWFs) are a force to be reckoned with globally. Thus far, their investment exposure to European assets (an average of US$4.0 billion annually in 2009-2013) has been insignificant and has not exhibited deliberate overemphasis on industries, activities or individual targets deemed particularly vulnerable from the socioeconomic or political perspective. Furthermore, country variations in the distribution of Chinese SWF investments across Europe lay bare more of a reflection on host country openness and local capital market competitiveness than a proactive bias on the part of the SWFs to under- or overweight particular economies. These findings, however soothing in the context of Chinese SWF investment in the EU, do not obviate the need for a coordinated pan-EU strategy aimed at upgrading the transparency of inward investment by all SWFs (including Chinese) and actionable policy measures to suspend or repel investments whose motifs are unclear and might be detrimental socioeconomically and politically. On the other hand, the EU needs to work hard on improving its investment climate to attract more Chinese investment (also in the form of SWF capital injections). This study comes up with a compendium of potential steps that the EU might contemplate to militate against harmful practises adopted by individual SWFs and to promote general SWF transparency. The paper draws on empirical transaction statistics recorded under the Sovereign Wealth Fund Transaction Database reconciled with those of the SWF Center Transaction Database.

Key words: Sovereign wealth funds (SWFs), European Union (EU), Chinese investments, EU-China relations, Chinese SWFs

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Introduction

For decades, the seemingly inexorable logic of capitalism has rested on two central tenets: shareholders goad companies into maximising the value of their shares and direct state ownership of business lags private ownership in economic efficiency. The rapid growth of emerging economies where state ownership plays a prominent role (e.g. mainland China), "shakes the logic of capitalism" (Summers 2007). The meteoric rise of sovereign wealth funds (SWFs), special purpose investment vehicles created, funded, owned or controlled by governments, is epitomic of an increasing role of state in managing the wealth and economic power of nations.

With an asset base estimated US$6.6 trillion at June 2014 (SWF Institute 2014), SWFs control a vast pool of global capital. Although incomparably less significant than conventional asset managers, SWFs top the rankings of all major classes of alternative investment management institutions (including private equity-, hedge- and exchange traded funds, ETFs) (Maslakovic 2014) . The lion's share of this wealth has been accumulated by only a handful of regimes, many of them viewed as authoritarian. Out of the six countries with assets over US$100 billion only Norway belongs to the Organisation for Economic Co-operation and Development (OECD), the traditional hub of wealthy states committed to democracy and free enterprise, which attests to the dramatic shift in the distribution of economic and financial clout worldwide (Truman 2010).

Over the coming decades, mainland China will represent a lasting challenge to pan-European interests. Although China per se does not pose and most likely will not pose an imminent security threat in the traditional military sense, its brisk economic expansion (coupled with rising assertiveness) will increasingly engender serious security risks for the EU. Among them are opacity in investment activity, accompanied by the growing penetration of and potential dominance over politically sensitive industries or companies.

Two competitive scenarios apply to Chinese SWFs' activities in such a context. One is that these SWFs are – de facto – politically minded and China (if need be) will not hesitate to use them to unscrupulously exploit the host economies and individual target companies. The other theory claims that Chinese SWFs are run-of-the-mill market players whose overriding objective is maximising risk-adjusted investment performance.

The paper's main contribution is to uncover patterns of Chinese SWFs investment in Europe and address the question of its motivations. It is divided into four main sections. Firstly, we seek to conceptualise SWFs in the context of political science, as well as to review the existing research on Chinese investments in Europe. Secondly, based on more than 100 transactions spanning the years 2007 -2014, we endeavour to demonstrate Chinese SWFs' exposure to the EU. We analyse industrial as well as geographical distribution of the investments, also highlighting the methods of asset acquisition. Thirdly, we compare and contrast Chinese SWFs with other SWFs, as well as with private equity funds, in order to discover proximities to other institutional, non-politically involved investors. Similarities among such investments would indicate that Chinese SWFs in Europe should be perceived as a bona fide market player. Finally, we confront concerns about SWFs being brought to the fore in Europe with the results of our empirical findings on Chinese SWF activities in Europe. We also enumerate response mechanisms that can be mulled by EU policymakers to identify and restrict potentially harmful SWF practises and to promote general SWF transparency.

1 Materials and methods

Owing to no explicit information disclosure requirements routinely imposed on SWFs and their selective accountability to insiders (let alone outside retail investors or the public at large), SWFs are widely perceived as relatively opaque (even among alternative investment managers). Consequently, their investment activity in the EU is commensurately obscure. This research study is based on empirical data gleaned from the Sovereign Wealth Fund Institute Transaction Database – arguably the most comprehensive and authoritative resource tracking the SWF investment behaviour globally. We have catalogued transactions indexed by the SWF Institute with those extracted from the Sovereign Wealth Center database (whose coverage appears to be considerably narrower). Thanks to this effort, we have succeeded in rectifying numerous omissions, correcting certain errors and compiling a list of more than 100 transactions.

