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ESADEgeo-CENTER
FOR GLOBAL ECONOMY
AND GEOPOLITICS

The Global Context:
How Politics, Investment, and Institutions Impact European Businesses

Javier Solana & Angel Saz-Carranza

Editors

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Table of **Contents**

The Global Context:
How Politics, Investment, and Institutions Impact European Businesses

Introduction I - XII
Angel Saz-Carranza & Marie Vandendriessche

01 | **Europe's Imperative** 01 - 08
Javier Solana

Part 1
The Impact of Institutional and Political Contexts on Businesses

02 | **Global Risks and EU Businesses** 10 - 37
Ángel Pascual-Ramsay

03 | **The Importance of Political Risk for European Business** 38 - 64
Antonio Roldan & Mujtaba Rahman

Part 2
Today's Trends in Investment and EU Businesses

04 | **Sovereign Wealth Funds: A Growing Financial Firepower** 66 - 85
Javier Santiso, Javier Capapé & Tomás Guerrero

05 | **The Major Role of Sovereign Investors in the Global Economy: A European Perspective** 86 - 109
Diego López

06 | **The Internationalization of Chinese Companies and Their Presence in Europe** 110 - 127
Ivana Casaburi & Carles Brasó Broggi

07 | **China's Renewed Attractiveness for European Firms** 128 - 146
Adrián Blanco Estévez

Part 3
A Deeper Look at the Institutional Environment for EU Businesses

08 | **What is the International Rule of Law?** 148 - 157
Ian Hurd

09 | **Can Global Governance Help Us Navigate the 21st Century?** 158 - 177
Bruce Jones & Katherine Elgin

10 | **Regulatory Agencies and Regulatory Networks in the European Union** 178 - 193
Susanna Salvador, Adrià Albareda & Angel Saz-Carranza

11 | **A Research Approach to International Governmental Organizations: Examining Executive Boards and Strategy** 194 - 211
Ryan Federo & Angel Saz-Carranza

Part 4
The Future of EU Integration

12 | **A Tale of Two Cities: Ideas and Narratives to Relaunch Integration** 214 - 235
José M. de Areilza

Introduction

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There is no such thing as isolation, or insulation, in today's world. The forces of globalization have woven all players – be they states, citizens, businesses, international organizations, or others – into a superconductive network. We have all become global citizens, and global businesses. Given this outlook, our horizons must necessarily be global.

This is especially true for Europe's firms. The objective of this edited volume is therefore to define the global context within which European businesses operate, by examining in depth how global and European politics, investment flows, and institutions affect these firms, and offering strategies adapted to these circumstances. In their chapters, the authors answer questions such as: *How do current political and institutional developments in Europe affect businesses there? How do global trends impact these firms, and is being part of the European Union a mitigating factor? How do investments flow across the globe, and where and how do they arrive and leave Europe?*

This twelve-chapter book is built up of original and applied research on these issues, which was developed with the support of the European Commission, in the Jean Monnet project *Mainstreaming EU Knowledge in Business Studies and Strategy* (MEKBiz), hosted by ESADE Business School. MEKBiz is a multi-dimensional project which aims to promote discussion, research, and teaching on global and European issues. The book's content is aligned with the four specializations of ESADEgeo, ESADE Business and Law School's Center on Global Economy and Geopolitics.

The Study of Globalization and Geopolitics at ESADE

In early 2010, Javier Solana joined ESADE Business and Law School as a professor. He had just left the post he had held for a decade, as High Representative for the European Union's Common Foreign and Security Policy. Professor Solana's contribution to the research and teaching of leadership at large was self-evident; however he added further value by significantly extending and strengthening ESADE's traditional emphasis on the nonmarket environment – this time, with a global perspective.

A few months later, ESADE's Center for Global Economy and Geopolitics, ESADEgeo, was founded, joining ESADE's two other emblematic nonmarket institutes: the Institute for Governance and Public Management and the Institute for Social Innovation. ESADEgeo's mission was set to "provide individuals and organizations with the necessary knowledge to organize and strategize in a global world." Chaired by Professor Solana, it brought together faculty and researchers dedicated to understanding business and its global interaction with politics.

Today, the center includes and draws on political economists such as Javier Santiso and Ángel Pascual-Ramsay; economists such as David Vegara, Xavier Mena, and Fernando Ballabriga; management scholars Francisco Longo, Ivana Casaburi, Carlos Losada, and Koldo Echebarría; political scientist Xavier Fernandez i Marin; humanities scholars such as Kyriaki Papageorgiou and David Murillo; and lawyers such as Patricia Saiz and Jaume Giné.

ESADEgeo currently focuses on four main areas: Global Economy, Global Governance, Global Risks, and Europe-China business relations. The contents of this publication cover these areas and are written by ESADEgeo researchers and scholars, as well as eminent scholars, think tank members, and consultancy experts we have invited to work with us and with whom we will continue to work and research in the future. The chapters vary in their styles and perspectives, thereby reflecting, in a way, the nature of ESADEgeo's diverse and multidisciplinary work. More importantly, they all target European businesses among their main audience. These firms, which already operate globally, will increasingly do so in the near future – it is their imperative.

Key Issues in the Study of Global Politics and Business

Given the web of globalization and interdependence enveloping us all, as described at the outset of this introduction, it is vital for all businesses to use a global lens. When

writing from London, Brussels, or Madrid however, there is another level to include in the analysis: Europe.

Europe, a microcosm of cooperation with its unique borderless trade and complex internal dynamics, provides an idiosyncratic platform from which to regard the global level. It is a distinctive and ever-shifting construction, built from the ground up after national rivalries ravaged the continent. The project has now attained its initial goal of ensuring peace between its members, and on its path, has sown the seeds of the cooperation that has led to borderless trade, a monetary union, and many other incipient unions.

In these pages, we offer a range of insights on the links between the European level of integration and the global context. This book proceeds as follows: the chapters reflect four key issues or areas of prime interest. Firstly, it both starts and closes with visions and reflections on Europe, present and future. The idea of Europe makes sense socially and economically. From a business perspective, captured national markets may temporarily be of interest to a few champions; but in the long term, a unified "flat" market across Europe is beneficial to business at large. Thus, the first and last chapters explore pivotal future dimensions for Europe, and viable routes for the EU's further development.

A second issue covered in this book links politics, geopolitics, and business in the clearest possible way: framing concrete political and geopolitical risks for businesses. Only a few decades old, this field has created a booming consulting industry that monitors, analyzes, and manages risks associated with sociopolitical developments, both national and international. A critical question, partially answered by this work, is *how do global and European politics affect businesses?* ESADEgeo and its partners have been working to quantify and translate the language of politics and geopolitics into business risks.

How do European businesses benefit from investing abroad or from investment inflows from abroad? is the next question studied in this book. Cross-border investments have blossomed in recent decades, and have proven to be a quintessential component of globalization. The world may never have seen such intense, fluctuating levels of cross-border financial flows as those of the past two decades. At ESADEgeo, we focus our work on investment trends related to the relatively new but increasingly important sovereign wealth funds, as well as to the world's largest rising economy, China.

The fourth, and final, issue we zoom in on is supranational governance. As the world continues globalizing, governance structures are created to coordinate or regulate transnational activity. While the debate about the state of global governance rages on,

the number of bilateral, plurilateral, and multilateral governance structures continues to multiply. It would be naive to think that the world is moving towards a perfect global governance system; nevertheless, many of these supranational institutions do have a say in the workings of almost any business sector and industry today. To discuss this issue, we invited two external, renowned scholars to write on global governance. We complement their studies by providing a brief overview of ESADEgeo's ongoing academic research on international governmental organizations and on European regulatory agencies and networks.

In This Volume

This volume commences with a **chapter by Javier Solana,** who, from his extensive experience in high-level policy-making in the European Union, describes Europe's imperative – past and present. He hereby places this book into its European context, while simultaneously looking outward, sketching Europe's place in the world.

The EU is described as a microcosm of continental peace, which marched ahead of the current global trend of intense interdependence. From its original goal of creating peace in a war-torn continent, a process of continuous construction among its member states has led to a set of interlocking unions: economic, monetary, banking, digital, and energy. The European project, however, recently reached a turning point, in the form of a blistering economic crisis which has left deep scars. Dr. Solana describes the main tasks ahead, including regaining the support of the Union's citizens and changing the post-crisis narrative.

In addition, Dr. Solana looks beyond Europe itself, to the disarray on its borders on the one hand (for which he suggests advances in both EU foreign policy, neighborhood policy, and common security and defense policy) and to the changing economic landscape around it. With the economic weight of the world shifting steadily eastward, Dr. Solana remarks that the European Union becomes ever more imperative. The EU's member states will be doomed to insignificance if they operate alone – but together, and drawing on their collective strengths and values, they will retain an important role in today's world.

The book is subsequently divided into four parts. In **part one,** we look at **the impact of institutional and political contexts on businesses.** *What institutional and political trends, both at the global and the European levels, stand to impact businesses – and how?* Moreover and more importantly, *what can businesses do to analyze these trends, adapt to them, and seek the opportunities they bring?*

This section commences with a chapter **by Ángel Pascual-Ramsay,** Director of Global Risks at ESADEgeo, who asserts that global risks do not respect national borders, and therefore, it is key that businesses understand the geopolitical landscape in which these phenomena occur. Pascual-Ramsay goes on to describe today's key global trends, pausing to detail their consequences for businesses.

The first set of risks is geo-economic: the balance in the global economy is shifting, but a new equilibrium has not yet been reached. This generates uncertainty, driven by a loss of trust in progress, slowing economic growth in some of the emerging countries, and a lack of global financial governance. Geopolitical risks form the second set: the new non-polar state of the world has left global affairs without a referee, and this while the risk of conflict has increased, especially in regions such as the Middle East and North Africa. Technological risks, meanwhile, are gaining prominence, as technological advances and the growing importance of non-state actors offer many benefits as well as dangers – such as jobless and non-inclusive growth, cyber-attacks, massive technological failures, and a balkanization of the Internet.

The fourth series of risks is societal, deriving from phenomena such as ageing societies all over the globe, the growth of a new middle class, changing demand patterns, and the rise of inequality. A fifth, critical set of risks is environmental: the world's natural resources are being overexploited and competition is increasing in their extraction and use. Meanwhile, urbanization poses new opportunities as well as challenges, and global warming has the potential to affect economic growth – especially in developing countries. Energy prices, in addition, continue on their track of volatility, complicating business operations.

In this context, Pascual-Ramsay urges EU businesses to adapt to the new trends, offering a range of recommendations including promoting internationalization and multi-localization, recruiting flexible and multicultural human capital, and adapting business strategies to the opportunities described above - which are often the flip sides of risk.

The second chapter in this section is written by **Antonio Roldan and Mujtaba Rahman** of the political risk consultancy Eurasia Group. In their chapter, they argue that companies must look beyond economic data, to political risk, in order to make sound investment decisions and weigh risks. The analysis they present focuses primarily on the uncertainties companies face when operating in Europe, including a Greek exit from the Eurozone, or the rise of new political elites in Southern Europe, among others.

In their depiction of the overarching context, Roldan and Rahman expect German influence in Europe to continue to grow over the next couple of years, leading to an unbalanced union. Keeping this central trend in mind, they go on to discuss four key challenges facing European politicians, policymakers, and businesses alike with respect to the end of the era of reforms in Europe's southern periphery. These include the variation in adjustment paths among the countries in the Eurozone periphery, and the fragmentation, populism, Euroskepticism, and nationalism that have boomed after the crisis. Secessionist movements such as the Catalan one are analyzed in detail.

Growing Euroskepticism also poses a risk in its possible effects on continued European integration. Meanwhile, citizens in Southern Europe are clamouring for more transparency and less corruption in their domestic contexts. This may engender the rise of new political elites – each with their own possible effects on business. Roldan and Rahman, however, do not foresee more populist parties (beyond those in Greece) entering government in the near future. They analyze in detail the case of the Podemos, asking whether this new party will become Syriza's Spanish cousin. The two authors end their chapter by delving into two political risks in detail: the chances of Greece's exit from the euro and the risk of the UK's exit from the EU.

Part two of this book examines **today's trends in investment and EU businesses,** focusing specifically on two of the main and most fascinating players: the massive sovereign wealth funds, and China, with its colossal economic might.

In their chapter, **Javier Santiso,** Vice President of ESADEgeo, and **Javier Capapé** and **Tomás Guerrero** of ESADEgeo's Global Economy program take a deep look at the 84 recognized **sovereign wealth funds** across the globe, which hold a total value of $5.9 trillion, more than twice the size of all assets managed under hedge funds. These government-owned investment funds are typically financed by current account surpluses or commodity revenues, yet they are internationally oriented in their investment scope, where they seek adjusted returns above the risk-free asset and lack explicit pension liabilities.

Santiso, Capapé, and Guerrero place these funds in the contemporary context, discussing their role in the Great Recession – when they took to the global stage with their contributions to bailout funds, and recent developments in their transparency. In 2008, 55 SWFs adopted the Generally Accepted Principles and Practices for Sovereign Wealth Funds, also known as the Santiago Principles.

The authors then focus on Europe, mapping both the continent's own SWFs and the investments made by extra-continental SWFs in Europe. In 2011, Europe was in fact the main recipient of investment, and Spain and its companies were the main destinations for sovereign wealth funds – receiving $8.34 billion of investment, ahead of France, the UK, and Germany. The asset classes that SWFs invest in reflect their risk inclination, and include infrastructure, energy, financial services, and real estate.

Diego López, Global Sovereign Wealth Funds Director at PricewaterhouseCoopers, delves into the major role these sovereign investors are playing in the global economy, taking a European perspective in his chapter. These highly heterogeneous funds, which hail from different backgrounds and vary in their structures and missions, ultimately have one common goal: to preserve capital and maximize the return on investment.

Given today's economic environment, marked by low interest rates across the Eurozone, the United States, and Japan and frequent quantitative easing, sovereign investors (both sovereign wealth funds and pension funds) have turned to alternative asset classes – real estate, infrastructure, and private equities. López explores each shift and the investment mechanisms employed in detail, halting to explore the opportunities for Europe in each case. He adds that SWFs offer a promising avenue for Europe in terms of human capital. This is particularly true after the crisis, with the goal of reversing the brain drain caused by the economic upset in mind: sovereign investors employ around 20,000 staff in offices around the globe.

Up to now, policymakers have focused on understanding SWFs by analyzing their investment strategy and focus (where and why they are going to invest next) and scrutinizing their transparency and corporate governance. However, sovereign investors are a very heterogeneous group, and analysts should also consider their missions, visions, and values. Sovereign investors are here to stay, and, according to the author, European countries should make them feel welcome, thereby capturing the great opportunities their liquidity brings to the global economy in general, and Europe's states in particular.

This section of the book then turns to another set of investors from emerging countries, namely **China**. China's outward foreign direct investment (FDI) has skyrocketed in the last decade, causing ripples in economies of every region in the world. One of the regions where this Chinese investment boom has been felt most is the European Union: there are currently 2,000 Chinese companies established in the EU, delivering a total investment of $40 billion.

In their chapter, **Ivana Casaburi,** Associate Professor at ESADE and Director of the ESADE China Europe Club, and sinologist and economic historian **Carles Brasó Broggi** explore China's investment in Europe as the logical result of the internationalization process embraced by China's companies and these firms' transformation into global brands. Through a short historical overview of China's overseas investment, from the opening launched by Deng Xiaoping in 1979 onward, Casaburi and Brasó lead the reader to the current age, where Chinese companies are "going global." In their efforts, they are incentivized by the government, and in effect, since 2000 – when the Chinese government declared that it wanted Chinese companies to shift their outlook abroad - China's outward FDI has grown dramatically, increasing a hundredfold in just over a decade.

In their internationalization, Chinese companies seek to move beyond a domestic context marked by an appreciating yuan, falling exports, growing production costs, stagnating capital returns, and an increasingly saturated market. When investing in Europe, they seek to expand their markets, improve their position in the value-added chain of global goods production (thereby escaping the "middle income trap"), boost their know-how on the management of global companies, and vertically integrate their production processes. They also aim for a European brand, which will in turn make them more competitive in China.

During the worst years of the crisis, Chinese FDI into the EU was spectacular: an aggregate investment of $1 billion in 2007 grew to $6 billion in just five years. Notably, this investment accrued both to the countries that weathered the crisis well and those most affected by the crisis. Nevertheless, the authors identify an important obstacle to the growth of Chinese investment in Europe: continued and excessive European legal and fiscal fragmentation.

Adrián Blanco Estévez, a researcher at the ESADE China Europe Club and consultant for the Latin American Program at the Wilson Center, describes the opposite side of the coin: ever since China gradually started opening up to foreign capital at the beginning of the 80s, European companies have established bases in China to the tune of $156 billion in cumulative investment.

The circumstances that once drew European firms to the Chinese market (including the size of the market, high rates of economic growth in a politically and macro-economically stable environment, low costs and abundant supply of labor, and proximity to other Asian markets) have changed, however. While some of these advantages are still present, others have eroded. For the first time in decades, a growing number of entrepreneurs,

academics, analysts, and traders have begun to question China's attractiveness for FDI. Blanco covers the main factors leading to this loss of appeal, including the slowdown in the pace of economic growth and the related societal imbalances; the rapid growth in operating costs – particularly the upward spiral in wages; the end to the first-mover advantage gained in the 80s and 90s; and the long-standing factors of operational and regulatory difficulties.

Highlighting the fact that these factors derive from China's changing economic model, Blanco signals seven new trends that will arise from this transition, generating business and investment opportunities: intensifying private consumption driven by rising disposable incomes and Western consumption patterns; significant opportunities in the underdeveloped interior rather than the overexploited coastal cities; continued opening of new sectors of the economy to foreign capital, with pilot projects in investment liberalization; productive activities using high level research and knowledge; increased integration of the internal market and between Asia and other world regions through recent infrastructure investments; the government's fight against environmental degradation and uncontrolled urban growth, which will lead to business opportunities in the field of alternative energy and sustainability; and finally, the recent arrival of Chinese investment in Europe, facilitating the entry of European firms into China itself.

After this exploration of today's trends in investment, the book turns, in **part three,** to the **institutional environment for EU businesses,** offering an in-depth look at specific elements in this setting through the prisms of law, global governance, and academic research.

The expansion of international law and organizations is a remarkable development of world affairs in the past 60 years or so. **Ian Hurd**, Associate Professor in the Department of Political Science at Northwestern University, expands on this phenomenon, based on the observation that while it is common to refer to the international rule of law, it is less prevalent to define it or to explore what it means.

In his chapter, Hurd sets out three distinct approaches to the concept of the international rule of law, comparing them to contemporary state practice. The first is anchored on the obligation of states to comply with their international legal obligations. The second draws on an analogy between the rule of law at the national and international levels. Contrasting these initial paradigms, however, Hurd finds that a third explanation trumps the others. It begins from the observation that states invoke

international law to explain and justify their policies, and from this it expands into a model of law as integral to political legitimation.

This is an instrumental view, where law is a resource which states and others put to use in the pursuit of their goals: governments strive to make international law work for them by invoking it in defense of their policies. Rather than undermining the legal order however, Hurd sees this instrumental use as essential to the legal system, and indeed as constitutive of it. Moreover, Hurd suggests that the content of international law is changed in the process of being used to legitimate state policies: the meaning of international legal rules arises from how it is invoked in the diplomacy of states.

In its final reflections, the chapter concludes that disagreements over the interpretation of international law are inherent in the legal project itself. Ultimately, these legal products become political resources which actors use in the political struggle over the legitimation and delegitimation of their desires.

In chapter 9, **Bruce Jones,** Interim Vice President and Director of the Foreign Policy Program at the Brookings Institution and **Katherine Elgin,** Research Assistant at the Brookings Institution, ask whether global governance can help us navigate the challenges of the 21st century.

Commencing with an outline of the evolution of global governance after the Cold War, Jones and Elgin opine that it now seems likely that we will look back on the quarter century of the post-Cold War era as a halcyon period for the West, interrupted by a number of milestone events that changed the history of global governance: the attacks of 9/11, the US overthrow of Saddam Hussein in 2013, and the 2009 global financial crisis. These challenges to the international system have resulted in what the authors call "great disruptions" to the global order: the unraveling of the Middle East order; the rise of the global middle class – with their resultant claims for governance change and political expression, as well as their carbon emissions; the intensification of the geopolitical rivalry, resulting particularly (and more so than from Russia) from China's increasing assertiveness; the proliferation of nuclear weapons, including to revisionist states; and the continued challenge of weak states.

In this environment, where managing geopolitics is troublesome, transnational threats – baptized "problems without passports" by former UN Secretary General Kofi Annan – pose a different challenge. The authors argue that in order to manage such interconnected issues and threats as global climate change, biological issues (weapons and pandemics), the proliferation of nuclear and other materials of mass destruction,

water, food, transnational terrorism, transnational organized crime, piracy, and cyber issues, there is a need for new modes of hybrid governance. Jones and Elgin assert that the state remains the bedrock in terms of organizing effective responses, however that global institutions and citizen action should be included as part of the solution. According to the authors, the most effective way to deal with transnational threats is to install mechanisms that use both the centralized authorities of nation-states and the decentralized capacities of the private and civic sectors.

The final two chapters of this section take an **academic research approach** to the institutional context. In their chapter, **Adrià Albareda,** Research Associate at the Institute for Public Governance and Management at ESADE, **Susanna Salvador,** PhD Candidate in Management Sciences at ESADE, and **Angel Saz-Carranza,** Director of ESADEgeo - Center for Global Economy and Geopolitics, provide a research perspective on the European regulatory landscape, which is plagued with agencies and networks with regulatory responsibilities in a wide array of policy domains.

Almost all aspects of human social and economic activity fall under the influence and control of these regulatory devices, characterizing EU meta-governance. The researchers argue that as upwards delegation to the EU institutions continues, and social and economic activities of all kinds depend to some extent on the activities performed by regulatory agencies and networks, it is critical for private actors such as companies to enrich their knowledge not only about what is being regulated, but also about how it is done and *by whom.*

Based on an original dataset, the authors analyze 40 European regulatory agencies and networks, covering all regulatory regimes in Europe, including utilities, health, medicine, chemicals, food, aviation, fisheries, postal services, transportation, security, judicial co-operation, and environmental issues, among others. Their data-driven analysis allows them to map the tasks that regulatory agencies and networks are currently responsible for at the European level, as well as characteristics of these organizations in terms of governance structures and decision-making mechanisms. For firms, actively managing the regulatory environment requires an in-depth knowledge of the regulatory activities performed at various European administrative and political levels.

The next chapter takes this organizational research approach to the global level. **Ryan Federo,** PhD Candidate in Management Sciences at ESADE and **Angel Saz-Carranza** contend that as myriad international agreements and over 300 international governmental organizations (IGOs) "meta-govern" national-level governance by

setting standards, guidelines, and even binding rules, European businesses must place these entities squarely on their radars. Shipping companies, for example, must closely follow the discussions and standard-setting dialogues of the International Maritime Organization, as energy and energy-intensive corporations should monitor the Conferences of Parties of the United Nations Framework Convention on Climate Change (UNFCCC).

The scholars take a managerial perspective in examining IGOs, presenting a map of the top decision-making units (boards) of 70 global IGOs, based on data collected in the original ESADEgeo IGO database. Presenting both current and future research, they examine what kind of boards IGOs tend to have, how they are structured, why they take on these structures, and whether board types determine IGOs' performance. They also outline future research avenues, namely the study of IGO strategy and strategic planning processes.

Rather than studying IGOs as mere arenas for states to deliberate in and where they engage in politics to promote self- and collective interests, Federo and Saz-Carranza view IGOs as actors in themselves. Taking this perspective, they argue that investigating these entities in managerial terms will be helpful to understand the underlying mechanisms that affect their performance, while also providing detailed information for outsiders – including European businesses – so they can improve their understanding of the decision-making within these organizations and enhance participation in them.

The **fourth and final part** in this volume considers the continuation of the institutional and political context studied throughout the previous sections: it addresses the **future of EU integration.** In this part, **José María de Areilza,** Professor of Law and Jean Monnet Chair at ESADE, presents a tale of two European "cities" which are very different from each other. Each represents an approach to the future of European integration, revealing ideas and narratives that can be useful for understanding European integration, presenting a critique of its current path and relaunching it in the present day.

Europe arrived in the first city at the beginning of the 21st century. This metropolis had been constructed in exceptional circumstances, in the wake of World War II, by the audacious Jean Monnet and Europe's other "founding fathers." It was a place built through successful pragmatism, and designed to rescue its own states. The results matched and exceeded the Utopia spelled out by Monnet's generation: this construction is the most advanced example of regional economic integration worldwide, and a

paradigm in the development of institutions capable of managing problems common to an entire network of states in the context of globalization.

Despite this success however, in the beginning of the 21st century, the Union began to be taken for granted. It was part of the landscape; it had always been there. The old ideals of shared peace and prosperity had been achieved and were no longer motivating factors. The motor started to falter, and the effects of the economic crisis (with its lack of leadership, the growing prominence of Germany, and widening divisions between creditor and debtor countries) aggravated a situation where the need for transferring new powers and resources to the Union (to maintain the viability of the single currency) was not matched by ambition or will.

Therefore, Areilza argues, Europe must now set its GPS towards a new city, taking a new road. The challenge is no longer to make nation-states become member states of a Union. Rather, it is to establish and flesh out the role of the new European power, making it legitimate, limited, effective, and global – and fully compatible with national democracies which, in turn, will reap the benefits of European legal and economic discipline.

***

We hope that this selection of issues provides a useful illustration of the global context within which European businesses operate, and secondly, an innovative set of insights which will help these organizations to strategize in our globalized world.

Chapter 1

Europe's Imperative

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01

EUROPE IN A CHANGING WORLD

We live in a dynamic and complex time. It is a time of great challenges, but also of great opportunities. Individuals, companies, and states must face shifts in paradigms and in the shape of power, social transformations, and new technological developments - all of which occur at lightning speed and will yield consequences yet unknown. In this context, certainties are few and far between. What we do know, however, is that only those who are able to innovate, evolve, and adjust to the changes in this interdependent and global environment will succeed.

In this time of uncertainty, we need great ideas. Europe is a great idea. It is a project with a very clear goal: to unite all Europeans and achieve continental peace after centuries of fighting. In his famous statement, Jean Monnet said: "We are not forming coalitions of states, we are uniting men."

The route to this peace meant Europe would share both prosperity, and new economic interdependence. Europe thus followed a trend that later took on enormous dimensions: the rise of interdependence.

Today, we no longer live in a world where states are the main players, competing among each other for territory. Now, states share their webs of interactions with a large number of players, some of them transnational, and each of them with different and mixed interests. Power, in this context, has become a far more complex concept. Companies, civil society, and non-state actors also play in this web - they simultaneously feel the impact of and themselves impact the national and international institutions around them. All of the actors in this network, therefore, are bound by invisible, but irreversible ties: the ties of interdependence.

THE ORIGINS OF EUROPE

Europe is built upon the memory of war, but based on ideas that define us. When World War II ravaged the continent for the second time in less than thirty years, the aspiration became crystal clear: such horrors must never again arise. While the desire was outlined

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sharply, the path was not. For many, the idea that countries such as France and Germany could become partners seemed impossible and even naive. Extraordinary times, however, compel new solutions, which may be inconceivable during status quo moments.

The European project cannot be fully understood out of the global context. Integration in Europe, in effect, saved the nation-state. By ceding part of their economic sovereignty, Europe's states reconstructed and developed under the umbrella of a European market. Moreover, after 1945, two great powers - the United States and the Soviet Union - emerged and confronted, with Europe left in the geographical middle. In the international scenario of the Cold War, being isolated was no longer an option for any European country.

Europe's founding fathers agreed on a revolutionary belief: stability does not derive from the balance of powers, but from common interests. This belief, and decades of gradual construction, have created the most innovative and successful integration process in world history. The product of the success is a community of law, with the aim of building a better future together.

History is the proof: never before have we seen and experienced such an extended period of peace, prosperity, and integration. In spite of the devastating economic crisis that has shaken the world for the last seven years, the European Union collectively remains the world's largest economy and its leading commercial power.

THE CONSTRUCTION OF THE EUROPEAN PROJECT AND ITS UNIONS

Initially, policymakers planned to join France and Germany's production of coal and steel. They ended up creating - along with Belgium, the Netherlands, Italy, and Luxembourg - the first organization with a common High Authority.

From then on, these six countries took steps towards a common market. More European countries trickled in, and the institutional structure started to take shape. A few decades later, monetary coordination was the next logical step to allow the common market to develop fully. The Maastricht Treaty (1992) formally created the European Union and by 2002, the euro was set into circulation.

Much has been achieved during these years of progressive building. Growing from the initial seed idea of economic cooperation, the European countries have agreed, over time, to be part of something larger: an economic and political union.

With a single market and freedom of movement flying at the mast of the project, a set of European institutions has been built from the ground up. Member states have come together on important issues such as energy, digital technology, and security and defense. A wide legal system now covers a full range of aspects to achieve common regulation for all European citizens.

The institutional pillars of the project include the European Commission, European Parliament, European Council, and European Central Bank, along with a considerable set of agencies that help those institutions make and implement their policies, such as the European Police Office, the European Environment Agency, and the Agency for Cooperation of Energy Regulators.

The latter agency was launched four years ago to further progress toward the completion of the internal energy market, benefitting citizens, ensuring security of supply, and integrating renewables into the market. Coming together on energy policy is vital: energy is not only at the historical root of the European project; it is part of its everyday, critical interest. Recent developments in Ukraine have brought energy security, including both diversification and infrastructure, into the spotlight once more. No member state should rely on just one source for its energy needs, and Europe's interconnection, solidarity, and coordinated policies should play an integral part in ensuring this. Another union was thus born: the energy union.

In order to guarantee affordable, secure, and climate-friendly energy for the EU's citizens and businesses in the future, a policy framework has been developed for energy and climate for 2030. In addition, in May 2014, the member states agreed on an energy security strategy, outlining both short- and long-term strategies to secure supply. Meanwhile, work continues towards sealing the integrated energy market across all EU countries.

The European project has revealed that tearing down barriers in one policy area requires at a minimum coordination, and at a maximum full union, in related policy areas. The EU's single market revealed the need to eliminate digital barriers along with physical ones, leading to a need for a Digital Single Market strategy. The aim is to develop an EU-wide digital market where the individuals and businesses can carry out their activities under guarantees and irrespective of their nationality or place of residence.

This is an important step for the EU to gain advantage in the technological competition. It is aligned with recent actions taken by the EU Commissioner in charge of competition policy, to safeguard free competition and to ensure that European standards - in areas such as tax regulation and privacy rights - are applied to all tech companies.

TURNING POINT: THE ECONOMIC CRISIS

Progress has thus been the thread throughout the Union's history, a slow but ever-moving trend. There was, however, a critical turning point: the year 2008 was an earthquake that woke us all. The international economic shock laid bare the monetary union's design flaws. The common currency was not supported by instruments to ensure stability and manage crises. Imbalances were magnified; and nation-states were left without tools to adjust. As always in a crisis, our instinct calls us back to the nest: although we were united under a single European market, the Schengen area, and a common currency, when the difficult times came, many voices called for a return to national sovereignty.

Fortunately, now that some time has passed, we can see the institutional learning that has taken place. Whereas a return to national isolation seemed a possible scenario, much progress has in fact been made on new instruments of integration, such as the European Stability Mechanism and the banking union. The latter has been a milestone in the recovery of the European banking system, helping to ensure that credit flows in the Eurozone. Of course, more remains to be done.

One of the worst crisis hangovers is the growing disaffection with the EU, and divisions between Northern and Southern European countries. Distrust between member states has replaced the original sense of solidarity. Many citizens in Northern Europe think the South has not fulfilled its duties, and in Southern Europe, many have blamed the North for imposing measures that constrain economies, causing deep social suffering.

Europeans showed their disaffection in last year's European Parliament elections, as well as in recent national and local ones. The 2014 election left the European Parliament highly fragmented, with Euroskeptic parties occupying a significant number of seats. At the national level, the landscape is similar: nationalist and Euroskeptic parties, many of them recently created, are gaining ground and forcing traditional parties out of the scene. Europe must respond.

The only answer is growth. It is the only way to continue along the path of reforms, transmit international credibility, and foremost, regain the trust of the European citizens. Broad-based recovery in investment, demand, and employment will be the best weapons to challenge those who would extinguish the European project.

THE EUROPEAN UNION, ITS NEIGHBORHOOD, AND THE WORLD

The benefits of the European project go far beyond what the 28 member states could have achieved on their own. Continental peace and prosperity are the EU's most obvious contributions to the world. However, there is more. Europe's experience with solving problems through multilateral channels can be of significant value in today's global context, which is marked by multipolarity and potential instability.

Current economic, technologic, and cultural trends are knitting us ever closer together. To govern our resulting interdependence, the world needs global governance institutions. And here, the European Union can play a constructive role. We developed our supranational government structure by giving up part of our national sovereignty; and this way of solving problems has proven successful. Although this model cannot be applied directly elsewhere, many of the cooperative processes we have forged and the experience we have garnered may prove useful. When, in this interconnected world, one action causes ripples throughout the planet, it becomes clear that today's problems will not be solved through confrontation and force between nation-states, but rather through dialogue and consensus.

Notably, many of the most unstable and conflictive regions in the world are in Europe's neighborhood. This proximity heightens our international responsibility. In recent years, we have witnessed a new threat in our Eastern border. The conflict in Ukraine and Russia's foreign policy has jeopardized the relations between the EU and the Kremlin. This growing tension may also affect the Balkans and other former Soviet republics in the South Caucasus and Central Asia.

Across the Mediterranean, meanwhile, we find a ravaged landscape. The Middle East and North Africa are extremely unstable, and the fragility spreading throughout the Sahel region poses an increasing threat to Europe. Terrorist groups are taking advantage of the gaps created by failed states. Dire poverty and the horrors of war shape daily life for millions.

The EU's Neighborhood Policy must therefore take into account how this environment has evolved, in order to adapt our approach to each specific situation. We are taking important steps in the right direction. In recent years, we have built the necessary structures for an authentic European foreign policy, and the creation of the European External Action Service, laid down in the Lisbon Treaty, has been a milestone. Now, it is crucial that those European countries more experienced in foreign policy embrace the European Foreign Service as their own.

We also share international legal duties that we must comply with together, as a Union. One of the most pressing issues at present is asylum for refugees fleeing across the Mediterranean. It is both our moral duty and legal obligation to protect them. Closing our borders to them would result in forcing them to live under conflicts and persecution. Though today's crisis is one of refugees and not of immigrants, Europe should also resume the immigration debate in light of its demographic trends.

With Europe's borders fraught with confrontation and disorder, having a shared view and a unique voice to defend European interests is imperative. It is unquestionable that member states share a common interest in having stable borders, but what is most essential to understand is that any European country acting on its own in the international arena of shifting and emerging powers would simply be at a competitive disadvantage.

This view also guides the EU's Common Security and Defense Policy. In recent years, this policy has become buried under varying preferences and threat perceptions among the EU's member states. Moreover, budget constraints due to the severe economic crisis led to (uncoordinated) cuts in defense spending across the Union.

It is imperative, however, that the EU stand prepared for any and all contingencies. In military terms, the relevance of each individual EU country is declining. Non-European countries import and spend more on arms than Europeans. Security threats have become hybrid, and fires are burning in Europe's strategic neighborhood. All the while, the United States has become much more selective in its engagement in foreign conflicts. Europe needs to update its policy in the area of defense, increasing its efficiency and effectiveness in order to face the security challenges of today while promoting the EU's own values and interests. Ultimately, this much-needed integration in defense should lead to a "European Defense Union," an important cornerstone of what should be a comprehensive, civil-military, EU security architecture.

THE TASK AHEAD

European integration has achieved its goal of establishing peace between historical rivals, but the road ahead - to more integration, improved effectiveness, and a more clear sense of European identity - is long. In this continuous process, all actors will be essential.

The EU's institutions need to regain the support of citizens. To tackle the challenges our societies are experiencing, we need more solid, accountable institutions. In last year's

European elections, and as a result of the Lisbon Treaty, the directly chosen European Parliament gained more power: an absolute majority of its votes is now needed to confirm the candidate the European Council nominates as the European Commission's President. A sizeable step forward was taken in the democratization of the institutions, but what is critical is for citizens to see how decisions made at the European level have a positive impact in their daily life.

The European Union is not a structure built once and forever, it is a living body that continuously changes as its members do. It is also, in the grand scope of things, a very young structure. The EU is still in a process of creation and definition. This is healthy: it shows we are adapting to the changes around us and among us. In this process, we recently experienced a strong setback. This experience, although painful, has cast the project's shortcomings in a harsh light - and given this revelation, we can see the work at hand.

Our main task ahead is to improve the sense of belonging to Europe. Companies, workers, students, intellectuals, NGOs, citizens, and all institutions of civil society should feel they are Europeans. Restoring the identification with the project will require an extensive educational effort. Many of today's European citizens did not experience the integration process, and they have never experienced a war. They take the European Union for granted and have felt the severe consequences of the crisis. We have a duty to show them where we have come from so they can value what we have achieved.

On the other hand, we cannot afford the risk of being entrenched in the past, without looking forward and working toward the future. The rhetoric of the great importance of continental peace is not enough, in the current context.

We should go one step forward and reinforce European integration by changing the post-crisis narrative that has seeped into many citizens. In order to do so, we should observe our trajectory honestly, acknowledging the successes and benefits that the Union has brought to all its members, as well as identifying the mistakes or flaws so that we can work to overcome them. The European Union should also keep democratizing its institutions and intensifying efforts to ensure no one is left behind.

One narrative should ring clear above all: there is no place in today's interdependent world, where economic weight is shifting faster than the eye can see, for national retrenchment. Only together will we retain our place in the world and in global governance.

This very special moment in the history of Europe demands commitment and political will. Today's young Europeans must continue the legacy of the founders, solving the new problems that may arise and shaping the EU to respond better to challenges: this Europe is one so many have worked so hard for before - not in vain, but with a grander picture in mind.

CONCLUSION

Europe is no longer the center of the modern world. Other countries are emerging and growing at break-neck speed, challenging our knowledge, our views, and our expectations for the future. No EU member state can compete on a global scale, by itself, with countries like China, the United States, or India. Further integration is essential to remain a competitive actor on this new global stage.

In 2030, it is projected that there will be only two EU member states (Germany and the United Kingdom) among the world's top ten economies. In 2050, Germany will be the lone remnant in this group of ten, holding last place. Emerging economies such as Indonesia, Brazil, India, or Mexico will be stronger than any European country.[1]

The shift in economic power towards Asia, and towards China in particular, is one of the most significant events on the international economic stage in recent years. It is crucial for us to carefully study and understand these processes as they are taking place, in order to adapt our structures and policies to the real world - which is not the one we lived in when the idea of European unity began.

Monnet envisaged a clear path: to seek the fusion of the interests of the European peoples, instead of simply maintaining the equilibrium among them. 37 years later, his message is exactly as valid, in the changing world described in these pages.

I have described the EU as a building under construction. Despite the scaffolding and the constant evolution, or perhaps in part because of it, this building is the most beautiful work of architecture created after World War II. In the words of President Lula, the EU is a part of the world's heritage, worthy of being recognized as such.

[1] PwC. *The World in 2050. Will the Shift in Global Economic Power Continue?* 2015.

PART 1

The Impact of Institutional and Political Contexts on Businesses

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Chapter 2

Global Risks and EU Businesses

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GLOBAL RISKS: THE NEW FACE OF RISK FOR BUSINESS

We live in a time of profound change in the global geopolitical and economic landscape. These transformative phenomena are creating a world full of opportunities, but also of risks. Many of these risks are of a global nature; they do not originate solely in a single country or, if they do, their effect is transnational. Climate change, intrastate conflict, migration, rising income inequality, youth unemployment, cyber-attacks, volatility in commodity markets, the Ebola outbreak, the emergence of ISIS, and financial instability are just some of these risks. Increasing access to information, technological progress, rapid urbanization, and greater mobility are modeling a new reality in the international arena that can accelerate these risks.

Global risks do not respect national borders. Therefore, it is key to understand the geopolitical landscape in which these phenomena occur, which is characterized by increasing multipolarity. The relative political and economic decline of the West, the process of globalization, and the rise of emerging economies are creating a world with several interconnected poles. On the global stage, the universal values and capabilities of the old powers are competing with the various idiosyncrasies of the emerging powers. The process of economic convergence has up to now gone hand-in-hand with the tacit support of the emerging powers for the current system of global governance. These emerging powers believe that the current regime is in their interests, but with regard to free trade, the rule of law, or human rights, their support is not guaranteed in the future.

It is unlikely that the current system will be radically questioned, but there are few signs that this multipolarity is heading towards real multilateralism. Emerging powers are not supportive of a truly multilateral international order and market economies and liberal democracy should not be expected to advance at the same rate as economic development. Rather, new forms of interaction will become increasingly common in the international arena.

This has important implications for European businesses. We are entering an era in which the rate of change is accelerating. Volatility, uncertainty, complexity, and

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ambiguity are here to stay. While geopolitical stability during the second half of the twentieth century enabled an increased liberalization of trade in the West and beyond after the collapse of the Soviet bloc, companies that venture abroad today find a more heterogeneous environment, where regulatory and geopolitical idiosyncrasies and risks decisively condition their strategies. Political risks are back and will seriously condition the context within which businesses must operate.

Awareness and analysis of these risks and the resilience needed to confront them will be hallmarks of successful businesses in the years to come. The coming years will see the consolidation of phenomena such as the displacement of the economic axis to the Pacific, the rise of the emerging middle classes, an increasing mobility of talent, the development of innovation hubs, and the energy revolution. European businesses will be more dependent on the outside world and will face much greater competition. In order to overcome this challenge, they must build "geo-strategic" capabilities (i.e., risk analysis, forecasting, scenario building, and other such tools) that will allow them to deal more effectively with the risks that this new global context brings. The following section identifies some of the key global trends that will define this new global landscape and some of the risks they may bring about.

KEY GLOBAL TRENDS AND RISKS AND THEIR IMPACT ON BUSINESS

This chapter identifies global risks grouped around five axes: geo-economics, geopolitics, technology, society, and the environment. In an interdependent world suffering from inefficient global governance, these risks are not only salient in and of themselves, but they are also interrelated and could have systemic effects.

Geo-economics: An Uncertain New Balance for the Global Economy

Developed Markets are Losing Trust in Progress

Since the first Industrial Revolution, the West has advanced by exploiting sources of growth that are questionable today. Although technological innovation continues, ICT technologies, robotization, or 3-D printing are far less labor-intensive and their

productivity and social impacts are incomparable to the introduction of the steam engine, electricity, sanitation, or containerization. The scope for improvement in education is also reduced now that secondary education is universal and a significant proportion of the population goes on to higher education. Economists such as Edmund S. Phelps, Robert J. Gordon, Tyler Cowen, and Thomas Piketty expect a future of slow growth in the West, even of "secular stagnation," especially in Europe and Japan. Some of them argue that rich economies are close to reaching a technological plateau. Productivity will not substantially increase in the years ahead because the "low-hanging fruit" have already been plucked. In the event that these approaches materialize in the coming years, some Western economies will be headed for economic stagnation and increased social pain.

In the West, the retirement of the baby boomers is threatening the sustainability of the welfare state and encourages savings to the detriment of investment. The opportunities for increasing the labor force are not spectacular, as women already represent around 50% of the labor force in most countries (except Italy and Japan). The generalization of consumer credit, mortgages, and complex financial innovations are not an option for generating long-term growth because they encourage excessive debt and tend to create bubbles – as shown in the last global financial crisis. Consequently, these processes will be difficult to repeat in the short-term. During the next two decades, it will be the emerging economies that contribute most to economic growth, although the rate of growth and convergence will be slower than in the previous two decades.

Globalization No Longer Needs a Western Anchor

In less than two decades, China will be the leading economic power and India the most populous country on earth. These factors will help the Asia Pacific region regain the central position it enjoyed in the world economy until 1820. The emerging economies will strengthen their political influence through economic growth and their new role as creditors. They will also encourage South-South trade, which will be increasingly conducted in local currencies, transforming the global currency markets. Emerging nations will cease to be major sources of raw materials and cheap labor and become consolidated as major markets and generators of innovation. Nevertheless, their growth will be more moderate, meaning their role as the locomotives of global growth will be less marked than in the past decade.

Over the next few years, eastern Chinese industrial wages will continue to rise, causing manufacturing production to shift into Central China (the "Foxconn effect") or to other countries. India, meanwhile, is in a unique position to receive part of the investment in labor-intensive manufacturing which now goes to China. According to the IMF, Indian economic growth will overtake Chinese growth in the next two years. However, a shift in investment will require New Delhi to put in order the complex Indian business environment and improve its poor infrastructure.

In this context of "de-Westernization" of globalization, there is still room for proposals such as the TTIP (Transatlantic Trade and Investment Partnership) that would strengthen the transatlantic relationship, creating a single area of economic and industrial regulations, and strengthen the capacity of the EU and the US to set global standards and best practices. However, European businesses clearly face increased risks deriving from the West's shift away from the epicenter of the global economy.

Europe and Japan in the Slow Lane

Low growth rates could become normal for many Western economies. It is not unreasonable to predict a three-speed global economy in which Europe and Japan lose dynamism and growth potential, while America and the emerging economies push ahead. Unless decisive action is taken, the combination of weak demand, high debt, an ageing population, a slowdown in productivity growth, and lower consumption could lead to permanent low levels of growth in the West. Nations will be forced to save, find new revenues, and boost structural reforms. The US is the exception, given its more youthful population, market size, integration capability, energy revolution, and ability to innovate and abandon old industries.

According to Gallup, 14 of the 15 countries that are most optimistic about the possibilities of improving their quality of life are African. Americans and Japanese are far more pessimistic, while European countries hold the top four positions in the *global pessimism ranking*.