Even if the outcome does not pretend to cover all Chinese SWFs' activity in Europe, it is certainly the most comprehensive study of this topic so far. The possible omissions are due to the fact that SWFs often operate through special purpose vehicles (SPVs), which complicates identification of their beneficial ownership or accurate and timely portfolio compositions. Moreover, even among global SWFs Chinese sovereign wealth funds are notorious for inferior standards of transparency measured via the Linaburg-Maduell Transparency Index (SWF Institute 2014)[2]. Suffice it to say that in August 2014, CIC scored 6,5 and SAFE only 5 out of a maximum of 10 points (SWF Institute 2014).

Despite numerous references in scholarly research and policymaking, the very definition and quantification of political risk remains controversial (Sottilotta 2013). For the purposes of this research, we have decided to use the following criteria to identify the existence of political risk – broadly interpreted as the fulfilment of non-economic objectives (cf. Grosse, Stack 1982):

- *sensitive industries*: we have assumed that – by virtue of their close relevance to national security – certain sectors are by definition riskier than others and any capital infusion into them from SWFs is potentially hazardous;
- *active control*: financial investors seeking superior risk-adjusted returns will routinely acquire minority stakes in portfolio companies – any evidence of active (majority) control of such companies (especially via business combinations, otherwise known as mergers and acquisitions, M&A) would be indicative of intentions beyond the simple pursuit of investment efficiency – the specifics of active control levels would have to account for disparities in EU members' corporate governance systems (with regard to voting power implications);
- *track record*: it can safely be presumed that any historical occurrence of politically harmful behaviour by SWFs globally should lead us to believe that such activity patterns can be repeated in the future (it is thus rational to assume their intended political impact).

Considering the aforementioned constraints and inevitable simplifications, it can be claimed that this empirical research – although not free from error – is sufficiently representative to enable the postulation of tentative conclusions and recommendations.

[2] The Linaburg-Maduell transparency Index is a method of rating transparency of sovereign wealth funds. The index is based on ten essential principles and each of them add one point to the transparency rating.

2 Sovereign Wealth Funds as instruments of policymaking

Reflecting on SWFs from the perspective of political science, one can perceive them as state-controlled entities that (by definition) are instruments of state-sponsored foreign policy. As **Gilpin** (2001) noted, even in the context of "a highly integrated global economy, states continue to use their power … to channel economic forces in ways favourable to their own national interests".

Thus, theoretically, as state sponsored actors, SWFs can be used by their mandators for politically driven purposes, potentially harmful for the recipient countries (Truman 2010, Weiner 2011, Csurgai 2011). Even **Barack Obama**, during his initial presidential campaign of 2008 commented: "I am obviously concerned if these… sovereign wealth funds are motivated by more than just market consideration and that is obviously a possibility" (Lixia 2010). In reply to such publicly voiced concerns, many scholars have endeavoured to assess to what extent SWFs follow investment strategies driven primarily by envisaged financial efficiencies and to what degree they respond to political agendas. Interestingly, depending on methodologies and time periods applied, varying conclusions can be drawn.

Balding's (2008) analysis of foreign and private equity transactions concluded by flagship SWFs, pointed to an absence of demonstrable, non-economic investment motives. He thus construed SWFs' policies to follow the path of expected investment efficiency. **Lixia** (2010) argued that anti-SWF concerns arise mainly from the lack of understanding of SWFs' role and her research showed no clear evidence of funds acting out of purely political motives. However, other researchers (Knill et al. 2012; Chhaochharia, Laeven 2008) argue that SWFs' investment policies are not entirely driven by profit maximising objectives and may include political motivations. **Clark** and **Monk** (2012) even go as far as defining SWFs as "long-term investors, whose holdings are selected on the basis of their strategic interests (fund and nation) rather than the principles of modern portfolio theory". This definition makes an important distinction between the owner and the fund itself suggesting that sometimes the ruling elites of a country and its fund managers might have conflicting interests. If this were to be proved right, SWFs – for all their direct proximity to state control – would fall prey to agency problems affecting most institutions of fiduciary investment management (Bernstein et al., 2013).

Although some authors stressed no clear evidence of funds acting out of demonstrably political motives, one can easily bring up examples of politically biased activities. For instance, in 2007 China's State Administration of Foreign Exchange (SAFE) used its funds to help persuade Costa Rica to sever ties with Taiwan and to establish relations with the People's Republic of China. Such a clearly politically driven transaction "raises questions about some of SAFE's other investments and will worry politicians and business people in places where SAFE is taking stakes in high-profile companies" (Anderlini 2008). Some other funds are overt in manifesting their politically-biased conduct. For example Norway's Government Pension Fund – Global, the largest SWF to operate worldwide (SWF Institute 2014), is permitted to invest in targets only as long as they will satisfy predefined environmental, labour or transparency standards (Chesterman 2008, Clark et al. 2013), a form of ethical pre-screening (Social Funds 2014).

Examples of potential political motifs behind SWF activities can comprise: quest for geopolitical visibility, control over strategic resources, access to privileged technological or military know-how, espionage or sabotage of sensitive enterprises or infrastructure, but they can also involve the promotion of sustainable development or gender equality (Steinitz 2012).

Thus, no clear consensus exists in academic literature whether SWF investment strategies are based solely on financial objectives and whether they are specifically geared to exert a hands-on effect on corporate value. This trait is expected to be highly fund-specific and any pan-industrial conclusions would be highly precarious. However, it would be equally difficult to refute the observations of **Truman** (2010) who claimed that "SWFs are political by virtue of how they are established, and by their nature are influenced to some degree by political considerations".