On another level, the crisis of the welfare state and budget problems are resulting in military spending cuts, reduced development aid, and a decrease in funding contributions to multilateral organizations. This is deterring EU governments from engaging in the international arena; the consequent loss of military power and (to a lesser extent) soft power will call into question the dominance of Western universal values.

China's Slowing Economic Growth

Beijing faces numerous problems in the medium term: an aging population, rising labor costs, land disputes, extreme pollution, food insecurity, and corruption, among others. However, the most serious concern comes from those risks that could lead to a hard landing of its economy: the overvaluation of the real estate market, high local debt, and opacity of the banking system. Housing prices and demand for commodities have plummeted in recent months, while inflation is at its lowest in five years. Last year's expansion of 7.4% is the slowest since 1990. These fears are compounded by both the doubts about the reliability of the data and the fact that the current generation of leaders, and in fact the entire post-1978 regime, have thus far not been tested by a severe economic crisis. A hard landing of the Chinese economy could seriously affect commodity-exporting economies, make US financing more difficult, and disrupt global stability. However, the likely scenario is a gradual slowdown while the Chinese economy continues its transition from an investment- and export-driven model towards greater domestic consumption.

Growing Doubts About the Performance of Emerging Economies

During 2015, global markets could start to suffer jitters with regards to the ability of emerging economies to adapt to a new international context where the elements that have enabled their fast growth over the last decade are withering away. The gradual withdrawal of liquidity injections and the expected rise in interest rates by the US Federal Reserve could trigger a gradual return of capital from emerging to developed economies. Turkey, Indonesia, India, Brazil, and South Africa have already taken steps to prevent price volatility and defend the value of their currencies. Three additional factors that have spurred the economic growth of emerging economies in recent years could also weaken substantially: (1) high commodity prices; (2) low interest rates; and (3) vast liquidity in global capital markets.

These changing circumstances are likely to split those emerging economies with solid fundamentals for growth from those with more worrying vulnerabilities. This reality has not escaped investors, which increasingly focus their investments in the former. Thus, it is likely that more FDI will be directed to "safer" emerging economies and that some EU member states, especially in Eastern Europe, could become attractive to international investors. The effect in the more vulnerable emerging economies would likely be a slowdown in the process of convergence and major geopolitical changes.

Countries with structural weaknesses and which depend excessively on crude oil and raw materials, such as Argentina, Iran, or Venezuela, could be caught in vicious circles in the short- and medium-term.

Limited Global Financial Governance

Economic interdependence generates volatility and may cause local crises to escalate into fast-spreading systemic crises. Many of the lessons learned in the recent financial crisis have not been applied and the global financial system remains vulnerable. Despite increased regulation, the relevant actors have failed to construct effective global mechanisms to deal with transnational financial and economic crises. In some ways, the imbalances have worsened: systemic institutions are larger, the shadow banking system has expanded, central bank actions have created distortions in the markets, and asset price bubbles are back. Paradoxically, at the same time, the risk of deflation looms over many developed economies, and the new emerging middle classes have experienced their own credit booms.

Regulators are still one step behind financial innovations and have yet to build firewalls against the spread of global financial risks. International competition and new technologies undermine national governments' ability to collect taxes from businesses operating in several countries. With its goal of attracting FDI, fiscal policy instead focuses on non-mobile assets such as human capital and consumption.

Unless several international agreements are signed in the near future, an unlikely hypothesis, these tendencies will intensify in the coming years, generating serious difficulties for the fiscal policies of states that want to maintain advanced welfare systems. This is the case of the Eurozone, which, despite progress, still lacks fully functional economic governance and is still far from being an optimal currency area.

Geopolitical Risks: A Game Without a Referee

A Non-polar World

Persistent gaps in most sectors of global governance represent a major concern. The main challenges will essentially be transnational (e.g., financial crises, tax evasion, organized crime, piracy, global warming, pandemics, migration, humanitarian crises, and international terrorism), yet their management will continue to rest, for the most part, in the hands of nation-states. Today's international organizations were designed by the West so that they could manage international relations between states, combining the principle of non-interference in internal affairs with a critical focus on human rights.

The rise of emerging economies has transformed this landscape. While only effective multilateralism based on the principles of coordination and cooperation will allow the international community to address the global challenges it faces, there is little evidence of this happening. An example of this global governance gap is the fact that negotiations for the Trans-Pacific Partnership Agreement (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) have a greater chance of success than the WTO's Doha Round. Following events of exceptional importance, such as the 2007 financial crisis or a possible breakup of the Eurozone, the international community can still coordinate to offer a response, but the tendency in day-to-day affairs is fragmentation, bilateralism, and regionalism. The G20 response was coordinated during the early months of the crisis, but this coordination slowly withered away. A global order without clear leadership (provided by a nation or set of nations) will be less effective in managing global problems and dealing with the interdependence that increasingly characterizes the global landscape.

A Diverse Global Order

A greater variety of concepts of national and international order will gradually co-exist and compete on the global stage. The great powers will remain politically and ideologically diverse, harboring differing ideas of legitimacy and justice. This plurality of institutions, values, and cultural traditions will be a major challenge for global governance. However, emerging powers are far from homogeneous and diverge significantly in areas such as political systems, rule of law, economic diversification, energy dependence, and demography.

Cultural relativism and new versions of nationalism may compete with liberal democracy and modern Western values as a reference for some emerging economies. Local and short-term interests will gain importance and politicians and business leaders may be less motivated to resolve major global long-term risks. Moreover, while power will continue to spread among an increasing number of actors, these actors will not assume global responsibilities at the same pace. It is not a zero-sum game:

newcomers' spending on global public goods is not in line with their economic weight. The gap in shouldering responsibilities will progressively narrow, but it is doubtful that the emerging powers are willing and prepared to truly replace the West in providing global public goods such as security, global financial stability, defense of international trade, and opposition to nuclear proliferation and climate change.

Potentially divergent interests and an increasing number of actors will make it more difficult to achieve the consensus required for the necessary reform of multilateral institutions. The instruments of governance tend to be less global, with a greater role for informal structures and *ad hoc* coalitions depending on the nature and scope of the issues being addressed. Consensus-building skills will be key for shaping international agendas. Due to its experience in consensus-building and its rules-based cooperation model, the EU has a great opportunity to position itself as a credible partner.

A More Complex Geopolitical Environment for Private Business

In 2030, five of the ten largest economies will be emerging or former emerging economies, with governments that tend to intervene in the economy, encourage the expansion of state-owned enterprises (SOEs) and sovereign wealth funds, and promote national champions against foreign rivals. Revealingly, a total of 65 of the 70 Chinese companies in the 2012 *Fortune 500* list were SOEs. Judicial security in emerging economies is not comparable to Western economies, and given the strength of emerging domestic markets, Western multinationals will be forced to accept strategic interference by state authorities. As emerging market companies internationalize, governments in developed countries will be tempted to protect their companies from foreign competitors or require reciprocal treatment of investments.

The ability of states to project power will increasingly rely more on geo-economic tools and strategies than on the traditional predominance of military power. Competition may suffer, as companies aligned with the interests of their states (e.g., diplomatic ambitions, energy supply, local job creation, infrastructure development, positioning on key routes and nodes, etc.) will receive the full support of their home governments. This will grant them an advantage when competing with companies where the distinction between state and markets is more clear-cut. All this will force the EU institutions and national European governments to increase their efforts to ensure a level playing field for European companies abroad.

Heightened Risk of Conflict

Since the end of the Cold War, the number and deadliness of armed conflicts have declined. The average duration of internal armed conflicts has dropped from 4.6 to 3.7 years, while the number of conflicts resolved by negotiations leading to peace settlements has tripled. However, today intra-state conflicts are on the rise. East Asian territorial tensions, the instability in the Sahel region, political turbulence in the Middle East, and the renewed pressure on frozen conflicts in the Russian neighborhood are samples of this new trend.

A new and more balanced world will lead to a deglobalization of risk. As America and Europe become more reluctant to intervene outside their regions, local actors will be forced to take greater responsibility for resolving conflicts – a task for which they are probably unready. When new powers rise and traditional powers decline, a period of instability often follows where the risk for miscalculation and conflict is ever present. However, it would be a mistake to overestimate the ability of new powers and underestimate that of established powers, especially the US. It would also be unwise to underestimate the potential of cooperation in a globalized economy.

MENA, a "Failed Region"

During the next 20 years, the population pressure that partially inspired the Arab Spring will deflate in the Middle East and North Africa (MENA). The future of the region will continue to be closely linked to the management of the Sunni-Shiite rivalry and the stability of emerging nations' transitions to democracy. Several nations in the area may become failed states. Iraq, Syria, Libya, and Lebanon could disintegrate into smaller and weaker units that are unable to control their territory; this may sow seeds of conflict throughout the region. Of particular relevance is the threat of the Islamic State (ISIS) in Syria and Iraq. The aspiration of this group is not limited to representing the most radical form of jihadism, it also aims to become the leader of the Sunni bloc. The actions taken by the US-led international coalition are insufficient to dismantle ISIS due to the lack of a credible ally in the field. The degree of involvement of Turkey and Iran in fighting ISIS will thus be key for the future of the region. In the same vein, the independence of Iraqi Kurdistan would be a game-changer for the Middle East. Managing the impact of the four million refugees and over seven million internally displaced persons is also particularly relevant.

The inability of Egypt, Algeria, and Saudi Arabia to open a process of peaceful transition to democracy could radicalize the opposition and cause chronic instability. Some of these states may become sanctuaries for terrorists with global agendas and thus greatly increase the political and military significance of jihadism in Europe's immediate neighborhood. Despite the current drop in oil prices, the position of these countries in the region as oil producers or transit countries could lead to a surge in energy prices similar to 1973, which could trigger inflation in both developed and emerging nations and put an immediate brake on the global economy.

Technological Risks: Leaving the Bottom Behind?

Innovation Could Lead to Non-inclusive Growth

Over the next 20 years, we will see an evolution in the post-industrial growth model, brought about by technological progress, in which value creation will increasingly rely on innovation and talent management. This new production model will have wide economic, social, and political implications, as well as having consequences for corporate management. From the political point of view, both the geographic and social concentration of wealth will test the resilience of democratic systems and the redistributive capacity of the welfare state in Europe.

Economic conditions increasingly reward talent and innovation, and these qualities will concentrate in hubs – spaces of interconnection where companies and highly skilled workers compete and collaborate at the same time. These hubs will attract creativity and capture most of the economic growth, acting as catalysts for development. At the industrial level, these hubs – with their respective *hinterlands* – will mainly be located in urban areas with large markets. However, disruptive innovation with highly technological content may develop in countries such as Israel, Singapore, Sweden, and Finland. Developing innovation hubs will be crucial and will spur the development of public policies to attract and retain talent. Starting companies will be easier and administrative procedures (or lack thereof) and fiscal incentives will help determine the residence of professionals and new businesses. A parallel market for cultural, gastronomic, and sporting services will grow to satisfy the needs of the innovative class. An increasingly important risk is the possibility that rural areas and less connected zones could enjoy a smaller part of the economic and social development.

Jobless Growth?

New manufacturing technologies such as robotics, automation, 3-D printing, and the massive use of computing technology, as well as the autonomous car and the use of new materials will revolutionize work patterns, increase productivity, and reduce outsourcing. If the spread of these technologies has a deeper impact than that of previous periods of technological change, the demand for semi-skilled workers could slow significantly - exacerbating wage inequality and greatly increasing unemployment.

Increasing numbers of analysts believe that this will be the case. Automation and mechanization of production processes threaten to consolidate intractable structural unemployment. In *The Future of Employment,* Carl Benedikt Frey and Michael A. Osborne claim that 47% of American jobs are at high risk of being automated or outsourced over the next 20 years, especially in manufacturing processes and production, but also in transport logistics, and administrative support. Other sectors will be affected, such as construction – where the generalization of prefabrication and additive manufacturing technologies may be critical. This is particularly important for Southern Europe at a time when long-term unemployment is turning into structural unemployment.

There is no consensus on whether automation will inevitably lead to a structural mismatch in employment. Although Luddites' arguments based on the "lump of labor fallacy" are unjustified, it is possible that a significant subset of workers will suffer degradation in the quality of employment and lower salaries. It seems clear that robotics will lead to standardized protocols and that companies will be forced to reorganize their staff to systematize all processes to the maximum. This development will reduce the employment opportunities for workers in these sectors.

"The Winner Takes All": A New Production Paradigm

Technological progress and globalization enlarge the size of the potential market that can be served by a single firm. Moreover, the *network effect* facilitates the cannibalization of the rest of the competitors: the more consumers use a service, the more valuable that service is to each consumer. Globally, there is only room for a few leaders and truly specialized smaller players. The space in the middle of the market is narrowing progressively and the first mover advantage is thus becoming more relevant than in the past. An increasing number of global markets are *winner-takes-all* markets. A shrinking number of players are taking most of the revenue while the rest struggle to

survive. Business opportunities will focus on hyperspecialization or economies of scale. From 2008 to 2012, the value of the 100 largest companies by market capitalization increased by 45% (to $14.32 trillion).

Countries whose business networks are predominantly composed of small and unsophisticated firms will have trouble competing. It is likely that governments will begin to focus on policy measures in order to stimulate growth in the size of enterprises instead of supporting smaller firms. There will be opportunities for small technology-based companies specializing in services provided to large firms, and for very specific niches following the model of the long tail. Long tail refers to the business model described by Chris Anderson, which is based on the accumulation of small levels of sales for many products in niche markets versus the traditional strategy of focusing efforts on a few successful products. The falling costs of production, distribution, and storage due to technological progress can make many small niche markets the equivalent of mass markets. Smaller firms can also take advantage of the comparative advantages through their ability to meet local partners and consumers. Moreover, the acceleration of technological development will make it increasingly difficult for a company to remain a leader for an extended period of time.

Cyber-attacks on the Rise

The increasing number of databases, the growth of cloud services, and greater accuracy in data mining will provide individuals, companies, and governments with more accurate and real-time knowledge about the surrounding world, boosting their efficiency. However, given the complexity of the technological environment and the expansion of the Internet of Things, a massive technological failure could affect critical infrastructure management systems. In many areas, information networks have progressed faster than our ability to manage them, which could lead to massive problems. For example, failures in automated high speed trading systems could cause serious financial disruption. Technological advances and the growing importance of non-state actors could make states more vulnerable to asymmetric shocks. State and non-state actors could open the door to systemic failures through cyber terrorist attacks. Examples of recent cyber-attacks on JPMorgan Chase, Sony Pictures, and large business e-commerce and retailers such as Target, Home Depot, and eBay, are a clear sign that this risk should not be underestimated. It is not unreasonable, for example, to expect a wave of Russian cyber-attacks on European and American companies in retaliation for the growing tensions between Russia and the Western bloc due to the conflict in eastern Ukraine.

The Dark Side of Cyber Optimism

Developments in ICT pose ethical dilemmas and paradoxes. Individuals can manage their futures more freely; however, their actions are increasingly monitored. The increase in data available on the Internet, along with the exponential reduction in the cost of storage and increasing efficiency of the physical network, encourages companies and governments to collect, analyze, and correlate enormous amounts of private information. The tendency to accept a privacy waiver in favor of greater openness, transparency, and usefulness of online services seems irreversible. As the number of digital natives increases, the process is less likely to be reversed.

Will governments in nations such as China, Iran, and Belarus continue to be able to limit the flow of information on the Internet within their borders? Can social movements achieve open societies through networking alone, without support from the media and the traditional repertoire of protest? The debate about the global governance model of the Internet will heat up, opposing those who prefer an intergovernmental model and more governmental control, led by China and Russia, to those who defend a multi-stakeholder system where non-governmental institutions play a fundamental role, led by the EU and the US. There is no certainty that the Internet will remain global: it may become balkanized, with a cloud computing system for each bloc. Undoubtedly, the digital world will continue to grow, although the transition to a fully digital model on a truly global scale will take longer than expected.

Societal Risks: Polarization on the Rise

Ageing Will Affect More Than Just the West

The world population will continue to grow over the next two decades, though at a slower rate. If the current trend continues, the overall replacement rate will be reached before 2025. By adding one billion people over the next 12 years, the global population will reach 9.6 billion by 2050. The population of the developed countries will be around 1.3 billion by that year. In contrast, the population of the 49 least developed countries (mainly in Africa) will double, reaching 1.8 billion by 2050.

Population ageing will no longer be an exclusive European or Japanese phenomena: it will become a reality in many regions. China will achieve its peak population (about 1.4 billion) around 2025, after which the population will stabilize and begin to decline.

By 2030, the average age worldwide will have increased by 5.1 years to 34 (44 in developed countries). Emerging countries' populations will stop growing (except India and sub-Saharan Africa) and begin a process of consolidation. The average age of the Chinese will exceed that of Americans.

Globally, the population of 60-year-olds will grow at the fastest pace. Within 20 years, the average age of citizens in countries such as Germany, Italy, or Spain will be around 50, and even higher in Japan. In the EU, life expectancy, once past 65, will increase by one year every eight years, while the percentage of the population over 60 will increase by around 1% annually. Young Europeans will not be able to replace the baby boom generation, and this will undermine the sustainability of pension systems, force a rethink of pension design, worsen older people's quality of life, and substantially change consumption patterns. Fully incorporating women into the labor market and integrating immigrants into societies will be crucial for sustaining economic growth in the long term. The most advanced EU member states will need immigrants to rejuvenate the population. On the other hand, seeing as half of the member states are now net emigrant nations, a rebalance of internal migration in the EU is desirable.

Health services for the elderly will need to be expanded, as their needs cannot easily be met by families in the developing world, given that women are working (among other reasons). More resources will be dedicated to age-related diseases, such as Alzheimer's and cancer. By the end of the century, life expectancy will be around 89 in developed nations and 81 in developing nations.

A New Middle Class, New Demands

During the next two decades, the emerging world will undergo a process similar to that experienced by Latin America over the past decade, in which the percentage of Latin Americans living in poverty was reduced from 48% to 29%, and the middle class increased in size by 50% (from 103 million to 152 million people). The purchasing power of the newly emerging middle class will double, its credit rating will probably consolidate, but incomes will remain far below their European, American or Japanese counterparts. In turn, the Western middle classes, especially the middle-middle and lower-middle, may suffer a loss in income and employability, leading to a phenomenon of downgrading that may generate social instability.

In recent years we have witnessed great popular protests led by the new middle classes in emerging economies such as Brazil, Chile, Hong Kong, Mexico, Thailand, Turkey, and Venezuela, but social unrest has also increased in EU member states such as Bulgaria, Spain, Greece, Hungary, Portugal, and Romania. New demands of increasing accountability, combating corruption, better environmental protection by the new emerging middle classes, and the downgrading of old Western middle classes could trigger a new cycle of protests. This will test the democratic resilience of a considerable number of nations, contribute to instability, and could lead to the rise of ultra-nationalist and xenophobic movements. Immigration, another consequence of the population boom in developing countries, will exacerbate this risk.

Rising Inequality

The last 20 years have brought about the largest income transfer since the Industrial Revolution. The new middle classes, especially in China and India, have benefitted the most from globalization. The other big winners have been the richest 2% on the planet: those billionaires in the US, UK, Japan, France, Germany, and in emerging nations such as Russia, China, Brazil, and South Africa who account for half of global wealth. Meanwhile, the big loser has been the middle class in developed countries (especially in the former communist countries), whose income and job prospects have stalled. Since the 1980s, the percentage of national income from salaries in developed countries has been diminishing; it now stands at record lows. Competition from emerging markets' exports and technological development are the two main causes. The downward trend will continue in the coming years and productivity gains are unlikely to be converted into wage increases for low skilled jobs. Inequality will continue to rise both in America and Europe; and the crisis of the welfare state, rising debt, and ageing will challenge the redistributive capabilities of the state, increasing the risk of social contestation.

The socioeconomic development of many current emerging economies is very different from that experienced by Japan, South Korea, or Taiwan, which grew their overall GDP while simultaneously improving their Gini coefficients. Urbanization and industrialization have led to growing imbalances that cause discontent, yet these imbalances are often assumed to be the price to be paid for development. Asia's nascent welfare states will gradually develop, but will remain well below the European level, while welfare states in Latin America will remain subject to political debate and economic growth.

Decentralization of Power

In the years ahead, power will move horizontally (from West to East) and vertically (from states to non-state actors). The erosion of the nation-state, the free movement of capital, and the emergence of a nascent international civil society have created new international actors and limited the hard power of states. New computer technologies enable citizens to collaborate and organize networks that bypass the hierarchical structures of traditional media or political parties. The color revolutions and the Arab Spring suggest that a few individuals on the "net" can have a disproportionate impact, although their achievements in establishing solid political foundations may be more limited. New technologies could serve to increase accountability, combat corruption, or support democratic demands, but can also be used to identify dissidents, polarize the debate, increase harassment, or enable espionage and sabotage.

Environmental Risks: Overexploitation of Natural Resources

Increased Competition for Resources

As the world's population increases, consumption patterns are changing among the new and rapidly urbanizing middle class, leaving food demand set to increase by about 35%, and water demand by around 50% in the next two decades. The increase in energy demand will continue decelerating, from about 2.2% per year to 1% in 2030, 95% of which will come from outside the OECD.

The dietary preferences and consumption patterns of the new middle classes will intensify the competition for resources. Oil states (i.e., Saudi Arabia, UAE, Qatar, and Kuwait) that lack farmland to feed their populations and Asian nations (i.e., China, South Korea, India, and Japan) with large populations and limited farmland will continue their land-grabbing practices to achieve greater self-sufficiency. Nevertheless, even without a green revolution, many countries may choose to modify their eating habits; and water-intensive crops (such as rice) may increase in price. The resource crunch and environmental degradation will have serious health effects and will bring geopolitics to the front and center in the management of natural resources. This trend is key for Europe, which lacks significant natural resources and is extremely dependent on the import of raw materials and vulnerable to energy supply disruptions.

Water Scarcity

Water is a renewable but finite and irreplaceable resource, whose availability determines the possibilities for economic growth. Over the next 20 years, demand for water will increase due to several factors, including population growth, increased consumption of meat in developing countries, rapid urbanization, climate change, and increased production of water-intensive corn-based biofuels. In 2030, almost half of the world population could live in areas experiencing water shortages. Attempts by nations to control water supply could trigger conflicts and new migration flows. It is expected that the demand for fresh water (which will double current demand) will exceed supply by 40%. Unless significant advances are made in performance technologies such as desalination, Southern Europe will be severely affected (especially Spain, where 65% of the population will live in water-stressed areas, double the current figure).

Water is key to economic and social development in much of the world, especially in fast growing areas such as Africa and Southern and Eastern Asia. Water availability also affects other sectors, such as energy. For example, China is facing major challenges in shale gas extraction because of its scarce water resources. In addition, plants that account for 85% of Chinese power generation capacity are in water-stressed areas. To overcome the shortage, there needs to be an increase in investment in technologies boosting efficiency and reuse, distribution networks, and improvement and encouragement in terms of responsible consumption.

Accelerating Urbanization Generates Opportunities, but Also Risks

Since 2007, the global urban population has exceeded the rural population, although rates vary depending on the degree of development (above 75% in advanced countries, compared with less than 50% in emerging economies). This trend will accelerate slightly over the next years. Megacities (i.e., cities with more than 10 million inhabitants) will continue to grow, but the greatest development will be concentrated in suburban areas. About 63% of the urban population increase will take place in ten emerging economies and North and South America. India (whose cities today only hold 31% of the country's population) and Africa are the regions where urbanization will increase most. UN-HABITAT estimates that Africa's urban population will exceed its rural population within nine years.

Urbanization will continue lifting millions out of poverty, as economic activity grows (and per capita incomes advance substantially) in societies where less than half of

the population currently lives in cities (such as India or Africa). Emerging markets will continue rapid urbanization while developing energy, water, and transport infrastructure. However, unplanned urban expansion is creating enormous challenges. Various sources estimate that 40% of the urbanization process is taking place through slums. Deteriorated neighborhoods are not properly equipped in terms of drinking water, housing, energy, transportation, waste management, ICTs, schools, hospitals, etc., reducing social cohesion and employment opportunities. This makes their inhabitants far more vulnerable to other risks. Both local authorities and the international community must invest more resources to prevent these phenomena.

Consequences of Global Warming

By 2030, average temperatures will be between 0.5 and 1.5 degrees Celsius higher than today. If no decisive action is taken on a global scale, the frequency and severity of extreme weather events such as droughts and floods will increase. Rainfall cycles and patterns are likely to alter, with rainfall declining particularly in North Africa and the Middle East. Note that economic interconnection and heavy dependence on imported foodstuffs have made droughts a global rather than a local issue.

At the current melting rate of glaciers and ice caps, sea levels will rise between 8 and 23 centimeters, endangering populations and livelihoods. The planet's biodiversity will be reduced by five points, to 65% of its full potential. Whole glaciers in the Himalayas, the Hindu Kush, and the Andes could disappear or be significantly reduced – leading to an increased flow to rivers that supply hundreds of millions of people, as well as severe flooding (in Bolivia, China, Ecuador, India, Pakistan, and Peru).

The least developed countries are the most vulnerable to climate change. The World Bank estimates that 100 billion dollars annually are needed over the next 40 years to fund adaptation to climate change in the least developed countries. These nations will suffer an increased incidence of diseases such as malaria, meningitis, and dengue, as well as phenomena such as droughts, floods, desertification, crop failures, and climate refugee migrations.

On the other hand, developed economies should do more. The recent agreement between China and the US is clearly insufficient. For its part, the European Commission expects, by 2030, to reduce greenhouse gas emissions by 40% when compared to 1990 levels and produce 27% of energy from renewable sources. The key to sustainability will be energy efficiency. According to the *BP Energy Outlook to 2035,* energy intensity

(i.e., the amount of energy required to generate a unit of GDP) will fall by 36% (1.9% annually) between 2012 and 2035.

Persistence of Energy Price Volatility

The revolution in the extraction of hydrocarbon unconventional sources (i.e., shale gas, coalbed methane, tight gas and oil, complex gas, and heavy oil) is dramatically changing the global economy and geopolitics. Since 2008, America has increased its oil production by 56%, mainly thanks to unconventional hydrocarbons. America could become the largest producer of gas within a few years, as well as the largest producer of oil by 2020 (2017 according to the International Energy Agency), and go on to achieve energy self-sufficiency by 2035. The American shale gas revolution has generated more than half a million jobs, improved the competitiveness of industry, and even enabled some re-industrialization.

The development of deepwater operations (especially in the Gulf of Mexico and sub-salt formations in Brazil), new areas of exploitation in Africa and the Arctic, and possible future exploitation of unconventional resources in Canada, Venezuela, or Argentina, as well as advances in biofuels, could fuel the current low prices. The decoupling between stagnant demand and oversupply could facilitate the maintenance of low oil prices in the medium term. The downsides are the cancellation of numerous investments in both conventional and unconventional oil, as well as the decreased attractiveness of boosting renewable energies.

The Geopolitical Impact of the End of the Oil Boom

The price of a barrel of Brent oil has dropped about $100 from 2008, when it cost $147.25. The main reason for this decline is the gap between supply, which has increased substantially due to unconventional production, and demand, which has slowed, particularly in China. Due to the failure of OPEC (which comprises 35% of global production) and the refusal of Saudi Arabia, its largest member, reducing oil production is not an option. In its actions, the Saudi Kingdom could be motivated by an intention to gain a greater international quota while damaging the economy of Iran, its main rival in the region. Another motivation of this production policy is the intention of reducing the viability and future investment in unconventional projects (which are usually not profitable under $70).

The sharp drop in oil prices is of particular relevance for hydrocarbon export-dependent economies. Thus, Algeria, Ecuador, Iran, Iraq, Libya, Nigeria, Russia, and Venezuela need prices above $100 per barrel to level their national budgets. This weakness substantially affects the foreign policy of these countries, which could change the geopolitical balance in the Middle East, the former Soviet Union, and the Caribbean. Moreover, the main beneficiaries of low oil prices are the EU and China.

Environmental Tensions in Emerging Economies

The growth of the middle class will raise environmental awareness and concern about food safety and air and water quality in emerging economies. It is expected that by 2030, premature deaths caused by tropospheric ozone will have quadrupled. Moreover, each year, more than three million people will die prematurely because of breathing in microparticles.

This risk is already prevalent in our everyday lives: the population regularly exposed to air pollution that is two and a half times (on average) higher than the level the WHO considers as "unsafe" has mushroomed from 606 million in 2000 to 1.8 billion today. In China, according to official statistics, over the past 30 years, the number of deaths from lung cancer quadrupled – a phenomenon that has generated great concern.

Emerging economies will gradually reduce their use of coal (which in China accounts for over 70% of electricity production). Large cities will limit vehicles' sulphur dioxide and nitrogen oxide emissions, applying stricter controls. Concern will continue to grow with regard to food security, especially the concentration of heavy metals in the soil in "second world" nations. In general, these nations will abandon environmental dumping in its more extreme variants due to pressure from citizens – who are increasingly less likely to accept environmental degradation in exchange for economic growth.

THE NEED TO ADAPT: RECOMMENDATIONS FOR EU BUSINESSES

Boosting the Internationalization of European Businesses

Europe is a major exporter. Germany has replaced China as the largest surplus state and the Eurozone has become the economic zone with the largest trade surplus. Although Europe's peripheral economies have drastically improved their current account balances, many EU countries and regions do not have a sufficiently internationalized private sector ready to compete globally. European businesses must assume the strategic nature of internationalization. The economic crisis has highlighted the urgent need to internationalize the productive sector to be able to export to emerging economies, which is where the most substantial part of global demand and economic growth will originate in the years ahead. Long-term growth will not exceed 2% annually in mature markets, forcing European businesses to focus on emerging economies. In order to do so, and considering the emerging economies idiosyncrasies described in the previous section, it will be necessary to implement corporate diplomacy and improve risk analysis in the EU corporate sector. In the current global context, it is no longer enough to have a general understanding of the political environment in which businesses operate. It is key to have the ability to anticipate and manage political risks through professional departments of political risk analysis and corporate diplomacy.

Promoting Multi-localization and SME Collaboration

European companies should develop multi-localization strategies. These strategies, combining outsourcing and market access, help mitigate global risks and access new markets while maintaining jobs at home. Such strategies are often not available to the small and medium-sized enterprises (SMEs) due to their reduced ability to mobilize resources. Therefore, EU institutions and national public administrations should support internationalization by facilitating cooperation and synergies among SMEs, in order to achieve sufficient scale and scope. This would allow many of these firms to take part in projects abroad, especially in low political risk countries.

Flexible and Multicultural Human Capital

In a context of high global mobility among skilled workers, European companies will have to rethink their human resource strategies in order to attract the best talent and promote multiculturalism. Human capital must be multicultural, flexible, and adaptable to new circumstances: a diverse human capital permeable to different ways of doing business is key. The presence of foreigners in the boards of directors of European companies should be an imperative.

Focus on Emerging Social Groups and New Consumption Patterns

The global market for goods and services is in transition. Companies prepared to provide goods and services to new social groups will enjoy great opportunities. For example, the emergence of the new middle classes generates a new market with high potential growth. The specialization in niche markets or luxury goods could provide opportunities for high quality EU businesses. The social transition to less traditional values will increase the disparity in market trends. Consumers tend to identify more with their lifestyle, which provides opportunities for niche companies specializing in specific aspects of fashion, exercise, diet, or culture. In this aspect, the composition of households will be more diverse, creating opportunities for suppliers of goods and services designed for singles, divorcees, single parents, or gay couples. In sum, EU businesses should be prepared to satisfy diverse consumers, as this will be key to their success.

The aging of societies such as the European or Japanese, but also Chinese, Korean, or Taiwanese, will represent a great business opportunity. Over-65 year olds will enjoy better health and their demands will be more sophisticated. Products and services for the over-65 population such as health, insurance products, ICT-applications, senior education, and leisure services adapted to their necessities will offer a great business opportunity.

The growth of the world population will be accompanied by rapid urbanization in emerging economies. This will increase the demand for transport infrastructure, energy facilities, water supply, waste management, and other services. The predominant focus in the coming years will be marked by sustainability, efficiency, and public-private partnerships. European business should be prepared to take advantage of the opportunities in areas with high rates of urbanization, such as Africa and India.

The Business Firm as a Political and Social Agent

The engagement of the business community must transcend the corporate social responsibility (CSR) paradigm. In the aftermath of the great recession, which has seriously dented the public's trust in the private sector, companies should more constructively manage their influence in their communities. They also must create mechanisms to more effectively incorporate the voice of businesses into the institutions that govern economic and social life at the local, national, and global level.

Companies are particularly significant in the context of multi-level governance characterized by non-hierarchical relationships, where non-state actors have acquired greater relevance. Large corporations are global governance actors and key stakeholders in setting standards, providing public goods, promoting soft law, developing best practices, and implementing international agreements. In sum, as economic and social clout grow, so must social and political responsibility.

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Chapter 3

The Importance of Political Risk for European Business

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03

WHY DOES POLITICAL RISK MATTER FOR BUSINESS?

Countries in turmoil fill the front pages of newspapers one day after another: Russia, Yemen, Venezuela, Syria, Nigeria, and Greece. Companies, meanwhile, fear unpredictable change, even as they seek to profit from the opportunities that change creates – a freshly privatized industry in Tunisia, a new government in Nigeria, or new licenses for solar infrastructure in Brazil. The examples are plentiful. To help weigh these risks and make investment decisions, corporations routinely consult economic risk analysts. However, making global investment decisions based only on economic data can be, to say the least, misleading.

Political risk is concerned with the impact of politics on markets. It focuses on understanding the drivers of policy decisions - such as the passage of laws, the behavior of political leaders, and the rise of popular movements - in order to anticipate how these can affect the business environment - in short, all the factors that might politically stabilize, or indeed destabilize, a country. Political risk focuses on the incentives and constraints behind political action rather than on the action itself. While economics will tell you whether an indebted government can pay its debts, political risk will focus the attention on whether it will be *willing* to do so.

Political risk analysis is nothing new for large global investors. However, the significance of any given risk varies depending on the investor. The concerns of a hedge fund manager are very different from those of a long-term corporate investor. While the former is focused on immediate political developments that will impact tomorrow's markets – for instance, whether Greece will decide to default on one of its debt repayments – the latter wants to understand deeper political trends such as regulatory dynamics, consumer attitudes, corruption risks, or the integrity of a country's constitution.

The importance of systematic political risk analysis is more evident for emerging markets, where political stability is low, government actions are less predictable, and social movements are more volatile. However, in the aftermath of the US and European financial crises, understanding, predicting, and dealing with political risks have now also become much more important for companies operating in the developed world.

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* The information and views in this chapter are based on the authors' analysis and opinions at the time of writing, in March/April of 2015.

This is true not only because international markets are more interconnected than ever before, but also because transnational flows of information, technology, and people have diluted the borders of political risk. Understanding geopolitics has become essential for global investors operating both in the developed and emerging worlds. From terrorism to energy supplies and cybersecurity, the transnational political dimensions of risk in the developed world are inescapable. But home-grown causes of political risk are often under-appreciated, including rising populism or nationalism, political polarization, and increasing social tensions and inequalities. These can pose significant challenges to juridical security, the passage of laws, or even to the territorial or constitutional stability of countries in the developed world.

Political Risks in Europe

As we have argued, companies operating in Europe face a number of uncertainties that cannot be captured by simple conventional economic analysis. In fact, since the beginning of the Eurozone debt crisis, in countries like Greece, it is political risks that have become critical and deterministic. Our outlook for Greece is addressed in more detail in the last section, but its example perfectly captures the complex dimensions of political risk in the developed world.

In order to make rigorous investment decisions in or related to Greece, it is not sufficient to look at the government's near-term financial obligations. A number of other factors will determine several pressing questions regarding Greece's fate, such as whether it will remain a member of the euro, indeed, even the European Union. These include, but are not limited to, the internal balance of power within the current Syriza-ANEL government, the true meaning of an "acceptable package of reforms" for creditor countries to disburse much-needed cash to the Greek government, the calculations within the German finance ministry regarding the potential costs of "Grexit," and the willingness of the European Central Bank (ECB) to continue to support Greece's banking system with emergency liquidity assistance. These are just some examples of the multiple dimensions of political risk that need to be taken into account in the context of Greece's current woes.

However, Greece is not an exception. In the coming two years, companies operating in Europe will need to be prepared to navigate a number of issues that will shape the future of the continent: Will a potential referendum on the UK's EU membership push the UK out of the European Union? What factors could further escalate tensions between the EU and Russia over Ukraine? Will Spain's new populist Podemos party win the country's national election later this year? Are the terrorist attacks in Paris in January 2015 an isolated event or evidence of an ongoing systemic threat for Europe?

In what follows, we will address these and other questions. We briefly apply the framework outlined above to set up our discussion of Europe's key risks over the course of the next two years. We review the origins and implications of the ongoing political and institutional crisis in the Southern periphery and discuss the risks of Greece's exit from the Eurozone and the UK's exit from the EU.

OUTLOOK 2015-2016: UNPARALLELED GERMAN INFLUENCE

How should we consider the framework outlined above and its application to risks in Europe in 2015-2016? From our perspective, one of the key sources of risk in Europe over this period will be Germany's unparalleled political influence.

This trend has been in play since the Eurozone debt crisis, in which Germany emerged as the euro's economic hegemon and key creditor state, but has crystallized over the course of 2014 with the Ukraine/Russia conflict, as German Chancellor Angela Merkel has assumed the role of key interlocutor in the conflict. Importantly, Germany's preeminence in the economic and foreign policy domains has created positive political spillover elsewhere, especially regarding Germany's capture of the EU's supranational institutions. All of Europe's current institutional leaders came to power or exercise power as a result of acquiescence in Germany. This has resulted in a default position of influence for Germany in Europe.

Why does this create risks for business in Europe? In all of the key political and policy debates on Europe's future, Germany will largely dictate the pathway forward. This is very unlikely to lead to optimal, and certainly not "market or business friendly," outcomes. Current sanctions in Russia, Europe's overly tight fiscal policy stance, the delay in the ECB's ability to undertake sovereign bond purchases despite Eurozone inflation being seriously "dis-anchored" from target, and the growing chances of a Greek exit given limited German flexibility all show the risks to business inherent in a continent governed by unrivalled German influence. A more balanced union, in which a larger number of EU states are able to determine a pathway forward, will result in more optimal, and indeed more market and business friendly, outcomes.

With this overarching context in mind, in the remainder of this piece we discuss four key challenges facing European politicians, policymakers, and businesses alike with respect to the end of the era of reforms in Europe's southern periphery. We also discuss two political risks in detail: the chances of Greece's exit from the euro and the risk of the UK's exit from the EU.

THE SOUTHERN PERIPHERY

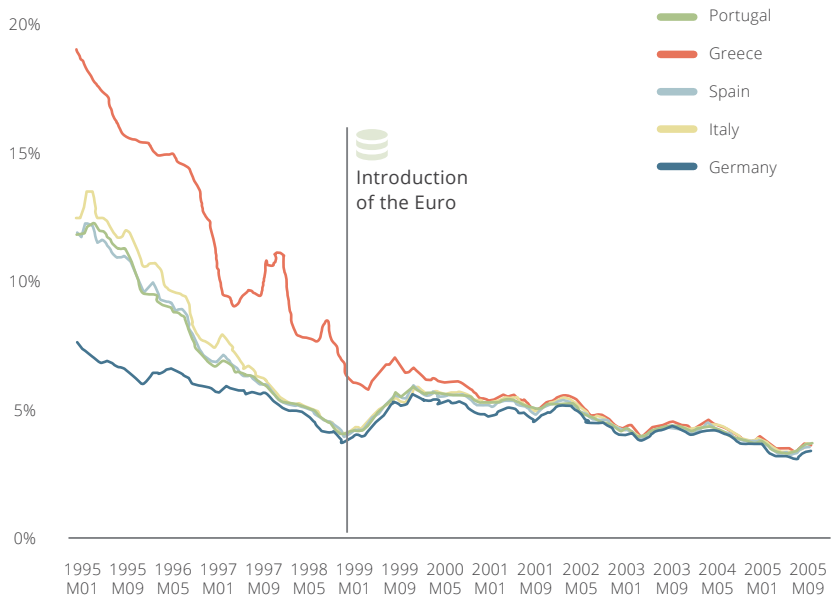
The Boom Years and Institutional Deterioration

Before EU member states' exchange rates were locked together on January 1st, 1999, conventional wisdom held that the monetary union would drive economic convergence between the bloc's less and more competitive members. Specifically, the unavailability of currency devaluation to boost competitiveness would force less competitive economies in southern Europe to pursue structural reforms to modernize and improve their institutions, and ultimately their growth capacity.

However, over the following decade, and in the aftermath of the Eurozone's 2010 debt crisis, it became clear that the result was the opposite: growing institutional and economic divergence. Efforts to reform monopolized product markets, rigid labor regulations, uneffective tax systems, and other impediments to long-run growth were abandoned and often reversed.

Why did this happen? One plausible explanation explored by Fernández-Villaverde et al. in 2013[1] is that the impact of the global financial bubble on peripheral Eurozone countries led to a relaxation of "constraints" on governments. The elimination of exchange rate risk after the creation of the euro led to a drop in interest rates and a rush of cheap financing into southern Europe. The large windfall of cheap credit resulted in the postponement of otherwise necessary reforms. Why would governments sacrifice political capital in backing unpopular reforms if they could instead borrow money at extremely low cost? There was an absence of a coherent economic governance framework able to identify and correct growing imbalances in competitiveness; public and private debt exacerbated the picture.

Graph 1: General Government 10 Year Bond Yields



Source: Eurostat

[1] Fernández-Villaverde, Jesús, Luis Garicano, and Tano J. Santos. "Political Credit Cycles: The Case of the Euro Zone." *Journal of Economic Perspectives 27*, no. 3 (2013): 145-66.

Importantly, the credit windfall gave politicians the opportunity to reinforce rent-seeking dynamics and other bad practices: public services became more politicized and inefficient, political parties grew increasingly clientelistic, and the quality of governing elites declined. The mirage of economic growth meant these problems festered and were not addressed for years.

For example, in Greece, the altered perception of risk caused by the euro and the subsequent fall in borrowing costs allowed weak governance to survive for years. Greece's productivity fell and the government continued borrowing from the rest of the world in order to maintain its living standards. As a result, net external debt rose from 42.7 percent of output in 2000 to 82.5 percent in 2009.

The case of Spain was different. The imbalances grew mainly in the private sector as a result of the real estate boom (which had in turn been precipitated by the large flow of liquidity into the country after it entered the euro). Spain grew at an average of 3.5% between 1995 and 2007, but productivity stagnated. In fact, in the same period, Total Factor Productivity (TFP) fell at an annual rate of 0.7%, while increasing by 0.4% on average in the EU.

This is partly because during the boom years, Spain's economy specialized in construction, a very low productivity sector. However, recent research by García-Santana et al. in 2015[2] suggests that low productivity levels were present across all sectors of the economy. These authors argue that the inefficient allocation of production factors likely resulted from crony capitalism and rent-seeking, noting that the sectors where the state's influence was greater (the allocation of licenses and permits, for instance) registered more significant falls in productivity levels during the boom years.

In the meantime, huge imbalances appeared in the financial sector, as the politicized Cajas (Spanish saving banks) gave unrestrained credit to developers and house buyers. During the peak of the boom, about 50% of the loans on the balance sheets of the Cajas were destined for real estate related activities. When the boom came to bust, the financial sector needed €41 billion of bailout money to recover.

[2] García-Santana, Manuel, Enrique Moral-Benito, Josep Pijoan-Mas, and Roberto Ramos. *Growing like Spain: 1995-2007.* 2015.

The boom in Spain had a number of other institutional side effects: school drop-out rates skyrocketed as many youngsters abandoned school to work in very well paid low-skilled jobs in the construction sector; political corruption in construction, local governments, and political parties became commonplace; and structural imbalances in the economy, such as poor labor market regulation, remained unaddressed. The result was that by 2008, the Current Account Deficit reached a clearly unsustainable peak of 12% of GDP.

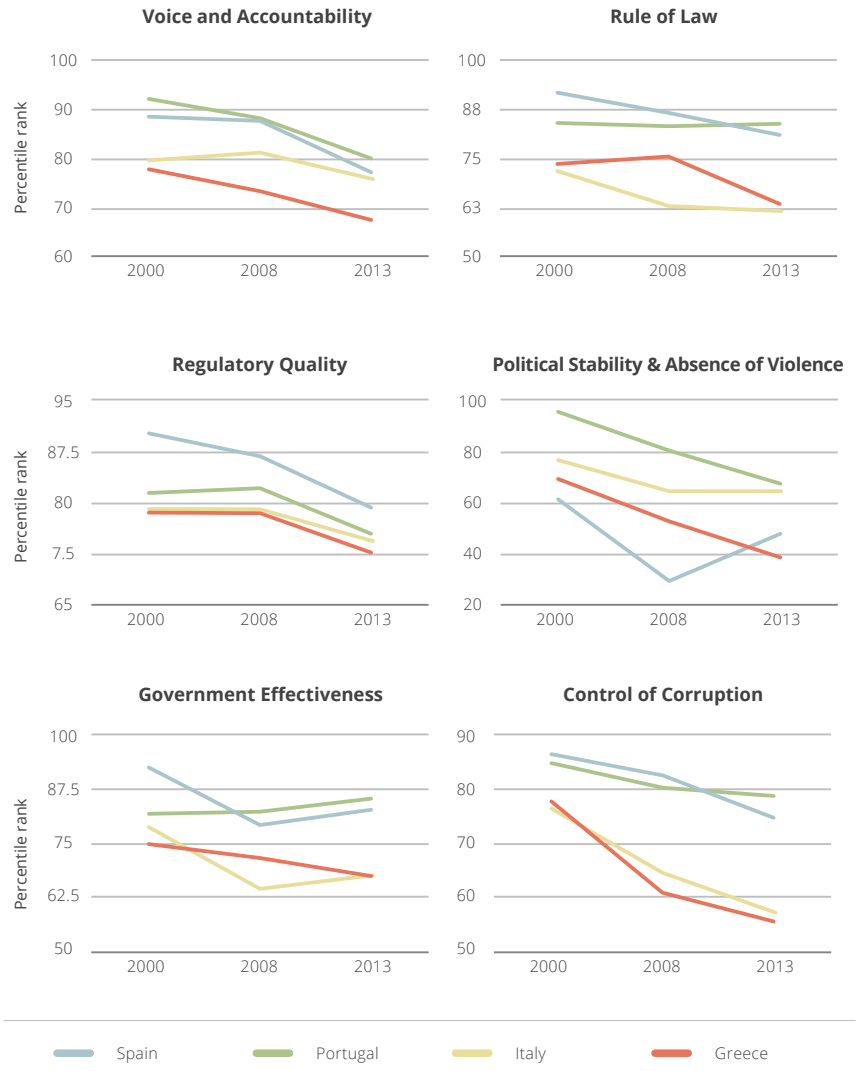
Portugal grew at a much slower pace than Spain and did not have a real estate boom. However, historically low borrowing costs allowed both the center-left Socialist Party (PS) and the center-right Social Democratic Party (PSD/CDS) governments to delay addressing some key growth bottlenecks: a highly inefficient judicial system, a heavily regulated labor market, and a very low level of human capital. In the meantime, large industries such as energy or transport remained shielded from competition.

Portugal did not grow nearly as much as Spain or Greece after the creation of the euro. There was no housing boom nor did private demand skyrocket - its economic performance was actually quite disappointing, with GDP averaging a growth rate of 1.2% between 2001 and 2007. However, by the turn of the century, transfers both from emigrants and the European Union started to slow down and the economy failed to adjust to this new normal. The result was a steady growth of net external debt that went from less than 50% in 1997 to more than 100% of GDP in 2008. This was not a good position to be in when the financial crisis unfolded.

On the fiscal side, the Portuguese government was not as profligate as Greece's, but it failed to accumulate sufficient buffers to weather the incoming storm. Only some creative accounting (hospitals and public transport companies were kept out of the government perimeter) ensured that Portugal was able to comply with the Maastricht criteria of debt and deficit.

In Italy, stagnation long preceded the financial crisis. Strict labor rules, an extremely inefficient judicial system, cumbersome bureaucracy, and rampant corruption made for a dismal investment climate by developed market standards, all the while stifling private investment and hampering competition. An overly rigid labor market and high taxation contributed to high labor costs that were not in line with declining productivity, further hurting firms' competitiveness and leading to a steady loss in export market share.

Graph 2: Evolution of Governance Indicators in the European Periphery Since Euro Entrance



Source: Kaufmann, Daniel, Aart Kraay, and Massimo Mastruzzi. "The Worldwide Governance Indicators: Methodology and Analytical Issues." World Bank Policy Research Working Paper, no. 5430 (2010). The Worldwide Governance Indicators are available at www.govindicators.org.

In summary, the first ten years of the euro helped to increase rather than reduce the institutional gap between the north and the south of the Eurozone, leading to increasing vulnerabilities to financial crisis, but also planting the seed for the political and institutional crisis that followed after the burst of the bubble.

The Effects of the Crisis: Long-term Political Risk Trends

Adjustment Paths Vary

The first effect of the crisis has been a deep fiscal and structural adjustment in the Eurozone periphery, which has been far from homogeneous. Ireland, Spain, and, to a lesser degree, Portugal have managed to address some of their most pressing growth bottlenecks and are now emerging from recession and returning to sustainable debt dynamics. Spain and Ireland, with economic growth above 2.5%, will be among the fastest growing economies in 2015. In Portugal and Spain, the enhanced flexibility introduced by successive labor market reforms has helped reduce unit labor costs and boost competitiveness, leading (at least temporally) to a rapid correction of the large external imbalances that resulted from the boom years. It remains to be seen, however, whether these improvements will be permanent. As we will address below in more detail, given the political dynamics that have emerged from the crisis (i.e., weaker governments and decreased requirements for reform), it is likely that some of the achievements will be undone.

Ireland's fall from boom to bust resembles the experiences of the Southern periphery, with the notable difference that the boom years in Ireland actually did deliver a number of improvements which help explain Ireland's spectacular recovery. Indeed, although the growth of the "Celtic Tiger" was boosted by an unsustainable property price bubble, the country also invested in education and infrastructure and climbed into the Top 20 of the World Bank's Ease of Doing Business index. This helped reinforce an already strong tradable goods sector. During the 1995-2006 period of growth, Irish banks borrowed abroad heavily to lend unconditionally into the seemingly ever-prosperous property market. When foreign credit became unavailable in the crisis, the property market crashed, taking most of the banks' assets with it and leaving the banks with much greater deposits to honor (as withdrawals went up) than assets. The government's decision to guarantee bailouts led to the 120% debt-to-GDP ratio the country is still grappling with today.

The story of Italy and France is very different. Despite sharing important institutional deficiencies with bailed out countries, these countries did not undergo EU-IMF Economic Adjustment Programs. Thus, the reform effort has been significantly more modest.

Since the introduction of the euro, France has suffered from a decline in competitiveness. Since coming to power in 2012, President Francois Hollande and his government have introduced a number of reforms. They have been more ambitious and far-reaching than what past governments have achieved, but their reach does not suffice to reverse declining competitiveness.

A combination of measures has been implemented to enhance labor market flexibility, France's main growth bottleneck. These include an abolition of employers' social contributions for salaries at the minimum-wage level; a reduction of employers' social contributions to fund family welfare benefits; and a reduction of self-employed workers' and artisans' social contributions to fund family welfare benefits. While these measures are expected to have a positive impact on competitiveness, the magnitude of the impact remains highly uncertain. Moreover, other central aspects of labor regulation are likely to remain off the table in the near future. For instance, with regard to flexibility in hiring and firing, France ranks 134th of 144 countries in the latest Global Competitiveness Report by the World Economic Forum, and there are no measures planned. Furthermore, with regard to reducing administrative burdens for business (for instance, regulations that constrain firms' growth) or introducing competition in certain industries such as services, reform efforts remain far from optimal.

More ambitious reforms are necessary. However, the chances of reform are not favorable, primarily because of opposition from within the Socialist Party (PS) – a factor that is unlikely to change. Well aware of Hollande's deep unpopularity, the leftist side of the PS is increasingly willing to abstain or vote against reform legislation that comes before parliament, thereby limiting the government's ability to implement structural changes, which will result in limited and piecemeal reform and progress.

The case of Italy deserves particular attention. Italy's economy had virtually stagnated for close to a decade before the onset of the financial crisis. Additionally, the country did not experience the boom that followed the adoption of the euro in other peripheral European economies. Subsequently, Italy has undergone the deepest and most protracted downturn among its neighbors between 2009 and 2014 (second only to Greece in this regard), leaving real GDP at 8% below its pre-crisis peak.

Still, the recovery has been very slow to take hold and, more worryingly, long-term growth prospects remain poor, with growth expected to average around 1% through 2020. This stands in marked contrast with Spain and Ireland: while the degree of fiscal consolidation has been significant, Italy has lagged behind in the implementation of structural economic reforms compared to its periphery neighbors.

However, Prime Minister Matteo Renzi's appearance on the political scene has improved the reform outlook for Italy. By virtue of his consistently high approval ratings, Renzi is considerably better placed to face a return to the polls than other key parliamentary stake-holders, whose reelection prospects would be severely at risk. Renzi therefore can and will use the implicit threat of snap elections to move his reform agenda forward, even attaching specific bills to confidence motions when necessary. Still, opposition from dissident Democratic Party lawmakers and centrist coalition partners will make for a noisy and lengthy approval process.

Structural reforms, addressing in particular the stagnant labor market and the inefficient public administration and judiciary, are ambitious by historical standards and could go some way toward improving the investment climate, but only over time. It will be one to two years before they are fully implemented and even longer before they have a meaningful impact on economic output. With public debt at over 130% of GDP (again, second only to Greece in relative terms) and absent stronger growth, Italy remains vulnerable to sovereign market pressures in case of a future downturn.

Fragmentation, Populism, Euroskepticism and Nationalism on the Rise

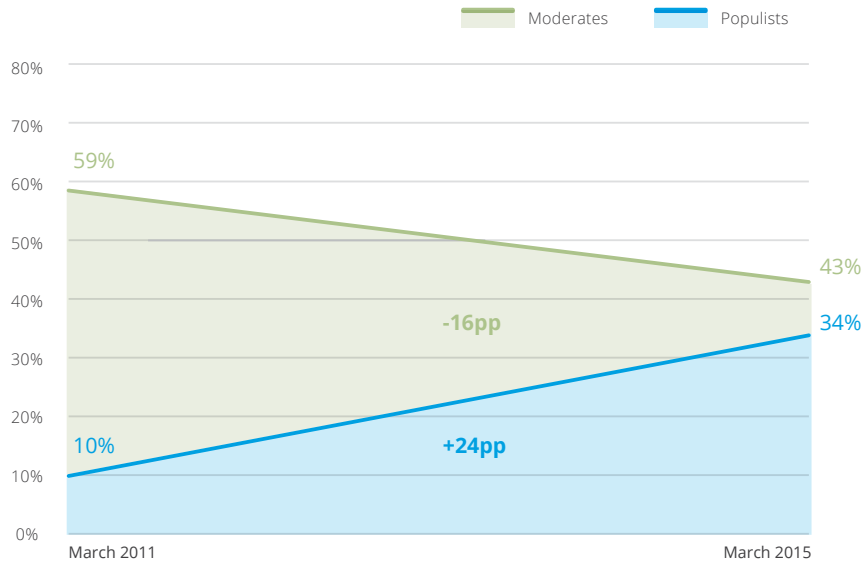
Besides the remaining institutional and competitiveness challenges, the crisis has led to a deep political crisis in southern Europe. The high social costs of the adjustment have translated into significant shifts in policy preferences among voters. In some ways these developments will lead to increasing risks for businesses, but in others, they will provide new opportunities. In what follows, we analyze some key long-term macro political implications of the crisis as well as their implications for business.

Over the last few years, traditionally dominant parties have seen their power erode in favor of smaller parties or new political parties, which are more populist, Euroskeptic, and extreme. Although this also holds true for the European core, the process has been far more intense in the Southern periphery.

In Spain, the two largest parties have moved from having 85% of the vote in 2011 to less than 50% today. A new populist party, Podemos, created just one year ago, is polling first preceding the local, regional, and national elections this year. Greece is now governed by the radical leftist party Syriza, while the traditional Panhellenic Socialist Party, PASOK, with over 100 years of history, almost failed to cross the 3% electoral threshold to enter parliament in elections earlier this year. In Italy, a protest party, the Five Star Movement, got 25% of the vote in the last election. The populist and Euroskeptic Lega Nord has been rising persistently over recent months and is now polling at close to 15%. In France, the extreme right party Front National will be a serious contender for the presidency of the republic in 2017.

Graph 3: The Rise of Populism in Southern Europe

Evolution of the Average Polling Data for Moderate and Populist Parties in Greece, Spain, Italy, and France.



Source: Own calculations based on averaging estimated voting intention for moderate (i.e., PASOK, ND, French PS, UMD, Italian PS, FI, PSOE, PP) and populist (Syriza, ANEL, Golden Dawn, Podemos, M5S, Lega Nord, FN) parties obtained from several polling houses

Parallel to that trend, Europe has seen a rise in nationalist and secessionist parties. The two most important movements have been in Scotland and in Catalonia. In Scotland, the tight victory for the "No" to independence from the UK in a recent referendum has been followed by a rise in polling of the leftist secessionist Scottish National Party (SNP), which is giving the party leverage to ask for extended devolution of powers in ongoing negotiations with London.

Conversely, the conflict between Madrid and Barcelona is stalled ahead of regional and general elections to take place at the end of the year. After about two million Catalans voted in favor of independence in a poll declared illegal by the Spanish government last November, Catalan President Artur Mas decided to call early elections on September 27th, 2015. The Catalan government sees these elections as a plebiscite for secession, meaning that if support for independence is greater than 50% (of the vote, not the seats), Mas will feel legitimized to carry out an 18-month plan toward independence signed earlier this year with the left-wing party Esquerra Republicana de Catalunya (ERC). However, such a scenario is unlikely.

Firstly, Mas has recently signalled he could backtrack on his commitment to hold elections. This is because the pledge depends on an unstable government deal, and tensions are mounting. Moreover, early elections will go against the interests of his party, Convergència i Unió (CiU), as it would likely lose power to ERC and, hence, lose the chance of capitalizing on potential concessions offered by Madrid after national elections later in the year.

Secondly, proceeding with the independence plan would lead to a break-up of Mas' own party, as the junior member of the historical coalition, Unió, does not want independence. Thirdly, ever since CiU became a secessionist party, the pro-independence vote has never exceeded 50%. In fact, since the Catalonian parliamentary election in 2012, support for independence has stopped growing in the polls, stalling at around 45%. The number of votes for secessionist parties in the 2012 election was very similar to the number of pro-independence votes in last November's referendum: about two million (40% of the electorate). Furthermore, the ongoing strong economic recovery and the increasing number of parties and policy options represented will work against the pro-secessionist platform.

In the upcoming Catalan election, therefore, the pro-independence parties will probably gather an absolute majority in parliament (in terms of number of seats), allowing them to form a government, but they will fall short of the 50% of votes needed to carry out the secession plan. As a consequence, the so-called *rough bargaining strategy* with

Madrid will stay on course. If the more radical leftist ERC candidate becomes president of the region, the tone of negotiations will harden somewhat, but a break-up remains unlikely, as it would lack the popular support of a clear majority of Catalans.

There are further instances of secessionist movements with significant popular support in the continent: Padania (Northern Italy), the Basque Country (Northern Spain), and Flanders (Belgium). It is unlikely there will be any sort of independence declarations or decisive movements in the short term in any of the cases. However, unavoidable uncertainty in the medium term will damage business prospects.

CATALONIA: THE "WHAT IF" SCENARIO

In the unlikely scenario that Catalonia launches a "unilateral declaration of independence" without negotiating with Madrid, the EU would enter into uncharted waters. Although there are precedents for nation-states breaking up into smaller states within Europe, never before has this involved a member of the EU. Catalan pro-independence leaders argue that it would be relatively easy to rejoin the EU. However, this is unlikely. Moreover, in a confrontational scenario with Madrid, the short-term economic costs are likely to be huge. These are just some of the key risks to consider:

A hard sell for the EU: As a newly independent state, Catalonia would have to reapply for membership. Article 49 of the Treaty of the European Union stipulates that any country seeking to become a member should begin by obtaining the status of "applicant country," which requires ratification by the European Council, after consulting the Commission and the Parliament. The country and the EU would then begin a formal negotiation process to ensure compliance with the body of EU law known as the "Acquis Communautaire." Most importantly, obtaining EU membership - and the mere status of "applicant" to allow formal negotiations to begin - would require a unanimous vote from all of the EU's 28 member states. European Commission President Jean-Claude Juncker has stipulated as much.

Assuming a unilateral declaration of independence, the government in Madrid will surely oppose Catalonia's readmission (this will not change, regardless of the outcome of the national election). Moreover, other countries facing

internal regional secessionist challenges may also be reluctant to admit Catalonia back in the club as they will not want to send a message to their regions that the costs of breaking up are low. Although each case is different, such countries include the United Kingdom (Scotland), Belgium (Flanders), France (Corsica), Cyprus (Northern Cyprus), and Italy (Lombardia and Veneto, in Padania).

For all the remaining countries, it is unclear why they would wish to grant Catalonia rapid access, with undetermined potential gains. Germany, for instance, holds a tough line against secessionist movements in Europe for fear of opening the door to a "Balkanization" that goes against its integrationist impulses. Even if these governments finally agree to accept Catalonia as a new member and not to use their veto power (officially they have all argued that Catalonia independence is an internal matter for Spain), the process would be a long and arduous one. The terms of accession would have to be ratified by national parliaments and, in some countries, also by a referendum. As a result, in the unlikely scenario of a rupture, Catalonia would remain outside the EU for a long period: probably more than three years.

The fiscal outlook: There is huge uncertainty about how public sector assets and liabilities would be divided. A key question is whether Catalonia would be willing to accept its hypothetical per capita share of Spanish debt, including its repayment commitments to government lending programs. We believe that, in a confrontational scenario in which Catalonia is blocked by Madrid from accessing the EU, Catalans would reject the notion that they should assume such debt commitments. This would leave Spain with a much larger debt-to-GDP ratio (given that the country would have the same amount of debt, but GDP would be about one fifth lower). With regard to the broader fiscal outlook, in principle Catalonia would be favored since the region is a net contributor to Spain.

However, there are many variables that could challenge that assumption. First, Catalonia is home to many large corporations that, in the event of independence, could decide to relocate, thus affecting the fiscal balance (given that corporate tax is paid where the headquarters is based). Second, a new independent state would have to build new institutions and would have to assume significantly larger expenditures (including defense and pensions or unemployment benefits), which are now provided by the state.

Third, borrowing costs would likely be significantly higher (despite Catalonia having a primary surplus) as a result of the stress in debt markets, arising from the developments explained above, and the fact that Catalonia, as an independent state, would not have a credit history.

The euro issue: Catalonia's first choice would be to maintain the euro. However, since Spain would likely block the region's admission to the EU, it would also be ejected from the currency union. It is unclear how any interim agreement would work. Such uncertainty would be highly negative for banks and large corporations who would probably, when possible, move their headquarters to Madrid or elsewhere.

In what follows, we identify two long-term effects from rising political instability in Europe that are likely to have a negative impact on business: a relaxation in the pace of structural reforms and difficulty in moving forward with more necessary European integration. These political dynamics are likely to compound existing challenges in growth, debt sustainability, unemployment, and demography, especially as it remains to be seen whether the reforms achieved over the last three years will significantly improve competitiveness in the countries concerned. On the positive side, however, the rise of new parties has raised pressure for traditional parties to reduce rent-seeking behavior and corruption. This could lead to some improvements in regulatory systems and juridical security – two factors which would reduce the costs of doing business across Southern Europe.

Reform Stalls

While progress on both fiscal adjustment and structural reform over the last three years has been remarkable, there is still a long way to go to achieve an institutional catch-up with the North. However, increasing fragmentation in national parliaments will translate into increased political instability, extra difficulties in forming governing majorities, and shorter tenures. Ultimately, weaker governments and polarized opposition parties will complicate the task of pushing forward structural reforms and addressing key remaining growth bottlenecks.

This is particularly important in a context in which other constraints for reform have also been relaxed. These include lower external surveillance as a result of the end of Economic Adjustment Programs (in all countries but Greece) and lower borrowing costs. In fact, as a result of the innovative monetary policies implemented by the ECB, especially its commitment to being a lender of last resort through its Outright Monetary Transactions (OMT) program, all peripheral economies are now borrowing at historically low levels. Moreover, the region is facing a super-electoral cycle in 2015, kicking off with Greece, followed by four rounds of elections in Spain (local, regional, Catalan, and national) and national elections in Portugal in autumn.

In fact, in Portugal, for instance, since the bailout program ended last summer, the government has delayed or abandoned a number of important reforms, such as liberalizing the energy and transport sectors and improving legislation for corporate deleveraging. In other cases where reforms were implemented de jure, there are lingering problems with enactment and impact evaluation. This is particularly true for adjustments in the functioning of public administration, such as merging public bodies. Furthermore, there are a number of areas in which the government has been backpedaling. These include raising the minimum wage, reintroducing some forms of collective wage-setting mechanisms, and toning down the recently approved law of the rental market.

In Spain, after three years of intensive reforms, the government has also significantly relaxed the pace of reforms in 2015. Given the likelihood of heavy fragmentation of the parliament after December's national election, with four parties likely to hold between 15% and 25% of the seats, these reforms will be difficult to pass. They include, but are not limited to, a reform of the tax system to boost very weak revenues, the opening of certain shielded sectors (such as the energy markets and some services) to competition, and a deep reform of Spain's poor education system.

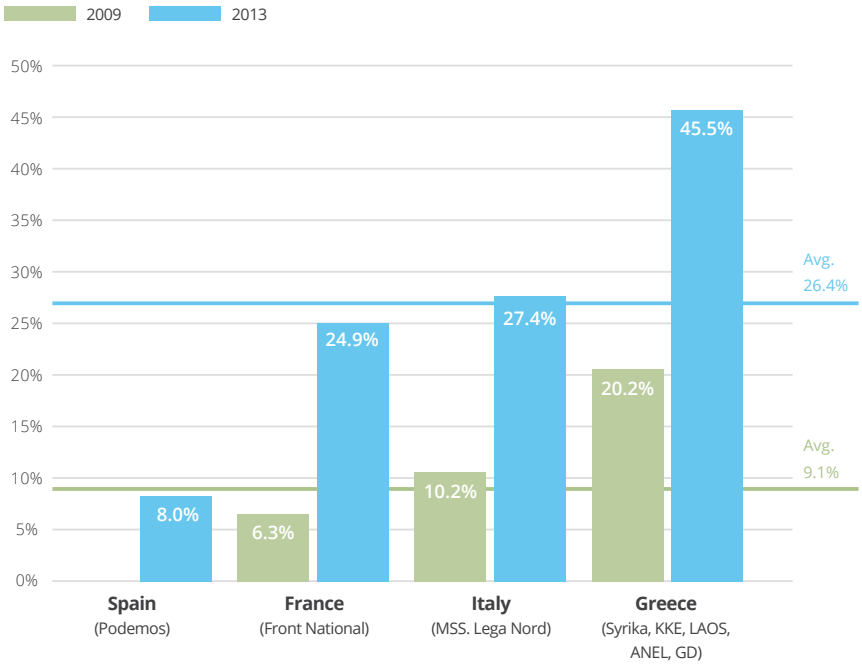
European Integration Remains Insufficient

A second political consequence of the crisis has been rising voter discontent with the European integration project. Euroskepticism has increased everywhere. Among creditor countries, taxpayers are tired of shouldering bailouts of their southern European neighbors. In the South, austerity policies associated with the euro have become the scapegoat for deep social suffering. All in all, the new scenario has led to the univocal realization that further European integration will now remain decisively off the table for some time.

This will, in turn, impact EU leaders' ability to credibly fix the Eurozone. With treaty change elusive, the capacity to introduce deeper fiscal integration will be limited. This means the institutionalized fiscal transfers and debt mutualization economists think are necessary to make the euro work are unlikely to be put in place, be they in the form of Eurobills, Eurobonds, a debt redemption fund, or a more robust EU federal budget. Meanwhile, the more poisonous nature of national politics will affect the issue of immigration, hurting one of the Eurozone's most important adjustment mechanisms absent the abovementioned transfer mechanisms, namely labor mobility, which has gained importance in the context of the monetary union.

Graph 4: Euroskepticism Support has Tripled in Southern Europe

Evolution of European Election Results for Euroskeptic Parties in Greece, Italy, and France



Source: Official election results from the 2009 and 2014 elections to the European Parliament, as provided by national governments

More Transparency and Renewal of Elites

A third ramification of the appearance of new players on the political scene is increased pressure to improve transparency, reduce corruption and rent-seeking practices, modernize political parties, and renew political elites.

In Italy, for instance, the rise of the anti-system Five-Star movement has led to greater public scrutiny of established political parties. Reforms have been initiated to curb corruption and make public bureaucracies more efficient and accountable. Still, Prime Minister Renzi's ability to act decisively on this front is limited by opposition from junior partners and his own reliance on the party structure.

In a similar vein, in Spain, the electoral crisis of the two large traditional parties has led to the introduction of new regulations to improve openness and accountability, such as a new Transparency Act, party initiatives to publish MPs' private accounts and commitments to exclude indicted politicians from electoral lists. Moreover, the appearance of new parties has prompted new mechanisms to renew party elites as well as more democratic processes to elect new leadership. The socialist party PSOE for instance, has introduced mandatory primary elections.

The renewal of political elites is likely to be accompanied by new, more reformist leaders, although it is still too early to appreciate the impact of those changes on business. Furthermore, it remains to be seen whether these initiatives will lead to permanent institutional changes. It is likely that further measures will have to be introduced to address the long-term roots of corruption, such as the strong politicization of the bureaucracy or the "cozy relationships" between business and politicians. In any case, however, all these initiatives are clearly steps in the right direction.

Unlikely to Come to Power

A final positive consequence for business is that besides Greece, it is unlikely we will see more of these populist parties entering government in the near future. The elephant in the room, however, remains the case of Podemos, Syriza's Spanish cousin, addressed in the box below.

WILL PODEMOS COME TO POWER?

After a meteoric rise, Podemos' electoral support has stopped growing. Since November, it has been consistently garnering 20%–25% in the polls. Spain's other two large parties, the Spanish Socialist Workers' Party (PSOE) and the People's Party (PP) have fared differently: while PSOE has stopped losing support, PP has continued to fall moderately in favor of a new centrist party, Ciudadanos, whose support has climbed from less than 4% in May's European Parliament elections to over 16% in the latest polls.

A number of factors will continue to hinder Podemos in the lead-up to national elections in December. Firstly, Podemos is not a new phenomenon anymore. It no longer benefits from being a newcomer, full of promises and with no past. In recent months, the party has been forced to define its policies in more detail (which naturally involves disappointing some voters) and it has been deeply scrutinized by the public.

In the process, Podemos' intellectual guru (and former advisor to Hugo Chavez), Juan Carlos Monedero, has been implicated in an inquiry on tax fraud. This is particularly bad news for Podemos given that its primary narrative has been built around the idea of presenting itself as the "clean" alternative against the old corrupt elites (the "caste" in Podemos' very effective wording) represented by the two traditional parties, the PSOE and the PP.

Secondly, Podemos' main electoral competitor, the moderate and traditional socialist party PSOE, is holding up to Podemos' ascent relatively well, as proven by national polls and the results in the recent Andalusian election, where the socialists received 47 seats out of 109 and Podemos only 15. In fact, the PSOE's vote drain has effectively stopped since Pedro Sanchez, its new young leader, was elected last September. Given the positive change in leadership, the credible commitment to renew the party's elite, and the hard stance taken by the party on corruption issues, there is no reason to believe PSOE's decline will continue – this as opposed to its Greek political cousin, PASOK, which has virtually disappeared. The left-wing votes in Spain are limited, meaning that if the PSOE remains at its current support levels, Podemos has little room for more growth (it has already mobilized many of the traditional abstentions and younger voters).

Thirdly, Spain's economy is likely to continue creating jobs at a faster pace than in previous crises as a result of more flexible labor market regulation. In fact, Spain has created 400,000 new jobs (year-on-year by February) and will have one of the fastest-growing economies in the Eurozone this year. This positive trajectory will weaken Podemos' anti-austerity narrative as well as the willingness of voters to attempt political experiments - particularly amid the likely ongoing tensions in Greece over the next few months.

Fourthly, Podemos will be running in local and regional elections in May, and in order to govern, it will be forced to form coalitions with the much-criticized PSOE. This will probably disappoint part of Podemos' radical electorate.

Lastly, the entry of Ciudadanos as a fourth player will not facilitate Podemos' aspirations to become a party capable of attracting votes from both the right and the left. Ciudadanos (also known as Citizens, or C's) is a centrist, pro-business platform that is attracting votes mainly from moderates disappointed with PP and PSOE, while containing Podemos' expansion beyond the left. Working in Ciudadanos' favor is the charisma of its young leader, Albert Rivera, as well as the party's strong economic team, and its tough line against both corruption and Catalan secession. However, in order to viably compete in the Spanish electoral system, Ciudadanos will have to expand its influence beyond its primary support base of urban voters.

Given the above, Podemos will likely not be Spain's version of Syriza because the party is unlikely to achieve as much power as its Greek counterpart. In the improbable event that Podemos does come to power, it would have to be in the context of a coalition with a relatively strong socialist party, which would greatly constrain its policy options.

TWO POLITICAL RISKS IN DETAIL: GREXIT AND BREXIT

Grexit

The country could abandon the euro, but not necessarily the EU.

Greece's fragile economic recovery has come under considerable threat due to politics. Despite the temporary relief provided by the late-February agreement to prolong Greece's bailout program by four months, diverging viewpoints in Berlin and Athens over how to deal with Greece's colossal debt repayments and outstanding reforms create a growing risk that the country could leave the Eurozone (a 30% probability). We still think it is more likely that the reforms required by its creditors – led by Germany – to extend needed financial support will be approved by a new, more centrist coalition. The Greek people, alternatively, could approve the reforms by referendum, or even another round of early elections, in the understanding that doing so is the only way to stay in the Eurozone.

While a last-minute agreement to extend Greece's original 2011 bailout program will be the simplest way to secure additional disbursements needed to repay a total of €6.7 billion to the ECB in July and August, developments in Athens and Berlin point to a growing risk that the two sides may not reach an agreement.

For instance, Athens has been permitted some latitude in deciding which reforms it wants to accept. The government has prioritized reforms aimed at battling corruption, tax evasion, and smuggling, and it took some piecemeal measures to ease the humanitarian crisis faced by the poorest households. But according to Syriza, the measures European creditors are demanding in order to release funding to the cash strapped government - privatization, pension, and labor reforms - are inconsistent with the mandate they received from the Greek public.

This has led to a protracted negotiation, but it is one in which we expect Greece will ultimately have to yield. The main reason is the Eurogroup, and most importantly Germany, which has very little appetite to come to a compromise with Greece. German Chancellor Angela Merkel's flexibility is constrained by members of her own Christian Democratic Union, the electoral successes of the new anti-euro party Alternative for Germany, and broader public opinion.

In order to carry out the reforms required by the country's creditors, we believe that Greece's Prime Minister, Alexis Tsipras, will have to reconstitute his governing coalition, substituting defectors from the far left wing of his Syriza party and junior coalition partner Independent Greeks for reform-minded lawmakers from Potami, PASOK, and New Democracy. However, a move like this would weaken Tsipras' domestic position. After having been elected on a pledge to reject the terms of the previous bailout agreement, he does not want to renege on that commitment, at least not yet.

Importantly, and as shown by recent domestic public opinion polls, the Greek public wants a better deal with Germany and other European countries; it does not want no deal at all. Negotiating and pushing for improved terms, therefore, is important for Tsipras. It will better allow him to sell the outcome domestically, both to his party as well as to the general public. Ultimately, we believe this means keeping Greece in the Eurozone, providing another reason why it is still considerably more likely that Tsipras will manage to pass reforms with the support of a broader coalition or that he will turn to the Greek electorate through a referendum. Recent polls suggest Greeks would overwhelmingly vote in favor of staying in the Eurozone, even if it means accepting onerous bailout terms.

The risk of no deal is, however, not negligible. While we can outline possible elements of such a scenario, it is important to emphasize that virtually all of the possible outcomes would most likely be chaotic while also involving many legal gray areas in the EU's treaties. It is therefore easier to identify policy contradictions and breakdowns than solutions in such a circumstance.

In a scenario of non-payment to the IMF and, potentially over time, a default to private sector creditors, all eyes would turn to the ECB's reaction regarding its assent to the National Bank of Greece's use of emergency liquidity assistance (ELA). The ECB is likely to be a critical actor in determining whether Greek citizens continue to have access to Eurosystem liquidity (via ELA) or alternately, whether solutions such as capital controls, the introduction of scrip as a parallel currency, or the full-on introduction of a new currency are the outcome.

If the ECB were to refuse to extend ELA, Greece would almost certainly have to respond with a bank holiday, and capital and border controls. This is likely to be the case regardless of whether Greece remains in the euro or whether it decides to introduce a new currency. In the former case (analogous to Cyprus), there simply will not be enough euros to meet the demand stemming from a bank run. However, even if Greece does decide to introduce a new national currency (ensuring legal and political complications detailed below), it is still likely to need strong capital controls (both on

deposit withdrawals and on cross-border transactions) to prevent the value of the new currency from plummeting dramatically.

As a result, the purported gains in liquidity from introducing a new national currency are likely to lie in the distant future (if they materialize at all). Meanwhile, the Greek government would also have to redenominate all assets and liabilities in the Greek financial system into its new currency. In addition, a new Greek currency would likely face intra-EU legal hurdles (or at least disputation) on two fronts. The first is that according to Article 140 (3) of the Treaty on the Functioning of the European Union (TFEU), "the Council shall, acting with the unanimity of the Member States whose currency is the euro and the Member State concerned, on a proposal from the Commission and after consulting the European Central Bank, irrevocably fix the rate at which the euro shall be substituted for the currency of the Member State concerned, and take the other measures necessary for the introduction of the euro as the single currency in the Member State concerned." The second issue is that Article 128 states that "[t]he European Central Bank shall have the exclusive right to authorise the issue of euro banknotes within the Union. The European Central Bank and the national central banks may issue such notes. The banknotes issued by the European Central Bank and the national central banks shall be the only such notes to have the status of legal tender within the Union."

The reason these legal issues matter is because they potentially open the door for challenges to a Greek redenomination in EU courts – via either the European Court of Justice (ECJ) and/or the European Court of Human Rights (ECHR) – even if the Greek government passes laws introducing a new currency and forces the redenomination of assets and liabilities in jurisdictions subject to Greek law. If Greek private citizens prove unable to challenge the Greek government at the ECJ or ECHR, citizens from other countries could attempt to enjoin their governments to do so, as Greece would be in serious violation of its treaty obligations.

In this regard, it is also worth noting that Greece's immediate liabilities to its EU interlocutors would be swollen by its Target 2 liabilities to the remaining members of the European System of Central Banks (ESCB), which were not hitherto included in calculations of the Greek debt stock. Greece's deficit in the intra Eurozone payments system had passed the €90 billion mark by mid-February of 2015 (the most recent data available at the time of writing), nearly double from December of 2014, and is set to grow further in coming months as capital flight continues. In the event of a break-up, other governments will have to decide whether to demand that Greece repay its liabilities to the Eurosystem, putting an unrealistic financial burden on a Greek government still reeling from Grexit, further exacerbating political tensions between

Greece and its partners. Alternatively, they could accept the losses being mutualized and distributed across other euro central banks. This would, however, increase the financial cost of Grexit for other Eurozone members.

The worst case scenario would be a default to the private sector. Given cross-default clauses, this could catalyze other private sector creditors to accelerate their requests for loan repayment. Therefore, not only would claims against the Greek government grow: in this scenario, the government's ability to fund itself would also be massively compromised. Rating agencies would declare Greece to be in technical default, locking Greece out of private sources of funding for some time. The state would be dependent upon central bank financing, with all the ensuing risks of medium-term inflation.

As noted at the beginning of this discussion, it is easier to identify legal, political, economic, or financial difficulties in the no-deal scenario, than it is to identify clear solutions to these dilemmas. We believe this is intrinsic to Greece's situation and that all of the tail scenarios involving Eurozone exit and disorderly default are likely to be unpleasant, chaotic, and legally and politically fraught. We therefore believe a deal is ultimately likely, though not just yet.

Brexit

Business confidence would be undermined, as would the EU's negotiating power in global trade deals.

National elections in May will be the defining political event in the UK this year and serve as a critical signpost for the country's future in the EU. The result will determine whether an in-out referendum on EU membership will be held in 2017, which could lead to a UK withdrawal from the bloc. Such a move would have a dramatic impact on business, especially companies headquartered in the UK that sell products and services in other European countries. Firstly, a UK exit would weaken the EU politically, which would undermine business confidence. Questions would be raised about whether other countries would likely follow the UK's lead, and the renegotiation of trading terms would create uncertainty for business and likely increase costs. Secondly, the EU would lose some of its negotiating power in global trade deals, as well as its attractiveness as a base for businesses with regional and global supply chains. The most imminent risk would be uncertainty about the UK's regulatory environment. Given its status as a global financial hub, this uncertainty would likely affect many of the world's largest corporations and their investments.

Domestic politics will therefore be an important focal point this year, as May's elections will determine the likelihood of a UK exit. Only the ruling Conservative Party, currently in coalition with the Liberal Democrats, has so far pledged to hold a referendum if reelected. The opposition Labour party has merely promised to do so in the unlikely event of a change to European treaties. Hoping for another hung parliament, the pro-European Liberal Democrats have purposely kept their stance ambiguous to heighten their chances of remaining in government with either of the larger parties. We believe the Conservatives are likely to pull ahead of Labour in the polls (which currently award both parties about 34% of the vote) given the continued economic recovery and the appeal of their EU referendum pledge. Nevertheless, even if the Conservatives do win the largest number of seats, they will most likely fall short of an outright majority. As a result, they will presumably form another coalition government with the Liberal Democrats, who will probably support a referendum in exchange for concessions on tax, welfare, and other policies. In this scenario, the UK government would attempt to claw back powers over the course of a two-year renegotiation of its relationship with Brussels, but this will not be easy.

A compromise with the EU on immigration, by far the most contentious issue for voters, is emerging. Prime Minister David Cameron's pledge to limit migrants' access to welfare payments will not undermine the fundamental principle of free movement of persons and falls within the boundaries of what EU partners consider negotiable. If it is approved, the proposal would likely convince the electorate that the country should remain in the EU (an 80% probability). The renegotiation period will, however, be somewhat confusing for business leaders. With the government presenting small changes as big breakthroughs and Euroskeptic lawmakers denouncing them, it seems as if the referendum could go either way.

The debate on EU membership is firmly in the hands of the Euroskeptics. Polls suggest more Britons support membership than an exit (45% as opposed to 35%), but the undecided are more sympathetic to the arguments of the Euroskeptic United Kingdom Independence Party (UKIP) than those of any of the status-quo advocates. Polls are likely to tighten and even flip in the final days prior to the elections, and businesses cannot rule out an exit scenario. In the event that the country votes to leave the EU, the UK's large appetite for imported goods would make it preferable for member states to maintain some degree of access to Britain's market. That said, the EU - especially large member states such as France, Germany, and Italy - would seek to establish a precedent that exit comes at a high price. To do so, they would likely constrain UK-based firms' ability to sell their services on the continent and jeopardize London's position as Europe's financial capital.

PART 2

Today's Trends in Investment and EU Businesses

2

Chapter 4

Sovereign Wealth Funds: A Growing Financial Firepower

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In his 2011 book *How to Run the World,* global strategist Parag Khanna looks at the state of the global economy and international relations, describing the "Next Renaissance" as "a future of mixed economies, and the blurring of the line between all things public and private." Whereas Adam Smith's *The Wealth of Nations* revolutionized economic thought and introduced notions on limited government intervention in the economy, context and interest have since proven to be better determinants of government intervention than theory. While working for State Street, Andrew Rozanov was the first to coin (in his 2005 article "Who Holds the Wealth of Nations") the term "sovereign wealth fund" (hereinafter, SWF), seeking to differentiate and delineate a new breed of state-owned funds from traditional central bank reserves in foreign currency. The state is back in the economic arena – and stronger than ever.

Swiss central banker Philipp Hildebrand argues that the French Caisse des Dépots et Consignations (founded in 1816), an independent investment vehicle designed to manage government savings and pensions, was the first actual sovereign wealth fund. General consensus, however, places the Kuwait Investment Authority (founded in 1953) as the first of the more modern and active kind of SWFs. What, then, is a sovereign wealth fund? Research interest in the field is less than a decade old, and due to their pragmatic or even customized nature, no two sovereign wealth funds are the same. Nevertheless, a list of common characteristics can be observed.

DEFINING THE EVOLVING PUBLIC INVESTMENT FUNDS

In short, a sovereign wealth fund is a government-owned investment fund, typically financed by current account surpluses or commodity revenues (e.g., oil, gas, and copper), yet internationally oriented in terms of investment scope. The fund looks for adjusted returns above the risk-free asset class and, importantly, is not subject to

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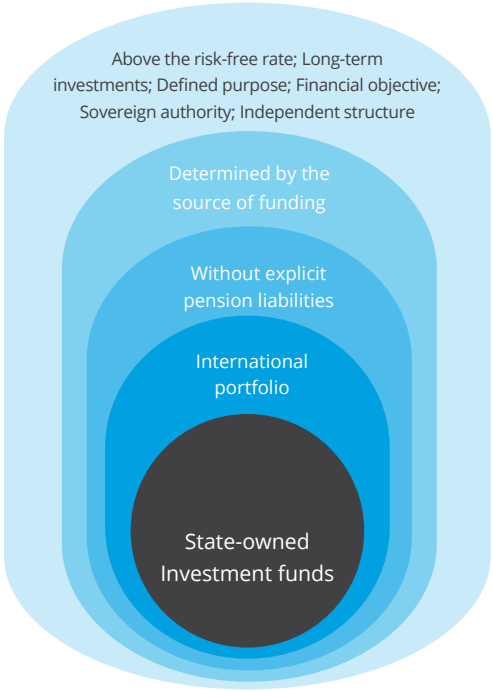
current and regular payment of pensions. A more comprehensive report detailing the general characteristics of this frontier category was published in 2014 (Capapé and Guerrero 2014). Few sovereign wealth funds will fulfill all of these conditions, as these funds remain highly heterogeneous and are constantly changing.

Figure 1: SWFs as Onions: The Multiple-layer Definition



Note: Concentric circles begin with the "core" characteristics of SWFs (investment funds and state ownership). This figure includes the 11 features cited by researchers when defining SWFs. The closer to the "core", the more the feature has been used to define SWFs.

Source: Capapé and Guerrero 2014

· **State-owned investment funds:** SWFs have two core features: they are public funds and they are devoted to investment activities. SWFs are funds initially fed by public gains from account surplus (i.e., commodities abundance or trade surplus), either from state-owned enterprise revenues or taxation and/or royalties from domestic private operations. While their primary focus is returns on investment (and not operations), they sometimes also own large shares in state-owned enterprises.

· **International funds:** SWFs' mandates reach beyond serving as a public-oriented domestic investment or stimulus tool as a strategy to boost competitiveness: for the most part, they invest abroad. SWFs all own some degree of foreign investments. Their isolation from directly government-managed reserves funds is a hotly debated issue: while major SWFs operate within monetary authorities (such as China's State Administration of Foreign Exchange (SAFE), Hong Kong's Monetary Authority Exchange Fund, and Saudi Arabian Monetary Agency (SAMA)), they are considered distinct insofar as their investment strategies go beyond the scope of traditional central bank risk hedging (Bodie and Brière 2011).

· **Stabilization mission:** While frequently originating from funds whose purpose was to stabilize fiscal balances or exchange rates with highly liquid assets (e.g., fixed income, deposits, and cash), SWFs have evolved, and currently invest in riskier assets in search of higher returns.

· **Liability side:** SWFs are not public pension funds: by definition, they cannot hold "explicit current pension liabilities" which might influence their investment strategy due to periodical liability payments. Though SWFs may owe to other branches of a given government, they have no external (i.e., non-government) creditors (Monk 2008). Nevertheless, SWFs are increasingly attempting to gain access to private capital in the form of IPOs or debt issuing (for instance, Temasek or Khazanah), benefitting from their structurally given low credit risk. "Private accountability" (Gelpern 2011) seems to be a manifestation of the transition from public opaque funds to new open funds with accountability to third parties (public and private).

· **Long-term horizon:** Riskier investment for higher returns usually takes the form of investment in foreign equities. Long-term value and growth (sought through equity and infrastructure) take precedence over short-term demands (such as currency stabilization). However, long-term investment strategies come bearing higher costs (such as staff and measurement systems), thereby creating the risk of SWFs turning into non-commercial strategic investors. SWFs seem to face a trade-off: either follow a standard financial profile and fail to achieve long-term aims, or transform into strategic financial players and lose legitimacy as global investors (Clark, Dixon, and Monk 2013).

SOVEREIGN WEALTH FUNDS: STYLIZED FACTS

There are 84 recognized sovereign wealth funds across the globe, with a total value of over $5.9 trillion – more than twice the size of all assets managed under hedge funds, and in far fewer hands. Since the 2000s, SWFs have increased their presence in the

global economy, making riskier investments and exercising more direct control over their assets. Their size is staggering: Norway's Government Pension Fund Global (GPFG), for example, has a market value oscillating around $900 billion. In other words, Norway owns roughly 1% of the world's listed equities through its sovereign wealth fund.

In addition to Norway, the main players are found in the Middle East, China, and Southeast Asia. They are either high-growth countries receiving significant foreign direct investment for industrial exports, or are exporters of oil and/or natural gas (see Figure 2). The funds therefore also play the role of insulating the domestic economy from these large sources of wealth, which might otherwise cause a distortion in the economy (e.g., Dutch Disease).

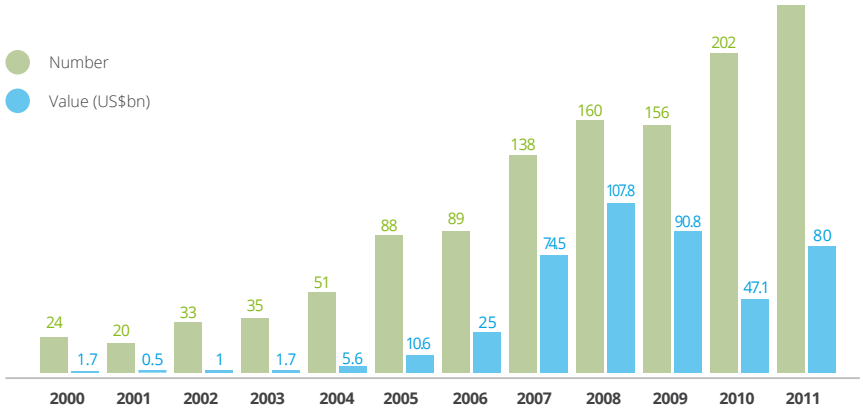
In Europe, aside from the leading role played by Norway (a non-EU member, nor a Eurozone country), three other countries have established SWFs: Ireland, France, and Italy. In 2001, Ireland established the National Pensions Reserve Fund (NPRF), which invested in a well-diversified international portfolio until 2008, when the crisis hit the Irish economy, and in particular its two largest banks. Since then, more than $24 billion has been deployed to recapitalize these ailing Irish banks and the NPRF has changed its scope. In 2013, NPRF assets were assumed by a newly established Ireland Strategic Investment Fund (ISIF). The fund now fully devotes its efforts towards economic enhancement in Ireland, sometimes through joint investment ventures targeting specific sectors or industries with other SWFs (for instance, investing in tech companies with China Investment Corporation (CIC)). This is an example of how a SWF serves as a fiscal buffer and may, in cases of extreme stress, act as a true rainy-day fund.