3 Chinese SWF investments in Europe

The People's Republic of China has two major SWFs – the China Investment Company (CIC) and the SAFE Investment Company (SIC), a Hong Kong based subsidiary of SAFE – commanding a total of US$1.2 trillion under management (SWF Institute 2014).

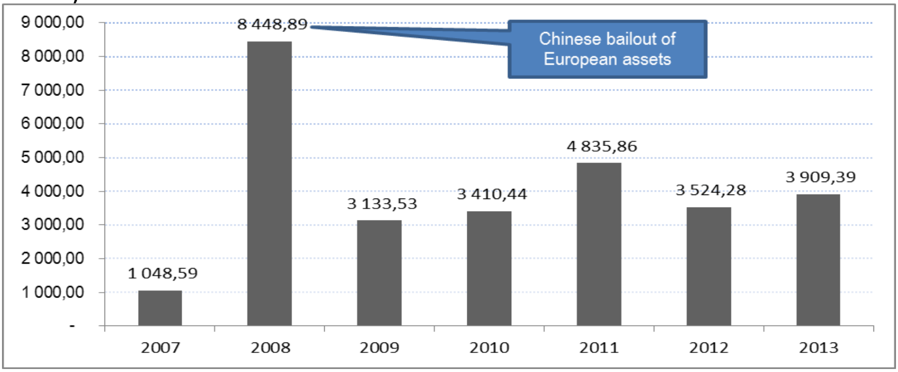
They are widely viewed as highly politicised and run in an obscure fashion. For instance, SAFE had repeatedly refused to acknowledge SIC's existence, until it was confronted with incontrovertible evidence collected amid a media probe in 2008 (Anderlini 2008a). It comes as no surprise that Chinese SWFs' behaviour has triggered a debate in Western countries whether the SWFs might serve as a source of market stability or as a potential menace to Europe (Bu, 2010). This has been echoed in a wider debate on rising Chinese investment and its potential ramifications for the European Union. The problem has attracted the attention of business consultants (Hanemann, Rosen 2012) as well as academics (Meunier 2014, Zhang, v.d. Buckle 2014) and finally politicians – e.g. research studies on this topic have been ordered by the European Commission (Apoteker 2012; Clegg, Voss 2012).

The aforementioned studies on Chinese investment in Europe seem to demonstrate that, so far, their political dimension has not been significant and none of the EU countries is seen as being "in China's pocket". Firstly, the scale of Chinese investment in Europe is still rather limited. The growth of the volume of Chinese investment in Europe might be impressive, but the share of Chinese firms in the European market remains marginal. Secondly, the studies do not confirm any clear relation between the size of Chinese investment and the approach of a given country to such issues as the situation in Tibet or embargoes on armament sales. From the behaviour analysis of Chinese firms, their decisions to enter the European market have appeared to be premised on business merits rather than political predispositions. A lower degree of politicisation of Chinese investment in Europe is caused by the fact that as many as 2/3 of Chinese investors are private companies (Hanemann, Rosen 2012). Thus, the typical profile of a Chinese investor in the EU is completely different from that in Africa where the dominant role is played by state-owned enterprises pursuing the political goals of their respective masters (Amighini, Rabellotti, Sanfilippo 2012).

As far as SWF investments in the EU are concerned, it is noticeable that their value has remained rather subdued. After a buying spree in 2008 when China snapped up US$ 8.4 billion worth of European "troubled assets", annual exposure in the subsequent years has hovered below US$ 5.0 billion (Figure 1).

The value seems particularly unassuming relative to the size of all SWFs investments allocated to Europe. From 2007 to August 2014, they have totalled about US$ 248 billion. This is significant if compared to other alternative investors (e.g. private equity funds whose routine investment strategy also involves acquisitions of shares or stakes in companies). Private equity vehicles allocated about US$401 billion in 2007-2013 (EVCA Yearbook 2013). Chinese funds, with slightly more than US$ 29 billion, are responsible for less than 12% of the value of SWF's investments, on a par with Singapore (about US$33 billion) and the United Arab Emirates, UAE (about US$29 billion).

Figure 1. The value of Chinese SWF investments in the EU in 2007-2013 (in US$ million)



Source: Own calculations based on SWF Institute Transaction Database and SWF Center Transaction Database (accessed on 20 August 2014)

As shown in Table 1, the United Kingdom (UK) attracted more than 60% of Chinese SWF investments. When combined with France, we see the vast majority (more than 90%) of SWF activity revolve around those two economies. It should not be particularly surprising given the fact that the British economy is perceived by Chinese as "one of the most open in the world", as per **Lou Jiwei**, the CIC CEO. Beijing also regards the UK as a "showcase" for sceptics in the US proving that mainland China can be a reliable and valuable source of bona fide foreign investment without a claim on national security (Parker at al. 2012). Another compelling factor is the breadth (diversity, complexity) and depth (specialisation, liquidity) of the City (the British financial services industry) – unparalleled in Europe and enabling convenient access to a variety asset classes and investible instruments tradable in London, as per the Global Financial Centres Index (GFCI 2014).

Interestingly, Germany has managed to lure a relatively puny proportion of Chinese SWF commitments, given its undisputable status as the most powerful economy in Europe. Perhaps it is due to relatively lukewarm approach to SWFs adopted so far by Chancellor **Angela Merkel's** cabinet. In 2009, Germany passed a law authorising the government to bar non-EU investments in German companies greater than 25% if deemed a "public order and security" risk (Chaisse 2012). Although this regulation is broadly in line with similar rules already in force in the UK and France – Germany enacted it in knee-jerk reaction to the rapid proliferation of SWFs.

Table 1. Chinese SWFs' investments in the EU member states (2007- Aug 2014) US$ million

Country	Value	Share in total
UK	18905.08	64,00%
Netherlands	1517.88	5,14%
Germany	484.97	1,64%
France	8391.75	28,41%
Other states	241.15	0.82%
Total	29540.83	100.00%

Source: Own calculations based on SWF Institute Transaction Database and SWF Center Transaction Database (accessed on 20 August 2014)

Due to the limited magnitude of Chinese SWF investments in comparison with all SWFs acquisitions undertaken so far in the EU, the resultant share in the overall SWF portfolio allocated to Europe has remained low. In none of the member states, except France, China has ranked as a major SWF investor (Table 2).

Table 2. Chinese SWFs' investments in the EU member states in comparison with all SWFs' investments (2007- Aug 2014) in US$ million

Country	All SWFs	China	Chinese share
UK	119202.5	18905.08	15.86%
Spain	16416.48	0.00	0.00%
Netherlands	9489.79	1517.88	15.99%
Italy	10232.17	0.00	0.00%
Germany	50661.46	484.97	0.96%
France	28142.72	8391.75	29.82%
Others	14047.96	241.15	1.72%
Total	248193.08	29540.83	11.90%

Source: Own calculations based on SWF Institute Transaction Database and SWF Center Transaction Database (accessed on 20 August 2014)

The sectoral breakdown of SWFs investments across the EU (contained in Table 3) demonstrates that securing access to natural resources is among China's top foreign policy goals. Keeping an iron grip on energy and raw materials is a sine qua non for continued economic growth, which is the cornerstone of China's social stability and survival of the Chinese Communist Party (Zweig, Jianhai 2005). Especially SIC is actively pursuing stakes in leading European resource companies, such as BP, Royal Dutch or Total. Between 2007 and 2014, SIC was involved in 25 out of the 28 transactions recorded in the energy and materials sector. During this period, CIC completed only one sizable transaction in the energy sector – in 2011 it acquired a 30% equity stake in the exploration and production division of GDF SUEZ.

A large proportion of Chinese SWF investment has come into real estate (mainly in the UK) and into the financial services sector. Together they account for one third of all Chinese SWF investments in Europe - in line with general historical trends in SWF activity. These sectors have tended to dominate the portfolio allocation of SWFs (Castelli, Scacciavillani 2012).

Table 3. Sectorial distribution of Chinese SWFs' investments in the EU (2007- Aug 14)

Sector	Value (US$m)	Share
Industry and pharmaceuticals	1692.88	5.73%
Energy and Materials	12185.5	41.25%
Financials	4538.57	15.36%
Infrastructure and utilities	2604.68	8.82%
Real estate	5368.9	18.17%
Telecommunications and information technologies	1960.11	6.64%
Other sectors	1190.19	4.03%
Total	29540.83	100.00%

Source: Own calculations based on SWF Institute Transaction Database and SWF Center Transaction Database (accessed on 20 August 2014)

Chinese SWFs invest in Europe directly or through subsidiaries (sometimes in the form of SPVs). For example, Gingko Tree Investment Ltd. is a SAFE subsidiary specialised in real estate acquisitions and registered in London. Gingko is owned by a Singapore-registered company called the Investment Company of the People's Republic of China (Singapore), which in turn is wholly owned by SAFE. Interestingly, Gingko was registered in late 2009 under the name Crius Investment Ltd., but it had not been until 2012 that it began to make investments. One of the company's directors is **Yin Yong**, the director general of SAFE's department of reserve management, which additionally helps strengthen the bond between Gingko and SAFE. Almost all SAFE transactions in British real estate are conducted through this particular company. However, Gingko does not always invest directly but it also moves to set up its own subsidiaries. For instance Beryl Datura Investment Limited, fully owned by Gingko, holds a 10% equity stake in a consortium that paid GBP 1.236 billion to take over Veolia Water Central Ltd. (the largest water-only supplier in the UK) subsequently renamed to Affinity Water Ltd. (MacMahon, Wei 2013)

CIC has also set up subsidiaries such as Best Investment Corporation or Stable Investment Corporation that stand behind some of its investments in Europe. Such a practice makes monitoring Chinese investments a highly complex effort that must back up publicly disclosed information with independent scrutiny.

4 Market players or politically biased investors?

Having conceptualised SWFs as political instruments wielded by states, we concede that they might invest in the political interest of their owners. Consequently, the question arises how accommodating are their sponsoring governments to European economic and political interests? The more strategic rivalry of a particular state with Europe, the bigger the threat of possibly hostile activities of its SWFs.