The other two funds, those of France (Banque Publique d'Investissement, holding $355 billion) and Italy (Fondo Strategico Italiano, with $5.3 billion), present a parallel structure and can be labeled as bilateral or co-investment funds. The former acts as a national private equity vehicle focused on domestic companies. In fact, the section of Banque Publique d'Investissement that can be considered a SWF is CDC International Capital: a wholly-owned subsidiary of the Caisse des Dépôts Group, dedicated to partnerships with sovereign funds and major international institutional investors, with an initial investment capacity of nearly $1.2 billion. CDC International Capital has already established agreements with Qatar Holding, Mubadala, and Russia Direct Investment Funds.

Meanwhile, Fondo Strategico Italiano (FSI) follows a similar strategy, mainly acquiring minority interests in companies of "significant national interest" which are economically and financially stable. In terms of partnerships, the Italian case is surprising: FSI signed an agreement with Qatar Holding in March of 2013 to establish a 50/50 joint venture, named IQ "Made in Italy" Investment Company. The JV targets Italian companies with significant growth prospects and which operate in select "Made in Italy" sectors, such as fashion and luxury goods, food and food distribution, tourism, furnishing and design, and leisure and lifestyle.[1] A year later, in May of 2014, FSI incorporated a new investment company (FSI Investimenti), owned by FSI (77%) and Kuwait Investment Authority (23%). FSI decided to transfer to the new FSI Investimenti a large amount of assets, including equity holdings in optic fibre, bio-pharma, and equipment companies. Surprisingly, the IQ Made in Italy Investment Company was included under the umbrella of the FSI Investimenti. In sum, Kuwait partially owns an investment firm which in turn owns a Qatariw joint venture. These networks are complex.

Following a similar trend, other European countries are attracting SWFs from abroad and establishing government agreements with domestic public institutions. For example, Belgium recently signed an international agreement with CIC, with the purpose of facilitating the entry of Belgian companies into China. Recently, COFIDES in Spain, which is devoted to funding export companies, signed an agreement with the State General Reserve Fund (SGRF) of Oman to create an initial joint fund of $226 million. This fund's purpose will be to finance Spanish companies with international expansion plans in Oman and the Gulf region in general.

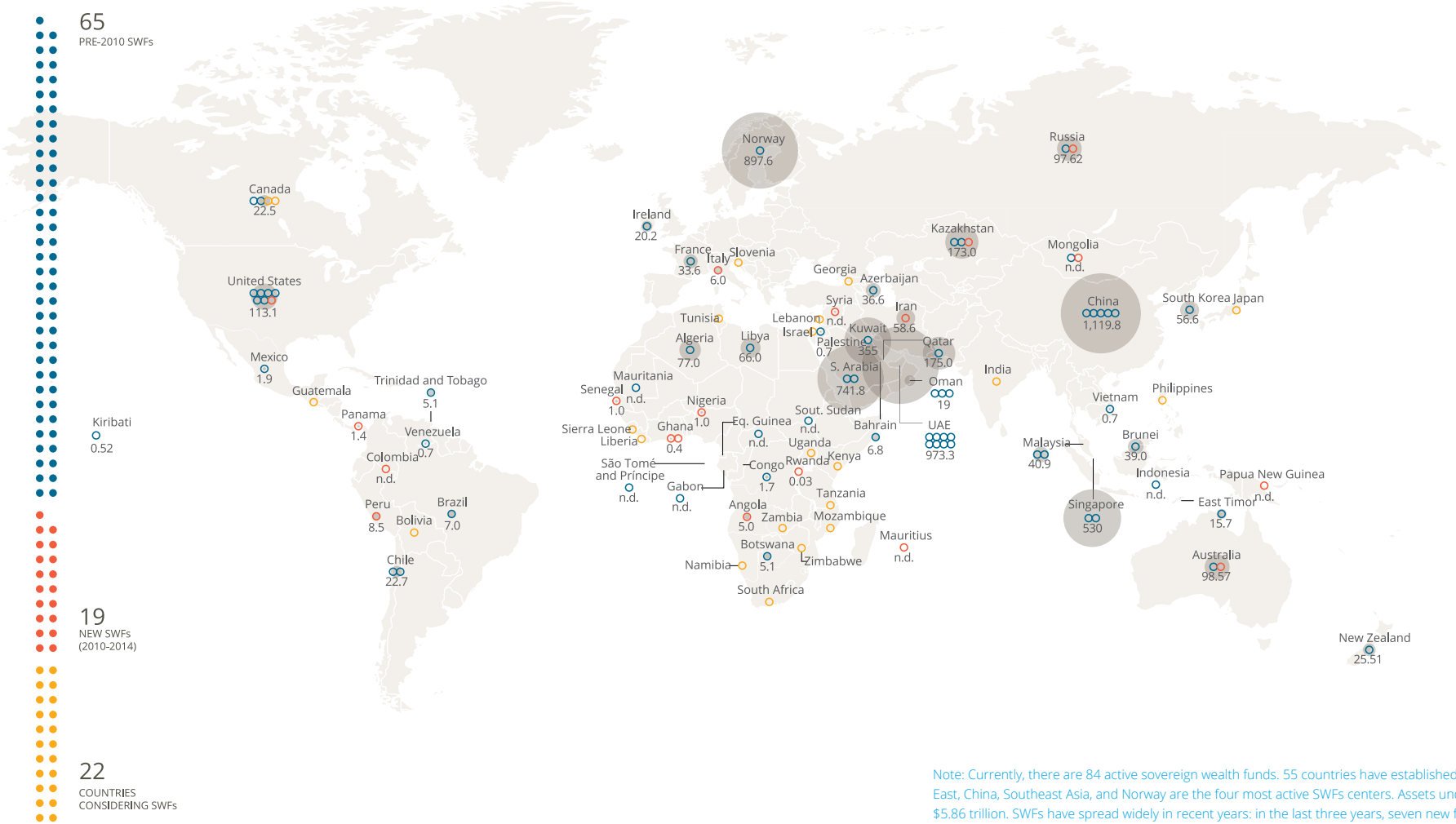
Graph 1: Direct SWF Investments Since 2000



Note: Based on publicly available data for direct SWF equity and real estate deals, joint ventures, and capital injections.
Source: Sovereign Investment Lab, Universitá Bocconi 2012.

[1] See the FSI website for details: http://www.fondostrategico.it/

Figure 2: World Map of Sovereign Wealth Funds (2014)



Note: Currently, there are 84 active sovereign wealth funds. 55 countries have established at least one SWF. The Middle East, China, Southeast Asia, and Norway are the four most active SWFs centers. Assets under management add up to $5.86 trillion. SWFs have spread widely in recent years: in the last three years, seven new funds were established and 22 countries are considering establishing one. Debates over new SWFs are growing in East and South Africa and in Latin America. Thus, in 2014, there are 105 SWFs in operation or projected to commence-.

Source: ESADEgeo SWF Tracker 2014

RECENT EVENTS: RECESSION & RECOVERY

Economic shocks, while disastrous for many actors within the economy, are tremendously efficient at revealing underlying truths and trends. Recently, the Great Recession was the catalyst for the grand entrance of sovereign wealth funds onto the global stage.

> *"As America has gone from the lender of last resort to the world's leading debtor, [emerging market countries] won't listen to its leaders' denunciation of high savings rates and their suspicion of sovereign wealth funds – which they quietly begged for bailouts when corporate America tanked" (Khanna 2011).*

Between November of 2007 and March of 2008, Western banks received almost $25 billion in emergency bailout funds from SWFs. Some of these took the form of equity purchases with eventual repurchase options; others were loans convertible into shares (see Table 1).

Table 1: Sovereign Wealth Fund Investments in Western Banks (November 2007 - March 2008)

Sovereign Fund	Bank	Value	Date
Abu Dhabi Investment Authority	CitiGroup	$7.5 bilion	November 2007
China Investment Corporation	Morgan Stanley	$5.6 bilion	December 2007
Temasek Holdings	Merril Lynch	$4.4 bilion	December 2007
Government of Singapore Investment Corporation (GIC)	CitiGroup	$6.88 bilion	January 2008
Kuwait Investment Authority	Merril Lynch	$3 bilion	January 2008
Kuwait Investment Authority	CitiGroup	$2 bilion	January 2008
Korea Investment Corporation	Merril Lynch	$2 bilion	January 2008
Temasek Holdings	Merril Lynch	$600 bilion	February 2008
Government of Singapore Investment Corporation (GIC)	UBS AG	$10.34 bilion	March 2008

Source: ESADEgeo, KPMG, and ICEX-Invest in Spain 2012

Many of these bailouts turned out to be poor investments in the aftermath of the recession. For instance, the value of ADIA's $7.5 billion convertible stock investment in Citigroup dropped from the high thirties in 2007 to a low of $4.52 per share in May of 2011. Even today, this case remains unresolved; ADIA has sued Citigroup on appeal for breaching contracts on the conversion of shares valued at $2 billion. Furthermore, SWFs' high investment in the European market, traditionally considered less risky, has left them exposed to the continuing sovereign debt crisis. For instance, GPFG from Norway has been caught up in the Greek debt crisis and restructuring, with a high chance of continued losses - and now with a subordinated claim vis-à-vis the European Central Bank (Sovereign Wealth Fund Institute 2015).

> *"The onset of the Eurozone Crisis in 2010 destroyed the belief that developed market sovereign debt was low risk and liquid. As heavily indebted countries in the Eurozone [...] struggled to pay off their debt, and bailouts were agreed for Greece and Ireland the investment climate deteriorated. The consequences rippled across the world, and as a result 2010 was a nadir for sovereign fund investments, [...] at the lowest levels of SWF activity in the "modern era" of SWFs. The year only [saw] them directly invest $47.1 billion – half their expenditure during the previous year" (ESADEgeo, KPMG, and ICEX-Invest in Spain 2012).*

While the recession provided the means for sovereign wealth funds to enter, it also served as a reminder of the need for ever more sophistication and professionalism in managing what are, in fact, investment funds. In effect, it was first expected that SWFs would return to less risky and more long-term oriented investments following the recession. However, to boost the security of investments, deals in consortia - joint ventures between SWFs – are mushrooming. Boosting openness and directness in investing (for instance, by purchasing less through third party asset managers) is becoming increasingly popular among SWFs.

Europe was the main recipient of SWF investment in 2011, as indicated in the 2012 ESADEgeo, KPMG, and ICEX-Invest in Spain SWFs report. Within Europe, Spain and its companies were the main destinations for sovereign wealth funds, receiving $8.34 billion of investment, ahead of France, the UK, and Germany. In 2013, Spain continued to be a priority target for SWFs, with an increase in the Qatar Investment Authority's equity position in Iberdrola, that of Temasek's in Repsol, as well as the advent of the first major real estate transaction with the acquisition of Barcelona's Hotel W by Qatari Diar (ESADEgeo, KPMG, and ICEX-Invest in Spain 2013). In total, between 2007 and 2014, SWFs made more than $15.5 billion of direct investments in Spain, representing 10% of total foreign investment in tangible assets – a clear demonstration of these long-term investors' capacity for counter-cyclical investment. SWFs such as the Qatar Investment

Authority (through its direct investment arm Qatar Holding), Mubadala and IPIC (in the UAE) and Temasek and GIC (in Singapore) are some of the most prominent active investors in Europe; and above all, Norway's GPGF.

TRANSPARENCY: TOWARDS BETTER PRACTICES, STEP BY STEP

> *"Criticism of SWFs' losses, [in] the domestic and international media, and the insinuation from some quarters that they were politically motivated, as well as being undeniably opaque, encouraged many [SWFs] to open up. A voluntary code of conduct, the Generally Accepted Principles and Practices for SWFs (the Santiago Principles), [was] written and signed by SWFs from 23 countries in October [of] 2008, which bound the signatories to invest commercially and transparently and with respect [for] the target country's regulatory structures. This has given life to the International Forum of Sovereign Wealth Funds, which meets on an annual basis, and while its work is nascent, its ability to help sovereign funds become more transparent looks promising" (ESADEgeo, KPMG, and ICEX-Invest in Spain 2012).*

Attention to SWF transparency and reporting standards has recently increased, serving as a proxy for legitimacy. For instance, GPGF and the Korean Investment Corporation (KIC) follow quasi-listed company standards; and as the Abu Dhabi Investment Authority (ADIA) and the China Investment Corporation (CIC) face increasing scrutiny over their secrecy, steps towards increased transparency are taken year after year.

To meet the demands for greater transparency, SWFs from 23 countries met in Santiago de Chile in October of 2008 to draft and sign the Generally Accepted Principles and Practices (GAPP) - the so-called Santiago Principles. The 24 articles call for further public disclosure of information (e.g., structure, relationship with the state, policy purpose or strategy, investment procedure, financial statements, and ethical standards), as well as the compliance of SWFs with certain professional standards (e.g., accountable governance, "independent" management, timely reporting, respect of financial regulations of host countries when operating abroad, focus on returns, and a guarantee not to benefit from a special relationship with the state).

These are, arguably, quite ambitious goals; and a recent report indeed puts the average signatory at roughly 70% in compliance (GeoEconomica 2014), with a large gap between

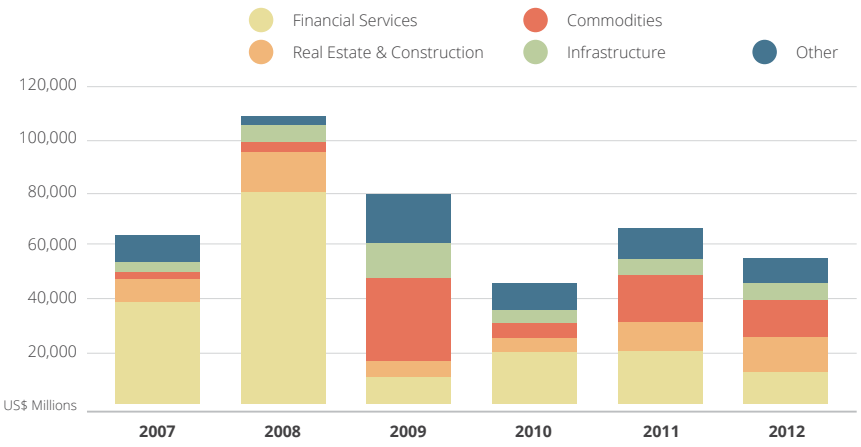
the top (Norway at 94%) and bottom (Bahrain at 24%). Pushing for greater transparency will be crucial for SWFs as their role in the global economy continues to take shape (Aguilera, Capapé, and Santiso 2015).

SOVEREIGN WEALTH FUNDS INVESTING: A SECTORIAL ANALYSIS

Infrastructure

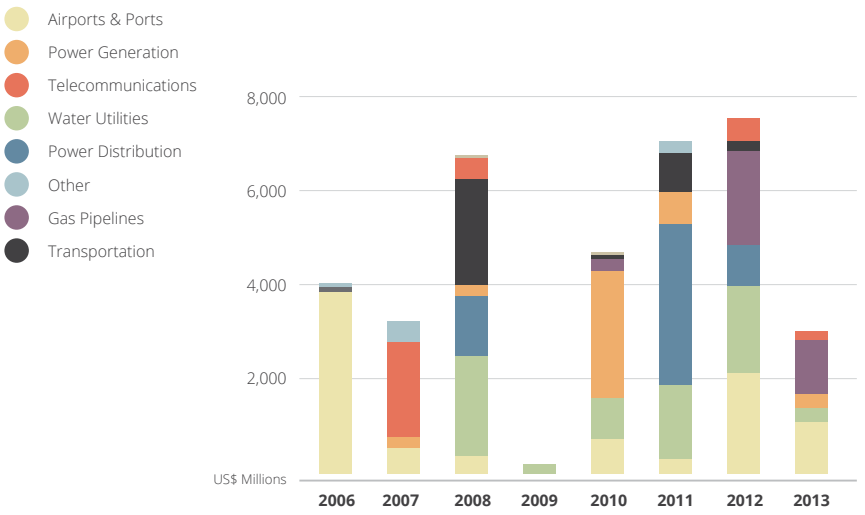
SWFs have a natural inclination toward infrastructure investment: its returns match their long-term liability structure, and the correlation of this asset class with the market is low - ideal for portfolio diversification. Traditionally, SWFs have invested in infrastructure by way of private equity firms. However, SWFs have progressively become aware of the weaknesses of this investment vehicle, given the boom of the 2000s, when many such firms went against the long-term (less risky) purpose of such investments by heavily leveraging their firms to increase market value. Even the standard ten-year duration of most private equity firms falls short of SWFs' time horizon; SWFs have therefore begun to increasingly make direct infrastructure investments.

Graph 2: Sector Analysis: Sovereign Wealth Fund Direct Investment (2007-2012)



Source: Source: ESADEgeo, KPMG, ICEX-Invest in Spain 2013

Graph 3: Sector of Sovereign Wealth Fund Foreign Direct Investment in Infrastructure (2006-2013)

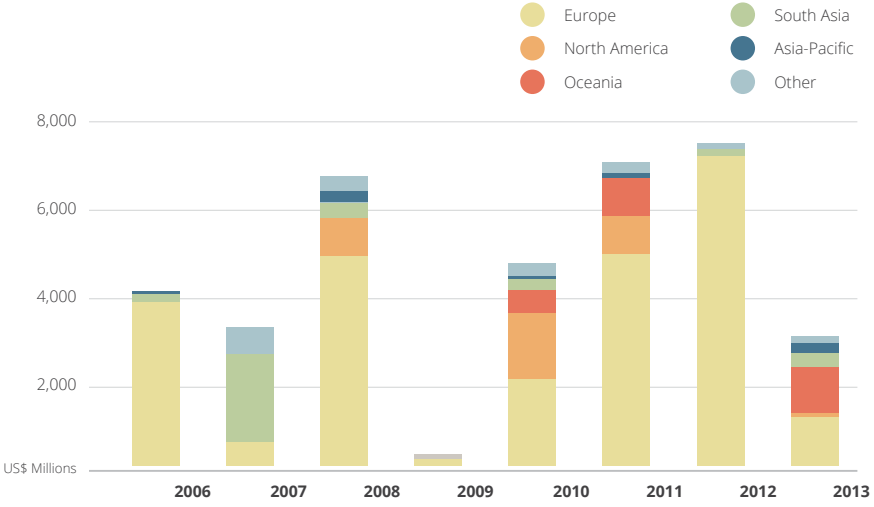


Source: ESADEgeo, KPMG, ICEX-Invest in Spain 2014

Singapore's GIC and ADIA are both big players: ADIA now holds stakes in London's Gatwick Airport, Norway's Gassled gas pipelines, Open Grid Europe (which operates about 12,000 kilometers (7,450 miles) of gas transmission pipes in Germany), and three major ports in Australia (ESADEgeo, KPMG, ICEX-Invest in Spain 2013). Though direct investment offers increased control, this alternative remains imperfect, as reliance on a single winner can prove to be quite risky.

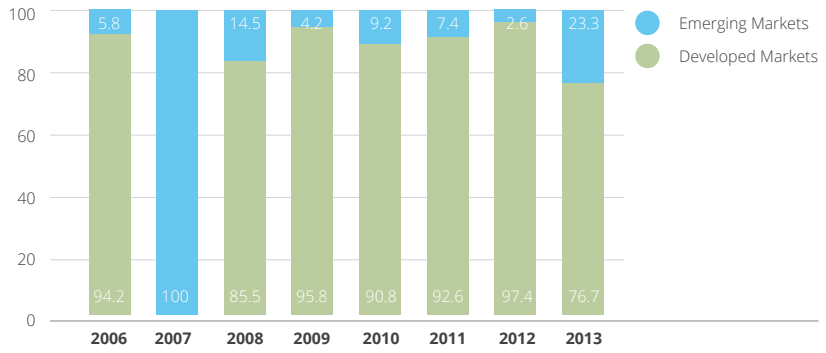
In the aftermath of the recession, many investors, now less risk-averse, have turned to infrastructure, making the market more competitive and driving prices up. Thus, improved market insight and expertise are of great importance to ensure quality investment and secure transactions, leading to another alternative: investing through strategic partnerships with commercial investors (see, for example, ADIA and Australian property investor Goodman Group). Although SWF infrastructure investment has traditionally been Europe-biased, market saturation has also translated into a shift toward emerging markets for under-valued high-return investments.

Graph 4: Sovereign Wealth Fund Foreign Direct Investment in Infrastructure by Region (2006-2013)



Source: Sovereign Wealth Center 2014

Graph 5: Sovereign Wealth Fund Foreign Direct Investment in Infrastructure: Developed vs. Emerging Markets



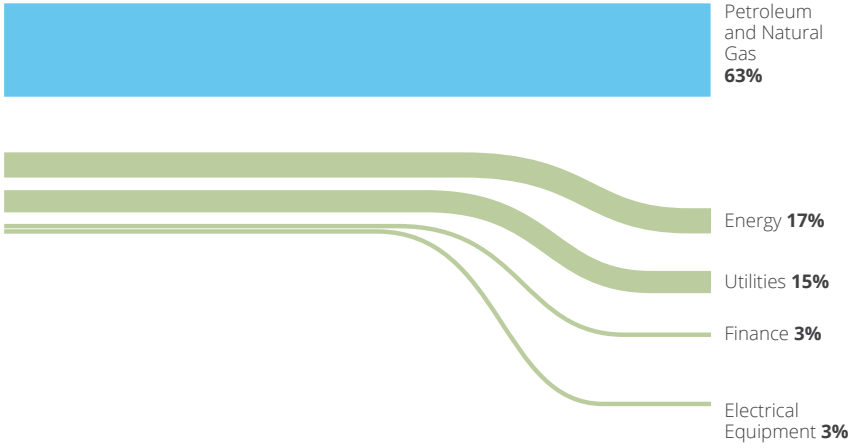
Source: Sovereign Wealth Center 2014

Energy

Energy represents a market of unique strategic importance for states, whether net producers or consumers - this will undoubtedly echo in SWFs' portfolios. The energy sector's specific need for large-scale and long-term funding as well as occasional political will to weather geopolitical risk and market volatility, makes energy an ideal candidate for investment. While many SWFs find their source of funding in energy resource wealth (and have been used to modernize and diversify such domestic economies), since the global recession, SWFs in net energy consumer countries (mainly Asian) have outpaced net producer country funds, reflecting further recognition that secure access to energy is strongly linked to economic growth. SWF transactions in energy are for the most part conducted through private equity investments and as large co-investments.

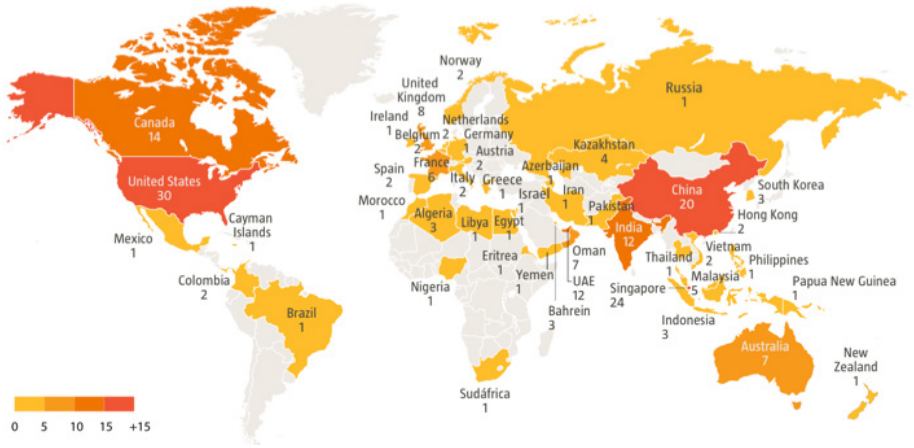
Many producer country SWFs are extending their investment into the market for renewable energies, demonstrating the growing concern for diversification in energy production. These investments are not home-biased, as geographic diversification seems to trump domestic development.

Graph 6: Allocation of SWFs Energy Transactions (2009-2012)



Source: ESADEgeo, KPMG, ICEX-Invest in Spain 2013

Figure 3: Number of Global Energy Deals by Country



Source: The Fletcher SWF Transaction Database 2013

Financial Services

With 30% of all transactions since 2006, SWFs invest more in financial services than in any other sector (ESADEgeo, KPMG, and ICEX-Invest in Spain 2014). The relationship between SWFs and financial services is unavoidably tied to the global economic recession. In the years leading up to the crisis, there was a growing concern about the impact of large amounts of state-controlled wealth on capital markets and global financial stability (see Table 1). In desperate search of liquidity, economies sought out deep pools of long-horizon capital to stop the flight of large global financial institutions' capital base (ESADEgeo, KPMG, and ICEX-Invest in Spain 2014).

In this context, SWFs nimbly anchored over $70 billion in recapitalizations, emerging as some of the largest investors in global financial services. Their impact was varied, either cross-border - as in the case of GIC or Temasek - or to stabilize a domestic banking sector - as in the case of Ireland. SWFs completed nearly 270 deals in the sector since 2006, and over 70% of them were completed after the onset of the global financial crisis - in many cases, these were follow-on commitments. Far from being destabilizing, these transactions constituted a base of long-term capital that has supported the stability of

the global financial system. In some respects, their actions since the outbreak of the crisis have forced a review of SWF's roles: from "powerbrokers" to sophisticated strategic financiers (ESADEgeo, KPMG, and ICEX-Invest in Spain 2014).

Real Estate

Currently, over 60% of SWFs allocate at least 5% of their portfolios to property, either directly or indirectly. Such patterns in asset allocation notwithstanding, it is mainly the largest SWFs that dominate, led by investors in the Gulf region and Asia. New to this field is Norway's Government Pension Fund Global, whose mandate to deploy up to 5% of its $900 billion portfolio in global real estate may have a significant impact on global real estate markets (it was, notably, the second largest foreign investor in real estate in the United States in 2014).

North America and Europe, and in particular the UK, have attracted the highest SWF real estate investment, luring funds based on the quality of their assets. However, the pace of SWF flows into emerging economies' real estate sectors has quickened in recent years.

Since 2006, SWF investment in global real estate markets has been dominated by seven funds, with six participating in over 75% of the nearly 200 SWF transactions in this period. Among these funds, GIC, QIA, and Temasek have been the most active, together participating in nearly 47% of the total transactions completed.

Graph 7: Asian Sovereign Wealth Funds Advance on the Spanish Real Estate Sector – by Type

Source: ESADEgeo, KPMG, ICEX-Invest in Spain 2014

Sovereign funds have recovered their appetite for the Spanish real estate sector. The $260 million purchase of Barcelona's W Hotel by Qatari Diar - the real estate arm of Qatar's QIA - may mark a change in trend and act as a catalyst for further deals by SWFs in Spain's real estate sector. For example, in November of 2013, Abu Dhabi acquired a purchase option until 2016 for $606 million on the Torre Foster in Madrid. Katara Hospitality, Qatar Holding's real estate arm, bought a portfolio of five European hotels, including Madrid's Intercontinental, valued at $96 million. Yet, the most significant deal took place in 2013, when Qatar raised its holding in Colonial – a Spanish real estate listed company with $6.8 billion in real estate assets – to 13.1%. Interestingly, it was a European transaction, as Qatar invested in Colonial-controlled Société Foncière Lyonnaise (SFL) in France to acquire its 22%; SFL is one of the crown jewels in the European real estate markets. Beyond Spain's borders, it was the United Kingdom, specifically London, that led the league of largest transactions, as discussed in the chapter by Diego Lopez in this volume.

CONCLUSION

As shown above, SWFs are playing an increasingly noticeable role in the global economy, especially in key growth and strategic sectors. With great power comes great responsibility however. Consequently, the rise of SWFs has carried with it fears and skepticism as to their purpose: are SWFs government agents or investment funds? How can market analysts expect them to behave? What is the real time horizon for these vehicles? Is this still all public money? Are their assets state-owned? Can states truly justify such high levels of foreign investment?

In effect, the Santiago Principles have pegged legitimacy to transparency measures and governance standards. This measure should facilitate further research - and time will prove exactly what role SWFs will end up playing. Nevertheless, as geopolitical stability unravels in certain regions of the world, it is possible that these funds become increasingly opaque or emergency purpose-oriented (for example, in Russia, Libya, Ireland, and Saudi Arabia). Others may follow a divergent path and increasingly resemble private funds (e.g., Norway, Abu Dhabi, Singapore, and Korea). Indeed, continued efforts within global governance and academia will be necessary to ensure SWF accountability and compliance with growing public expectations (Aguilera, Capapé, and Santiso 2015).

Europe, after a financial, labor, and sovereign-debt crisis (which is not yet resolved, especially in the South), faces current debates and concerns regarding internal coordination (i.e., banking to fiscal union), Greece's potential exit from the European Union, the new United Kingdom referendum menace, North Africa's illegal migration flows, and Ukraine's fragile situation, among others. Given this fraught situation, Europe has relaxed its concern over politically-motivated investments made by SWFs. As a result, SWFs have chosen Europe as the top destination for their immense pools of assets harbored in the Middle East, Southeast Asia, and China. From Heathrow, Canary Wharf, or The Shard (the tallest building in Europe, built by the Qataris) in the UK, Valentino in Italy to Siemens in Germany, LVHM (owner of luxury brands such as Moët-Chandon, Louis Vuitton, Loewe, and Bvlgari) in France to oil and gas multinational Cepsa in Spain, and football stadiums and sponsorships all over the continent (e.g., for Real Madrid, Barcelona, Paris Saint Germain, Olympiacos, and Arsenal), many of Europe's icons are totally or partially owned by SWFs. A quiet invasion has taken over many of Europe's assets. Should we be concerned over these strategic assets, or should we celebrate because we were able to board the train toward the future complex financial global landscape? Time will tell.

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Chapter 5

The Major Role of Sovereign Investors in the Global Economy: A European Perspective

Diego López

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PricewaterhouseCoopers

05

THE RISE OF SOVEREIGN INVESTORS

The global economy has witnessed the emergence of a new set of key actors over the last two decades. Sovereign Wealth Funds (SWFs) and Pension Funds (PFs) – or Sovereign Investors – have become pivotal players in global financial markets thanks to their liquidity, and continue to grow rapidly in number and in size. This group of highly heterogeneous funds has different backgrounds, structures, and missions, but shares an ultimate goal: to preserve capital and maximize the return on investments.

While the economic crisis and subsequent cash constraints in developed economies quickly brought these investors to the forefront, the global economic recovery is intensifying the competition for high returns. The Asset Management industry is expecting a number of fundamental shifts; hence the way many asset managers operate in 2020 will be significantly different from the current model (PwC 2014). Similarly, sovereign investors keep adapting their investment strategy and focus, and this will condition the performance of the global markets over the next five years.

A Global Playground

Most of the wealth sitting on the books of these investors has its origins in public budgetary surpluses fueled by commodities exports, foreign exchange reserves, or pension contributions. The location of the fund is therefore not necessarily correlated with the GDP or purchasing power of its country in the global context. Of the G8 economies, only Canada, the US, and Russia have sizeable sovereign investors.

In fact, the majority of these players are located in the so-called emerging markets. 70% of the funds in terms of both number and size are headquartered in the Middle East, North Africa, and Asia-Pacific regions. This is unlikely to change in the near future, as most governments having conversations to set up new investment vehicles are from Africa and Latin America.

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Europe is not a significant player when it comes to sovereign wealth. Norway's NBIM is considered the world's largest SWF, but it sits outside the European Union. If it weren't for the Dutch pension funds and for the incipient French and Italian vehicles, the EU would not have any significant sovereign investor. In fact, the French and Italian funds only emerged as a solution to attract other foreign players to co-invest with them in the irrespective domestic economies. Other European countries, such as Spain, are showing signs that they will soon follow (COFIDES 2015).

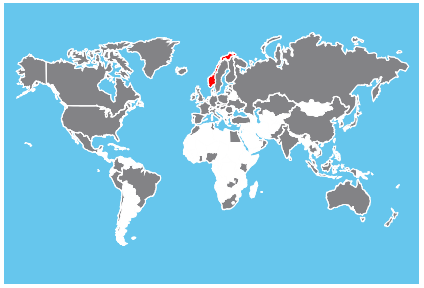
Sovereign investors have generated an unprecedented flow of capital from emerging economies to developed markets and subsequently heated up numerous policy debates in Europe. On the one hand, some of these funds come from non-democratic states and the recipient countries may consider the inward investment an issue of national security if there are objectives beyond the economic and financial goals. On the other hand, it is argued that the presumption of innocence should apply, and that these equity investments are just an issue of economic governance, which, if well managed, can ultimately be beneficial to Western countries (Thatcher 2012).

In any case, political considerations aside, these funds continue to invest in search of long-term returns, leading their investments to expand not only to Western economies but also to emerging markets around the world. The maps below (see Figure 1), showing the current holdings of two of the world's largest SWFs - Norges Bank Investment Management (NBIM) and Abu Dhabi Investment Authority (ADIA) - are proof of their truly global mandate.

Figure 1: ADIA and NBIM: A Truly Global Mandate

Investments

NBIM Investments



Source: Norges Bank

ADIA Investments

Source: ADIA

Megatrends Matter

Given their typically global mandate and long-term horizon, sovereign investors should build their portfolio based on major future trends, rather than on short-term market movements. Observers have defined the following five megatrends that will shape the global economy in the long run: the shift in global economic power, demographic and social change, rapid urbanization, climate change and resource scarcity, and technological breakthroughs (PwC).

Figure 2: Megatrends

Source: PwC

The shift in economic power to the East is especially meaningful when it comes to sovereign investors. Southeast Asia and the Middle East hold some of the largest funds and are the most active outbound-capital regions. China's assets under management alone almost equal the wealth of all the rest of the sovereign investors combined, when including the almost $4 trillion of foreign reserves in the books of China's State Administration of Foreign Exchange (SAFE). As economic power shifts to the East, it is crucial for sovereign investors to grant an equal importance to investments in both developed and developing countries.

Demographics will draw a line between Sovereign Wealth Funds, which do not have obvious liabilities, and Pension Funds, whose obligations will become more evident in the next few years. Unless open migration policies are enacted, developed markets like Japan and Canada will face significant pension obligations due to their aged and relatively larger populations, and this will certainly affect the investment policies and risk-aversion of their funds.

Accelerating urbanization and the rising number of megacities in countries such as China and India will drive large infrastructure needs. From hospitals to roads and

airports, the performance of the infrastructure asset class will depend on bodies like the Asian Infrastructure Investment Bank. Others, like the African funds, are dedicating part of their allocation to domestic infrastructure. Sustainability and responsible investments will be on the investors' agendas too.

Climate change and resource scarcity have traditionally inspired a large number of cross-border acquisitions. China has long invested in soil and agribusinesses in Africa and Latin America to offset its unparalleled economic growth and increasing urban population. Food security is also a main concern for Middle Eastern states, who, irrespective of the risk and logistical issues, will continue to invest in land and resources in more fertile lands elsewhere.

Lastly, technological breakthroughs are difficult to ignore. Institutional investors are increasingly focusing on venture capital and incipient Internet companies, which may lack tangible assets and enjoy inflated valuations. Though the dot-com bubble is still on everyone's mind, funds cannot afford to be out of the technological game. Southeast Asian funds, for example, have recently opened new offices overseas in the San Francisco Bay Area, signaling their interest in technology.

Meet the Greeks

Regardless of the differences in their missions and taxonomies, the ultimate goal of most sovereign investors is to preserve their capital and maximize the returns of their investments for future generations. By nature, however, superior returns are not sustainable over time and the funds must be flexible and seek the optimal strategies at each point in time.

One of the most common strategies has been the replication of equity indexes. Investors like to keep a reasonable level of "beta,"[1] or even better, seek "smart beta" that allows them to follow indices while taking into account the volatility of their portfolio. This approach, however, is not as passive as it seems and may present some flaws. In the midst of the financial crisis, it was of little comfort that losses were smaller than the benchmark index's, and most funds started thinking in terms of absolute returns and aiming to achieve consistently positive earnings over time.

[1] Beta, in investment terminology, is understood as a factor revealing the volatility of a portfolio or security when compared to the market in general.

In this context, it appears that what sovereign investors are really after is "alpha," i.e., earning a return in excess of the benchmark index, while maintaining a similar risk profile. But given their demographic and operational constraints, very few sovereign investors can afford to be truly active investors, and in addition to their in-house investment teams, most try to leverage the unique skills and experience of external asset managers to generate alpha. Today, some of the largest and most successful institutional investors maintain a high proportion of their assets managed externally.

portfolio return = risk free rate + ***beta **** *equity market premium +* ***alpha***

However, as sovereign investors mature and grow in size, their dependency on index-replicating strategies and external asset managers will likely decrease, thus they will have to be able to generate superior "Greeks" on their own.

Shifts in Asset Allocation

Sovereign investors are generally risk-averse - especially the Pension Funds, whose liabilities will become more evident in the next few years as their pension obligations are realized. The latter have traditionally invested in developed markets and liquid assets, in search for high returns with a tolerable risk level.

However, the current investment landscape, characterized by sluggish economic growth, low interest rates, and frequent quantitative easing, makes it more challenging to achieve superior returns. One possible answer is to increase the allocation to alternative assets - including real estate, infrastructure, and private equities. Investing in these asset classes increases the diversification and balance of the portfolio, and offers potentially higher returns. Needless to say, investors expect very different internal rate of returns (IRRs) from each of these three asset classes; some experts talk about a target IRR between 8% and 12% for real estate and infrastructure and 20% plus for private equities (Clark 2014), but the truth is that returns depend on a variety of factors such as sub-product, sub-industry, geography, and timing.

Nevertheless, building an uncorrelated portfolio is not an easy task. Real estate, infrastructure, and private equities require a deep knowledge of local markets, which can only be attained through external managers or in-house specialists in the different

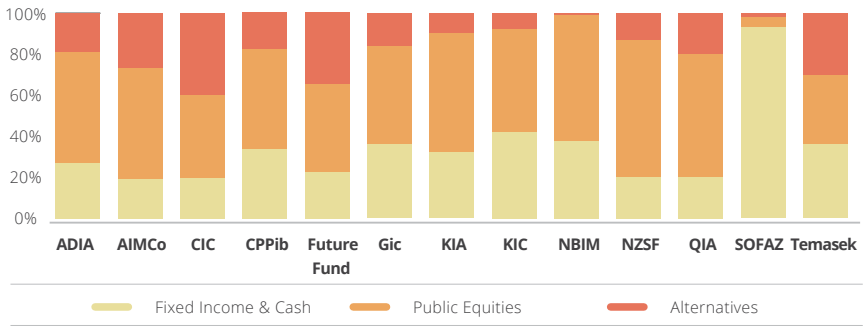
asset classes, industries, and geographies. It also requires an internal strategy team that defines the strategic asset allocation and adapts it over time. In short, building an uncorrelated portfolio requires sovereign investors to grow in size and sophistication.

Recent developments in oil prices have made the shift to alternatives even more challenging. Over 60% of SWFs are oil and gas-related (Sovereign Wealth Fund Institute), and tighter government budgets may translate into a reduction or removal of the annual cash flow into the fund. Though this should not be a problem in the short term given the accumulation of wealth in their balance sheets, it may require a level of dividend yield that is usually harder to find in alternative assets.

Lastly, the size of the fund may be an advantage, but also a weakness. The theory holds that the larger the fund and the allocation, the cheaper it is to enter into the asset class. However, very large funds, also known as Leviathans (Bortolotti et al. 2010), may face difficulties in moving and adapting their strategies. The best example is Norway's massive SWF, NBIM, which has decided to increase its allocation to real estate from 1% to 5% through the acquisition of properties in very specific locations (Norges Bank Investment Management 2013). This 4% increase will require NBIM to deploy a large amount of capital in a relatively short period of time in already overcrowded cities, probably at the expense of high premia.

Below is a representation of some of the sovereign investors' reported current asset allocations (see Chart 1), which change over time due to internal or external factors, such as macroeconomic and geopolitical changes, monetary policies, oil prices, budget balances, and pension contingencies.

Graph 1: Sovereign Investors' Asset Allocation



Source: Funds' websites, news releases, and other public sources

SOVEREIGN INVESTORS AND ALTERNATIVE ASSETS: AN OPPORTUNITY FOR EUROPE

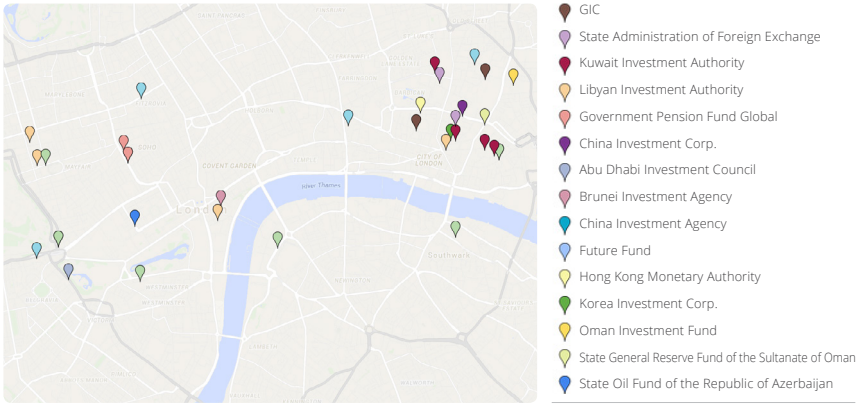
Real Estate

The first dive into alternative asset classes is typically real estate. Sovereign investors are not necessarily experts in brick-and-mortar, but they do have the liquidity to build a diversified portfolio of properties around the world. Most funds have developed specialized teams of in-house experts drawn from the main real estate developers and operators, and tend to leave the operations of the properties to external managers.

Funds have initially focused on high-quality assets in prime locations in London, New York, or Paris. Over the last few years, most of the large real estate deals in these cities have involved a sovereign investor. Though their low cost of capital gives them an advantage in price auctions, the supply cannot meet the rising demand and competition is increasingly fierce, so acquiring a high-quality asset in a prime location most often results in paying a high premium.

Real estate is a local business and investors apply a very granular method. They not only look at specific cities but at specific areas within those cities. Price and availability of properties can vary significantly in a matter of meters. The best example is London, where funds continue to compete for the few prime properties left in the city center.

Figure 3: The Big London Takeover



Source: Sovereign Wealth Center

As prices rise, funds are beginning to look at different options in search of higher returns. One alternative is industrial and retail properties and another is hospitality assets - sovereign investors invested over $5 billion in luxury hotels and resorts in 2013. Another possibility is to invest in development projects or in secondary cities with an acceptable level of risk. In all these, relationships with managers and developers are increasingly important in securing access to off-the-market opportunities and keeping a reasonable risk-return balance.

What's in it for Europe?

Since the mid-70s, sovereign investors have poured over $65 billion into the European property markets, half of which was invested in the last three years (Sovereign Wealth Center). Aside from the UK, which was allocated almost $40 billion, these funds have acquired numerous properties and real estate portfolios in France, Italy, Germany, Switzerland, and Spain, amongst others.

The largest investors are the usual suspects in the Sovereign Wealth Fund space: ADIA, Qatar Investment Authority (QIA), and Kuwait Investment Authority (KIA) from the Middle East; Government of Singapore Investment Corporation (GIC) from Singapore; NBIM from Norway; and China Investment Corporation (CIC) and SAFE from China. Some of these funds still generate anxiety among European politicians and businessmen alike, but they are making efforts to improve corporate governance and transparency (e.g., Santiago Principles[2]) that should minimize these fears over time.

Sovereign investors will likely continue to focus on developed locations, but given the overcrowded status of London and Paris, they have started to eye European secondary cities such as Manchester, Barcelona, or Milan, in an effort to gain the "first-mover" advantage.

From the inbound perspective, this may represent a great opportunity for some of the European financial institutions holding large portfolios of non-core real estate assets and/or those in need of liquidity. Depending on the investor's risk profile, it may also scope out additional options such as distressed commercial properties, industrial and logistic portfolios, hospitality assets or developments in peripheral European cities.

[2] The Santiago Principles is a voluntary set of principles and practices that members of the International Working Group of SWFs support and either have implemented or aspire to implement in order to "identify a framework of Generally Accepted Principles and Practices (GAPP) that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis."

Infrastructure

Real estate may not provide enough diversification and dividends in times of uncertainty. Sovereign investors must diversify further, and the timing is ideal for infrastructure assets. Governments of the developed world face an increasing pressure to reduce debt levels, which has pushed them to privatize some of their prime assets. Growth and urbanization trends are generating large infrastructure needs, and recipient countries have no choice but to welcome foreign direct investments.

Sovereign investors present a natural fit with this asset class, given their long-term view and passive management, and their potential need for a stable cash flow. Infrastructure is in fact the most popular alternative asset class, with 60% of SWFs investing in it (Preqin 2015b). Just as in real estate, the funds entered this asset class by targeting prime assets; and they now own some of the most iconic airports, hospitals, and water managers in the developed world (Santiso 2014). In addition, leverage is cheap and abundant again and some of these investors have managed to achieve impressive returns with certain assets.

Being a direct investor in infrastructure requires expertise and bulky investment that few funds are keen to face alone. This has generated an unprecedented level of collaboration - and competition - between all major types of Sovereign players: Middle Eastern and Singaporean SWFs, Chinese State-Owned Enterprises, Japanese Trading Houses, Canadian PFs, American and British University Funds, and Australian Superannuation schemes. Today, any bid for a prime asset in the developed world is likely to involve five or six bidding consortia formed by these investors and led by infrastructure specialists such as Macquarie, Brookfield, UBS, or Goldman Sachs.

The increasing rivalry for the few remaining top-end projects has driven valuations up significantly, and sovereign investors have had to adapt their strategy. Infrastructure investment teams can no longer afford to be picky, and are expanding their targets into greenfield assets and developing markets around the world.