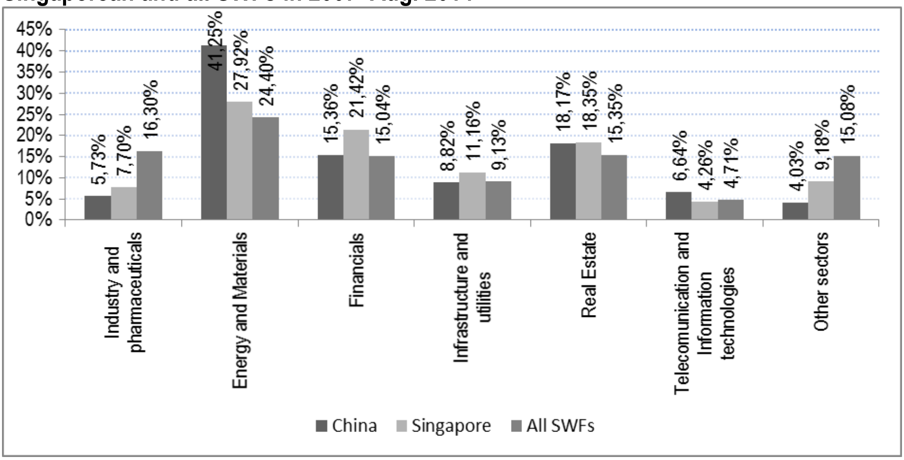
In analysing major SWF owners (Norway, the UAE, Saudi Arabia, China, Kuwait, Singapore and Qatar) we could split them into three major groups with regard to their political relations with the EU. Norway is in the first group as a close European ally: a potential member of the EU, closely linked through the European Economic Area, a helpful partner on the international stage with numerous policy priorities shared with the EU.

The second group consist of the Gulf states and Singapore – significant trade partners for the EU, yet too small and too far flung to capture a great deal of political attention in European capitals. They all have limited political ambitions, visibility and interests in Europe. According to **Curzio** and **Micelli** (2010), who aptly characterised these funds, their objectives are to ensure long-term returns rather than to impose strategic interests of their owners. Therefore, we could assume that their acquisitions in Europe tend to be market and not politically driven.

China, the lone member of the third group, acts as a strategic partner and a rival to the EU with massive economic and political interests in Europe (cf. Vogt 2012; Vangeli 2013). Such a political presence leads us to view Chinese SWFs in a slightly different way. Beijing's diplomacy towards the EU involves a complexity of instruments and a variety of economic impacts (Fox, Godemont 2009). Long-term goals (such as the promotion of Chinese culture) are accompanied by ad hoc, opportunistic measures, such as intervening in the euro-zone crisis. SWF investments should obviously be seen as another "tool in the toolbox" of Chinese policymaking.

In spite of rational concerns voiced above, the empirical evidence of political impact associated with Chinese SWF activity in Europe appears to be rather scant. Firstly, to date, they have never been caught red-handed acting solely out of political motifs in any of the EU member states. Secondly, as already stated, Chinese investments in Europe remain rather modest in value. If China were to use them aggressively in Europe, their magnitude would have to rise commensurately. Thirdly, Chinese SWFs tend to behave similarly, in terms of sectoral as well as geographical distribution of investments, to other SWFs seeking financial rather than political gains on the European market.

Figure 2. The sectoral distribution of Chinese SWF investments in the EU against Singaporean and all SWFs in 2007- Aug. 2014



Source: Own calculations based on SWF Institute Transaction Database and SWF Center Transaction Database (accessed on 20 August 2014)

It is even more evident when comparing Chinese investments to those of Singapore or the UAE (Table 4), which are the biggest Asian SWF owners. The standard deviation of Chinese SWF investments from the two benchmarks is surprisingly low. The visibly higher Chinese investment exposure to energy and materials is, as previously mentioned, a hallmark of the Chinese economy and its structural dependence on commodity importation – a vital lifeline for an emerging superpower whose growth has increasingly been fuelled by globalisation.

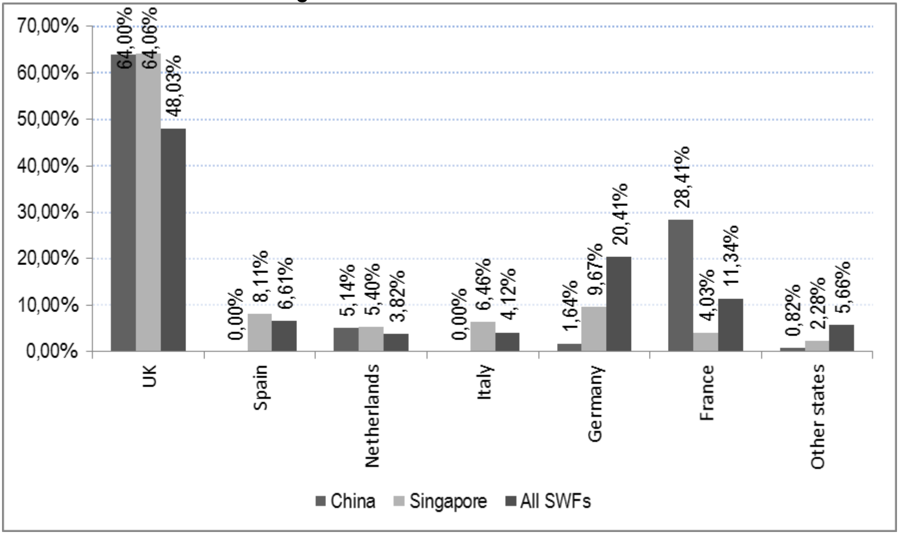
Table 4. Industry specific standard deviation of Chinese SWF investments from investments of other SWFs in 2007- Aug. 2014