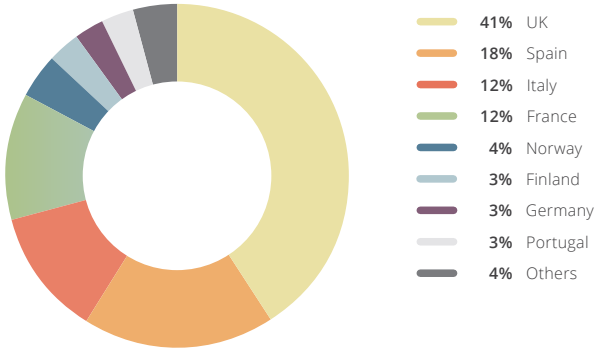
What's in it for Europe?

Infrastructure assets have long been considered of strategic interest for a country. Foreign investors were banned from acquiring European airports, ports, and highways until very recently. In fact, the first foreign acquisition of an infrastructure asset in Europe took place as recently as 2006 - with DP World's takeover bid for the British

shipping and logistics company P&O - creating considerable controversy on both sides of the Atlantic Ocean.

The financial crisis changed it all. Governments from the UK first, followed by continental Europe, started to raise money from the partial sale of their national champions. In fact, it has not been uncommon since then for European heads of state to lead roadshows to the Middle East, Singapore, and China. Non-European Sovereign entities now own (but do not operate) some of the main European structural assets, including airports (Heathrow, Gatwick, Budapest, Rome, and Aena), power and utilities conglomerates (Iberdrola, GDF Suez, EdP, Enel, Gassled, Kelda, Madrilena Red de Gas, and E.On), nuclear energy companies (Areva and Hanhikivi-1), highway operators (Atlantia), and telecoms (Eutelsat and Telecom Italia).

Graph 2: Recipients of Infrastructure FDI in Europe



Source: Sovereign Wealth Center

Sovereign investors are setting up direct infrastructure investment vehicles (sometimes with a different name, like Canadian pension fund Ontario Municipal Employees Retirement System or OMERS' Borealis and Kuwaiti KIA's Wren House) with strong teams of in-house experts that scan global opportunities on a daily basis. As they turn their attention to greenfield projects, there will be great opportunity for European governments, not only to raise money from the privatization of established companies, but also from developing infrastructure projects where the financial muscle of sovereign investors and the operational expertise of their partners can add an even greater value. This asset class may also transition into a subset of real estate, where a combination of properties and infrastructure can present great long-term value propositions.

Private Equities

For an even deeper reach into different industries and higher targeted returns, sovereign investors are transitioning into private equities. A large number of investment specialists have moved in from leading private equity houses, allowing SWFs to evolve from fund investing to co-investments and direct investments in virtually every industry.

Private equity funds (PEs) are quite successful on their own, with $3.8 trillion of assets under management and over $530 billion raised in 2014 by circa 1,100 funds (Preqin 2015a). In fact, the buyout industry continues to be dominated by corporations and private equity houses: from 2009 to 2013, only 15% of the buyout deals over $1 billion involved an institutional investor, either as Limited Partner (LP)[3] or as a direct investor (Bain & Company 2015). Only a handful of sovereign investors have the capabilities and appetite required to compete directly with the top-tier private equity funds for buyouts on a standalone basis.

Sovereign investors are the largest group of LPs, co-investors, and sometimes even competitors of PEs for the same targets. Alignment, in terms of horizon and risk-return profile, remains the key issue between both groups of investors, although the liquidity of SWFs has made them attractive co-investors for which PEs are willing to adapt their offer. In November of 2014, the private equity firm CVC announced the launch of a new $4 billion fund dedicated to SWFs, with a lifespan of 15 years and a targeted IRR of 12%-14% (Chassany and Sender 2014). Earlier that month, Blackstone and Carlyle had announced they would consider takeover deals outside their existing funds if it meant a better alignment with their LPs.

Just as in real estate and infrastructure, strategic allocation is still biased towards developed markets, but as high-quality assets become more pricey and scarce, new options are also being considered. Private equity activity continues to be centered in the US (both buyout and venture capital) and in Europe (mostly buyout). The industries with the highest activity are financial services, healthcare, commodities, and consumer goods - as compared to venture capital deals, where over 70% of the businesses acquired are related to telecoms and Internet activities.

[3] Limited partners are usually institutional or high net worth investors interested in receiving the income and capital gains associated with investing in the private equity fund and that do not usually take part in the fund's active management.

In fact, it seems that venture capital is enjoying a rejuvenated relationship with institutional investors. Thanks to their long-term horizons and significant financial capacity, SWFs are great candidates to invest in technological start-ups. In 2013, Alberta Investment Management Corporation (AIMCo), New Zealand Superannuation Fund, and ADIA created the *Innovation Alliance* to collaborate with Venture Capital (VC) firm Kleiner Perkins. Since then they have injected capital into two growth capital opportunities on both coasts of the US. Abu Dhabi Investment Council (ADIC) is also developing its VC footprint, and has invested in the open-source document database MogoDB, in the mobile messaging service Whatsapp and in the music player Spotify in the past few months.

This trend has translated into a larger physical presence of sovereign investors in the Bay Area. At the end of 2013, Malaysian SWF Khazanah Nasional Berhard chose San Francisco as the location of its first office outside Asia. Last year it was Singaporean Temasek Holdings' venture holdings subsidiary Vertex who, following the footsteps of GIC, hired an executive from Facebook to launch a subsidiary in Silicon Valley.

The New Co-investment Model

The strategy of sovereign investors is shifting rapidly from fund investments to a new direct investment and co-investment model. For new fund commitments, a large number of LPs now request co-investment rights, which are usually granted. And while some SWFs consider co-investments separately, others include them as part of their broader private equity fund allocation (Preqin 2012).

The LP has several reasons to co-invest. First, it gains influence over the transaction and gives direct exposure to its investment executives, while reducing management fees and carry[4] by half. Second, it leverages the access and knowledge of the General Partner (GP) of the country, industry, and of the mid-market in general. And lastly, the liquidity provided early on in the transaction mitigates the J-curve effect[5] associated with private equity deals and may help to outperform the returns of traditional fund investing.

[4] Carry is the performance compensation that the limited partners of a private equity fund receive if they exceed a specific threshold return.

[5] The J-curve effect occurs when funds experience negative returns for the first several years due to capital drawdowns and an investment portfolio that has yet to mature. A J-curve is formed after the fund recovers from its initial losses and shows profits above the initial level.

The GP, however, faces competing views about this new trend. It can use the capital to target larger deals or stakes and "punch above its weight" - thus benefiting from offering high quality co-investment opportunities to LPs. But it is also tempted to keep these highest quality deals in traditional fund structures, in order to maximize management and transaction fees.

The co-investment model is in its early stage, and most players are still seeking to tap and maximize its potential. In November of 2014, the Korea Investment Corporation (KIC) hosted the first Co-investment Roundtable of Sovereign and Pension Funds (CROSAPF) in Seoul, with thirty of the top tier global investors - twelve of which entered into a non-binding memorandum of understanding to facilitate deals and co-investment opportunities going forward. A session solely focused on private equity opportunities was chaired by Providence Equity Partners, whose investors include KIA and GIC.

The relationship matrix between sovereign investors and private equities is growing in size and complexity. A sample of these interactions is included in the table below.

Table 1: Sovereign Investors and Private Equity Funds Matrix

PE \ SWF/PF	ADIA	ADIC	AIMCo	bcIMC	CIC	CPPib	Future Fund	GIC	KIA	QIA	Temasek
3i Group	LP, Co	LP		LP	LP			H, LP, Co	LP	LP	Co
Advent International	LP, Co	LP	LP	LP		Co	Co	LP, Co	LP		
Apax Partners	LP	LP	LP		H, LP	LP	H, LP, Co	H, LP			
Apollo Management	H, LP		LP	LP	Co	LP			LP	LP	
Bain Capital		LP						Co			
BC Partners		LP			LP	LP		Co	LP		LP
Blackstone Group			LP	LP	H, LP, Co		LP, Co	LP, Co	LP		Co
Carlyle Group	LP	LP	LP	LP	Co	LP	LP	Co		LP	Co
Cinven			LP	LP		LP			LP		
CVC Capital Partners	LP		LP	LP		Co		H, LP, Co	H, LP		
KKR	LP, Co					LP		LP, Co			Co
Onex Partners				LP		LP					
Permira			LP					Co			
TPG Capital	LP, Co	LP	LP	LP	Co	LP		LP, Co	H, LP		Co
Warburg Pincus	LP, Co							Co			Co

H= Stake in PE firm LP= Limited Partner Co= Co-investor

Source: Sovereign Wealth Center

In the current market conditions, sovereign investors are very valuable partners and private equity funds appreciate the importance of aligning interests with them. The accumulated dry capital, the rejuvenation of the venture capital, and the new co-investment model are signs of the increasing relationship between both groups of investors.

Sovereign investors will continue to boost their allocation to private equity and buy stakes of buyout and venture capital funds, but more as an active long-term stakeholder and partner than as a purely passive investor. Most partnerships will include co-investment rights, and as a result of a continuous and more open collaboration, investment "clubs" will arise.

What's in it for Europe?

Private equities are generally associated with Small and Medium Enterprises (SMEs), i.e., the backbone of the European economy. 99 out of every 100 non-financial businesses in Europe are SMEs, as are two of every three employees, and 58 cents in every euro of value added (European Commission 2014). These companies continue to face difficult economic conditions: their value added in 2013 was just 1% above 2008 levels and employment in 2013 was still 2.6% below levels registered in 2008. For a full recovery based on economic growth, Europe needs its SMEs to grow and reach full speed.

However, it is not only about SMEs. Larger companies on a stand-alone basis can also be classified as private equity investments. In fact, the single largest holding of a sovereign investor in a foreign country is not a property or an infrastructure asset, but a Spanish private company called CEPSA, which was fair valued at almost $11 billion when it was fully taken over by Abu Dhabi's IPIC in 2011 (Institute of Management Technology).

In addition to the efforts of the European Central Bank and the European Commission, and of several national SME funding programs, sovereign investors and private equity funds will continue to provide the market with liquidity. Given the restrictions of bank lending and the problematic access to finance for smaller businesses, this may represent an optimal short-term solution for such a meaningful and crucial piece of the economy.

In terms of industries, the acquisitions of sovereign investors in European healthcare are still relatively small. However, judging from the megatrends and demographic prospects of the continent, this could be one of the main industries of focus in the next few years, in addition to the always-preferred industrial products and consumer-related European companies.

The Human Side

Sovereign investors typically have a global mandate and need to be close to their target markets. The shift in the investment strategy into alternative asset classes and into direct investments poses some challenges in the short and the long term. One possibility is to hire bespoke foreign professionals, as one of the funds' main strengths. The better the fund's investment team, the more likely it will achieve superior returns. Still, several demographic characteristics drive sovereign investors' human capital needs and policies:

- **National talent:** Some of the largest sovereign investors face demographic challenges. Norway is a country with a population of 5 million that hosts a $890 billion fund. There are just 1.4 million Emiratis, 1.2 million Kuwaitis, and 0.3 million Qataris in the world, who own almost $2 trillion in combined assets. GIC and Temasek, which together manage over half a trillion in assets, are owned by only 3.3 million Singaporeans. Despite having ambitious programs in place to nurture local talent, most funds look for the best talent around the world. Today, between 30% and 75% of their workforce are non-nationals, who do not usually hold executive positions, however.

- **Reverse brain drain:** The contrary is true for the Chinese funds. It is difficult to ascertain how many foreigners work for China's CIC, SAFE, National Social Security Fund (NSSF), or Hong Kong Monetary Authority (HKMA), but they probably represent less than 5% of the total workforce - and the same could probably be said of the Russian funds. Given the enormous population and the increasing number of Chinese and Russian nationals studying in Ivy League colleges and working for top-notch investment banks, these funds don't need to recruit foreigners, but rather need to lure their own people back to their country.

- **Challenging attractiveness:** The typical locations of their headquarters make it more challenging for sovereign investors to attract talent. Oslo, Beijing, and Kuwait are not necessarily first choices for top graduates or investment professionals. This issue has been covered by Bachher and Monk, who believe that sovereign investors are almost exclusively successful at hiring the "green" (early career individuals looking for a fast track career), the "gray" (experienced professionals escaping fast-paced cities) and the "grounded" (people with ties to the region) (Bachher and Monk 2012).

Faced with these challenges, several sovereign investors are choosing to open additional offices in the main international financial centers (IFCs), which can be a win-win situation: it allows a closer interaction with external asset managers and is a temporary solution to attract international talent.

Kuwait's KIA is known not only for being the first Sovereign Wealth Fund to be set up in 1953 - before the emirate had gained independence from Great Britain, but also for having opened the first ever overseas office of a sovereign investor: the Kuwait Investment Office (KIO) in London, in 1965. KIO is now the largest sovereign investor's overseas office with well over 100 professionals; it receives 10% of the country's budgetary surplus and manages some of its alternative investments including real estate and infrastructure assets.

KIA is not alone. In spite of not hosting any of their headquarters, London and New York combined have over 1,000 professionals working for 28 sovereign investors' overseas offices. NBIM is an excellent example, with 44% of the manpower working in five offices outside Oslo (Norges Bank Investment Management), as are Temasek and GIC, with 12 and 10 international offices respectively. The Singaporean funds are pioneers in their approach to new markets, and have tentacles in all major IFCs as well as in emerging countries of their focus within Asia and Latin America. GIC and Temasek combined have 30 professionals based in Sao Paulo, who speak the language and understand the local market - and manage a portfolio of over 20 and 10 investments in Brazilian private companies, respectively.

Abu Dhabi's Mubadala has also put its feet on Brazilian soil, after investing $2 billion in Brazilian EBX group and acquiring stakes in its companies Porto Sudeste and IMX. However, this "asset management" office in Rio de Janeiro will probably be different than the Singaporean funds' branches in Sao Paulo, which primarily focus on new business development. Earlier this year, Oman's State General Reserve Fund (SGRF) announced the opening of its first office abroad in Tanzania – a country the Sultanate has blood relations with - "in order to capitalize on the growing opportunities in Sub-Saharan countries" (State General Reserve Fund Ministry of Finance). It is now the first and only non-African sovereign investor to have a physical presence in the African continent.

Another interesting case study is CIC. Many will remember the fierce opposition that made Chinese State-Owned Enterprise CNOOC withdraw its $18.5 billion takeover bid for California-based Unocal in 2005, and the general trade tensions between China and the US. Not surprisingly, when CIC decided to open an international office at the beginning of 2011, it initially chose Toronto to "ramp up its Canadian holdings" particularly in the resource sector (Hoffman and Perkins 2011). Two years later, CNOOC acquired Calgary-based Nexen for $15.1 billion in the single largest foreign takeover by a Chinese company. Due to the investment losses faced in Canada and to the substantial US rebound, the Chinese fund has considered moving its North American headquarters to New York, next to SAFE and HKMA, but is still reported to be based in Toronto.

All in all, and depending on the definition, it is estimated that sovereign investors employ around 20,000 staff. Eight percent of them work in one of the 72 overseas offices shown in the table below. We expect this number to increase further over the next few years as these institutional investors mature and focus on new and unfamiliar markets.

Table 2: Sovereign Investors' Offices Overseas

SI	HQ	Operational branches and Representative offices overseas																				
		Amman	Beijing	Brussels	Chennai	Dar es Salaam	Hanoi	HCMC	HK	Istanbul	London	Lux	Mexico DF	Mumbai	New York	Paris	Rio de Janeiro	San Fran	Sao Paulo	Seoul	Shanghai	Singapore	Toronto	Tokyo
AIMCo	Edmonton										√													
APG	Amsterdam			√					√						√									
Aust Super	Melbourne		√																					
BIA	Brunei										√					√								
Caisse	Montreal		√												√	√						√		
CIC	Beijing																						√	
CPPib	Toronto								√		√				√				√					
GIC	Singapore		√								√		√	√	√			√	√	√	√			√
HKMA	Hong Kong														√									
Khazanah	Kuala Lumpur		√							√	√			√				√						
KIA	Kuwait		√								√													
KIC	Seoul										√				√									
LIA	Tripoli										√													
Mubadala	Abu Dhabi																√							
NBIM	Oslo										√	√			√						√	√		
NPS	Seoul										√				√							√		
OMERS	Toronto										√				√									
PIF	Ramallah	√																						
QIA	Doha		√								√			√										
SAFE	Beijing										√				√							√		
SGRF	Muscat					√																		
SOFAZ	Baku										√													
Teachers'	Toronto								√		√				√									
Temasek	Singapore		√		√		√	√	√		√		√	√	√			√	√		√			

Source: Funds' websites, news releases, and other public sources

High rent for office spaces is not usually an obstacle for sovereign investors. However, some funds are starting to consider buying out these offices. Last January, Norway's NBIM acquired Queensberry House, the offices they had been renting for years in Mayfair (London) for almost $300 million. Others, like QIA, lend the space they own to their sister organizations: Al Jazeera has recently moved its London offices from Harrods to The Shard, both owned by QIA (Norman 2013), while Qatar Airways' ticket office remains in Harrods.

Sovereign investors will keep acquiring properties that create a long-term value proposition and it would not be surprising if some of them are used to establish new presences overseas. Similarly, the OECD has exerted a renewed pressure on tax matters lately, through the Base Erosion and Profit Shifting (BEPS) - which may accelerate the establishment of fully operational offices overseas.

What's in it for Europe?

It is undeniable that the financial crisis has been a game changer for Europe's human capital. While policymakers have focused on saving the banking system and the common currency, thousands of skilled professionals – especially young graduates - have left the continent since 2008. If we look at the financial sector, many of those resigning (or fired) from European investment banks have flown into emerging markets and joined SWFs. This brain drain may be a blessing in disguise for Europe if, as in the case of China and Russia, it is reversed, luring these executives back to their home countries after having gained an invaluable experience investing in the global markets.

At the same time, the new focus of sovereign investors on direct investments, alternative assets, and new geographies can represent an opportunity for European economies. Four institutional investors have opened offices in Brazil in the last few years to focus on Latin American investments, and SGRF opened an office in Tanzania to look at deals in Sub-Saharan countries. It is a shame that the presence of sovereign investors' offices in continental Europe is still insignificant, as this could drive a significant number of investments if promoted properly. Javier Santiso of ESADE has long suggested that an office in Spain could be used by funds as the base for their Latin American and European portfolio (Santiso 2013).

Other countries are one step ahead. Based on the Russian Direct Investment Fund (RDIF) model, France and Italy have set up collaborative investment platforms to attract foreign investment to their countries. The Caisse des Dépôts' objective is "to make a major contribution to attracting foreign capital to multiple asset classes in order to provide long-term finance for the French economy and improve its competitiveness." Similarly, Italian FSI has scored some important goals by signing co-investment agreements with top funds like QIA, KIA, CIC, KIC, and RDIF, and by joining the International Forum of Sovereign Wealth Funds (IFSWF), which will host its seventh annual meeting in Milan this September.

To sum up, there are a number of measures that European countries can adopt to ensure the increase of activity and investments of sovereign investors in their countries. Hosting some of their international offices or signing collaborative investment agreements may be a good start.

CONCLUSION AND CHALLENGES AHEAD

Since the start of the decline of oil prices in June of 2014, analysts and journalists alike have been asking the same question: what is going to happen to Sovereign Wealth and Investment Funds? There is no doubt that for some of the crude-rich states, low oil prices will translate into a lack of budgetary surplus to be transferred to their investment vehicles, but this is unlikely to be a game changer in the short term. Most sovereign investors have accumulated large stocks of capital on their balance sheets that still need to be deployed, and they will keep investing in opportunities in all asset classes.

There are, however, a number of other challenges that may condition the strategy of these investors going forward:

- **Achieving superior returns in an environment of low interest rates and a "new normal":** asset allocation is moving towards alternatives, and most funds are now trying to invest directly and seek alpha on their own - delivering a great deal of implications and challenges.

- ***L*ack of familiarity with new investment grounds:** competition for prime assets is fierce and funds have no choice but to start looking at new options, such as greenfield assets and emerging markets. These are new grounds for them that may require revisiting the risk-return profile.

- **Corporate governance, transparency, and commitment to open markets:** sovereign investors have come a long way with steps like the Santiago Principles and

they should make sure to continue down this path, especially when markets pick up again and the need for selling assets becomes less pressing in developed economies.

- **Talent attraction and retention:** human capital is crucial for investment businesses and sovereign investors are transitioning into a model with fewer external asset managers and more in-house experts. Offices overseas at IFCs or generous packages may be their only competitive advantage when financial markets pick up again.

Sovereign investors are still relatively new players in the global markets. When Michael Douglas characterized Gordon Gekko in the 1987 film Wall Street, only 15 funds were in place and their holdings were rather domestic or relatively small. Today, the average age of these investors is not yet 20 years old. The industry will keep facing challenges, and evolving with them.

For Europe, it is important to understand the role of these new players in the global economy. Policymakers have placed a lot of attention on their investment strategy or focus, i.e. where and especially why they are going to invest next. But fundamentally, Sovereign Wealth Funds are a highly heterogeneous group of institutional investors, and no two funds are the same. While corporate governance and transparency are treated as the main issues, a step back must be taken to fully appreciate the funds' missions, visions, and values.

If something has become clear it is that sovereign investors are here to stay, and European countries should make them feel welcome, more than they have in the past. At the end of the day, both Sovereign Wealth Funds and Pension Funds can represent a great opportunity for the global economy in general, and for the European recipient countries in particular, in these times of uncertainty.

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Chapter 6

The Internationalization of Chinese Companies and Their Presence in Europe

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06

China's outward foreign direct investment (FDI) has skyrocketed in the last decade, causing ripples in the economy of every region in the world. One of the regions where this growth has been felt most is the European Union, where Chinese stock investment practically quadrupled in the course of just two years, rising from $768 million in 2005 to $2.942 billion in 2007. Three years later, this figure quadrupled once again (to $12.496 billion in 2010) (MOFCOM 2011, 101).[1] According to official Chinese data from 2014 (MOFCOM), there are currently 2,000 Chinese companies established in the EU, with a total investment of $40.097 billion, so China accounts for four of every ten dollars invested in developed countries. Consequently, almost the entire stock of Chinese direct investment in Europe has flowed in very recently, during the years of economic crisis (Casaburi 2014a, 10). From China's perspective, Europe is a key destination in the context of the international expansion of its companies.

Contrary to the widespread image that suggests Chinese FDI is targeting natural resource extraction in Africa and Latin America, Europe is a very attractive region for Chinese companies. What are the causes of this dramatic growth and why is Europe now a priority destination? This chapter explains China's investment in Europe as the logical result of the internationalization process adopted by China's companies and their transformation into global brands.

One of the objectives of the internationalization process pursued by Chinese enterprises is to improve their position in the value-added chain of global goods production, in order to make them capable of competing with the leading technology and innovation companies in the Western world (KPMG 2013, 12). This objective – together with environmental goals and the reduction of social inequality – are the three cornerstones that underpin the change of economic model planned by the Beijing government in Chapters 52 and 53 of the Twelfth Five-Year Plan (Bernasconi-Osterwalder, Johnson, and Zhang 2013, 12-13). According to research conducted by the World Bank in cooperation with the State Council of the People's Republic of China (PRC), if China is to continue moving forward with high levels of growth through 2030, it will have to overcome six major challenges: the relationship between economic competition and the role of the state; innovation; sustainable development; social

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[1] Statistics for 2005 do not include financial FDI.

equality; fiscal modernization; and integration into global markets (World Bank 2013, 20-22). The flow of Chinese capital towards the most developed markets in innovation and technology, such as the United States and the European Union, offers Chinese companies the opportunity to address two of these major challenges: increasing their capacity for innovation and ensuring a strong position as global competitors, thanks to their presence in the markets with the greatest purchasing power. In short, by means of FDI in the European Union – as well as in the United States – Chinese companies are seeking to become global brands capable of innovation and of being as attractive as they are competitive in the international arena.

The internationalization strategy pursued by Chinese companies also coincides with the first of the challenges listed by the report, which consists of prioritizing the market as the lynchpin of the Chinese economy, to the detriment of state planning. In this respect, it is not important whether the companies that invest outside China are public or private (a distinction which is hard to identify at times). Rather, what matters is their competitiveness, both in China and overseas. In fact, the main way in which this much sought after competitiveness can be put to the test and supported is by venturing into foreign markets, which do not have the systems of economic control that hold sway in China. The medium- and long-term objective is that these companies compete successfully in global markets, while helping to improve competitive conditions within China. Therefore, this internationalization strategy fulfils three basic objectives relating to the change of economic model: improving its companies' market conditions (both in China and overseas), developing their capacity for high value-added production, and turning them into global brands that are known throughout the world, like the most famous American and European brands.

Since 2000, when the Chinese government declared that it wanted Chinese companies to adopt a "going global" strategy, China's outward FDI has grown dramatically, increasing one hundredfold in just over a decade and topping $100 billion in 2013.[2] Indeed, the Tenth Five-Year Plan (2001-2005) underscored the importance of "encourag[ing] outward investments, reflecting China's competitive advantages, and expanding the fields, channels and methods of international economic and technological cooperation" (Bernasconi-Osterwalder, Johnson, and Zhang 2013, 2).[3] However, it would be an

[2] According to UNCTAD (United Nations Conference on Trade and Development) data (statistics/foreign direct investment/outward flows/countries, 1980-2013)

[3] Chapter 17, Section IV, on the implemenation of the "going global" strategy (*zouchuqu*)

exaggeration to think that the growth of China's outward FDI into Europe is solely due to a strategy masterminded and overseen by the Beijing government.

While the "going global" strategy was being planned, Chinese companies achieved greater autonomy in terms of their management capacity, adopting the logic of market capitalism and abandoning the directives of the planned economy, a change which, in 1999, led to the amendment of various sections of the Chinese Constitution, together with other laws governing the responsibility of private companies. These were the institutional conditioning factors which caused China's outward FDI to skyrocket after 2000, coinciding with the country's entry into the World Trade Organization and its inclusion in international trade regulations.

Since then, China's outward FDI has never stopped growing, and everything points to this trend continuing in the future. In the case of the European Union, besides the institutional support, this growth feeds off of the powerful economic synergies between China and the EU economic zone. In China, the yuan's appreciation, along with falling exports, growing production costs, easier access to foreign currency, stagnating capital returns, and government incentives for internationalization have encouraged many companies to "go global." On the other hand, in Europe, it has been the combination of companies with technological assets and financial difficulties, the European Union's openness to foreign investment (it is among the most open world regions in this respect), the euro's weakness, falling land prices, and Europe's position as China's number one trade partner which has attracted Chinese capital.

In general terms, there are also synergies on a micro level between European and Chinese companies: European companies are strong in the parts of the production chain where margins are usually higher – both downstream (i.e., distribution, logistics, and transport) and upstream (i.e., technology, design, brand, etc.) – whereas Chinese companies lead the middle part of the production chain, where margins are relatively low (basically, production and assembly of goods) (Hanemann and Rosen 2012, 28). Thus, when Chinese entrepreneurs invest in Europe, they are seeking to expand their markets and vertically integrate processes, not only integrating Chinese companies into the European Union markets, but also obtaining a European stamp of approval which will enable them to compete better in China. There is, therefore, an economic and commercial logic behind China's institutional internationalization strategy towards Europe. Nevertheless, there are also uncertainties, and the flow of Chinese FDI into Europe is not assured, as indicated by the fall in this investment in 2013, after several years of growth (MOFCOM 2014).

What ramifications will the entry of Chinese capital have for institutions in Europe and for European society as a whole? Since its inflow is relatively recent, this is difficult to foresee at present (Hanemann and Rosen 2012, 9). In truth, despite its progress in recent years, Chinese stock investment in Europe remains low, accounting for only 1% of total FDI. On the other hand, almost three quarters of China's outward FDI stock is in Asia, with a large proportion in the Hong Kong's Special Administrative Zone, which, for the purposes of FDI, counts as a separate territory (MOFCOM 2011, 88). Finally, although Chinese overseas investment has shown considerable growth in recent years, in absolute terms it remains below its potential. In 2013, for example, Spain's outward FDI stock totaled $613.584 billion, slightly more than China's.[4]

The fact that Europe became a priority destination for investment just as the growth of China's outward FDI accelerated means that there are strong synergies between the two regions, and therefore this relationship should become closer in the future. In this respect, China's FDI should not be seen any differently from other inflows of foreign capital which have had a fundamentally positive impact on Europe. On the other hand, Chinese investment in Europe should be as positive as European capital investment has been for China, which has helped the Chinese economy develop since the reforms initiated by Deng Xiaoping.

GLOBAL COMPANIES AND CHINESE OVERSEAS INVESTMENT

When Deng Xiaoping's reforms were implemented in 1979, China embarked on its path of "reform and opening up" (*gaige kaifang*), attracting foreign investment to modernize its production system and boost industrialization through Special Economic Zones (SEZs) devoted to the export of manufactured goods. This process allowed the country to sustain, for several decades, an industrialization process with very high levels of growth up until becoming the global power that it is today. However, during this first period of growth, China showed little interest in investing overseas, and the balance between incoming and outgoing capital was always one-sided. A historic turning point in China's progress is just around the corner: the moment when, for the first time, China's outbound investment will exceed its inbound investment, turning the country into a capital exporter (Zhong 2014). This reversal is the result of the process of internationalization pursued by Chinese enterprises.

The progress of China's outward FDI can be divided into two distinct phases: the first phase, running from 1980 to 2001, and the second, which commenced when the "going global" policy began and lasted until 2014. During this first period, China's FDI started off at a very low volume ($134 million in 1984) and increased dramatically in specific years (1985, 1992, and 2001), with year-over-year growth of more than 300%, causing the outward flow of investment to skyrocket suddenly. Following these sharp increases, the flow of investment remained fairly stable for a decade (less than one billion in the 1980s and between two and four billion in the 1990s), until another exceptional year caused another great leap forward.[5] Nevertheless, since the last boom in 2001 – which produced the highest year-over-year growth figures recorded – growth has stabilized, becoming more constant and predictable. This indicates that China's FDI is diversifying and becoming less dependent on a small number of large capital investments, instead depending on many investments with more variable volumes of capital.

The study of China's outward FDI yields methodological difficulties for three reasons: significant disparities according to the statistical source used, the existence of offshore centers that absorb a large chunk of China's FDI (although they are not the final destinations of investment), and the importance of the city of Hong Kong as a global investment distribution hub, attracting more than half of China's outward FDI stock at the end of 2013 (National Bureau of Statistics of China 2014).[6] As in the case of other zones that act as offshore centers, data provided by Hong Kong does not indicate the final destination of Chinese investments received. In the face of these obstacles, investigations usually combine statistics that quantify the nominal value of the FDI with studies that measure the number of projects accepted by the Chinese government or the number of investment projects undertaken outside China (Marukawa, Ito, and Zhang 2014). Comparison of these values with the quantitative data confirms that the number of small projects has increased, whereas the high growth of earlier years (1985, 1992, and 2001) was based on just a few major investments.

[4] UNCTAD data (statistics/foreign direct investment/outward stock/countries, 1980-2013).

[5] UNCTAD (statistics/foreign direct investment/outward flows/countries, 1980-2013).

[6] The most commonly used statistical sources in Chinese FDI analysis are: China's Ministry Of Commerce, its National Bureau of Statistics (China Statistical Yearbook), the UN (UNCTAD), and regional organizations (EUROSTAT for the European Union, Asian Development Bank for Southeast Asia, etc.).

During the first two decades of the economic reforms, Chinese capital outflow was strictly regulated and directed by the government. In fact, almost all China's outward FDI prior to 2000 came from State Owned Enterprises (SOEs): in particular, from companies in the oil sector such as China National Petroleum Corporation (CNPC) and China National Offshore Oil Corporation (CNOOC), which emerged in the 1980s following the fragmentation of the former ministry of petrochemical industries. These large corporations made numerous investments in foreign assets in order to guarantee the supply of oil and gas for the Chinese economy, which was in the full throes of industrialization and economic growth. In 2005, CNOOC made media headlines with a bid to buy the American oil company Unocal for nearly $20 billion. This would have been the largest foreign operation headed by a Chinese company up until that time, but the move was aborted following political pressure from Washington, which voiced concerns over national security.

In 2000, most Chinese outward FDI stock was capital invested in energy reserves and had not reached $30 billion (Clegg and Voss 2012, 18). This type of investment did not diminish in the following decades, rather it continues to grow to the present day and remains vitally important. In 2010, the three Chinese companies with the largest volume of outward FDI stock were oil companies: China Petrochemical Corporation, CNPC, and CNOOC (MOFCOM 2011, 103). With their multinational presence, and despite their being state-owned, the Chinese government refers to them as Transnational Corporations (TNCs). These companies therefore play a fundamental role in the internationalization of the Chinese economy.

Nevertheless, when the strategy of "going global" was put into practice, the investments made by the large state-owned companies began to include other raw materials. Amidst 2001's boom, these investments mushroomed, causing worldwide raw materials prices to rise considerably, a situation that lasted until the outbreak of the crisis in 2008. Logically, these investments were mainly made in countries rich in raw materials: this was the period in which Africa and Latin America attracted the lion's share of Chinese FDI, reaching 56% in 2005 (MOFCOM 2011, 82-87). However, when the strategy of "going global" was introduced, Chinese foreign investment also diversified its cast, involving new players who were interested in other economic sectors. The combination of increased investment in raw materials and the diversification of investment towards other sectors constituted the accelerator of the flow of Chinese foreign investment.

Consequently, the strategy of "going global" should not be interpreted exclusively as the result of a state strategy focused on the supply of raw materials. In reality, the extraction of raw materials – "when these are scarce in China" – is just one of the many objectives of the "going global" policy, whereas making the most of China's competitive advantages and expanding into new fields of economic and technological cooperation play a much more important role (Bernasconi-Osterwalder, Johnson, and Zhang 2013, 2-3).[7] While introducing the terms of this new strategy into the framework of the Tenth Five-Year Plan (2001-2005), the Chinese government maintained public control of the energy sectors. However, it did remove certain bureaucratic obstacles hindering the internationalization of companies in other sectors by facilitating credit and access to foreign currency. These measures boosted outbound investment linked with services to companies, mainly in the financial sector and in what the Chinese Ministry of Commerce calls "leasing and business services." These sectors accounted for barely 14% of China's total outward FDI stock in 2004, but by the end of 2012, this proportion had risen to more than 50% (National Bureau of Statistics of China 2013).[8]

The sector that showed the highest growth during this period was the Chinese banking sector, which had barely set foot abroad before then. In the last few years, there has been a rapid increase in the number of overseas branches held by the main Chinese banks, such as the Bank of China (BOC) and the Industrial and Commercial Bank of China (ICBC). At present, the ICBC is the largest bank worldwide by capitalization, and one of the most influential publicly owned companies around the globe, with a presence in 39 countries. It is no coincidence that it was one of the first Chinese banks to expand overseas, opening a branch office in Singapore in 1992. Today, it has assets outside China to the value of $170 billion (Cortés and Blanco 2014, 62). In 2010, financial assets represented 17.4% of all Chinese FDI stock (MOFCOM 2011, 79).

On the other hand, if during the 1990s the key players in China's expansion were the oil companies, in this new arena it would be the technology companies that proliferated. In 2004, China became the principal exporter of technology worldwide, although a vast majority of products belong to companies that are not Chinese. The latter take the lion's share of the profit, since the elements of most value (i.e., technological patents, product design, distribution, etc.) remain in the hands of the foreign companies. In this race, the Chinese companies are aiming to catch up with the top companies worldwide; in order to fulfil this aim, they can adopt two possible strategies. As a first option, some have made a bid for organic globalization, opening their own subsidiaries overseas

[7] Tenth Five-Year Plan (2001-2005), Chapter 17, Section IV

[8] *China Statistical Yearbook, 2013* (6-19 Overseas Direct Investment by Sector)

(greenfield investments), that is to say, pursuing their own growth and investing in research, in order to compete with global companies. As a second option, many other companies have sought to move up the ladder in the value-added chain through mergers and acquisitions (M&A) involving foreign companies which are already high up the value chain, allowing them to make a qualitative leap.

Huawei Technologies is a good example of the first strategy. Created in 1987 in the Special Economic Zone of Shenzhen, this company has successfully become a global brand through organic growth, making a commitment to internationalization and opening offices in more than one hundred countries. At present, it has more than 150,000 employees, of whom 73% work outside China, providing one third of the world's population with direct or indirect information technology services (through international operators) (Casaburi 2014c, 86). At the root of its internationalization strategy is a strong commitment to investment in technological research, with greenfield investment and, above all, R&D centers. Huawei was the company which registered the highest number of patents worldwide in 2008, and it is the Chinese company with the highest level of greenfield investment in Europe (Meunier, Bourgon, and Jacoby 2014, 118). In 2011, the company launched its first mobile telephone model, and at the end of 2013, it found itself among the three biggest mobile vendors worldwide, just behind Apple and Samsung. However, since 2014 it has been facing tough competition in Asian markets from the Chinese company Xiaomi (*The Economist* 2014). In 2010, Huawei already ranked number seven among the Chinese companies with the highest overseas revenue and no private Chinese company ranked higher in terms of FDI invested, according to the Ministry of Commerce (MOFCOM 2011, 107).

Lenovo provides another example of a global company, but it has followed the second strategy. Founded in Beijing in 1984, and now administered from Hong Kong, Lenovo purchased the American multinational IBM's PC unit (the famous *ThinkPads*), thereby gaining access to a global market and to a company that played a historic role in the IT revolution in the United States. In 2011, pursuing its strategy of mergers and acquisitions, Lenovo purchased the German technology company Medion in what was one of the largest investments by a Chinese company in Europe (Hanemann and Rosen 2012, 46). More recently, in 2014, it made further inroads into IBM (purchasing the x86 service) and it entered the smartphone market with the acquisition of Motorola Mobility (Backaler 2015). It is currently the world's third largest seller of smart connected devices (tablets, computers, smartphones, and smart TVs) (Casaburi 2014b, 35). It is through the acquisition of leading companies in the West that Lenovo has forced its way into the global markets' first division of cutting-edge technology specialists.

According to a study by IBM – not limited to Lenovo – Chinese companies' three primary motivations for foreign investment are: expanding their markets, acquiring new technologies, and differentiating themselves in the domestic market (IBM 2006, 4-5). In sum, while Huawei has become a global company by investing in new subsidiaries (i.e., greenfield investments), Lenovo has done so through M&A. This said, not only have these companies expanded internationally as the oil companies did, but they have also succeeded in moving up the value chain in the global production of goods.

CHINESE INVESTMENT IN THE EUROPEAN UNION

Thanks to the process of internationalization and to investment in research, many Chinese companies have attained the technological standards of global companies, and they are now in a position to compete in the more mature markets of Europe and the United States. There can be no doubt that the fall in Chinese exports to these markets – following the outbreak of the world crisis and the rise in production costs in China – has increased China's determination to look overseas in search of markets, technology, R&D centers, know-how in the management of global companies, and patents or Western brands that can provide its companies with the added value they need. This is the logic behind the new change of model, the objective of which is to prevent China from falling into the so-called "middle income trap"; this trap occurs when a country cannot rise above middle income levels, due to difficulties in increasing the added value of its products. Thus, if a middle income country is unable to compete in the more developed markets, it runs the risk of economic stagnation and the failure to converge with richer economies (World Bank 2013, 11-12). Fear of becoming ensnared in this trap is what has driven the change of economic model in China, firing the country's interest in the high value-added industries in the United States and Europe.

The Twelfth Five-Year Plan, approved in March of 2011, specifies how this change of economic model is to be implemented: by driving internal demand and the internationalization of Chinese companies. In this respect, a social security and urbanization program has been planned to protect and increase the purchasing power of the middle classes. In addition, large increases in public R&D spending have been programmed, as a result of which productivity and the added value of production will be improved, accompanied by a strong commitment to internationalization. Moreover, the Plan identifies the strategic sectors at which China's outward investment is especially aimed: infrastructure, energy, agriculture, high-tech, environment, healthcare, agri-food, and consumer goods. Other investments seen as strategic are also maintained

and remain under the control of the government and state-owned companies, specifically investments in defense, electricity generation, oil, telecommunications, steel, civil aviation, and water management (Casaburi 2014b, 18). The role to be played by private companies and the degree of economic competition therefore depend on the strategic nature of each economic sector. However, it is foreseeable that China's FDI will increase in all these sectors, and as a result, companies will be looking to become more competitive.

The aforementioned Five-Year Plan confirms the Chinese government's intention to directly encourage FDI through tax incentives and financial support. These same plans establish the future needs for raw materials, although perhaps without the growth of the previous decade (which led to a fall in their prices). On the other hand, the high level of savings in the Chinese economy and its currency reserves suggest that foreign investment ought to be the most logical solution in the face of the falling returns on capital on the domestic front. It comes as no surprise that many Chinese executives point to saturation and high competition in China as key motives for their internationalization strategy. The massive currency reserves held by the country ($3.3 trillion, principally in dollars, euros, and yen) are exerting upward pressure on the yuan; but if the government wishes to maintain parity, it will have to encourage the outflow of capital, as it is doing (Casaburi 2014b, 22). In the case of the euro and the yen, it would appear logical for these currencies held by China to be reinvested in Europe and Japan.

The recent increase in China's FDI in Europe shows that interest in the EU as a destination for Chinese investment has grown in the last few years, and although the flow decreased in 2013, everything points to a return to the rising trend by the end of 2014. In 2012, Chinese FDI in Europe totaled more than $7 billion, and this was when foreign investment collapsed due to the euro and sovereign debt crisis (National Bureau of Statistics of China 2013).[9] 34% of the total foreign investments made by the four major Chinese sovereign funds (which manage the largest volume of assets) target Europe and they have covered the needs of European debt over the last few years (Santiso and Capapé 2014, 38). In the first four months of 2012, in terms of the number of projects, Chinese investment in the EU overtook European investment in China for the first time, symbolizing the changes on the horizon in the international economy (PwC 2012, 8). In fact, the rise of Chinese FDI into the EU during the worst years of the crisis was spectacular: in just five years' time, aggregate investment of $1 billion in 2007 had grown to $6 billion by 2012 (Nicolas 2014, 104). Furthermore, Chinese investment has reached both the countries that have weathered the crisis well, such as Germany, where Chinese investment grew twentyfold between 2003 and 2011, as well as those countries most affected by the crisis, such as Greece and Hungary (which show the greatest differences when their inward Chinese investment is compared to FDI from the rest of the world) (Hanemann and Rosen 2012, 96).

The data on Chinese FDI into Europe vary substantially depending on whether the statistical sources are European (EUROSTAT), Chinese (MOFCOM), or private consultancy firms (KPMG 2013, 8). One of the causes of the divergence in data between Chinese and European sources can be found in the role of Luxembourg as a low-taxation offshore center: this country registers the largest flows of Chinese FDI into Europe according to the Chinese Ministry of Commerce, most notably in 2009 (more than 60% of the total) and 2010 (47.4%). However, according to Eurostat – and the analyses that measure the number of investment projects actually executed – Germany, the United Kingdom, and France are the biggest targets of Chinese investment, followed at a distance by Italy, the Netherlands, Hungary, and Spain (Clegg and Voss 2012, 27). Similarly, there is no consensus on which EU member state receives the most Chinese investment, since this depends on the methodologies used and the year studied. A single investment can make a big difference, as was the case in Sweden when Geely purchased Volvo, or in France with the investment made in GDF Suez, in 2011.

To be precise, in 2011, the Chinese sovereign fund CIC purchased 30% of the French company GDF Suez ($3.2 billion), one of the largest public service companies in the world. This has been the largest Chinese investment in the European Union to date, and as a result, France became the leading destination for FDI from China in 2011, although in the past this country had received considerably less investment than Germany or the United Kingdom (Nicolas 2014, 106-107). It is foreseeable that these large investments, principally in the EUMI (Energy, Utilities, Mining, and Infrastructure) sectors, will continue to create statistical peaks in studies of Chinese FDI into the EU, in spite of the growing sectorial diversification.

The number of greenfield investments being made in Europe is significantly higher than the number of M&As, the ratio being approximately three to one (Hanemann and Rosen 2012, 38; Casaburi 2014b, 33). However, the aggregate value of M&As tends to be much higher than the aggregate value of greenfield investments, since the former are usually large investments that involve huge amounts of capital, as in the case of GDF Suez, whereas the latter involve smaller amounts of capital and are more diversified. Between

[9] *China Statistical Yearbook, 2013* (6-18 Overseas Direct Investment by Countries or Regions). These data include Russia and non-EU European countries.

2006 and 2009, 90% of the largest M&As were affected by SOEs or Chinese sovereign wealth funds (Nicolas 2014, 106). However, recent studies tend to consider operations of less than $100 million as one of the main drivers of the growth in Chinese investment.

This type of smaller investment is usually found in industrial and technological sectors, as is the case in Germany and Eastern Europe, for example. The industrial sector and consumption account for almost half of China's total investment in Germany, and although the volumes of capital in each operation are not as high as in the previous examples, this investment has been more regular and sustained. There have also been some large acquisitions, such as the purchase of the machinery company Putzmeister by the Chinese multinational Sany for $471 million in 2012, or the purchase of the automotive company Kiekert by Hebei Lingyun. This said, these two German companies form part of the German business fabric based on family-run SMEs (known as *Mittelstand* companies) (Casaburi 2014b, 35).

Sany, one of the world's largest heavy machinery manufacturers, has thus made a firm commitment to expansion in Germany, seeking to coordinate its business mission (in Chinese, *sanyi* means "the three ones") with the new model that China wishes to introduce: creating a first-class company, training top-quality workers, and making a first-rate contribution to society. However, industrial investment in Germany has mainly been channeled through smaller companies and in sums of less than $100 million. Furthermore, entering new markets is a decisive factor for many Chinese executives who invest in Germany, according to a report by a well-known consultancy. In addition to Germany's industrial, technological, and engineering strength, Chinese entrepreneurs value the country's geographical position in the center of Europe, with its excellent transport communication (Deloitte 2007, 10).