Sector	Singapore	UAE	All SWFs
Industry and pharmaceuticals	0.57%	3.61%	6.65%
Energy and Materials	7.29%	0.41%	9.78%
Financials	3.70%	3.94%	0.81%
Infrastructure and utilities	0.39%	0.15%	1.04%
Real Estate	2.22%	0.52%	0.10%
Telecommunication and information technologies	2.63%	4.82%	2.32%
Others	3.04%	4.36%	7.21%

Source: Own calculations based on SWF Institute Transaction Database and SWF Center Transaction Database (accessed on 20 August 2014)

Similarities also come to the fore when comparing the geographical distribution of Chinese SWF investments in the EU to other SWFs (Figure 3). All SWFs tend to concentrate their acquisitions on the UK, almost completely ignoring smaller and Central and Eastern European economies. The only small European state which has managed to attract a visible number of SWF investments is the Netherlands (a relatively open and well developed capital market benefiting from substantial regulatory and tax advantages).

Figure 3. Geographical distribution of Chinese SWF investments in the EU compared with other SWFs in 2007- August 2014

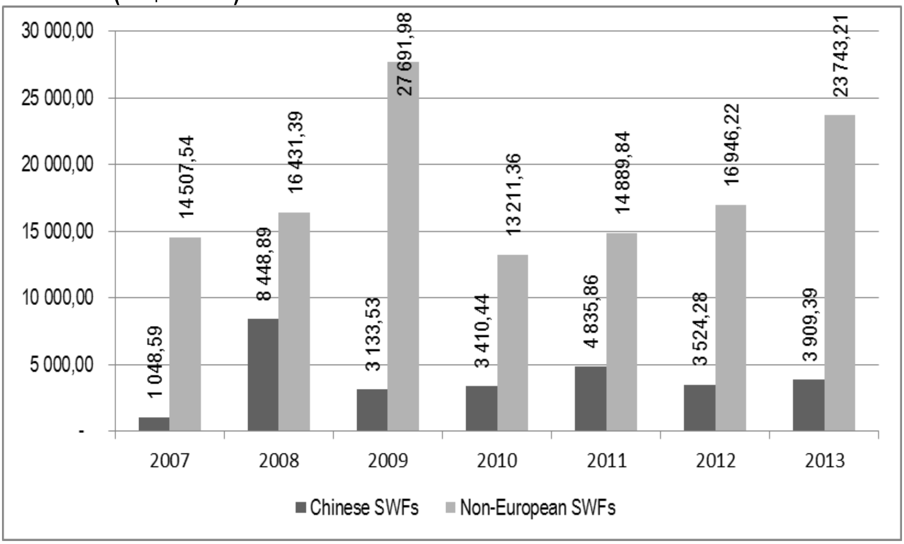


Source: Own calculation based on SWF Institute Transaction Database and SWF Center Transaction Database (accessed on 20 August 2014)

Despite the long-termism of their investment goals, the global financial crisis of 2007-2008 did not spare the SWF community. Just like many other institutional and private investors, they incurred significant financial losses – sparking domestic debates on investment strategies and prompting them to refocus on domestic markets, where they were able to provide the much-needed liquidity and financial support for undercapitalised banks and other distressed companies (Kunzel et al. 2010). This does not mean, however, that they turned their backs on Europe. In analysing the behaviour of non-European SWFs during the crisis in Europe (Figure 4), we note that the relative asset undervaluation at that time lured certain SWFs into overweighting their exposure to rather than abandoning the European market. **Castelli** and **Scacciavillani** (2012) emphasise that the sub-prime crisis in 2007-2009 equipped SWFs with a unique opportunity for under-priced bargains. In the last quarter of 2008, following the default of Lehman Brothers, the SWFs' flirt with the Western financial sector ground to a halt but numerous historic under-valuations in other sectors (such as manufacturing, natural resources or technology) encouraged them to keep investing in Europe. Nonetheless, a sharp drop of the value of investments occurred in 2010, when non-European SWF investments shrunk to a meagre US$ 13 billion (i.e. roughly by half in year-on-year terms).

Interestingly, Chinese SWFs moved to downsize their investments in Europe as early as 2009, perhaps due to greater domestic engagement. At that time, CIC invested in three banks – Industrial and Commercial Bank of China, China Construction Bank and Bank of China (affected by the crisis) and in divestments by foreign strategic investors (Subbacchi 2012). Since then, Chinese funds have begun to weight even less in comparison with other non-European SWFs, which soon gradually commenced to increase their acquisitions in the EU. In 2013, the Chinese share of all non-European SWFs investments in the EU dropped to 14% (from as high as 34% in the crisis year of 2008).

Figure 4. Value of Chinese and other non-European SWF* investments in the EU in 2007-2013 (US$ billion)



* without Norwegian, EU member states and Chinese SWFs
Source: Own calculations based on SWF Institute Transaction Database and SWF Center Transaction Database (accessed on 20 August 2014)

Does the comparison of Chinese SWFs with the behaviour of other SWFs betray clear non-commercial motifs on the part of their sponsoring governments? What has emerged from our analysis is that China's activity is broadly in line with the moves of other investors, which confirms the proposition that the key motivation behind their investments has been investment performance (geared to macro- and microeconomic efficiencies).