One of the novelties in recent years has been China's industrial FDI into East European countries, particularly in Hungary (and its chemical industry) and the Czech Republic, with the establishment of various industrial hubs to join those already existing in the Netherlands, Italy, and the United Kingdom, as well as the research and technology hubs scattered across Europe and set up by companies such as Huawei and its competitor ZTE (Clegg and Voss 2012, 68). In fact, some of the Chinese industrial companies that were sending their exports to Europe in the past are now making inroads into Eastern Europe, as demonstrated by the presence of home appliance manufacturers such as Hisense, TCL, and Haier (Nicolas 2014, 109). Some of these enterprises, including Haier, for example, are present in 30 European countries, with technology plants in Germany, design centers in Italy, and offices in Spain and the United Kingdom. Haier, the only Chinese company in the ranking of the ten most innovative companies of 2012 (according to the Boston Consulting Group), defines itself as "a Chinese brand made in Europe" (Casaburi 2014c, 88). This strategy allows Chinese consumer goods companies to adapt their products to European consumers with greater precision, speed, and efficiency. Once again, these investments have been driven by market and commercial expansion criteria.

Moreover, the large acquisitions in the industrial sector have been made in the automotive industry, as shown in Geely's M&A of Volvo, the purchase of the British company MG Rover by Nanjing Automotive in 2005, and the acquisition of Saab Automobile by Beijing Automotive Industry Holdings. In this sector, FDI has been focused on the United Kingdom and Sweden, indicating that Chinese investment has earmarked strategic sectors in particular countries, as outlined by the Chinese government in its foreign investment guides (Clegg and Voss 2012, 63-64). In these projects, there is an underlying need to take over research centers with the capacity to design and plan efficient cars with low CO_2 emissions. Through these acquisitions, Chinese companies seek to become more competitive in both the international and the domestic markets. Up until the 1990s, the automotive sector in China was carefully protected by the state and the prices of cars were inflated, which had a dampening effect on innovation and competition. At present, China is seeking to modernize its car sector by turning its gaze overseas, removing barriers to the import of cars and making it possible for Chinese vehicles to be exported at competitive prices. This situation favors mergers between Chinese and European brands and the exploration of potential synergies, providing a good example of how the internationalization of Chinese companies helps to improve innovation and market conditions in China itself.

On the other hand, it is calculated that approximately one third of China's outward investment projects have not turned out to be successful (Nicolas 2010, 36). It is precisely the lack of experience in the international area and insufficient knowledge of the market conditions in the destination country that can endanger the success of a foreign investment project, as seen in TCL's 2004 purchase of the French company Alcatel's mobile subsidiary. This acquisition was principally motivated by the desire to take advantage of the French company's patents and its two R&D centers, with a view to producing more advanced mobiles at lower production costs. This is unsurprising given the high prices Chinese enterprises usually pay to use the foreign companies' patents. The combination of TCL's manufacturing strength and presence in the Chinese market on the one hand, and Alcatel's technology and high added value on the other appeared to be a perfect match. Nevertheless, the acquisition failed and the merger was abandoned in less than a year, resulting in heavy losses. The unexpected increase in competition in China and the different management styles of the two companies eventually weighed down the merger, which did not take sufficient account of the costs of integrating two large enterprises with very different cultures (He 2005).

Finally, Chinese investment has also affected other economic sectors. Curiously, the level of Chinese investment in the agricultural, fishing, and food sectors in Europe is higher than in these sectors in the rest of the world, as borne out by the much publicized purchases of vineyards and agricultural properties in France by Chinese companies, which have caused considerable resentment among the French.[10] The high reputation of European food products, along with strict hygiene, environmental, and health standards, make this sector very attractive to the Chinese, who are accustomed to food scandals in their own country. In Spain, sizeable investments have also been made in the real estate and tourism sector through the acquisition of hotels and properties by large Chinese groups specializing in leisure and travel, such as Dalian Wanda and HNA (Casaburi 2014c, 75). All in all, it is apparent that in Southern Europe, Germany, and Eastern Europe alike, Chinese enterprises look for the strongest sectors with one objective in mind: to increase their competitiveness and expand their markets.

CONCLUSION: EUROPE AND CHINESE FDI

Insofar as Chinese investment is dominated by global companies which act according to their own commercial strategies, its impact on the destination society should not differ from that of other foreign investments in the business fabric of Europe, such as those made by North American and Japanese companies, which have now been investing in the European Union for commercial motives for decades now. In general, non-financial FDI creates employment, is stable in the medium term, and involves capital injections which improve market conditions. Moreover, these initial investments tend to grow if the commercial strategy achieves good economic results, spawning multiplier effects that benefit the economy as a whole.

Most of the Chinese companies that invest in Europe do so in order to expand their market. But this expansion is not only outward: these companies are just as interested in penetrating the European market as in gaining a European brand that will make them more competitive in China. At present, the saturation of the Chinese market is causing many companies to leave in order to differentiate themselves from their local competitors (KPMG 2013, 12). This situation opens up new horizons for European companies, which can benefit from expanding into Chinese markets, making the most of the acquiring company's networks. In reality however, players in Europe very often see things differently, believing that the sole interest of Chinese enterprises lies in adopting technology and purchasing patents. In designing M&As, this synergy – which the Chinese entrepreneurs consider to be vital – can lead the Chinese companies to overvalue the assets of their European counterparts (PwC 2012, 18). In short, opinions voiced by Chinese entrepreneurs show that they are accustomed to developing a long-term commercial vision with great insight into these expansion synergies.

When operating in Europe, Chinese companies also look to boost their know-how regarding the management of global companies. When engaging in mergers and acquisitions, Chinese entrepreneurs not only pursue technology, innovation, and R&D centers, but they also look for a match that will open the door to vertical integration of the production process: from assembly lines in Asia to R&D centers in developed countries, together with distribution networks, logistics, design, and sales. The experience of many European and North American companies in the international arena is greatly welcomed by Chinese enterprises, which generally have fewer years of experience. From the point of view of business management, the internationalization of transnational corporations such as CNOOC, Huawei, and Sany involves a high degree of competence in international and intercultural management, which, in some cases, has also been acquired and continues to be acquired through FDI.

On the other hand, the decrease in China's outward FDI in the European Union in 2013 – the first after a period of continuous growth – is a sign that the inflow of Chinese investment into Europe is not guaranteed. While Chinese investment into Europe has decreased, it has increased into the United States and other developed countries, including Israel, Australia, and Canada (MOFCOM 2014). According to a new index launched by The Economist Group, Germany is the only EU country in the ranking of the ten most attractive countries for Chinese investment, holding tenth place behind the United States (first place), Switzerland, Norway, and Russia (The Economist Intelligence Unit 2013, 2). Seven of the countries on this list are developed countries from the OECD. On the other hand, six EU countries (Germany, UK, France, Sweden, Netherlands, and Denmark) dominate the list of the countries best positioned to attract Chinese investment in the "brands and technology" sectors (The Economist Intelligence Unit 2013, 18).

Chinese entrepreneurs bemoan excessive legal and fiscal fragmentation in Europe. Indeed, when in March of 2014 Xi Jinping became the first Chinese leader to make an official visit to the institutions of the European Union, he emphasized the need to create a bilateral International Investment Agreement (IIA) between Brussels and Beijing. This deal would seek to alleviate the confusion Chinese companies face when dealing with the 26 bilateral investment agreements currently in force between China and the member states of the European Union (Berger 2014, 11-13).

[10] On cross-data between economic sectors and destinations for Chinese FDI, see Marukawa, Tomoo, *China's Outward Foreign Direct Investment Data* (2-4 Destination Country by Function of Affiliate).

The boom in Chinese outward investment into Europe has sparked opposition from protectionist and nationalist sectors, who fear a Chinese "invasion" that will buy up European companies *en masse*, echoing the fears expressed in the United States in the 1980s, when Japanese FDI was booming. However, rather than being conducive to protectionism, the fragmentation of the legal and fiscal framework in fact leads countries to compete with each other in order to attract foreign investment through tax benefits – as in the case of Luxembourg (Hanemann and Rosen 2012, 6). Keeping up the flow of Chinese investment in Europe will depend on Europe's capacity to draw its territory together and standardize its legal and fiscal system. In truth, excessive European fragmentation is the main obstacle to the growth of Chinese investment in Europe.

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Chapter 7

China's Renewed Attractiveness for European Firms

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07

Ever since China gradually started opening to foreign capital at the beginning of the 80s, European companies have established bases in China and made a cumulative investment of $156 billion.[1] European firms have been drawn to an economy with a GDP growth rate of 9.8% per annum,[2] an underexploited market of 1.3 billion potential consumers, manufacturing labor costs of $0.60 per hour (Banister 2005),[3] and China's position as an export platform for the Asian region.

However, China has since made great strides in economic growth and has become an upper middle income nation.[4] This has led to an erosion of the abovementioned factors and a reduction in China's attractiveness to foreign investors in recent years. China has slowed its growth (to below 7% of GDP), features mature and highly competitive markets in several coastal provinces (Shanghai, Guangzhou, and Zhejiang), and has labor costs that are now high by regional standards (the minimum wage is $1.19 per hour, compared to $0.28 in India, $0.52 in Indonesia, and $0.73 in the Philippines). Moreover, these are additional factors in an investment climate in China that has been persistently unfavorable for decades (90th position in the World Bank's *2015 Doing Business* report).

The Chinese model of economic development based on massive public investment, high levels of domestic saving, and exports of low value-added products has shown signs of exhaustion and has generated significant imbalances that threaten the country's economic sustainability. Therefore, China is currently in a critical phase of its economic development and must make profound reforms to change the basis of its growth and avoid being caught in the middle income trap. China is seeking, through a government-drawn road map, a model of growth with more private consumption and less public investment on the demand side – and with more activities rooted in research, knowledge, and differentiation, and less emphasis on manufacturing with low value added on the supply side.

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1 Eurostat data from December 31st, 2012 (most recent data available).

2 Average annual growth rates for China for the period 1980-2012 according to the International Monetary Fund's (IMF) World Economic Outlook Database (WEO).

3 Data for 2002 from the US Bureau of Labor Statistics.

4 According to the World Bank.

The transition to this new development model will generate promising new business and investment opportunities for European companies. The increase in disposable income, with GDP per capita growing 9.2% annually over the past 20 years, combined with increasingly Western consumption patterns, generates significant business opportunities through the emergence of new consumer groups. The massive growth of cities (currently 500 million more Chinese people live in cities than three decades ago (The Economist 2014b)) and environmental degradation will generate new opportunities in sectors such as infrastructure and public transportation, urban waste management, and water treatment.

China is driving increased trade integration through infrastructure development, including megaprojects such as the Nicaragua Canal and the New Silk Road, which will reduce operating costs and create new incentives to use China as a production and logistics platform. Significant investment opportunities will also arise by opening more sectors, such as finance or property, to foreign direct investment (FDI) (Yao and Elsinga 2014), and launching new pilot projects with special advantages for foreign investors, such as the Shanghai Free Trade Zone (SFTZ). Furthermore, Chinese firms are currently investing heavily in the European Union – according to Eurostat, in 2011 and 2012, Chinese FDI reached record-breaking levels in the EU. This investment was made through strategic alliances or direct equity investment in European firms and will facilitate the entry of European companies into China - with investing firms opening the doors as local partners, and providing distribution networks.

35 YEARS OF OPENNESS TO FOREIGN CAPITAL IN CHINA

The years after the proclamation of the People's Republic of China by Mao Zedong in Tiananmen Square in 1949 were marked by fierce economic autarky as the country turned its back on foreign capital. Foreign investment - particularly from Western countries - was rejected as the country aspired to self-sufficiency under a socialist model, and only enterprises from countries with similar ideologies were allowed to make occasional investments. Exceptionally, some joint ventures[5] were undertaken with local companies during the 50s and 60s, as in the cases of the Sino-Soviet Zhongchang Railway, the Polish Sino-Polish Joint Stock Shipping Company in shipbuilding, or Sino-Czechoslovak International Marine Company in shipping (Wei and Liu 2001).

[5] In the three cases mentioned below, joint ventures were formed with Chinese and foreign capital.

After Deng Xiaoping came to power in 1978, a profound and irreversible economic transformation was launched with progressive external openness and a shift of economic and industrial policy towards the market economy. The aim of the reforms was to promote and modernize a stunted and barely competitive economy - the result of decades of state control and economic and business autarky. Deng Xiaoping opened the door to foreign multinationals and even visited the headquarters of the Coca-Cola Company in Atlanta to reopen a bottling plant after the company's expulsion by the Mao government decades earlier. It was hoped that the selective insertion of foreign firms would be an important source of external financing, generating significant externalities in the adoption of production technologies, and the improvement of human capital. The aim was to give Chinese public companies more market orientation and modernize strategic industries.

Openness to foreign companies occurred gradually, starting with financial support for foreign companies in special economic zones (SEZs)[6] and coastal cities, and legislation that laid the groundwork for the participation of foreign companies in certain economic sectors (i.e., the Chinese Foreign Joint Venture Law). In the following decades, numerous foreign companies arrived and China became one of the world's major investment destinations. China went from being a closed economy (in the 50s, 60s, and 70s) to an open market that attracted little investment (in the 80s), and then to an attractive destination for business (in the 90s), before finally becoming known as the "world's factory" and the "world's biggest market." In the first decade of this century, China was the fifth largest global destination for FDI. In 35 years, a newly opened China reached the point where it was building 80% of the air conditioners in the world, 90% of the personal computers and mobile phones, 65% of the shoes, and almost 70% of the solar panels (Towson and Woetzel 2014).

The stock of accumulated FDI in China is currently close to $1 trillion and the value of assets held by foreigners is close to $4 trillion[7] – volumes only overtaken by the US, UK, Hong Kong, and France. However, foreign capital participation in the country is not so impressive when compared with economic size. FDI stock is only 10.1% of GDP, somewhat lower than other large emerging economies such as India (12.1%), and significantly lower than Brazil (32.2%) or South Africa (39.9%).[8] Nevertheless, foreign companies have come to play an essential role in the Chinese economy by generating tax revenues, developing industry, modernizing economic sectors, and

[6] The first four SEZs were: Zhenshen, Zhuhai, Shantou, and Xiamen.
[7] Balance of payments. Data for end of 2013.
[8] Author's calculations based on United Nations Conference for Trade and Investment (UNCTAD) data.

helping integrate China into the world economy. According to World Bank estimates, foreign firms account for 22% of Chinese tax revenue, 28% of value added in industry, 55% of exports, and 50% of technological imports (World Bank).

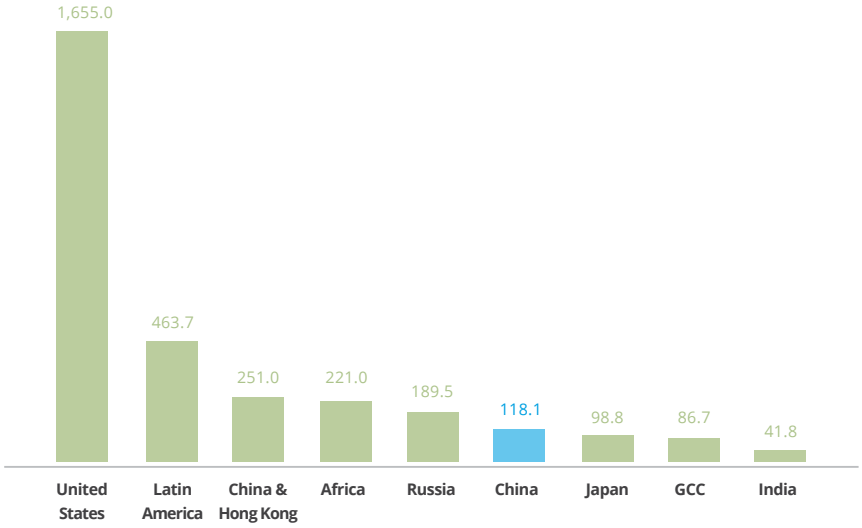
These $1 trillion of foreign investment are spread over 440,000 foreign companies (Xinhuanet 2013). Discovering which countries and regions are behind FDI in China is not straightforward, as the information is subject to statistical limitations - mainly because some major investors are based in offshore financial centers (OFCs), such as Hong Kong or the British Virgin Islands (BVI), making it impossible to identify the real investor. In the case of Hong Kong (the leading investor in mainland China, at 49.9% of total investment), it is important to remember that many mainland companies establish Hong Kong companies to take advantage of the more favorable business environment and to access capital markets in order to then return the investments to China (known as "round tripping").

Keeping these important information limitations in mind, official Chinese statistics reflect that between 2005 and 2012,[9] 67% of FDI in China came from Asia (49% from Hong Kong), 16.4% from Latin America (15.6% BVI and the Cayman Islands), 6.3% from Europe, 4.2% from North America, 2.8% from Oceania, and 1.5% from Africa. There is a clear preference among foreign companies for the manufacturing sector, which accounts for 50.9% of the FDI China received – in other words, one out of every two dollars. The sector with the second highest investment is property (20.2%), followed by leasing and business services (6.3%), and wholesale and retail distribution (5.9%).[10] Official Chinese data also reveal that FDI is highly concentrated in the coastal provinces, especially in Jiangsu, Guangdong, and Shanghai (which absorb about half of total foreign investment). In contrast, provinces such as Yunnan and Xinjiang receive little foreign investment.

EUROPEAN MULTINATIONALS ARRIVE IN CHINA

The EU is the world's main source of foreign investment, with a total of $10.6 trillion, accounting for 37% of total global investment since 1980 - well above American investment ($6.3 trillion) or the emerging countries ($5 trillion). The EU has invested a total of $156 billion in China[11] ($331 billion if Hong Kong is included)[12] as reported by Eurostat at the end of 2012. This volume represents only 2.2% of the total amount invested outside the EU, a modest figure compared to investments made by European companies in Latin America or Africa, whose economies are much smaller than China's, but which have received, respectively, almost four times and twice as much investment. It is also noteworthy that while European companies have been in China for over 50 years, their presence is relatively recent: 84% of the investment in China has been produced since 2000.

Graph 1: Stock of EU Foreign Direct Investment (2012)



Source: Eurostat. Billions of euros.

European FDI is made through operations carried out by multinational companies (hereinafter MNCs) such as Rio Tinto, BASF, GDF Suez, Fiat, and Telefónica (to name only a few). The highly competitive and successful expansion processes of these companies have been crucial in making the EU the world's largest investor. According to UNCTAD data, 50 of the 100 largest MNCs in terms of foreign assets are European,[13] and these firms have accumulated 66% of their total assets outside the EU (UNCTAD 2014). In addition, up to 72% of these 100 firms' sales originate abroad and they have created 4,300,000 jobs overseas.

[9] The last year available in which data reflects the national origin of investment funds.

[10] Data for 2006-2012 from official Chinese statistics.

[11] Eurostat data from the end of 2012. Most recent data available on December 15th, 2014.

[12] Many Western companies operate in China through Hong Kong-based companies because HK has the most attractive double tax agreements, a low tax rate, and an Anglo-Saxon business environment that is agile, predictable, and open.

[13] Data for non-financial firms.

German companies account for around one in three euros invested in China from the EU, making up 36% of European investment stock in China. It is estimated that there are about 5,000 German companies in China operating in a heterogeneous group of sectors such as chemicals, electronics, or capital goods. In recent decades, investment in the vehicle sector has also been significant. Volkswagen, for example, began producing the Santana model at a plant in Shanghai in 1984 through the creation of a joint venture with a local company. It established a second joint venture in 1990 with the opening of a factory in Changchun (that made up to 50 models, including the Golf, Jetta, and Audi A6 and A4). German service companies also have a significant presence in the Chinese market. For example, the Allianz insurance company entered the Chinese market in the 80s by reaching agreements with local businesses to strengthen the reinsurance industry. The German firm then acquired a small stake in the Industrial and Commercial Bank of China (ICBC) and sold insurance through its 18,000 points of sale. Aware of the importance of being near customers in the Chinese market, Allianz has opened offices in Beijing, Shanghai, and Guangzhou, and currently has 1,100 employees in the country.

France is the second largest European investor in China, accounting for 16% of the EU's total investment. French companies have made major investments in the raw materials sector, as well as the financial and automotive industries. French presence in distribution networks, in both coastal cities and in the hinterland, is particularly notable. Carrefour opened the first hypermarket in China in 1995, and today has 238 stores spread across 73 cities, employing over 50,000 people. Auchan, meanwhile, has 115,000 employees in China, more than the total it employs in Europe (excluding France).

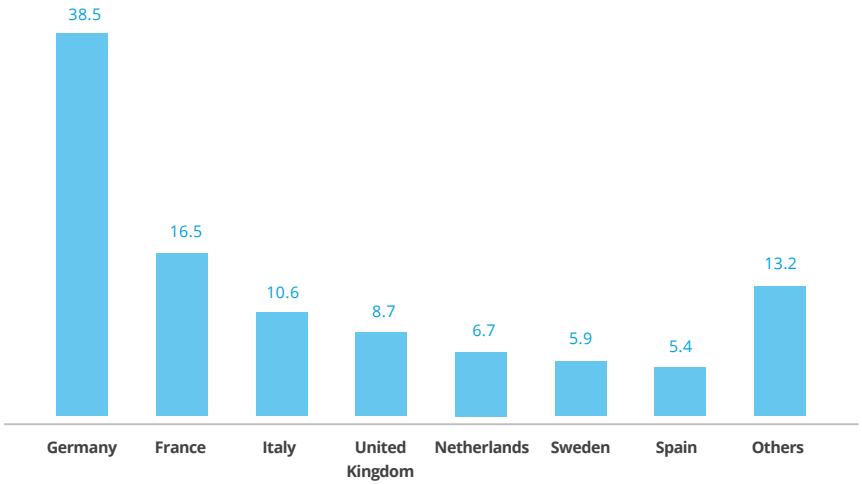
The third largest European investor in China is Italy - with 10% of the total amount invested by the EU. The financial sector has been particularly active, as evidenced by the Chinese presence of Banca di Roma, Banca Monte dei Paschi di Siena, Banca Nazionale dei Lavoro, and Unicredito. Vehicle companies such as Fiat and Pirelli also have plants in China, and various groups in the consumer goods sector have a range of investments. Large fashion and couture companies have opened numerous outlets aimed at the growing and increasingly wealthy Chinese upper class - including Versace, Armani, Ermenegildo Zegna, and Salvatore Ferragamo.

The fourth largest investor is the UK, holding 8% of the total. Investors include energy companies such as BP and Royal Dutch Shell, mining companies such as Anglo American, financial institutions such as The Royal Bank of Scotland and Lloyds, supermarket chains such as Tesco; chemical companies such as GlaxoSmithKline, and

the news agency Reuters. UK financial institutions, just as their European counterparts, have typically entered the market by acquiring shareholdings in local banks. This is the case of HSBC, which has a stake in the Bank of Shanghai (part of which was later acquired by the Spanish Banco Santander) and the Bank of Communications.

Spanish firms also operate in various economic sectors. Two examples of successful implementation in China are the ALSA bus company[14], present since the 80s and operating 5,000 vehicles in the country, reaching some 549 destinations, and textile giant Inditex, which in addition to having more than 400 shops, recently announced plans to begin marketing through the online portal TMall, owned by the distribution giant Alibaba.

Graph 2: Main European Investors in China (2012)



Source: Eurostat 2014. Billions of euros.

[14] Note that since 2005, ALSA is part of the British company National Express.

OLD AND NEW DIFFICULTIES FOR EUROPEAN COMPANIES

European companies invest in China for four main reasons: the market size and huge numbers of potential consumers of Western quality products and services, the high rates of economic growth in an environment of political and macroeconomic stability, low labor costs and abundant labor supply, and proximity to other Asian markets that enable the whole region to be covered from China. However, although some of these advantages are still present, others have eroded. For the first time in decades, a growing number of entrepreneurs, academics, analysts, and traders have begun to question China's attractiveness for FDI. Headlines such as "China Loses its Allure" or "China Loses Edge as World's Factory Floor" were recently published by *The Economist* and *Wall Street Journal*. A recent survey published by the European Chamber in China reflected a loss of optimism about China as an investment destination and has generated debate about whether China is still a suitable place for investment by European companies. Some production lines are moving from China to other Asian countries or "reshoring" (returning to the country of origin of the investment). A recent survey conducted by the Shanghai American Business Council in 2012 found that among American investors, 15% had relocated their investments outside China and 13% to the hinterland. Another survey conducted by PwC on a sample of 384 Eurozone MNCs showed that 60% had conducted reshoring operations (PwC 2014).

China may have lost attractiveness to foreign companies because of a combination of new economic factors related to its changing economic model - such as slowing growth, increased operating costs, and growing business competition. Moreover, various factors that have been limiting the operations of foreign companies for decades remain unresolved (although some have been partially addressed) - including an enduring investment climate that is less favorable than in other emerging countries.

Among the new factors that may have led to the loss of attractiveness of China in terms of FDI, the first to be highlighted is a slowdown in the pace of economic growth caused by the imbalances accumulated during the long period of expansion. This slowdown has been supported by government economic policy in response to the dangerous spiral of uncontrolled growth. The Chinese economy has been losing steam and growth rates have fallen from above 9% between 2002 and 2011 to the current "cruise control" rate of 7% (7.1% in 2015, 6.8% in 2016, and 6.6% in 2017, according to the IMF).[15] One of the most important of these imbalances is overgrowth because of a build-up of factors (especially capital) which has led - in an environment of manipulated interest rates and high savings rates - to inefficient and unproductive public investments. The value of these investments may have reached $6.8 trillion (more than the combined GDP of Germany and France) according to recently published estimates by The Economist (2014a).[16] The size of this hole generates major doubts about the health of bank balance sheets, the threat of a housing bubble, and the sustainability of the sustainability of public finances in the provinces.

Other growth model-related imbalances include growing income inequality between citizens and between provinces. According to the World Bank's *China 2030,* China now has more than one million millionaires living alongside 170 million people below the poverty line of less than $2 per day. The divergence between the eastern provinces and Western cities is creating a two-speed China - which could erode the confidence of Western Chinese citizens in the economic system and generate unwanted political pressure. In addition, poorly controlled industrial and energy production has led to serious environmental degradation that threatens the health of the Chinese. The nation was recently ranked as 116 out of a total of 132 countries in the Environmental Performance Index compiled by Yale University.

A second aspect that reduces the attractiveness of China for FDI is rapid growth in operating costs, resulting in a squeeze on margins and corporate profits. Of particular importance has been the upward spiral in wages - despite the fact that many European companies had located in China specifically because of very low labor costs, which have been the key to Chinese global competitiveness. Labor costs in China are no longer competitive within Asia. The minimum hourly wage in China is $1.19, versus $0.28 in India, $0.52 in Indonesia, $0.73 in the Philippines, and $0.64 in Vietnam (China Briefing 2014). China is even losing price competitiveness when compared to other emerging regions. A decade ago, labor costs in Mexico were double those of China, but in recent years the gap has narrowed: unit manufacturing labor costs are now higher in China than Mexico. Besides the increase in wage costs, China has remained relatively uncompetitive in other non-wage costs. For example, insufficient infrastructure means that business logistic costs account for 12% of GDP in China, compared to an average of 12.3% in Latin America and 10.9% in the rest of Asia, excluding Japan (Armstrong & Associates, Inc.). Other costs are excessive bureaucracy (China is ranked 128th in the "Starting a Business" dimension in the World Bank's *Doing Business* report, an

[15] Growth predictions according to the World Economic Outlook (WEO) made in December 2014.

[16] Calculations made by Xu Ce of the National Development and Reform Commission and Wang Yuan of the Academy of Macroeconomic Research.

authoritative report on the comparative analysis of business climates) as well as costs associated with operating in one of the most complex tax and legal systems in the world.

Thirdly, the advantages gained by being among the first to arrive in the Chinese market in the 80s and 90s and taking a leadership position have fallen sharply. In many sectors and economic activities, China is no longer an emerging market: it has reached maturity. This is especially true in coastal cities, where European MNCs are operating in a highly competitive market that has a great adaptability to new market trends. Competitive pressure has increased because of the increasing capacities of local public and private companies, as well as the flood of foreign companies that have arrived in China in recent decades. The falling cost of access to information and rapid knowledge dissemination have quickly eroded many European companies' production and technological advantages. Market niches that had traditionally been dominated by foreign MNCs with their technological superiority are increasingly occupied by Chinese companies. The Forbes ranking of the 100 most innovative companies in the world includes six Chinese companies (Henan Shuanghui, Tingyi Holding, Hengan International, Baidu, Tencent, and Inner Mongolia Yili) - more than Germany or Britain. These companies occupy new business niches, such as the Chinese technology company Tencent (which, in 2014, announced the launch of the first private online bank in the country, Webank), online distribution (where Alibaba dominates its competitors), and mobile phone manufacturing (where Xiaomi, founded in 2010, has become the third largest mobile phone maker in the world, after Samsung and Apple).

Long-standing factors that limit China's attractiveness for FDI include the operational and regulatory difficulties faced by foreign companies - both *de jure* and *de facto* - as well as the poor investment climate. Chinese legislation does not facilitate foreign capital entering into the main economic sectors - rather, it establishes a three level regime for foreign participation with permitted, restricted, and prohibited investments - that respond to the needs of the economic and industrial policy dictated by the Chinese Communist Party. Despite operating in a sector open to foreign investment, foreign companies face additional barriers such as a lack of transparency in requirements and procedures for obtaining licenses, abusive requirements for establishing joint ventures with local companies, mandatory technology transfer, and costly subsidies for Chinese companies, which interfere with free competition (Directorate General for Trade of the European Commission 2011).

Chinese constraints on FDI can be compared internationally using the benchmark of the OECD's FDI Regulatory Index report. The study examines openness to foreign capital in 22 economic sectors in 58 countries, analyzing areas such as restrictions on the entry of foreign capital, approval mechanisms, as well as restrictions on the employment of foreign personnel, repatriation of profits, or ownership of industrial land by foreigners. The study shows that China is one of the least open of all the countries analyzed. In addition to regulatory restrictions on the entry of foreign capital in many sectors, there are other significant regulatory barriers that hinder European companies. For example, in the automotive sector, subsidies for the production of electric vehicles are restricted to cars produced under a Chinese brand or joint venture. In the case of the railway sector, foreign manufacturers cannot achieve market access without transferring technology to their local partner.

Barely improving in recent years, the investment environment in China continues to impose significant operating costs on foreign companies. According to the World Bank's Doing Business report, China ranks 90th in the world. Other emerging countries have much more favorable investor environments. In Southeast Asia, Malaysia (18th), Thailand (26th), and Vietnam (78th) are ahead, as well as the main coastal Pacific Latin American economies, such as Colombia (34th), Peru (35th), Mexico (39th), and Chile (41st). Moreover, China's position on several aspects of importance for foreign investors reveals the difficulties that companies face. In "Starting a Business," China is ranked 128th, for "Protecting Minority Investors," it ranks 132nd, and for "Paying Taxes," it is ranked 120th. In these areas, China falls behind many much poorer nations.

NEW AND PROMISING OPPORTUNITIES FOR EUROPEAN COMPANIES IN CHINA

Nevertheless, the benefits of a large, scarcely exploited consumer market or of competitive labor costs far outweigh the difficulties that foreign firms face in their Chinese operations. There is no alternative explanation for the continued growth of FDI in China since the country opened to foreign capital in the early 80s. On average, annual FDI received in the 90s was $29 billion, while in the first decade of this century it was $68 billion, rising to $121 billion between 2010 and 2013 (UNCTAD 2014). However, the question is why China remains attractive and profitable for foreign companies in this new scenario of slower economic growth, a more mature market, and less competitive labor costs. The answer is that China is changing to an economic model in which the new engines of growth are private consumption on the demand side and production activities operating at the upper end of the value chain on the supply side. As desired, growth is shifting towards total factor productivity rather than capital accumulation.

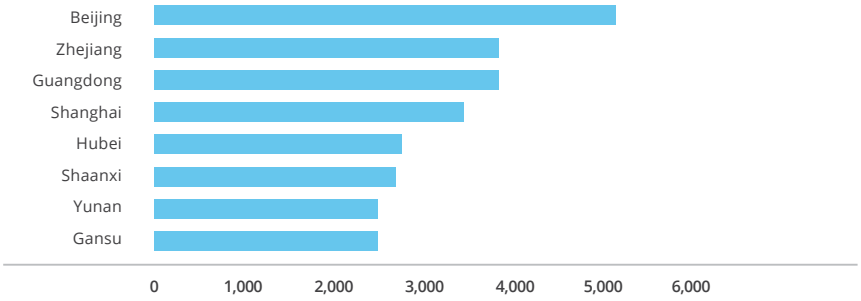
Opinion polls among entrepreneurs are slightly less favorable than a few years ago, but firms in general continue to include China as a priority investment destination. According to the authoritative report on prospects for investment, the 2013 AT Kearney Foreign Direct Investment Confidence Index,[17] China is the second favorite country for investment, behind only the United States - although it should be noted that China was at the top of the list in 2012. Investors highlight narrowing profit margins due to increased costs, but maintain that China still offers additional factors that make investments profitable. Another survey of 227 multinational CEOs conducted by PwC and the China Development Research Foundation found that the key market for investment over the coming years was China in 56% of cases, compared to 52% for Brazil, 37% for India, 26% for Mexico, 25% for Turkey, 19% for Russia, and 11% for South Africa. Therefore, although China may have lost some appeal for foreign investment in recent years, it remains a key destination for international expansion plans (PwC and CDRF 2013).

Moreover, the new Chinese economic scene opens exciting possibilities and investment opportunities for European firms in the short, medium, and long term. The new model means more purchasing power for Chinese citizens, improved infrastructure and interconnection within the country and with neighboring countries, more sectorial deregulation, and a firm commitment by the authorities to modernization and to research and business development. All of these factors will help create new and interesting investment opportunities for European firms over the coming years.

Firstly, the changing economic model in China is altering the traditional engines of growth (public investment and exports) towards private consumption – driven by rising disposable incomes and an assumption of Western consumption patterns. China has become a middle income country. If by middle income we mean $5,000 annually, then the potential market would be 275 million persons, whereas if we take an average income of $10,000 annually, then the market would be 100 million. The increase in purchasing power has been reflected by increased access to consumer goods. In the agri-foodstuffs market, chicken consumption rose by 54% between 2005 and 2010. China currently consumes 12 million tons of chicken per year (more than the US market). Vehicle sales have grown exponentially - in 1985, there were 12 vehicles per 1,000 inhabitants on Chinese roads, and by 2011 this number had risen to 69. In the telecommunications sector, there were seven mobile phone line subscribers per 100 inhabitants in 2000, while today the number has increased to 89 (World Bank 2014). In addition, the government is supporting the transition from an economy based on public spending to an economy based on private consumption, which should benefit foreign MNCs. For example, after the tax reform of 2011, a citizen with an income of 10,000 yuan saw their income tax rate fall from 12.3% to 7.5%, freeing up resources for private consumption (KPMG 2012).

Secondly, China has lost much of the attractiveness held by emerging markets in coastal areas such as Beijing, Shanghai, or Shenzhen, but the investment advantages that China boasted about 20 years ago are still present in the interior. For example, China still offers attractive labor costs in some of the interior provinces. The average annual salary in Beijing, the highest in the country, was $7,962 in 2012, but average salaries in Yunnan stood at about a third of this level, namely at $2,702. Monthly minimum wages range from $290 in Shanghai and Shenzhen on the coast to $185 in Qinghai and Guizhou in the interior (China Labour Bulletin 2013).

Graph 3: Average Salaries by Province (2012)

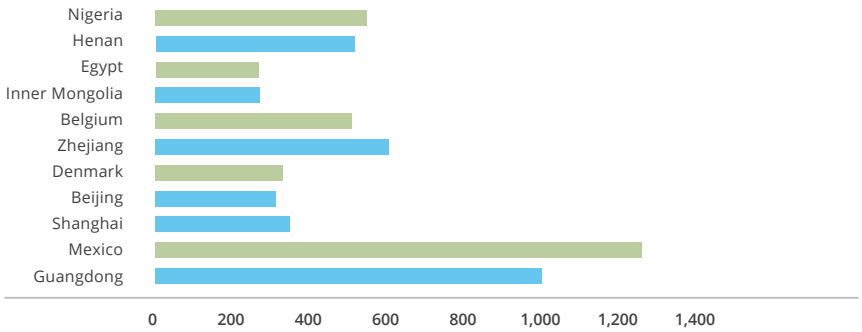


Source: China Statistical Yearbook 2013. Data in euros.

The interior provinces have much less competition and fewer foreign companies. They offer a market of 750 million consumers, equal to all of Latin America and the Caribbean. The economic size and potential for consumption in various interior Chinese provinces should not be underestimated: the GDP of Hunan province is similar to Nigeria; while Inner Mongolia is similar to Egypt. Moreover, the Chinese government is encouraging investment in the interior, providing incentives for foreign companies to locate in these provinces, and compensating the loss of profit margins resulting from operations in less accessible areas or particularly difficult investment environments.

[17] Information in this study is based on a survey of 300 large companies in 26 nations.

Graph 4: GDP Comparison Between Chinese Provinces and Selected Countries

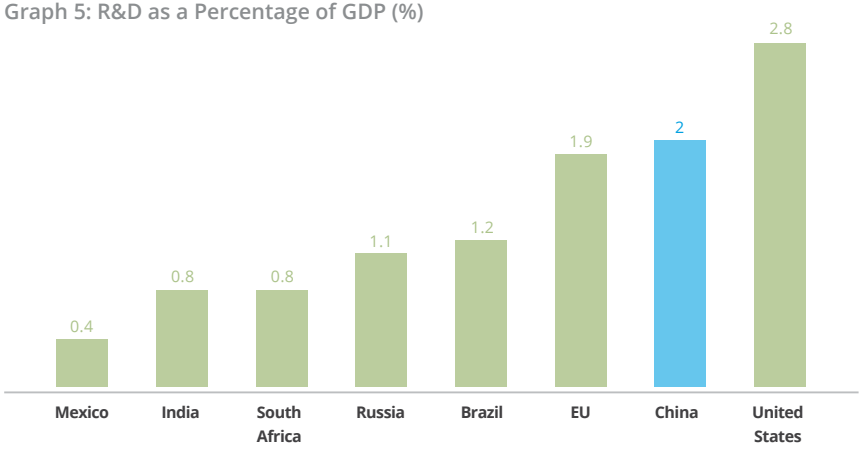


Source: Various sources. Billions of dollars.

Thirdly, China has continued to progressively open new sectors of its economy to foreign capital. In late 2014, China's National Development and Reform Commission proposed reducing, from 79 to 35, the number of sectors where FDI is restricted (facilitating investment in the financial and insurance sectors) and reducing, from 43 to 11, the number of sectors where investment must be made with a local joint venture partner (De Brauw Blackstone Westbroek 2014). In addition, there are sectors where investment is encouraged, known as "strategic emerging industries," including the new information technologies (especially broadband, Internet, and software development), value-added equipment manufacturing (most notably aerospace and telecommunications), advanced materials (rare earths and semiconductors), alternative energy (including renewables, nuclear energy, and biofuels), energy saving, environmental protection, and biotechnology (medicine and advanced medical devices).

It is also worth taking note of the pilot projects in investment liberalization that are taking place, and which could be replicated on a larger scale. For example, the Shanghai Free Trade Zone (SHFTZ) was launched in September 2013, a business area of 28 square kilometers consisting of docks, hangars, warehouses, and industrial land. Beyond its obvious advantages as a logistics platform, SHFTZ is intended to explore new initiatives for economic openness that can be replicated in other parts of the country. The advantages include the fact that no authorization is needed for investment (excluding those on the "negative list"), streamlined bureaucracy, favorable tax policies, and financial measures such as interest rate liberalization, free convertibility for the yuan, and greater openness to financial services for foreign companies.

Graph 5: R&D as a Percentage of GDP (%)



Source: World Bank. Data for 2012, 2011, and 2010 depending on availability

Fourthly, there are new opportunities for productive activities using high level research and knowledge, especially where R&D activities at moderate labor costs take place close to the production plants. China has made great budgetary efforts to become a country with more value-added activities and higher technological content. According to the OECD, China's spending on R&D over GDP was 2% in 2013, higher than the EU's 1.9%, and is expected to overtake the US by 2020. Moreover, half of the graduates in China are studying science or engineering. The fiscal framework for intensive R&D businesses is also highly favorable – with a corporate tax rate of 15% (compared to the general rate of 25%) and the possibility of deductions for other R&D expenses.

Fifthly, thanks to a huge infrastructure investment effort by the government, China is becoming an increasingly integrated internal market. Integration is also rising with Asia and other world regions. European companies can benefit from the lower costs and quicker delivery times produced by new and ambitious infrastructure projects in the region, which should produce a breakthrough in the integration of the Asian market and the integration of the Chinese market with other world regions. The ambition and impact of these megaprojects are promising. The New Silk Road is an infrastructure megaproject intended to make transport of goods within the country more efficient. It could eventually spread through Asia Minor and reach Europe.[18] The Chinese-

[18] At the end of 2014, the first train (Yxinou) between the Chinese Eastern seaboard and Madrid arrived with 70 containers. The journey took 21 days.

Nicaraguan Transoceanic Canal - an alternative to the Panama Canal - could modify maritime transport worldwide by generating new sea routes and have a major positive impact on trade with companies operating in China.

Sixthly, the Chinese government is determined to combat phenomena that could threaten political stability and hinder economic growth, such as environmental degradation or uncontrolled urban growth. Business opportunities will increase in the field of alternative energy and sustainability, strongly supported by a government that is engaged in a struggle to minimize the economic damage (over $200 billion annually) and social damage (more than 600,000 premature deaths annually) caused by environmental degradation. Some 53% of the population was urban in 2013 (compared to 13% in 1960), and that proportion will rise to 60% by 2030. This will generate the need for new services to make cities more liveable, such as expanding and modernizing the public transport infrastructure, as well as waste management and sewage and water treatment.

Seventhly, the recent arrival of Chinese investment in Europe, which has grown exponentially as of late, is facilitating the entry of European firms into China itself. Factors such as high saving rates, a political impetus to invest abroad, and business requirements to access new skills have led an increasing number of Chinese enterprises to invest overseas (The Economist 2010). Chinese investment in the EU is growing at an explosive rate, multiplying by 41 since 2001. Minority or majority participation by Chinese companies in the EU can lead to strategic alliances and facilitate the entry of European firms in the Chinese market - using Chinese distribution and commercial networks.

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PART 3

A Deeper Look at the Institutional Environment for EU Businesses

3

Chapter 8

What is the International Rule of Law?

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08

The expansion of international law and organizations is a remarkable development of world affairs in the past 60 years or so. Increasing numbers of policy areas are now the subject of intergovernmental legal institutions, and increasing numbers of actors now find themselves covered by these institutions. The European Union has been in the vanguard of legalizing inter-state relations, to the point where the domestic and inter-state legal structures in Europe are essentially inseparable. But today, the movement to construct legal frames for international affairs is universal, and the growth of legal institutions and logic has brought international relations to the intersection of politics and law.

These phenomena rest on and reinforce the idea that international affairs should be governed by the rule of law. The importance of the international rule of law is routinely affirmed by governments, international organizations, scholars, and activists. It is variously credited with, among other things, reducing the recourse to war in Europe and elsewhere, preserving human rights, and constraining (albeit imperfectly) the pursuit of states' self-interests. Chris Patten (2015), the former EU Commissioner for external affairs, said recently that "nothing guarantees free societies' liberties as much as the application of the rule of law." The international rule of law is commonly seen as a framework of mutual interests, cemented by state consent, which displaces power politics and coercion.[2]

While it is common to refer to the international rule of law, it is less common to define it or to explore what it means. In this essay, I examine the international rule of law both in practice and as a concept. This is important because many controversies about the direction of world politics in fact rest on different accounts of the international rule of law. Understanding the various ways the idea is used, and their implications for policy-choices, can help clarify what is and is not being argued over in global controversies.

I set out three distinct approaches to the concept of the international rule of law and compare them to contemporary state practice. The first is anchored on the obligation of states to comply with their international legal obligations. The second draws on an analogy with the domestic rule of law. The third begins from the observation that states

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[1] This chapter draws on material from Ian Hurd's "The International Rule of Law: Law and the Limits of Politics," Ethics and International Affairs 2014.

[2] Guzman, Andrew. *How International Law Works: A Rational-Choice Theory*. Oxford University Press, 2008.

invoke international law to explain and justify their policies - from this it expands into a model of law as integral to political legitimation. I find that the third approach provides the most conceptually coherent understanding of the international rule of law, and has interesting implications for the study of international law and politics.

THE RULE OF LAW BASED ON COMPLIANCE?

The conventional account of the international rule of law defines it in terms of the obligation on states to comply with their legal commitments. In other words: states are free to take on legal obligations as they see fit, but once they do, they are required to comply with them. The idea that states should comply with their legal obligations is fundamental to conventional accounts of the contemporary international legal-political system. It is central to international law and is almost universally preferred over violation.

Compliance is widely seen as a legal, political, and moral imperative for states. Legally, the obligation to comply is institutionalized in the principle of *pacta sunt servanda* and in the "good faith" clauses that appear in many international treaties, including the Vienna Convention on the Law of Treaties. Morally, it is usually assumed to lead to normatively good outcomes, at least as compared with the consequences of violation. It is also a key political obligation, in the sense that a consistent record of compliance is taken to be a marker of appropriate international behavior - and its opposite is seen as a danger. Madeleine Albright (1997), for instance, defined rogue states as "those who, for one reason or another, do not feel that they should cooperate with the rules that have been established by other nations of the world." International law scholars often identify the features of states or of laws that correlate with compliance and with noncompliance in order to maximize the former and minimize the latter. Human rights, international stability, and perhaps even the progress of civilization itself are said to be dependent on compliance with international law.