"Strategic benefits" seems to play a less prominent role, although obviously the Chinese preoccupation with energy and materials closely reflects this country's economic priorities, as posited by **Miao** and **Liyan** (2011).

However, if we use the above-mentioned **Grosse** and **Stack** (1982) framework for non-economic risk evaluation, we can conclude that the Chinese investments are politically risky, at least to some extent.

First, China invests a lot in sensitive industries, such as critical infrastructure management or energy. Those investments can be potentially hazardous because of their relevance to national security. Secondly, although Chinese SWFs usually acquire minority stakes and act as a passive shareholder without active control over the companies, there are examples of active investing. The most prominent one is already mentioned acquisition of exploration and production division of GDF SUEZ. CIC has a right to nominate two out of seven members of International's Board of Directors and access to all sensitive information and direct influence on the management. Thirdly, despite the positive track record in Europe (there were no direct politically harmful behaviour by Chinese SWFs revealed), one should remember about the SAFE's behaviour in Costa Rica and general rule that "every country has been using its domestic resources, including foreign exchange reserve, to maximize its national interest" (Ming 2008). Therefore, it is rational to assume that there is a political risk associated with Chinese investments.

5 How should Europe react on Chinese SWF?

The aforementioned empirical evidence supports earlier claims that there is no solid proof of Chinese SWFs' using their ownership stakes in a way that would threaten host countries' national security (Bu 2010). However hypothetical such concerns, the arrival and presence of SWFs does mandate a by far more meticulous insight and scrutiny than the activity of private investors. The following five reasons explicitly enumerated by **Chaisse** (2012) seem relevant in the Chinese SWF context:

Firstly, China is keenly interested in acquiring the know-how of European companies in such advanced areas as innovative technologies (also for military or dual use), weapons or state-of-the-art research and development. Being a shareholder in a company considerably facilitates privileged access to intellectual property and other business secrets. State-owned entities, such as SWFs, can potentially hamper a European company in favour of its Chinese competitor. Any resultant losses of the SWF would (in such a case) be offset by gains of another state-owned entity – which might represent a rational choice for the Chinese government.

Secondly, China has already invested in companies directly or indirectly involved in areas relevant to national security. For instance, in 2009, SIC purchased US$3.42 million worth of BAE Systems stock, a British multinational defence, security and aerospace company headquartered in London. Although this particular open-market transaction (in which SIC acquired a paltry 0.02% stake) does not appear to be particularly menacing, one could easily imagine acquisitions of lower-profile companies holding significant national defence secrets. Such deals may be much harder to track and control.

Thirdly, investments in sensitive sectors such as energy or public utilities (e.g. water supply) may provoke unwelcome dependencies. Critical infrastructure in the hands of a foreign country is per se a weakness of public security (especially in times of potential crises). Chinese investors have already bought minority stakes of British water suppliers, an intriguing epitome of foreign renationalisation of previously privatised companies.

Fourthly, as we have already observed, Chinese SWFs keep a low profile and are not forthcoming with adequate information disclosure on their activity. They operate in the shadows, which obviously raises legitimate questions about their genuine rationale. Murky intentions come as an evident answer.

Finally, the European Commission as well as various international chambers of commerce and trade have been alarming for years that China erected numerous barriers to European investors, aiming at protecting its own economic interests (European Commission 2006). Chinese investments in European companies via SWFs give vent to voices demanding greater openness from China in order to achieve rudimentary reciprocity.

In a special communication focused on SWFs, the European Commission (2008) decided to avoid bringing legislative action at the EU level. Soft measures, such as non-binding guidelines, were put forth as a more appropriate response to the rising SWF activity in Europe. However, it is evident that maintaining 28 national monitoring systems and separate regulatory regimes is likely to lead to ineffective protection of European interests as well as will send the wrong message to SWFs. Following a few informal talks with officials of the

Polish Ministry of Foreign Affairs and the Polish Information and Foreign Investment Agency (2014), we are not convinced that there is a well-established system of foreign investment monitoring in the EU's sixth largest economy. That brings us to the question whether all of the small EU members are truly capable of adequately monitoring SWF activities and if individual EU members should be left to their own devices on this issue. In reviewing the dilemma, we share **Chaisse's** (2012) view that there is a clear need to clarify at the EU level which sectors should be protected from foreign takeover attempts (going beyond the vague criteria of protecting public security and public order). This move would establish clear rules for such entities as Chinese SWFs and would mitigate the risk of heavy-handed protectionism based on public mistrust of China among certain EU members. We argue that although precautions regarding the opaque Chinese SWFs are necessary, the EU should remain as open as possible to attract their investments into the Common Market. Hitherto, Chinese funds have invested too little in Europe and not too much.