The normative preference for compliance over violation is deep-seated in international legal scholarship, in part because law is seen as the alternative to power politics. Thus, a legal order appears to be the antidote to coercion. Many thinkers, from Woodrow Wilson to Hedley Bull to Anne-Marie Slaughter, have argued that international order depends on states' choices to comply with international law and thus to pursue a negotiated common position rather than an individualistic, short-term, and self-interested one. The

dichotomy between law and power is popular among scholars of both domestic and international politics. Jürgen Habermas (2006, 116), for example, said that social order rests on the "normative taming of political power through law" (cited in Teitel 2008, 668). And it is this spirit that David Kennedy (1994, 335) recognized in noting the tendency of international lawyers and associated scholars "to see themselves and their work as favoring international law and institutions in a way that lawyers in many other fields do not—to work in banking is not to be for banking."[3]

Moreover, in scholarship on international law, compliance is often seen as important for methodological reasons: it is seen as providing the link between legal causes and behavioral effects, and thus becomes the measuring stick for the success or failure of a law. A law that is measurably complied with is seen as successful and one that is violated is seen as a failure.

Problems soon arise when this emphasis on compliance is brought into contact with how international law actually operates in real-world international politics.[4] Compliance is not self-evident or objectively ascertainable. As Rob Howse and Ruti Teitel (2010) have noted, much of the energy animating international political disputes arises from states' competing visions of what constitutes "compliance" in the first place.[5] Indeed, it is no simple matter to determine whether the act of a state constitutes "compliance" or "noncompliance" with its legal obligations. To identify compliance as opposed to violation of international law requires several interpretive moves, each of which entails much controversy. First, which international rules apply? Second, what precisely do those rules permit, forbid, or require? And third, what is the meaning of the present case with respect to those rules? To decide, for instance, if Iran is violating its commitments as a member of the International Atomic Energy Agency (IAEA) requires decoding Iran's internal motivations for conducting its atomic research, as well as the relationship between Iran's IAEA commitments and other international instruments such as the UN Charter, which among other things explicitly reaffirms a state's inherent right to self-defense.

These difficulties lead many scholars to conclude that compliance is a poor centerpiece for assessing the impact of international law. Faced with the deep difficulties associated with the effort to measure compliance, James Morrow (2007, 562) suggests instead that scholars should consider "whether broad pattern of acts… are consistent with the

[3] Emphasis in original

[4] Ambiguities that arise in applying international rules to practical politics are discussed in general in Orakhaleshvili (2008) and in practice in Jenks (2009) on drones and Hurd (2012) on whaling.

[5] Kingsbury (1998, 345-72)

standards of the relevant treaty" (cited in Martin 2013, 597). Similarly, Beth Simmons (2009) operationalizes compliance in terms of changes to a state's human rights policies rather than whether the state has technically complied with the treaty (cited in Martin 2013, 593). More dramatically, Lisa Martin (2013) concludes that the attempt to achieve an objective coding of compliance may be futile and argues instead that the positivist research program on international law should look elsewhere for its dependent variable.

THE RULE OF LAW BASED ON THE DOMESTIC ANALOGY?

Faced with the difficulties in making sense of "compliance," it may be tempting to understand the international rule of law as a derivative function of the domestic rule of law. Many references to the international rule of law draw directly from ideas developed in domestic settings.

The two clearly have some features in common. In both, the "rule of law" describes a social system that divides society into political and legal domains and situates the latter within the former. A rule-of-law system is one in which the choices of an actor are made in light of rules that are fixed and external relative to that choice. Actors may opt to violate the rules, but when they do, they do so knowing what the rules specify and considering the implications of compliance and violation.

However, despite the popularity of domestic analogies among international relations scholars, the international rule of law cannot simply be derived from the domestic version because the two rest on unique historical and political foundations and consequently they operate very differently in practice.

The domestic and international versions of the concept arose as responses to different political problems, and they are consequently different in their logic, history, and content. In a domestic context, the rule of law addresses problems associated with an overly powerful centralized authority. It describes a political system based on three commitments: that laws should be stable, public, and known in advance; that they should apply equally to a government and to its citizens; and that they should apply equally among the citizens without regard for their particular circumstances. Simon Chesterman (2008, 336) has summarized these three commitments as "regulating government power, implying equality before the law, and privileging judicial process."

Each pillar contributes to distinguishing between a legal and a political domain in society, and together they counteract the centralizing tendencies of domestic political power. According to Brian Tamanaha (2009), these commitments preserve space for the autonomy of individuals and groups under the authority of a state. Clear, stable, and equal laws are essential if a legal system is to give what Joseph Raz (1979) calls "effective guidance" to citizens on how their behavior will be judged (cited in Beaulac 2009, 203). Thus, as Renáta Uitz (2009, 82) argues, "[t]he minimum requirement of the rule of law is that all actors, including both private individuals and the state, behave in accordance with the law."

The international rule of law is premised on the opposite concern: in a system where authority is decentralized and atomistic, such as exists among sovereign states, the units have more legal autonomy than the common good can tolerate and the "excess" autonomy of the units must be limited in order to preserve society itself. The traditional view of international law is that it provides a self-imposed set of limits on states in order to better allow those very states to pursue their mutual and individual interests. It is consistent with the idea of state sovereignty because it is the sovereign states that bind themselves to the law, which reconciles their autonomy with the fact that coordination among them is often desirable. Expressing an extreme version of this positivist approach to international law, the Permanent Court of International Justice said in the Lotus case: "International law governs relations between independent States. The rules of law binding upon States therefore emanate from their own free will."[6]

Thus, practices that would be considered normal in international law would be violations of the rule of law in the domestic setting. For example, states in the international context retain the agency to tailor their legal obligations largely as they see fit, and self-interest is accepted as the motivating force behind these choices. States pick and choose which international obligations to accept and which to decline; they author their own reservations and interpretations to fine-tune treaty obligations; and their conduct toward and interpretations of these obligations are significant factors in the determination of their meaning. Each state has a unique set of legal obligations as a consequence of its past statements and actions and it cannot be said that treaty commitments apply equally to all states.

[6] This judgment from 1927 centered on whether Turkey could prosecute the French crew of a French ship for a collision on the high seas with a Turkish ship. It is remembered today mainly for its paradigmatic statement regarding the free will of sovereign states. The "Lotus principle" says that, in the absence of a clear legal prohibition, the acts of states are presumptively legal under international law. *The Case of the S.S. "Lotus"* (France v. Turkey), "Judgment of 7 September 1927," PCIJ Series A, no. 10, at p. 18.

In international affairs, the legality of an act is dependent on the actor doing it - it is impossible to assess the legality of an international act without knowing the identity of the agent. Consider an example: a whale is killed on the high seas and brought on board a whaling ship. Is this legal or illegal? The International Convention for the Regulation on Whaling is the dominant legal instrument on the question, and the central obligation of ICRW members is to abide by the catch limits set by the International Whaling Commission. Since the mid-1980s, the Commission has maintained that the catch limit for most commercial whaling shall be zero - that is, it has imposed a moratorium on killing whales for commercial purposes. Australia, Iceland, and Japan are all signatories to the ICRW, but Iceland has opted out of the moratorium while Japan authorizes its whaling as "scientific" rather than "commercial." The act of killing a whale is therefore illegal if it is done by Australia, which accepts the moratorium and does not grant scientific hunting licenses, but is legal for Iceland (Hurd 2012). It is legal as well for Japan if Japan submits the prior paperwork to declare that its whaling has a scientific purpose, as it consistently does even after the recent decision of the International Court of Justice.[7]

This is not an anomaly. The international legality of an act depends on which state undertakes it, what that state says about the act, and what it has previously said previously said about its relationship to the pieces of international law that may apply. International legal obligations therefore attach to states in a particularistic fashion that contradicts the element of equality that is said to be essential for the domestic version of the rule of law. In domestic law, the identity of the actor should not enter into the assessment of how law regulates the act; in international law, it must.

THE RULE OF LAW BASED ON JUSTIFICATION?

The third alternative draws from the ubiquitous practice of states using international law to justify their policies. States routinely provide explanations for how their conduct is consistent with their international commitments, and as a consequence we are accustomed to competing diplomatic and legal accounts regarding compliance. In effect, there is no possibility for an "objective" settling of the differences. Rather than seeing this as a formality or cheap-talk, it can instead be seen as the core of the rule of law itself. Governments find political value in showing that they are complying with the law - the third approach sees this as a discourse of legitimation rather than as a comparison with an objective standard of compliance (as in the first approach).

The premise for this approach is that social action is impossible without a conceptual framework of meaning and language which allows agents to understand, explain, and justify their desires and their actions (Hurd 2015). In the international setting, this implies that states need some set of resources by which they can give meaning to their actions and those of others - and I suggest that international law provides those resources for foreign policy and international affairs. This is a necessary implication of the constructivist insight that states and their actions are socially constructed. Since the meaning of state acts is neither self-evident nor fixed by material conditions, actors are always involved in the process of interpreting and constructing their interests, their relations, and their ideas about the interests and relations of other actors. Governments use the categories and concepts provided by international law to explain their needs and their actions - these include ideas and rules around sovereignty, intervention, self-defense, humanitarian rescue, self-determination, and much more.

Belief in the "ideology" of the international rule of law ensures that legal resources carry political weight, and that being seen as acting legally is politically powerful for states. Legal resources are an available and socially legitimated pool of such ideas and concepts. They are a useful, and powerful, instrument in the process of "sense-making" for states.

Making sense of the world through legal categories rests on both a shared understanding of the international rule of law as part of the political structure for international relations as well as the agency of actors to manipulate and put to use elements of the legal system with their own interests in mind. The ubiquitous use of international law in foreign policy sits at the crossroads of international structure and agency and it consumes, produces, and is limited by international legal resources.

[7] In *Australia v. Japan* (2014) the ICJ found that Japan was misusing the designation "scientific research" to disguise a commercial whaling program. It ordered Japan to stop. The decision can be found at: http://www.icj-cij.org/docket/files/148/18136.pdf (accessed May 7 2015).

CONCLUSION

Seeing the international rule of law as consisting of the use of law to legitimate state policy leads to three implications for the relationship between international law and politics.

First, it leads to an instrumental view of international law. That is, it sees law as a resource which states and others put to use in the pursuit of their goals. State interests are therefore inseparable from the practices of international law. This contradicts a common assumption that law must stand independent of the preferences of the agents. My view is that it is unrealistic to insist on that separation - it is abundantly clear that in practice, governments strive to make international law work for them by invoking it in defense of their policies. The conventional view rejects such uses of law as threats to the underlying legal order; I see them as essential to the legal system, and indeed as constitutive of it.

Second, my approach sees international law as a set of resources. This complements the instrumental point above, and recognizes that law contains the capacity to legitimate state policy. International law provides the resources with which states talk about and understand their behavior.

Finally, I suggest that the content of international law is changed in the process of being used to legitimate state policies. Through the practices of diplomacy, as states give legal justifications for their actions, one can see the mutual constitution of international law and foreign policy. The meaning of international legal rules arises from how it is invoked in the diplomacy of states. As David Kennedy (1994) and others have noted, the favorable legal interpretations that states give to legitimate their own actions, which are inseparably legal and political, are part of the process of international politics. Moreover, the practice is unavoidably productive of international legal resources: it situates, specifies, and refines the rules. As governments and others deploy international law to explain and justify their actions, they contribute to the meaning of the rules they invoke. This is both motivated by the political desires of states but also constraining on them.

The approach that I set out here suggests that disagreements over the interpretation of international law are inherent in the legal project itself. In the EU, the judicial bodies do not solve the ambiguity of legal-political dynamics – for the simple reason that they are not a problem that can be solved. Chris Patten (2015) is therefore wrong to imagine the rule of law as a solution to the governance challenges in Europe or anywhere else. The rule of law can rewrite political disputes in legal language, but the international examples here show that ultimately, these legal products become political resources which actors use in the political struggle over the legitimation and delegitimation of their desires.

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Chapter 9

Can Global Governance Help Us Navigate the 21st Century?

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09

It has become commonplace to bemoan the state of global governance in contemporary politics, to rue the seeming inability of governments to come together to solve major problems, or of international institutions to arrange mechanisms to help them do so. This distress has echoed in unexpected places - even the US National Intelligence Council (2010) has warned that the weakness of global governance constitutes a critical threat to US national security in a turbulent 21st century. But what exactly are the challenges we face today, and to what extent is global governance really the answer to them?

BACKDROP: THE EVOLUTION OF GLOBAL GOVERNANCE AFTER THE COLD WAR

Both a commitment to and a sense of expectations of global governance are relatively new, at least in the domain of peace and security. During the Cold War era, no one watched the traumas of the Biafran civil war - which took more than 3,000,000 Nigerian lives, in conjunction with corresponding famine and disease - and wondered why the UN Security Council had failed to respond. The UN's humanitarian system was not expected to respond to famine in Ethiopia, let alone the civil war and state crisis that caused it. Refugees were met by the Red Cross once they crossed a national border; the idea of humanitarian responses inside a country was an anathema to the sacrosanct principle of sovereignty. The numbers of deaths associated with war rose steadily during the 60s and 70s, and remained high in the 80s (Human Security Report Project 2011), yet no one bemoaned a lack of global governance. When recession hit the West in the early 1970s and the savings and loans crisis knocked the US financial system, the only "global governance" mechanism that received significant attention was the G7.

All this changed with the end of the Cold War. Suddenly a UN Security Council freed from the constraints of superpower rivalry found a case for intervention in internal wars, and a logic for mounting humanitarian operations across borders. New, and in some cases very large and expansive operations were mounted to respond to crises from northern Iraq to Mozambique to Cambodia. Though the UN has had a mixed record of successes and failures since then - roughly half of each during the 1990s and 2000s (Fortna 2008) - the overall effect of this engagement was that more wars were

brought to an end than started, and steadily the number and intensity of wars in the world declined (Human Security Report Project 2011).

This coincided with a shift in policy in critical capitals - notably Beijing, Delhi, and Brasilia - away from an ideological rejection of the West's economic orthodoxy, embodied in the Washington Consensus. Decisions by Beijing, Delhi, Brasilia, Ankara, and others to begin to open their economies unleashed a post-Cold War wave of economic growth. This was not just limited to major emerging markets: remarkably, in the two decades between the end of the Cold War and the onset of the global financial crisis, every developing country in the world (except those mired in war) grew - and grew substantially (Sharma 2012). Between 1990 and 2009, the global economy effectively tripled in size, with the vast bulk of that growth taking place in the developing world.

This increase in shared economic wealth and growing globalization had, in the first instance, a huge positive effect. What Security Council unity was to civil war, post-Cold War economic liberalization was to poverty, which fell in massive numbers during the two decades following the collapse of the Soviet Union - one billion were lifted out of acute poverty. Dozens of countries ascended to middle income status.

The role of global governance in this economic growth is contested. Certainly, the expansion of the international free trading system is closely correlated and almost certainly connected to middle income growth in the developing world. On the other hand, while some ascribe the decline in poverty to the adoption of the Millennium Development Goals in 2000, the evidence suggests otherwise. Rigorous analysis finds the connection between the adoption of the MDGs and poverty reduction to be extremely tenuous.

There is strong evidence to suggest that in the latter part of the 2000s, the existence of the MDGs was an important tool for domestic mobilization against some of the most pernicious impacts of poverty - on child health and women's development, for example - in countries like India and Nigeria (McArthur 2013; World Health Organization 2010). However, the large-scale declines in poverty were not a function of the MDGs or the aid flows they mobilized, but rather of policy choices long preceding the MDGs (though admittedly informed by similar logics) by developing country capitals (Friedman 2013). Global growth and its accompanying rise in living standards for a billion new members of the global middle class was not, at its core, a success of global financial governance, but rather of national decision-making. And when economic developments in the developing world caused its first major interruption to the global economy, in the

Asian financial crisis of 1997, the dominant institutions of global governance were ill-equipped to respond. Rather, an ad hoc mechanism for national coordination - the G-20 Finance Ministers mechanism - was born to respond.

While a more interconnected world brought about these broadly positive trends, it also made more pressing a set of challenges described by Kofi Annan, then Secretary-General of the UN, as "problems without passports" (Annan 2009). Annan identified a rather inchoate category of transnational and global threats that encompassed such unconnected issues as radical Islamic terrorism and climate change. They were conceptually linked by a loose connection to globalization, or at least to its networks.

GLOBAL DISRUPTION: FEATURES OF THE CONTEMPORARY MOMENT

The first decade of the 21st century highlighted some of these issues, but also bore witness to a series of events that disrupted the post-Cold War set of global governance mechanisms. It is hard to know what the history of globalization and the governance of global challenges would have been had two events not punctuated the early 2000s. The first was the Al Qaeda terrorist attacks on the United States on 9/11; and the second - joined by rhetoric and policy choice, not by necessity - was the American overthrow of Saddam Hussein in 2003. The former action unleashed a dominant superpower from what had been a rather passive and benign post-Cold War slumber, and the latter (combined with a decade more of policy choices and mistakes) would unleash the forces of Arab nationalism, sub-state radicalism, Sunni-Shia division, and regional competition.

A third event helped shape global governance history: who knows whether we might have seen a soft landing to the crises in the Middle East and the rise of the new global middle income countries, had it not been for the global financial crisis of 2009? This crisis was born both of underlying realities but also of profound policy and regulatory failures in most major economies, above all in the United States. The consequences were a shock to growth; a loss of confidence in Western models; a loss of confidence in American leadership, most importantly in Washington; and the stoking of nationalist, protectionist, and isolationist forces in every major capital - forces so far held in check, but only just so.

It also now seems likely that we will look back on the quarter century of the post-Cold War era as a halcyon period for the West, a period free of existential threat, a period in which it was possible to make tremendous, sustained progress on reducing the ills of war and poverty and advancing the benefits of growth and democratic freedom.

The events of 9/11 and the launch of the Afghan and Iraqi operations in their wake meant that the latter half of the post-Cold War period was spent in wars, to be sure; but these were wars fought at a distance from the West and fought with a minimal need for the European or American political bodies to sacrifice (except for those thousands of men and women who died or suffered casualties, and their families). In the United States, it has become in vogue to refer to Iraq as the most unpopular war in American history. We need only recall the massive social and political upheaval surrounding the Vietnam War to see the ahistorical nature of that sentiment, and indeed by contrast to reveal the modest strain placed on the West by its Afghan and Iraqi campaigns.

The Afghan campaign was largely a source of unity among the Western powers, and beyond. Yet, in the launch of the Iraq War and the contestation that surrounded it, we can see the early glimmers of two phenomena that would grow in salience over the ensuing decade. First, we saw in the political clash at the UN Security Council both the divides within the West and the beginnings of a more assertive stance by China and Russia - with countries like South Africa, India, and Brazil lurking in the background, states that would later join the ranks of the BRICS. Second, we had a preview of the consequences of tearing down the Middle East's authoritarian regimes, long propped up by the West: the unleashing of political, factional, sectarian, Jihadi, and inter-state competition that would challenge the stability of Iraq and eventually, the region.

These three major international events of the early 2000s - 9/11, the Iraq War, and the 2009 financial crisis - were profound challenges, difficult but interconnected, to the international system. They resulted in what we call the "great disruptions" to the global order, detailed below.

The Unraveling of the Middle East Order

For several decades, there have been two forms of rough order in the Middle East. Domestically, autocratic regimes - several of them backed by US power - suppressed domestic dissent. Regionally, an approximate balance between the Shia Iranian

theocracy and the Sunni Gulf monarchies, again backed by American power, prevented a repeat of the 1981 Iran-Iraq war. There was nothing noble or just about that order; it was brutal and repressive. That doesn't mean, though, that what comes next - events which will be driven by the overthrow of Iraq in 2003, pushes for democratic transformation by the Bush Administration, a too-rapid withdrawal of American forces from Iraq by the Obama administration, the launch of nuclear negotiations with Iran, the Arab Spring, and counter-revolutions by Arab governments - will not be worse (Wittes 2015).

The brief moment of optimism of the Arab Spring has come and gone, except in Tunisia and perhaps Morocco, where it holds on precariously. Elsewhere, it has been replaced by a range of forms of counter-revolution and brutal suppression, as well as unsustainable financial subsidies (Totten 2014). At the same time, the US potential rapprochement with Iran has the Sunni Gulf Arab states looking over their shoulders, and eyeing Iran with heightened suspicion. Each side believes (probably correctly) that the other has helped foment internal dissent.

The Sunni-Shia thread connects the two dimensions. Fearing greater Iran-backed Shia influence in the region, the Sunni Gulf monarchies have moved aggressively to finance counter-revolution and counter-extremist forces (and also revolutionary and extremist forces of their own). Qatar, in contrast, bet on the other side of that coin, using its substantial energy wealth to back extremist forces, even while continuing to host and pay for a major US military base in the region. Tensions between the Sunni Gulf monarchies and Qatar are rising. The Sunni Gulf states are in a tactical alliance with Israel against some forms of Islamic extremism and against Iran; but we've seen that movie before (in 2006), and there are strong reasons to believe that the alliance will shatter quickly (Riedel 2013). Meanwhile the US has been at odds with every one of its regional allies - quite a feat of statecraft (Indyk 2015).

How all this will unfold is uncertain. The rise of ISIS has caused the US to thrust itself back into Iraq militarily, for what it describes as a short-term engagement that does not involve ground forces, but almost certainly will. This has once again put the United States into alignment with a series of regimes seeking to quell domestic dissent. The descent of Syria into a multi-party war portends a spreading of violence. Foreign fighters - thousands of them, trained now in the tactics of violence - pose a genuine risk to security in Europe and the United States, albeit possibly a modest one (Hamid and Byman 2015).

The Rise of the Global Middle

One billion new members of the global middle class have emerged, located for the most part in countries that have only recently become middle-income (Pezzini 2012). The first and benign consequence of this growth was that absolute and relative poverty dropped dramatically, and living conditions and life expectancy improved. These results were applauded, and rightfully so.

However, there are two further, more complicated, consequences. First, these new middle classes have begun to express themselves politically, demanding governance change. This expression sometimes manifests itself through politics and sometimes through demonstrations and riots, including million-strong demonstrations in Brazil; smaller, but more pointed demonstrations in Turkey; and less large but extraordinarily frequent demonstrations or mini-riots in China (which are quickly suppressed) (Fukuyama 2013; Murray 2013).

The second consequence is the emission of substantial amounts of additional carbon into the atmosphere, above all by China, precisely at a time when the world was beginning to understand that it was reaching the limits of sustainable growth (Jones and Steven 2014). The exacerbation of climate change, and the need to square that circle with the continued challenge of development, has been captured by the renewed concept of the sustainable development goals, but it remains a profound economic, political, and scientific challenge.

The Intensification of Geopolitical Rivalry

In the United States, the phrase "the return of geopolitics" has become fashionable to describe the present moment (Mead 2014). Perhaps fewer Europeans have forgotten the intense confrontation with Russia over Kosovo, the near-clash between NATO and Russian forces at Pristina airport in the summer of 1999, the tense diplomatic maneuvering between Russia and the West over Serbia and then over Kosovar independence, to say nothing of the (admittedly brief) war in Georgia. Geopolitics never went away.

Russia, though, was in a particularly weak moment throughout the 90s and early 2000s. It is revealing to look back at the economic statistics and remind ourselves that between the Soviet economy of 1989 and the Russian economy of the early 1990s, there was a 90%

contraction. This economic calamity, with attendant social and political consequences, makes the Great Depression of the 1930s look like an economic road bump by comparison. In the early 1990s, Europe and the West were contending with a hugely weakened Russia.

However, two decades of rapid economic growth in China, with its consequent massive resource consumption, fueled a Russian rebound. Putin's period in the backseat behind Medvedev was a well-timed period for husbanding economic and diplomatic resources. His return to the presidency coincided with the West on its economic back-foot, and the Russia that Europe and the US now confront in Ukraine - and perhaps beyond - is, while still a far cry from the global power of Soviet days, a more considerable power than that of the 90s or early 2000s - albeit an internally fragile one.

Yet the primary geopolitical threat, over time, is not that posed by Russia. China's increasing assertiveness in the East and South China Seas and in global affairs potentially portends a period of deep contestation between the world's two top powers. This is not yet written in stone: there may still be hope for a relationship between the US and China that contains contestation, yes, but also cooperation (Steinberg and O'Hanlon 2014). This potential glimmers through in the weaknesses in the Western policy response to China and the continued debate within Beijing about the speed and scale at which it would be wise to challenge the United States.

What does seem set in stone is a revival of classical inter-state security dynamics between Asia's several powers, with intense diplomatic gamesmanship combined with real security risks playing out between China and Japan as well as the broader cast, including India, Korea, Russia, and the United States. That this does not directly confront Europe should not be taken to mean that it is not part of the strategic environment. It will be a defining feature of the strategic environment for the United States, it threatens the stability of the world's largest trading and economic bloc, and it threatens core pillars of the international order on which Europe relies (as does Russian revisionism on its western border).

These tensions have contributed to the erosion of great power cooperation, whether on international economic issues or on core security questions, and include: a loss of confidence in the willingness of major economies to use the G-20; a loss of confidence in the projection of American power; renewed divisions in the UN Security Council which block the UN from responding to the crisis in Syria the way it had become normal for that body to respond to wars; and more.

In addition to these disruptions, there are two more important challenges that we continue to face.

The Proliferation of Nuclear Weapons, Including to Revisionist States

The tense Asian theatre is also the site of continued concern about nuclear weapons. India, once a cause for worry, has settled. At a calmer juncture, the United States' decision, under the George W. Bush administration, to sign a nuclear deal with India initially caused political headaches in the West. For a time, it even looked like some members of the Nuclear Suppliers Group might try to stymie the deal. However, those concerns quickly faded, to be replaced by a race to be in line for Indian nuclear contracts. India poses no near- or medium-term threat to the West - unless it takes the highly unlikely move of forging a security alliance with China.

However, other states in the region - notably North Korea - continue to pose a far more serious challenge. Sino-American cooperation over North Korea has improved, but is still a work in progress, and the stability of the regime in Pyongyang continues to cast a grave shadow over the stability of North Asia. North Korea has been treated as a trans-Pacific problem, but it of course threatens the global non-proliferation regime as well.

In the Middle East, Iran's nuclear weapons program has been a source of unity between Europe and the United States, and of late even of relative unity among the West, Russia, and China. The launch of serious negotiations on the nuclear program following Iran's surprise election result in 2012 has created new possibilities, but also new risks. One of the lessons identified (but not necessarily learned) from past experience is that the greatest moment of risk in any conflict comes at the point where serious negotiations fail - as the Iran nuclear talks may well do (Einhorn and Pollack 2014). What is more, as the US gets drawn into Iraq again, it will be put into a "strange bedfellows" relationship with Iran versus ISIS, and the temptation to cut a wider deal with Iran will grow, creating serious risks associated with the regional order.

The Continued Challenge of Weak States

There are weak states elsewhere too. The question of whether weak states in, say, sub-Saharan Africa pose a genuine threat to Europe and the United States, or are simply part of a wider humanitarian concept that should engender a response in those terms,

has been long debated, and will continue to be debated. However, the deployment of 3,000 American troops and a UN operation to West Africa to help contain the spread of Ebola does highlight the consequences of the continued existence of pockets of under-governed territory, wherever they are found: they can cause both genuine human tragedy and present clear potential risks to Western states.

The challenge of weak states and governance is an area where global institutions have performed better than commonly assumed. In the wake of the wars in Afghanistan and Iraq, it has become fashionable to assert that military intervention cannot work, and that post-conflict nation-building is too hard a challenge for the international community to take on. But these declarations elide a richer history of successful support to intervention and successful post-conflict rebuilding efforts. By "successful" here, we do not mean that all such efforts are successful, or that even those that are largely successful are perfectly so - neither point would hold. But from Cambodia to Mozambique, Guatemala, El Salvador, Nicaragua, Sierra Leone, Liberia, Rwanda, Bosnia, and East Timor, international efforts have frequently helped provide a degree of stability and institutional development that has allowed countries once mired in war to move past conflict towards non-violent political and economic development, however imperfect. Currently, such a prospect is even viable in Afghanistan, although the challenges there are legion. But the point is still worth making, because it does allow us to remember that global governance - states cooperating out of a sense of shared interest, using effective institutions as a tool to channel that cooperation - can in fact make a meaningful difference.

TRANSNATIONAL THREATS: THE CASE FOR HYBRID GOVERNANCE

But while we today face a certain difficulty in the governance of geopolitics, transnational threats - Kofi Annan's "problems without passports" - pose a different challenge yet.

The simple fact that transnational threats transcend national borders means that nothing other than governance that transcends the nation-state can help us meet such challenges. However, none of the patterns of action or institutions for coordination that we currently maintain are adequate for the task.

Before discussing the governance of transnational threats, we must define them. There is a debate about what properly constitutes the terrain of global or transnational threats; they sometimes overlap with the concerns we treat as geopolitical security challenges. At various points in time, and by various actors, we have seen the term used to cluster together some or all of the following topics:

- **Global climate change** - to some, the ultimate "we're all in it together" issue, but also the source of intense geopolitical, national, and local contestation;
- **Biological issues** - both the spread of naturally occurring infectious disease, and the related but different question of biological terrorism;
- **Proliferation of nuclear and other materials of mass destruction** - especially when it involves non-state actors;
- **Water** - the issue of changing water patterns, and of potential conflict over water;
- **Food** - both in terms of the global market for food, and the effects of global climate change on options for food production;
- **Transnational terrorism** - that is, that sub-set of terrorist actions that either involves groups hosted in one state acting in another state, or involves actions by a group whose self-identification transcends national boundaries;
- **Transnational organized crime** - which should increasingly be referred to as global organized crime, given the reach and scale of transactions, especially in the drug trade;
- **Piracy** - almost all of which is transnational; and
- **Cyber** - the Internet is obviously a critical global network, though it is an open question whether the most important challenge comes from transnational cybercrime, from an effort to retool the governance of the Internet, or from a classic state-based security dynamic, primarily involving the US, Russia, China, Iran, and North Korea.

Another topic can be added to this rather odd constellation, namely energy, which is often treated as a national security issue, or an economic issue, but operates in a global market and flows through globalized networks (Jones and Steven 2014). What

is more, energy is far more central to the inter-locking dynamics of climate, energy, land, food, and water than is commonly understood; this is relevant to the dynamics of proliferation as well.

These issues vary widely, but are routinely listed together in both scholarship and policy debate. There are important differences between sets of transnational threats, and they need to be recognized in order to properly govern each of them individually and as a group. This being said, there are also important points of commonality in the governance challenges posed by transnational and global issues - in fact, there are two quite different subsets of common characteristics.

First, while details matter, so do broad patterns, and there are broad patterns of similarity in the way transnational and global issues have to be handled at the level of governance. These include issues of the sheer number of actors, all of whose preferences and actions must be accounted for in governance approaches; it includes not just the number of countries involved, but their diversity (from top powers to emerging powers, middle powers, lower income countries, and fragile states); and it includes what we might call diffusion. That is, there are invariably a wide number of types of actors beyond central state authorities implicated in responses to threats. These actors often include sub-national authorities, the private sector, civic actors, and citizens themselves. As a result, transnational and global issues differ widely from more traditional national security challenges.

These features create a number of practical problems. There are coordination problems that arise from the sheer number of actors involved, both internally and externally. And there are problems reflected in the game theoretic concept of "prisoner's dilemma," whereby weak information flows and lack of trust make it harder to align actions than it should be given various actors' underlying preferences and interests. One of the thorniest challenges lies in the fact that a large subset of transnational and global challenges involves domestic regulatory authorities, rather than foreign policy bodies, posing major problems in the accountability of "externalities" - that is, the overseas consequences of domestic actions.

What is more, important sub-sets of the issues have causal connections: that is, actions, events, or evolutions in one domain have direct consequences in another. These causal connections demand integrated analysis and responses that are often absent from existing governance approaches, either at the sub-national or global level.

There are two broad categories that can be usefully distinguished. Following the scholarship of Nils Gilman, we refer to these as "deviant globalization" and "bio-material connections" (Gilman, Goldhammer, and Weber 2011). The category of deviant globalization includes some (though not all) forms of transnational terrorism, non-state proliferation, organized crime, and piracy. These share important characteristics as well as important common relationships with the main structures of economic globalization and sovereign state security. Then there are a cluster of issues between which there are direct, bio-material connections: climate, land, food, and water - and, to a certain degree, infectious disease. This cluster of bio-material issues should not be divorced from a discussion of energy use, which it turns out is centrally implicated in how each of these issues connects to one another (World Economic Forum 2011; Water Institute at the University of North Carolina at Chapel Hill 2014).

There are also some connections between these two categories of issues, though this can be overstated. A focus on "food wars" or "water wars" in the current literature tends to overstate the importance of one variable in generating conflict or transnational threats (Burke et al. 2009; Zhang et al. 2007; Hsiang, Burke, and Miguel 2013). There are long-term consequences, though, and in some regions - like the Sahel - we can argue that these connections are being played out in our lifetimes. Over time, further erosion of the situation with regard to climate, land, food, and water will certainly accentuate the pressures caused by deviant globalization, and weaken states' and societies' capacities to respond and cope.

Even more than the common features of transnational and global threats, it is these material interconnections that demand integrated responses - at the very least at the level of analysis, and often at the level of action. Much current effort on governance does not take this approach: it is focused on individual issues, and often on individual institutions or negotiating bodies. By contrast, what we need is an alternative way of thinking about this problem, a focus on what we term "governance systems" - that is, interlocking efforts at the global, national, and sub-national level that can give us better purchase on transnational and global issues.

There is good news and bad, here. The good news is that there is more innovation in this space than was true even five years ago, as governments have increasingly realized that traditional modes of inter-foreign policy action are not producing solutions. There is also good news in that at one degree of abstraction, there are substantial common interests among major actors in producing solutions - though interests often diverge quite widely in terms of details and timing.

The bad news is that the context for the elaboration of governance systems to deal with these issues is deteriorating. The interplay between geopolitics, globalization, and the global climate is likely to be a defining feature of our era, and will shape our options for the response to global and transnational threats. This reality is evolving as these words are written; just as the very concept of transnational threats has been an evolving one.

Furthermore, the interconnections between geopolitical and sub-state problems mean that we need to form connections between our institutional responses to both sets of problems. A large body of the literature on transnational and global issues looks to global institutions as the solution, or bemoans the inability of existing global institutions to adequately cope with transnational and global challenges. A competing school of thought, often invoked by the high-tech community, eschews governments altogether and looks for solutions in the private sector and in citizen mobilization. We argue that while global institutions and citizen action are both part of the solution, national government authorities are still the bedrock to organizing effective responses. Finding ways to use both the centralized authorities of nation-states and the decentralized capacities of the private and civic sectors is central to the challenge of dealing with transnational threats (Jones, Pascual, and Stedman 2009).

In the end, we live in a world organized by states. They are jealous guardians of their sovereignty, ideologically diverse, and often very competitive with each other. But those states have a host of common, transnational problems, and no nation can hope to isolate itself from such problems. Coping with these problems and simultaneously mitigating future geopolitical rivalries will require hybrid governance arrangements that take advantage of both national and sub-state capacities. Some of this is emerging, but the challenge remains great.

WHERE DOES GLOBAL GOVERNANCE HELP?

Across these necessary responses, where does global governance fit in? What functions of order can it reasonably be assumed to help foster?

Merely reforming existing global institutions to bring in new, emerging actors is no panacea, and in some areas, might make things more complicated.

This is in contrast with the oft-heard reference that the necessary step to revitalize global governance is reform to make it more representative, and thus more legitimate. It is a fair argument - if one assumes that a more representative set of institutions would be able to reach decisions for action. If so, then wider representation would certainly increase legitimacy, and this might increase compliance among second-tier states or states not prone to abiding by international law. It might also induce the newly participating members to increase their participation in enforcement - but that is far from certain. The first problem is that the addition of new actors to governing bodies might impede, not accelerate, decision-making.

Nor would membership reform necessarily remove the worst problems on our docket. Take the unauthorized use of force. There are only four actors on the global stage with the combination of interests, capacity, and attitude towards international law that make them likely to use force in the absence of UN Security Council (UNSC) authorization. These are the United States (proven), Russia (proven), China (not yet proven, but nudging awfully close to the line in the East and South China Sea), and India (in its own neighborhood). Three of these are already in the Council and their membership has done little to constrain their behavior. Why would adding countries like Germany, India, and Japan to the Council make further adventures against international law less likely? To be sure, if there were more members, when Council members could agree, there would potentially be a greater number of assets to bring to the table: a restored public sense of legitimacy of the UN may - at the outer margins - make states want to go the extra mile to find solutions; and once solutions are identified, states with seats on the Security Council may feel more compelled to share resources with the UN for implementation. Still, the track record of Western UNSC members provides exactly no evidence for that suggestion.

On balance, however, a more inclusive Security Council does give us one tool that currently does not exist - an organization with relevant instruments for managing peace and security issues that would, upon reform, contain all of the Asian powers. This configuration could prove useful as the Asian region stumbles towards the management of increasing tensions and the possibility of the breakdown of the East Asian peace.

In the same vein, expansion of the membership of the IMF and the World Bank may give us one necessary tool: an inclusive mechanism for economic or financial crisis management. This comes at the risk, though: that new members would gum up the works on issues short of acute crisis - just as they might at the UNSC.

ON ECONOMIC GLOBAL GOVERNANCE

Of course, we also confront continuing ripples from the global financial crisis. Experts in the area must answer the question of whether we are likely to see effective global governance in the fields of global economics and finance. Will we see macro-economic coordination among the G-20 members? Will the IMF be further strengthened along with Basel III, the Financial Stability Board, and other tools to prevent a further financial crisis? Will institutional innovation by emerging markets amplify or undermine international banks? Far from claiming expertise on this topic, which we leave to others, we note four points on the subject.

First, both the major economies and global financial institutions reacted far better to the global financial crisis than any prior analysis of global governance would have led us to expect. This includes the emergence of the G-20 as a rapidly-formed evolution of international tools faced with a systemic crisis.

Second, the next phase of economic growth will have to square difficult circles between rising economic development and falling carbon consumption - a goal admirably, but perhaps unrealistically, captured by the UN's efforts to negotiate Sustainable Development Goals.

Third, the inclusion of the emerging powers in global financial institutions, while certainly legitimate and perhaps necessary, will not necessarily lead to better outcomes. The West has been criticized - and the authors of this chapter are among the critics - for failing to adapt with adequate speed the G7, the IMF, or the World Bank to the participation of the emerging powers. But there is an important assumption here, and it is untested. The assumption is that the emerging powers, in joining these institutions, will gradually take on their character; that is, that they will adopt the rules and habits of the liberal institutions, and move increasingly towards transparency, predictability, and the rule of law. But what if it is the other way around? What if the emerging powers, gaining seats at the relevant macro-institutional tables, begin to chip away at those rules?

And finally, while those who focus on global economic governance tend to neglect international security issues (and vice versa), it is unlikely that we will see sustained - or more inclusive - economic growth if we witness during the same period a reversal in levels of war or, more importantly, a reversal in great power comity and cooperation. Sustained security tensions between the US and China, between the West and Russia, or among the Asian powers will over time prove a substantial impediment both to growth itself and to the kind of macro-coordination necessary to maximize growth and to make it more inclusive and resilient to crises. Thus, an account of the likely pathways for global governance must start with a debate on the likelihood of the maintenance of peace and responses to security challenges - geopolitical and transnational.

In short, two adaptations to global governance are probably useful, but certainly not necessary, features of more effective management of challenges in the 21st century: building a form of "hybrid governance" with strong links to the private sector and non-state actors that can help us manage transnational and global threats; and membership reform of the key international institutions so that we might have inclusive tools for responding to acute crises.

But a more instructive approach is not to rely on the concept of global governance and its associated tools, but to dig deeper, to the concept of international order which lies underneath it, and undergirds whatever effective global governance exists. The core question of international order is about the relations between top powers: the extent to which they operate within some stable balance of power; whether as a matter of prudence they choose to exercise restraint in the use of force in their relations, or are deterred by the balance of power from doing so; and whether, thereby settling into some form of stable relations, they go farther and align their capacities to tackle transnational threats.

Ten years ago it felt as if the integrative aspects of the global economy and the spread of liberal trading and financial systems meant that such questions were archaic; that integrated economies facing a set of transnational challenges could eschew traditional questions of the balance of power and rivalry and look instead towards economic coordination and security cooperation. These issues are in the proper realm of global governance, and important successes were recorded for each of them during the post-Cold War era. But they rested on a basic reality: the absence of great power rivalry. Now, we confront a situation where economic coordination and security cooperation are not only more needed than ever, but the basis on which they rest is eroding. That challenge is not the terrain of global governance per se: a (logically, not temporally) prior effort is needed: to reintroduce a degree of stability into great power relations, so that the space of rivalry recedes and the space for global governance once again grows.

Thus, rather than focusing on global governance, we should be focusing on international order - a more encompassing framework that puts great power relations centrally, but leaves room for the core rules, frameworks, and institutions that can shape global economic growth, focus on poverty and development, enable response to conflict and humanitarian crisis, and tackle transnational threats like climate change. And here, the West must lead.

CAN THE WEST RISE TO THE CHALLENGE?

Not all of the challenges we confront are new, or severe. The challenge from Russia is less than what it was during the Cold War, although it is very real; and the challenge from weak states is one we have confronted in the past. The challenge of weak states in the Middle East is worse, to be sure, than the challenge of weak states in Africa. This is simply due to the size of the armies involved, the population links back into Europe and the United States, and the resultant risk of transnational terrorism. The challenge from China is a new factor, though it probably poses the least direct threats to the trans-Atlantic community in the short term, and is the one most balanced by opportunity.

What is new is having to confront all these forms of threat or challenge simultaneously.

The intensification of geopolitical rivalry will both draw attention and resources away from the terrorist threat and the weak state challenge, and make the response more complicated. Defense assets will be strained across all of the challenges we now face, with the weak state problem most likely to suffer from a loss of attention (as in the Central African Republic), but occasionally demanding surges in attention and capacity. The hope that cooperation on transnational threats would serve as a buffer against the return of geopolitical rivalry appears to have floundered - though this cooperation does still occur, and can be usefully continued.

What is more, the need to galvanize the public and mobilize resources to take on these threats, and the need to confront the reality of a new insecurity, both come at a time of both internal and cross-Atlantic division. Within Europe, the political and economic strain of the global financial crisis and the Eurozone crisis endures. The United States is engaged in a major debate - hardly the first in its history, nor the fiercest - about whether and how to engage in the world. Additionally, there are important tensions across the Atlantic: notably between Germany and the United States over intelligence gathering on allies. Overcoming divisions and rallying to the moment may be the most difficult challenge of all. Eventually things will get so bad that the transatlantic community will find greater unity. But will that be too late?

What is worse, Europe itself is divided and sapped of strength. The Eurozone crisis has not only cost European taxpayers hundreds of billions of dollars in bailouts and lost growth, it has also strained the relationship between populations and pro-Europe elites. Greater space is thus accorded to nationalist movements and nationalist parties, and centripetal forces are gaining strength by the minute. Should Germany

fail to muster the energy and resources to support an ultimate resolution to the Greek economic crisis, should nationalist parties gain a critical electoral breakthrough in the U.K. or France, should Hungary's democracy erode past the point of salvage, Europe will be the weaker - not only on its own continent, but in the trans-Atlantic relationship and in its contribution to global governance.

Finally, the challenges that the trans-Atlantic community confronts are not limited to trans-Atlantic actors, nor can they be confronted by them alone: the trans-Pacific partnership matters at least as much, if not more. And in the Pacific, there is a dilemma to be confronted: any action that is designed to reinvigorate the alliance structure (either Atlantic or Pacific or both) risks excluding or alienating important "swing voter" states like India, Turkey, and Brazil - whose actions will matter in part because they matter to China and Russia. The hope is for a strategic concept that will simultaneously mobilize old alliances while welcoming in new potential partners - even part-time partners. Finding that strategic concept may be the key to unlocking the divisions that threaten to paralyze the West at a time of genuine risk.

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Chapter 10

Regulatory Agencies and Regulatory Networks in the European Union

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10

THE BOOM OF REGULATORY ACTIVITY IN THE EU

Throughout the last decades, the EU has significantly increased its regulatory capacity, a development that has run parallel to the more traditional trend of delegation of powers from European member states to EU institutions. As a result, the European regulatory landscape is plagued with agencies and networks with regulatory responsibilities in a wide array of policy domains (Levi-Faur 2011a). Almost all aspects of human social and economic activity fall under the influence and control of these regulatory devices which characterize EU meta-governance.

The use of autonomous regulatory mechanisms to foster market integration and market correction policies in the EU reveals a complex picture both of governance mechanisms, as well as of tasks (ranging from the mere exchange of information to the power of sanctioning or even autonomously enacting new rules and norms), resources (in terms of staff, decision-making structures, and professionalization), and levels of autonomy and discretion in the pursuit of their objectives. The aim of this chapter is to provide an overview of the current state of regulatory networks and agencies in Europe, through an analysis of 40 European regulatory agencies and networks and their main characteristics.

The data used in this chapter was drawn from a data-set built by the authors that contains information about structural characteristics in terms of governance (membership, characteristics of boards, and voting mechanisms), age, staff, budget, and tasks of a total of 40 European regulatory agencies and networks. The data covers all regulatory regimes in Europe including utilities (energy and telecommunication), health, medicine, chemicals, food, aviation, fisheries, postal services, transportation, security, judicial cooperation, and environmental issues, among others.

Our results are consistent with previous findings, which show that regulatory agencies and networks actually do co-exist in Europe. In fact, the analysis of the structural characteristics shows that, beyond labels, regulation in Europe is undergoing a process of hybridization and orchestration that must be acknowledged by all economic, social, administrative, and political players both within and outside the EU.