More coherence on SWF policy and more scrutiny of cross-country investment by SWFs (including Chinese funds) are mandatory to ensure a high quality and high security of SWF capital involvement in Europe. Despite the obvious need to enhance SWF transparency, a light regulatory touch and a great deal of investor openness are necessary to keep the EU within the orbit of SWF activity and help benefit the diverse recipients of SWF capital. Further to these observations, the following steps towards SWFs might be contemplated by the EU (as a pragmatic compromise between blissful oblivion and excessive micromanagement):

- *SWF central repository and common "passporting"*: the EU should set up a central repository of pending SWF transactions in its member countries and work out a common policy on SWF "passporting" (whereby a uniform set of rules would apply to an SWF seeking entry into the European common market) – this practise would prevent SWFs from exploiting regulatory arbitrage (i.e. by following the path of least regulatory resistance) and would ensure a coherent approach to cross-border transactions whose beneficial ownership is oftentimes impenetrable to a single EU member state – the passporting process would require a EU-wide directive and would be modelled on the concept of passporting the so-called undertakings for collective investment in transferable securities (UCITS), effectively open-ended mutual funds (UCITS Directive 2014),

- *catalogue of sensitive sectors and companies*: cognisant of limitations related to industry nomenclature, the EU should compile a catalogue of sectors considered sensitive from the perspective of national or pan-EU interests (the entry of a new SWF into such sectors would automatically trigger a due diligence process by national regulators (coordinated by the European System of Financial Supervisors); in the light of the rising complexity of economic activities (e.g. multi-activity conglomerates whose core business is enigmatic) a separate catalogue should comprise individual enterprises deemed vulnerable socioeconomically or politically,
- *list of harmful SWFs*: any demonstrable and uncontroversial evidence of SWFs' having in the past worked to the detriment of host economies (anywhere in the world) should lead the EU to believe that their propensity to relapse into hostile behaviour is greater than average and mandates heightened assurances (contractually) and enhanced transparency measured through the Linaburg-Maduell index and conformant with the Santiago Principles (Santiago Principles 2008),
- *merger & acquisition (M&A) controls*: another line of defence from potentially abusive practises by the SWFs would relate to business combinations implicating alternations to active corporate control and would supplement the existing EU merger regulations (European Commission 2004) governing business concentration issues arising from M&A activity in the EU – in practise, the EU would be equipped with yet another factor (SWF involvement) in the decision-making process on cross-border M&A.

The aforementioned measures would insulate the EU from SWF practises deemed socioeconomically or politically onerous and would still preserve enough investor friendliness to attract further SWF capital.

Conclusions

Global sovereign wealth funds (SWFs) have been widely associated with strategies combining dual objectives: risk-adjusted investment efficiencies and attainment of selective, predefined political goals. Evidence supporting the pre-eminence of political goals among Chinese SWFs' strategies is scant; however, several high-profile examples can be brought forward to justify deliberate political impact by these entities. Nonetheless, no persuasive clues of Chinese

SWFs' hostile activity in portfolio companies located in Europe have been detected. Nor have we observed discernible threats to the national security of EU member countries or the EU as a whole that would originate from SWF activity.

Chinese SWFs (whose investment patterns remain broadly in line with global SWF averages) have not demonstrated characteristics mandating the erection of special barriers. Nevertheless, such an observation comes with a few important caveats. Firstly, even among global SWFs (whose average transparency leaves plenty to be desired) Chinese SWFs stand out as particularly murky, this factor is a major hazard per se, as it is difficult to pass judgment on the underlying motifs of SWF investments (if their information disclosure remains deficient or non-existent). Secondly, despite their lack of clear over-exposure to particular European industries (with the exception of energy and commodities), Chinese SWFs have established a discernible presence in sectors and companies deemed vulnerable in the socioeconomic or political context (e.g. defence, security, public utilities, infrastructure and intellectual property). Thirdly, given the transient character of SWF investments in Europe (many of them are made through third parties: special purpose vehicles or holding structures) and growing sophistication of capital markets (including complex financial intermediation and hybrid instruments), it is hard to ascribe the investments to particular SWFs, which further complicates the advocacy of any snap response mechanisms.

Despite its magnitude (the European common market still represents the largest reasonably uniform economic area globally) and relative attractiveness (e.g. several recognisable and globally competitive capital centres), the EU has managed to woo only a fraction of the US$1.2 trillion commanded by the two leading Chinese SWFs. Hence, the overriding priority of European policymaking should be investor friendliness to SWFs at large, as the leading source of alternative institutional management worldwide.

More coherence on SWF policy and more scrutiny of inward investment by SWFs (including Chinese funds) are mandatory to ensure a high quality and security of SWF capital involvement in Europe. Despite the obvious need to enhance SWF transparency, a light regulatory touch and a great deal of investor openness are necessary to keep the EU within the orbit of SWF activity and help benefit diverse recipients of SWF capital. As a golden mean between laissez-faireism and over-protectionism towards SWFs investing in Europe, a combination of the following SWF monitoring measures appears to be advisable:

- *SWF central repository and common passporting*,
- *catalogue of sensitive sectors and companies*,
- *list of harmful SWFs*,
- *merger & acquisition (M&A) controls.*

As previously mentioned, the EU policy on Chinese SWFs needs to take on board the benefit of attracting and diversifying capital inflows with legitimate concerns on potentially disruptive practises followed by individual SWFs. The thrust of the proposed measures would be on SWF transparency (as a prerequisite for informed decision making by EU members). Failure to satisfy this objective ought to induce the EU to implement selective repellent measures (whose ultimate goal would be again to improve SWF transparency in the long term).

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