This process is critical to our times and must be studied and recognized for many reasons. First, as regulation becomes determinant in the exercise of economic and

social activities of any kind, practitioners need to know who is regulating a certain sector or industry. More importantly, they need to delve more deeply and increase awareness of how and through which mechanisms a certain agency or network decides which exact regulatory tasks are to be performed at the European level and, therefore, which regulations should be performed on a national basis. This, in turn, holds consequences for the degree of professionalization of a certain agency or network. In addition, many regulatory devices at the European level were established by mandate, in contrast to voluntary devices encompassing national regulatory agencies, whose creation has been much more bottom-up. This contrast poses a challenge in understanding the complexity of regulation.

Second, it is widely recognized that non-market strategies – defined as the coordinated actions firms undertake in public policy arenas – are becoming increasingly relevant (Baron 1995; Bonardi, Holburg, and Vanden Bergh 2006). The current governance framework (Emerson, Nabatchi, and Balogh 2012) assumes a more cooperative relationship between private and public actors. In this exchange, regulation and information flows are pivotal. Regulatory decisions and activities affect and have important consequences for firms and companies. Economic, corporate, and social agents must consider that beyond the state's traditional redistributive role (Lowi 1964; Majone 1997), where the flow of resources is identifiable, regulation defines arenas in which interests are confronted and costs and benefits are much more difficult to track (Levi-Faur 2011a). Thus, actively managing the regulatory environment requires an in-depth knowledge of the regulatory activities performed by players at various European administrative and political levels.

The paper flows as follows. First, we briefly summarize the developments and trends in the widespread use of regulatory agencies and networks all over the world. Afterwards, we specifically refer to the case of the EU and reflect on the existence of both regulatory agencies and regulatory networks in the European regulatory landscape. Finally, we consider the tasks these regulatory agencies and networks are performing.

PRESENT-DAY SHIFTS IN GOVERNANCE AND REGULATION

Our world is a networked one (Castells 2001). The dynamics of business, social, and economic interactions revolve around interdependences, which determine the nature of exchanges and the mechanisms needed to govern them (Hillman, Withers, and Collins 2009). In parallel, modern organizations of all kinds are becoming more complex, challenging traditional responses to firm, social, and policy issues (Farazmand 2002).

Two intertwined features define today's reality. On the one hand, the trends of regionalization, internationalization, and globalization are unstoppable. On the other hand, regardless of whether you are a firm manager, politician, social activist, or common citizen, the problems you encounter and tackle will be complex (Rittel and Webber 1973), and not easily bounded by regional or national borders.

In this scenario, the old hierarchical mode of top-down governing with state authorities and civil society does not fit (Mayntz 1998). Previously, policy formulation and implementation fell into the exclusive realm of governments, now non-state actors have an active and central role in these activities (Rhodes 1997). In addition, the state is no longer considered omnipotent and capable of unilaterally resolving societal problems; it has to establish a more balanced relationship with corporate and social actors (Mendoza and Vernis 2008).

Regulation and regulatory activities have not been immune to these changes and challenges. Nowadays, the regulatory role of the state, in its relation to the private sectors of society, is diverse and ranges from creating rules, on its own or by delegation, to holding more of a monitoring function (including investigation and sanctions), with a tipping point at the role of courts in resolving conflicts or offences (Freiberg 2010).

However, regulatory activities are no longer solely performed by the state. In this vein, Hancher and Moran (1989) signal the existence of the so-called "regulatory space." This image of the regulatory space allows one to illustrate the interplay of traditional norms and legal rules with other frameworks in the design, implementation, or even enforcement of regulation in which private and autonomous actors have an active role. The contribution of private actors to governance and regulation is analyzed from the perspective of de-centering[1] (Black 2001; Scott 2004; Parker and Braithwaite 2003; Gunningham 2009). As Wolf (2006) signals, private actors provide issue-specific contributions to governance (problem identification, provision of information, articulation of rules or implementation, conduct monitoring, arbitration, and sanctioning) as well as more general contributions, such as when they promote the avoidance of negative externalities or support common societal goals. As mentioned, some of these activities are identifiable with regulation (as is the case with authoritative decision-making or accreditations), a capacity that not long ago was an exclusive property and prerogative of the sovereign state (Cutler, Haufler, and Porter 1999).

[1] As Black poses (2001, 103), de-centering is "used to express the observation that governments do not (…) have a monopoly on regulation and that regulation is occurring within and between other social actors: there is regulation in many rooms."

Following Freiberg (2010), we argue that regulation is a pervasive activity inherently related to power, influence, and control – or, in other words, that power, influence, and control are used to achieve compliance with agreed upon behaviors that otherwise would not be followed. This comprehensive view of regulation assumes that regulatory activities can be exerted using, individually or complementarily, diverse mechanisms in all social and economic policy arenas as well as in all human activities and relationships. As an illustration, Gunningham and Grabosky (1998) propose the following categories for regulatory activities: "command and control," self-regulation, voluntarism, education and information, economic methods, and markets. Others, such as Parker and Braithwaite (2003), consider co-regulation, corporate compliance systems, incentive-based systems, authorizations, and third party accreditations to standards, among other categories.

Some of the activities related to this broad concept of regulation (e.,g. rule-making, accreditation, research activities to inform policy, information diffusion, sanctioning, authorizations, standard setting, cross-border interactions management, etc.) have, over the last decade, become increasingly delegated to autonomous regulatory agencies. Jordana, Levi-Faur, and Fernández-i-Marin (2010) show the global diffusion of these agencies over recent decades (from fewer than five created per year up until the 80s, to more than 20 per year between 1996 and 2002). Thus, the authors argue that regulation through autonomous regulatory agencies has become the prominent model of governance, at least in the advanced capitalist economies, over a majority of social and economic sectors.

The increasing number of regulatory agencies is somehow related to the emergence of the paradigm of New Public Management, which demands that public services be restructured both vertically and horizontally and government be scaled back (Christensen and Laegreid 2011). In fact, for decades, regulatory activities in Europe have been ideologically linked to an active government role in shaping the economy (Levi-Faur 2011a). Establishing regulatory agencies with strong autonomy and professional values represents a paradigmatic shift. However, as counterintuitive as it may appear, the initial attempt to deregulate to devolve autonomy and control to other economic and social agents, underlying the New Public Management reforms, has in fact resulted in new hyper-regulation, fragmentation, and turf-wars among public organizations (Christensen and Laegreid 2011).

At the same time, at the international level, globalization has prompted a need for multilateral provision of goods and services, requiring transnational and global regulatory agreements (Levi-Faur 2011b; Mattli and Woods 2009). Nowadays, special

purpose organizations coordinate regulatory activities superseding national or regional boundaries in an increasing variety of domains. These organizations constitute not only a political challenge, since they are to harmonize regulatory practices among countries whose interests and constituencies may collide, but also represent a novelty in public management, as the OECD has pointed out.

Although the shifts towards a globalized governance are evident, the still dominant role of national governments, and national sovereignty have positioned networks of regulatory authorities to be a feasible means for inter-organizational transnational co-ordination (Kahler and Lake 2009). Networked forms of regulation perform three basic functions (Slaughter 2004): information-sharing, rule harmonization, and cross-national enforcement of regulatory policies. As presented in the next section, the functions of EU regulatory agencies and networks seem to be affected by the field in which they operate, and have direct implications for their governance structures.

EU REGULATORY AGENCIES AND NETWORKS

Throughout the last decades there has been an impressive spread of regulatory agencies in Europe (Gilardi 2005). The emergence of the "regulatory state" (Majone 1997) also named "regulatory capitalism" (Levi-Faur 2005), has led to the foundation of national regulatory agencies across countries and sectors. According to Majone (1997), since the 1970s, there has been a shift from the positive, interventionist state to a regulatory state. This shift is explained by increasing international competition and economic and monetary integration within the EU, but also by governments' strategic choices since the 1970s, which led to new styles of policy-making, and "more complex standards of legitimacy and methods of accountability" (Majone 1997, 163).

While the 1970s, 80s, and 90s were characterized by the creation of independent or semi-independent regulatory agencies at the *national* level, the Europeanization process of the 1990s and 2000s favored the establishment of *EU* agencies and networks (Levi-Faur 2011b). These *EU* networks and agencies, created in the sectors of energy, transport, environment, finance, health, and justice, aim to deal with regulatory issues at the EU level.

These regulatory agencies are responsible for implementing EU legislation at the national level. As noted by Coen and Thatcher (2008), the many difficulties that national regulatory agencies face when implementing EU regulation has led to the

establishment of formal and informal networks of regulators. Hence, in this study we take into account two important institutions that have appeared recently: agencies and networks (Levi-Faur 2011a; Coen and Thatcher 2008; Majone 1997).

The foundation of EU agencies implies, first of all, that national governments delegate part of their sovereignty to EU institutions, and secondly, that the European Commission delegates responsibility to independent, professional institutions (i.e., EU agencies). Thus, national governments delegate part of their sovereignty to these supranational regulatory bodies. EU agencies are comparable to mandated public networks, where a legislative superordinate actor – in this case the EU – may impose coordination and collaboration among various actors who have the obligation to participate (Rodríguez et al. 2007; Isset and Provan 2005; Moynihan 2009). EU agencies are established through EU law, which also determines their functions and tasks. In this vein, they are "hybrid bodies that link the EU and national national levels [...] namely the Commission and national regulatory agencies" (Coen and Tatcher 2008, 52). Following Levi-Faur's characterization (2011b, 813), in this study an agency is defined as "an administrative organization with a distinct, formal identity, an internal hierarchy, functional capacities, and, most important, at least one principal."[2]

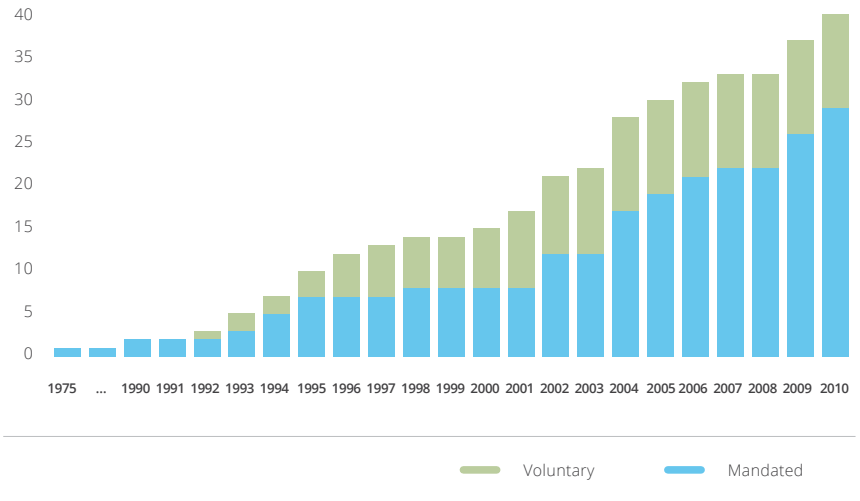
In contrast to EU *agencies,* voluntary networks are an effort to "harmonize the fragmented institutional landscape" (Levi-Faur 2011b, 811). A voluntary network is defined as a set of stable relationships of "a non-hierarchical and interdependent nature which link a variety of actors" (Levi-Faur 2011b, 813). The main feature that distinguishes EU agencies from EU networks is the mandated party (i.e., the European Commission), which is not present in the EU networks.

This study takes into account 40 regulatory agencies and networks. Our sample is based on Levi-Faur's 36 regulatory regimes (Levi-Faur 2011b) and on the European Union's official decentralized agencies list.[3] More specifically, we take into account 29 out of the 34 EU decentralized agencies and 11 out of the 51 networks included in Levi-Faur's study. In this chapter, we analyze the governance structure characteristics of these organizations. Although regulatory networks and regulatory agencies could be expected to have different governance mechanisms, in our approach we analyze the top decision-making structures of each organization without taking into account the label which identifies them (i.e., authority, agency, or network).

In our enquiry we use one of the ideal types for network governance devised by Provan and Kenis (2008), the "network administrative organization", which identifies the unit deliberately created to govern the organization. Thus, only those networks with a network administrative organization were included in the sample. We do not include those organizations that are under direct control of EU level institutions.

The following figure illustrates the emergence of agencies and networks. Even though one regulatory agency was founded in 1975,[4] it was not until the 1990s, and particularly since the beginning of the 2000s, that the establishment of agencies and networks boomed.

Graph 1: Number of EU Agencies and Networks



Source: Authors' own compilation based on original dataset

Research into the organizations captured in this study reveals how EU agencies and networks are organized in order to accomplish their goals. First of all, all the agencies

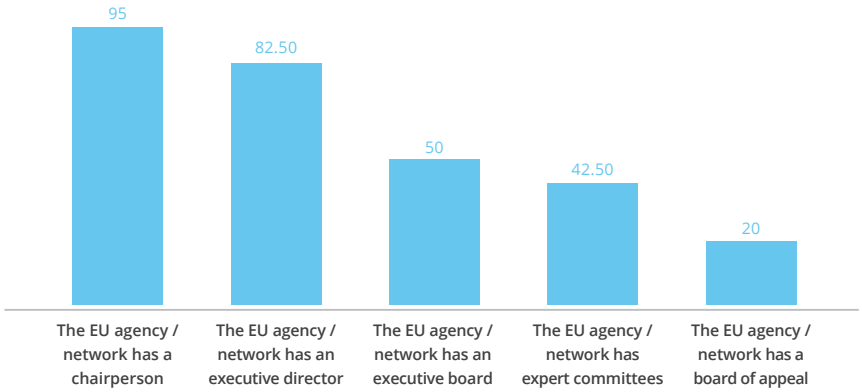
[2] A Principal-Agent relationship implies that one entity appoints another to act on its behalf (i.e., the agent acts on behalf of the principal). In the case of European regulatory agencies and networks, there is a double delegation: from national governments to the European Commission, and from the Commission to European agencies or networks (Coen and Thatcher 2008). Therefore, there are three types of principals: national governments, national regulatory agencies, and the European Commission.

[3] http://europa.eu/about-eu/agencies/

[4] The European Foundation for the Improvement of Living and Working Conditions

and networks have a plenary meeting where representatives from the national regulatory agencies come together in order to discuss the main guidelines of the agency or network. Secondly, most of them have a management or executive committee - elected in the plenary meeting - that monitors the implementation of the plenary guidelines. Thirdly, most of the organizations have an office or secretariat responsible for daily management. In addition, almost half of the agencies or networks have working groups or expert committees dealing with specific issues or policies. Finally, most of these organizations have a chairperson and an executive director, regardless of whether they are agencies or networks.

Graph 2: Governance Structure of EU Agencies and Networks (%)



Source: Authors' own compilation

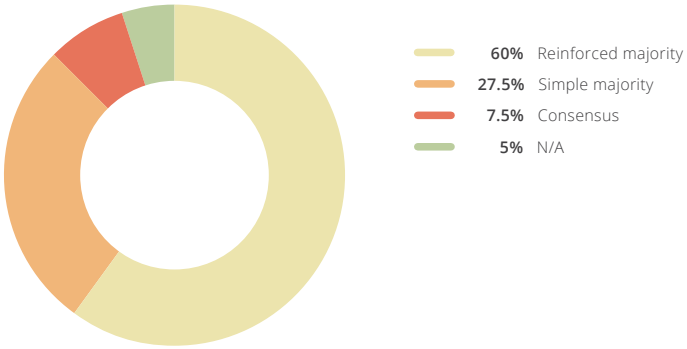
Even though Levi-Faur (2011b) notes that the modes of governance used by EU networks are less hierarchical and more open and collegial when compared to EU agencies, our empirical data show that the most relevant feature differentiating voluntary and mandated networks is the existence of a board of appeal and expert committees – which are only present in EU agencies.

The presence or absence of a board of appeal is not only related to the nature of the organization (i.e., whether it is an agency or network), it is also associated with the sector in which it operates and, as presented below, with the functions of the network. A high level of market integration seems to correlate with the establishment of a board of appeal. In this vein, we found that agencies within the economy and finance sector (i.e., banking, insurance, and harmonization of internal market) are the ones with a higher percentage of boards of appeal.

In fact, the creation of the EU internal market has increasingly generated a new agenda. Upwards delegation to the EU, weak as it may be, lessens the capacity of national governments to shape policies and their implementation, thus constraining the capacity of national authorities to directly influence economic, social, or environmental activities. At the same time, businesses and social actors are obliged to play in a larger, and far more distant market, in which European-wide regulatory activities performed by regulatory agencies and networks play a crucial role as they foster harmonization of rules, standards and norms, and economic liberalization. However, market integration needs to be balanced with market correction initiatives that tackle, at the European level, urgent demands, crises, or complex social, economic, or environmental issues requiring a supranational response. Regulation also serves as a vehicle in this aim. Although consensus regarding market correction initiatives is not as easily achievable as it is for market integration policies, regulatory networks and agencies play a role in both.

We also found variation in the decision-making systems established, which has clear implications for how agencies and networks function. More specifically, it is expected that those agencies and networks that make decisions using simple or reinforced majority will be more efficient and effective, being able to rapidly react to uncertain environments, produce the necessary advice, and propose required regulations and sanctions. Thus, when governance boards need consensus instead of simple or reinforced majority, the risk of stasis increases (Greenwood and Webster 2000). In this vein, most of the governance boards of agencies and networks included in the sample make their decisions based on simple or reinforced majority, and only 7.5% of the networks use unanimity procedures (see Figure 3).

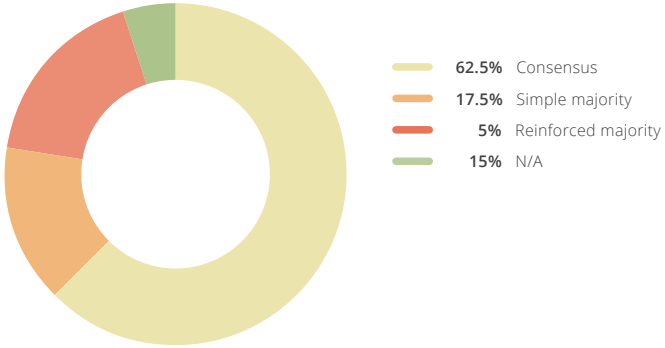
Graph 3: Decision-making System in the Governance Boards



Source: Authors' own compilation

The picture changes significantly when we look at the decision-making system established in the executive boards. As Figure 4 shows, most of these bodies make their decisions by unanimity of the representatives. Though this may hamper effective decision-making, it can also produce stronger positions which are more easily defendable in EU institutions and across the member states.

Graph 4. Decision-making System in the Executive Boards



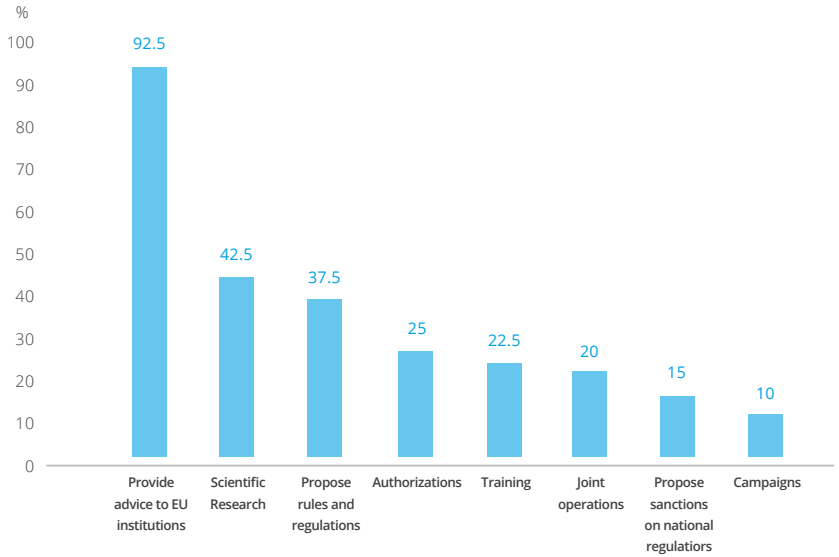
Source: Authors' own compilation.

In addition, it is worth noting that agencies and networks coexist within the same sectors. Thus, when a more formalized agency is established under the mandate of the European Commission, voluntary networks do not dissolve. Therefore, voluntary networks keep gathering NRAs and/or IRAs in order to share information and, in some instances, provide information to EU institutions. The coexistence of both mandated and voluntary regulatory devices raises interesting questions: are they substitutable (and therefore, in the long run, will one eventually disappear?) or are they meant to perform different roles as to allow regulatory authorities to interact freely without constraints?

EU agencies and networks' tasks differ depending on their nature and the sector in which they work. Slaughter (2004) identifies three basic functions of agencies and networks: information-sharing, rule harmonization, and cross-national enforcement of regulatory policies. In a similar vein, and particularly focusing on EU regulatory networks, Coen and Thatcher (2008) distinguish regulatory networks along a "soft" - "hard" continuum, which goes from coordination to drafting secondary legislation at the EU level.

Our empirical analysis of 40 regulatory agencies and networks shows that all of them at least share information. However, as presented in Figure 5, there is more variation when it comes to performing tasks such as providing advice, conducting research, proposing rules and regulations, offering training, imposing authorizations to NRAs, conducting joint operations, sanctioning members if these do not comply with previously agreed upon commitments, and carrying out campaigns.

Graph 5: EU Agencies/Networks and Tasks (%)



Source: Authors' own compilation

Following Coen and Thatcher's (2008) continuum, we can state that "proposing sanctions on national regulators" and "being able to determine authorizations with direct implications on EU businesses" are at the end of the continuum and can be labeled as "hard" functions. None of the voluntary regulatory networks have the capacity to carry out these functions. More importantly, only ten out of the 29 EU agencies have the capacity to impose authorizations.

As noted above, the tasks and functions of EU agencies are related to their organizational structure. With the exception of two cases, those EU agencies with a board of appeal

are also able to produce authorizations. Even more importantly, the three EU agencies that have the capacity to propose sanctions on national regulators also have a board of appeal.

Similar to the organizational structure, the sector of an EU agency influences its capacities and functions. On the one hand, those agencies operating in the economy and finance sector, in addition to ACER (the Agency for the Cooperation of Energy Regulators), are the ones that have "hard" functions: the capacity to propose sanctions on national regulators. This list is expanded when we take authorizations into account: agencies within the medicine, aviation, and chemical sectors that also have this capacity. On the other hand, 13 out of the 29 agencies do not have any "hard" functions (i.e., they do not propose rules and regulations, authorizations, and sanctions), and their tasks are focused on providing advice, scientific research, training, and, in some instances, coordinating joint operations (this is particularly the case for those agencies dealing with security and policing issues). The same is true for the 11 networks included in the sample: their functions cannot be considered as "hard," as they are mainly focused on sharing information, providing advice, and externally lobbying the EU.

From our analysis, the tasks and functions regulatory agencies and networks perform vary and may be related to the level and need for market integration, or the salience and sensitivity of different economic and/or social sectors. In fact, while some think that regulation is linked to neo-liberalist views which undermine the welfare state (Majone 1994), others propose a social engineering role of regulation (Zedner 2006). The EU case illustrates this tension, as shown by the number of regulatory devices and the tasks they perform in all areas of European policy. Moreover, as mentioned, when delegating regulatory tasks to European-wide networks and agencies – a shift which is initially triggered by the need to harmonize and coordinate in order to ensure the free movement of people and goods in Europe (market creation and integration) – it is important to guarantee, at the same European level, regulatory devices and practices that avoid negative externalities and execute the market correction activities that society demands.

CONCLUSION

The EU regulatory system is not fixed, as noted by Levi-Faur (2011b, 826): it is "constantly changing and reinventing itself in order to keep pace with Europeanization, liberalization, and market integration." In addition, economic, social, and environmental crises can shape the universe of agencies and networks in the EU. EU regulation, a pervasive activity nowadays, is partly executed by regulatory agencies and networks. This was apparent in the last economic crisis, which fostered the establishment of new agencies in the economic and finance sector and strengthened the capacities of the old ones.[5] Regulatory activities in the EU cultivate the creation of an integrated market while at the same time aiming to preserve and safeguard the common good. In other words, regulatory activities shape markets, but also correct them.

As upwards delegation to the EU institutions continues, the role of European-wide regulatory agencies and networks is crucial. Social and economic activities of all kinds depend to some extent on the activities performed by regulatory agencies and networks. Whether these activities merely share information or actually establish norms, authorize activities, and/or sanction non-compliances, private actors must enrich their knowledge not only about *what* is being regulated, but also about *how* it is done and by *whom*. To this end, this chapter offers a brief overview of the tasks that agencies and networks are nowadays taking on at the European level when it comes to regulatory activities. Even more importantly, we offer a brief depiction of the characteristics of these organizations in terms of governance structure and decision-making mechanisms.

In the governance framework, the horizontal interaction between public and private actors is pivotal. Exchanging information and resources between social and economic agents requires a high-quality and in-depth analysis of the nature and characteristics of the public and private organizations, in order to determine how economic and social activities are to be performed in our societies.

[5] The three EU financial and economic regulatory authorities (i.e., European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority) were established after the economic crisis of 2008.

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Chapter 11

A Research Approach to International Governmental Organizations: Examining Executive Boards and Strategy

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11

As the world is increasingly governed by a mesh of supranational institutions, European organizations and businesses should better understand how this mesh works. How does the International Civil Aviation Organization (in charge of designing a new emission trading scheme for the airline industry) make decisions? Or how does the International Monetary Fund, partly in charge of the fiscal restructuring in Ukraine and Greece, function? There is almost no sector untouched by international governance schemes; thus European businesses must scan them continually with their institutional radars. Shipping companies must follow closely the discussions and standard-setting dialogues of the International Maritime Organization, as energy and energy-intensive corporations should monitor the Conferences of Parties of the United Nations Framework Convention on Climate Change. Thus, the purpose of this chapter is to inform European businesses and other organizations about the functioning of the international institutional environment.

This chapter uses an organizational approach to study global governance institutions. The chapter particularly focuses on these institutions' top decision-making units – their boards – and strategy-making processes. As these institutions' responsibilities grow in prominence, their top decision-making and strategy processes become ever more relevant.

THE BOOM OF INTERNATIONAL ORGANIZATIONS – AND THEIR STUDY

The number of international governmental organizations (IGOs) has increased dramatically, in particular following World War II (Wallace and Singer 1970). Wallace and Singer's seminal work tells us that the number of IGOs leaped from 82 to 120 – an increase of roughly 50% – following the Second World War. States form these meta-entities to address transnational issues via mutual cooperation. The paradigmatic United Nations (UN), a replacement of the League of Nations, was established precisely to prevent transnational armed conflicts and promote peace. However, peace is just one of the many global issues IGOs address. At the Bretton Woods conference in 1944, industrialized states gathered to form institutions that promote commercial and financial cooperation: the International Bank for Reconstruction and Development (IBRD) – now part of the World Bank – and the International Monetary Fund (IMF).

IGOs can be defined as transnational public bureaucracies created by three or more states, having an organizational structure, permanent secretariat, and relative autonomy, that are established to provide an assembly for states to conduct multilateral processes of decision-making, along with the capacity to initiate and execute the collective will of its member states. They are established to solve supranational problems related to security (e.g., conflict solution), the world economy (e.g., financial crisis responses), society (e.g., humanitarian aid), and the environment (e.g., addressing climate change).

International relations scholars have traditionally studied IGOs as mere arenas for states to deliberate in and where they engage in politics to promote self- and collective interests. Recently, scholars have also begun to view them as actors in themselves, given their capacity to initiate collective action among member states and/or execute policies. The European Commission is a prime example of a supranational institution with agentic capacity: it is capable of sanctioning, on its own initiative, a specific firm or member state. Under such conceptions, IGOs are no longer understood as passive assemblies, but rather as possessing agency and specific behavioral dispositions (Ness and Brechin 1988; Barnett and Finnemore 1999, cited in Federo and Saz-Carranza 2015).

Some of these IGOs tend to perform well and are perceived by their stakeholders as efficient and effective in fulfilling their mandates, such as the World Health Organization (WHO), International Telecommunication Union (ITU), and International Criminal Police Organization (INTERPOL), among others. Some have been perceived as sleeping beauties, such as the International Maritime Organization (IMO) (Bauer 2006), or inefficient and problematic such as the UN (Analoui 2009) and the World Bank (Nielson and Tierney 2003). Certain IGOs, at some point, cease to exist: examples are the Arab Cooperation Council (ACC), Southeast Asia Treaty Organization (SEATO), and the Latin Union, among others.

A promising avenue for research is to explore IGOs' functioning and performance from an organizational point of view. In the literature, research is prevalent on how and why IGOs are established, but studies on how they operate and on their performance are lacking. Taking a managerial perspective in examining IGOs will be helpful to understand the underlying mechanisms within these organizations that affect their performance. Additionally, it should provide detailed information for outsiders, including European businesses, to help understand how decisions are made at various levels within these IGOs.

IGOS AS FORMAL ORGANIZATIONS

In this chapter, IGOs are examined as a form of organization distinct from any other. IGOs inherently belong to the non-profit sector, as they do not ultimately aim to generate profits through their operations. As both function to serve public interests, IGOs are also comparable to the public sector; however they differ in that public organizations are restricted to the jurisdiction of the country they operate in, whereas IGOs traverse national borders and cater to a wider scope: the global public interest. Given their transnational character, IGOs' stakeholders tend to be of a more varied nature as compared to those of public organizations. IGOs are, as their name implies, a subgroup of international organizations (IOs), which include international non-governmental organizations (INGOs) – such as Greenpeace, World Wide Fund for Nature, CARE International, and Amnesty International, among others – and multi-national corporations (MNCs).

Present-day research on IGOs is incomplete. Various factors remain to be studied: an understanding of their organizational characteristics, the factors that may lie behind the distinct organizational forms IGOs adopt, and their differing performances. To address this gap, organizational theories may be informative when studying why IGOs are formed and how they are governed. The key theories this chapter draws on are Institutional Theory, Transaction Cost Economics Theory, Agency Theory, Contingency Theory, and Resource Dependence Theory.

More specifically, two aspects regarding IGOs have not been studied in depth: first, the governance structure of these organizations – in particular, their executive boards – and second, IGOs' use of strategic management to improve their performance, which includes understanding whether IGOs use strategic planning, and how.

GLOBAL INTERNATIONAL ORGANIZATIONS

The research described in this chapter is based on a database which holds the institutional characteristics of all global IGOs. A *global* IGO is defined as an international governmental organization which includes at least one member from each of the five continents. Information is drawn from multiple sources of public information available online, including the IGOs' statutes, terms of reference, procedural rules, financial regulations, annual reports, and strategic plans. Two researchers coded the database,

resulting in very positive and exceptionally high inter-rater reliability – the database's Cronbach's alpha[1] is between 98 to 100 percent on each indicator. This database helps explain the institutional mechanisms of all global IGOs and sheds light on the differences among IGOs and their respective performance.

As of today, the database includes all 69 global IGOs (see Annex for the full list). The IGOs' organizational characteristics, such as number of member states, age, and size in terms of number of hired personnel and budget, are highly heterogeneous. The number of member states ranges from a low of six up to a high of 197, with a mean of 118. Most of these IGOs have been established for quite some time now: the mean age is 56 years, with more than 97% of IGOs established at least a decade ago. These IGOs also employ a large number of personnel: the average headcount is 750, with the exception of the UN, which has at least 43,747 office and field personnel.[2] Lastly, global IGOs have large budgets, averaging $2.7 billion (excluding international financial institutions that have exceptionally large budgets, e.g., IFC - $7.5 billion, EBRD - $8.5 billion, IDA - $10.2 billion, and IBRD - $20.5 billion). As an important side note, in the organizations pertaining to the World Bank Group (IFC, IBRD, and IDA), EU countries, if combined, are the shareholders with the largest voting rights. Unfortunately, the lack of integration among EU countries does not allow Europe to benefit from such a majority.

Out of the 69 IGOs in the database, 23 belong to the UN and 10 are international financial institutions. More than half of the IGOs are transparent to their stakeholders, evidenced by 39 IGOs making their annual reports available online.

Table 1: IGO Basic Characteristics

Characteristic	Minimum	Average	Maximum
Foundation year	1865 (ITU)	--	2003 (CLSF)
Members	6 (CWCG & IPC)	118	197 (Montreal)
Personnel	4 (BioNet)	750 (excl. UN)	43,747 (UN) & 8,500 (WHO)
Budget	$1.5M (IIR)	$2.9B (excl. IFIs)	$20.5B (IBRD), $10.2B (IDA), $8.5B (EBRD), $7.5B (IFC)

Source: Authors' own compilation

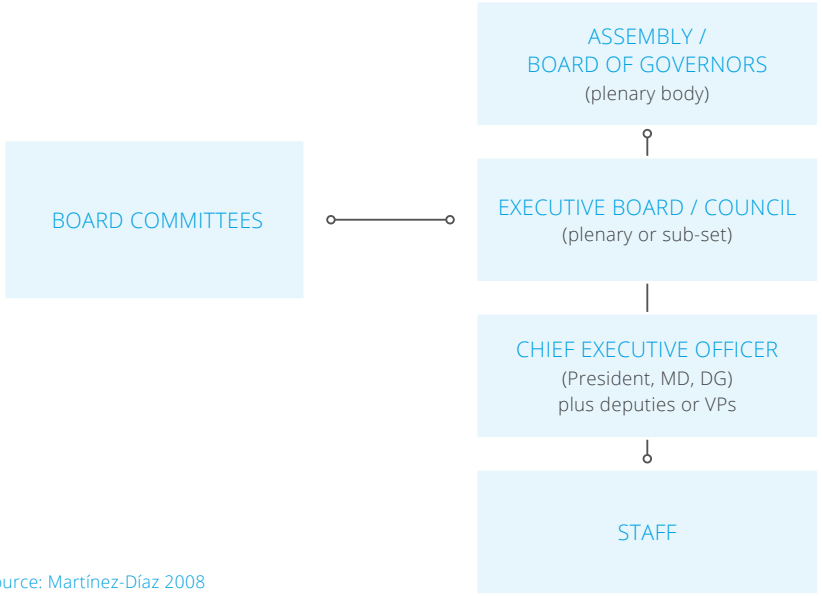
[1] Cronbach's alpha is the test of reliability between inter-raters' measurements of the same construct.

[2] This figure includes peacekeeping missions but does not include the military personnel, civilians, volunteers, etc.

EXECUTIVE BOARDS

Similar to corporations, IGOs have governance structures comprised of three levels (see Figure 1). The plenary sits at the top, encompassing the member states. In the middle are the boards, whose members are selected by members of the plenary. Lastly, there is the top management team of the secretariat, headed by a person selected either by the board or the plenary. The head of the secretariat is known by multiple names, such as CEO, Secretary General, and Director General, to name a few.

Figure 1: Typical IGO Governance Structure



Source: Martínez-Díaz 2008

What Kind of Board?

The IGO governance structures are as diverse as their organizational characteristics, particularly with regard to the size of their executive boards. Out of 69 IGOs, 57 have executive boards. The average board size is 28 members – without considering the World Trade Organization (160 directors) and the Permanent Court of Arbitration (115 directors), which both have all of their member states represented on the board – and

the minimum number of directors is three, while the maximum is 77. However, most of these boards meet just once a year. This is likely because their primary responsibilities are to approve budgets and working programs.

Table 2: IGO Board Size

Characteristic	Minimum	Average	Maximum
Board size	3 (IHO)	28 (excl. WTO & PCA)	160 (WTO) & 77 (HCCH)

Source: Authors' own compilation

Boards of IGOs and their specific characteristics are the central focus of this research. Scholars of (for-profit) corporate governance have consistently found that board characteristics affect board effectiveness, thus impacting organizational performance. We examine this notion for IGOs, hypothesizing that differences in performance among IGOs are partly determined by the characteristics of these organizations' boards. In this regard, we examine how the boards of IGOs differ from one another.

Larcker and Tayan's (2011) analytic framework of corporate governance includes three characteristics of IGO boards: structure, board director selection, and duties. Empirically measuring each of these dimensions allows us to quantitatively research and compare the top decision-making units in IGOs.

How Are Boards Structured, and Why?

Some of the indicators studied to determine board structure are: size, representativeness (i.e., the ratio of board size to plenary size), and whether board decisions are made by majority voting or not. The selection of board members is measured through indicators such as: whether board directors require minimum expertise or technical knowledge, if directors have a fixed term in office, and whether or not they are elected by majority voting. The boards' duties are measured through indicators such as: whether IGOs have a resident board (which theoretically implies greater duties for the board directors), have the capacity to remove the head of the secretariat, or have explicit functions regarding the budget.

Perhaps the most pressing research goal is to identify the contingency factors that may affect how boards are constructed. One research avenue is to explore whether board characteristics are correlated with other IGO attributes, such as age, organization size (in terms of budget and number of personnel), and number of member states. Being an agency affiliated with the UN or being an international financial institution may also affect board structure.

The key finding is that the number of member states is related to board characteristics. IGOs that have a higher number of members tend to have a smaller board and tend to use majority voting in decisions and elections of board members. Their boards also have more duties as well as more requirements to become director of the board. Also, IGOs that are financial institutions tend to have smaller, resident boards.

Does Board Type Determine IGOs' Performance?

A vital area yet to be researched in order to advance our basic understanding of IGOs is their organizational performance. In particular, an interesting research line is to identify possible configurations of board characteristics, which are conducive to higher performance.

Measuring performance is a very difficult endeavor in social science research, in particular with respect to nonprofit and public organizations. Fortunately, for IGOs, a point of departure exists: the Multilateral Organization Performance Assessment Network (MOPAN), which publishes evaluation reports on most multilateral development organizations. 18 IGOs have been assessed by MOPAN, and the reports are publicly available on the MOPAN website. In these reports, MOPAN assesses IGO performance along two dimensions – *real performance,* based on official documents of the evaluated organizations, and *perceived performance,* captured through a survey of the IGOs' stakeholders. These two dimensions are subdivided into four different types of performance relating to strategic management, operations management, relationship management, and knowledge management. When the data collection is concluded, the IGO's performance is categorized into one of three levels: (1) adequate and/or exceeding expectations, (2) below expectations, and (3) not assessed or not available. Future research will combine board data for these 18 IGOs with MOPAN's performance data.

STRATEGY IN IGOS

Strategy is not new for IGOs: a growing number of such organizations publish their strategic plans. The IMO, IMF, Hague Conference, and the World Bank, among others, have long-term strategic plans that target certain global issues. Most of these organizations make their annual reports, through which they showcase their achievements, publicly available. Understanding how IGOs define their priorities is important for global governance, as well as for any organizations interested in participating in such priority setting – including EU businesses and nonprofits.

A relevant question, then, is how IGOs execute strategic planning and how they use it. Research on strategic planning is prevalent in the for-profit sector, yielding numerous approaches business leaders use in formulating their strategies. Recently, the public sector has recognized that public organizations can apply strategic planning approaches from business. Bryson and Roering (1987) examined, some time ago, how business strategic planning approaches were transposable to public organizations and produced a conceptual framework for strategic management for public organizations (see Figure 2).

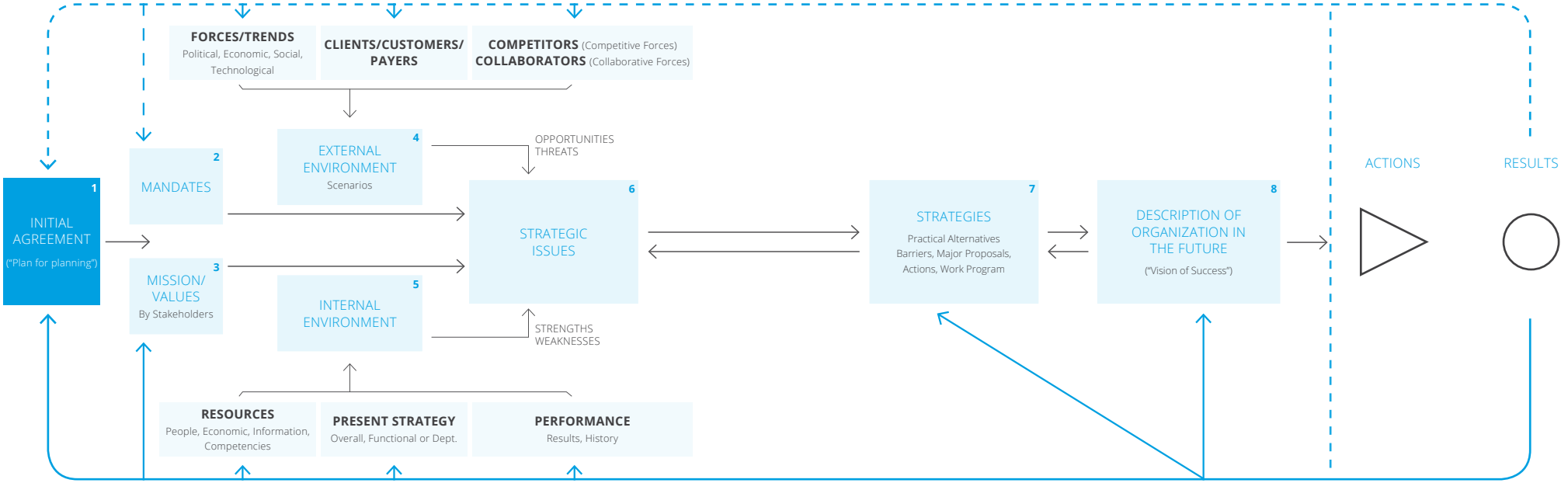
The strategic planning process is divided into three parts. The first is composed of the antecedents of strategy, namely the initial agreement, mandates, mission/values, and internal and external environment. Secondly, strategic issues are identified. Thirdly, strategies are developed.

Is this framework directly transposable to IGOs? Probably not, as two aspects of the strategic planning process may apply differently to IGOs: decision-making, and legitimacy.

Decision-making is the bedrock of strategic planning, as a continuous process of choosing among alternatives to come up with the best choice for the strategy. In corporate governance, decision-making is one of the generic board functions. However, it is not as volatile for IGOs, where decision-making is a far more complex and sluggish process because it is inherently political in nature. The complexity of making collective decisions in IGOs is the primary reason why an orthodox public or business strategic planning process is not automatically applicable to IGOs.

Figure 2: Strategic Planning Process

Source: Bryson and Roering 1987



Additionally, IGOs have an array of sources for legitimacy, which are vested by their stakeholders. Since each stakeholder has its own needs and interests, which often vary and conflict which those of others, this complicates how strategy is formulated. IGOs can use specific strategic planning approaches that consider legitimacy issues, such as stakeholder management and strategic negotiations. Some of the stakeholders taken into consideration when formulating strategies are the IGOs' principals: the member states, the general public, NGOs and INGOs, other IGOs, and sometimes even trade or business sector representatives.

In terms of the array of stakeholders that must be considered, IGOs are similar in nature - albeit not in form nor transparency - to European policy-making, their with its structured consultation initiatives and institutionalized expert and stakeholder groups.

Based on the specificities of IGOs highlighted above, process-related strategic planning approaches can be used by IGOs, but not the content-related approaches that are specifically intended for market-based results. Nevertheless, it is yet to be determined empirically what strategic planning IGOs mostly use and why.

THEORETICAL AND PRACTICAL CONTRIBUTIONS

In the international relations literature, IGOs have usually been studied using single cases or the two-case comparative method. Seldom do these studies use large samples. A quantitative comparison of the top decision-making units in IGOs is extremely welcome: this would contribute to a better understanding of how an important dimension of global governance works, thus allowing for improvement and increased participation.

Decision-making and policy implementation by international governmental organizations is extremely relevant, relevant, as revealed earlier in this chapter. Global economic and social interaction is structured by myriad international treaties and more than 300 active international governmental organizations – European businesses, business associations, and nonprofit advocacy groups should follow this web closely. With international agreements and organizations "meta-governing" national-level governance by setting standards, guidelines, and even binding rules, European businesses must place these organizations squarely on their radars.

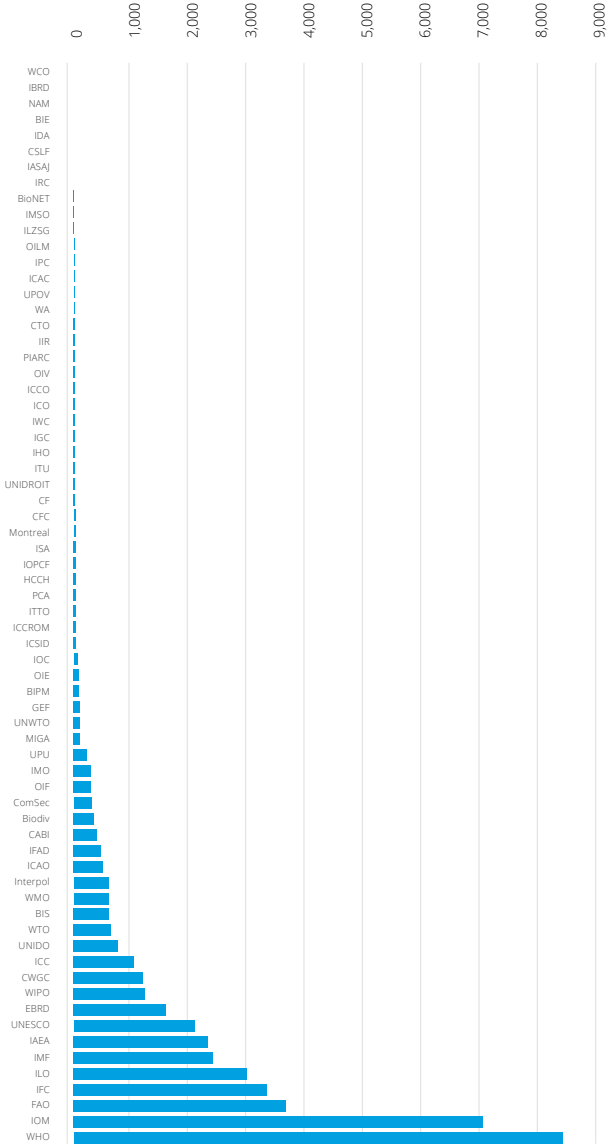
ANNEX

Annex 1: List of International Governmental Organizations

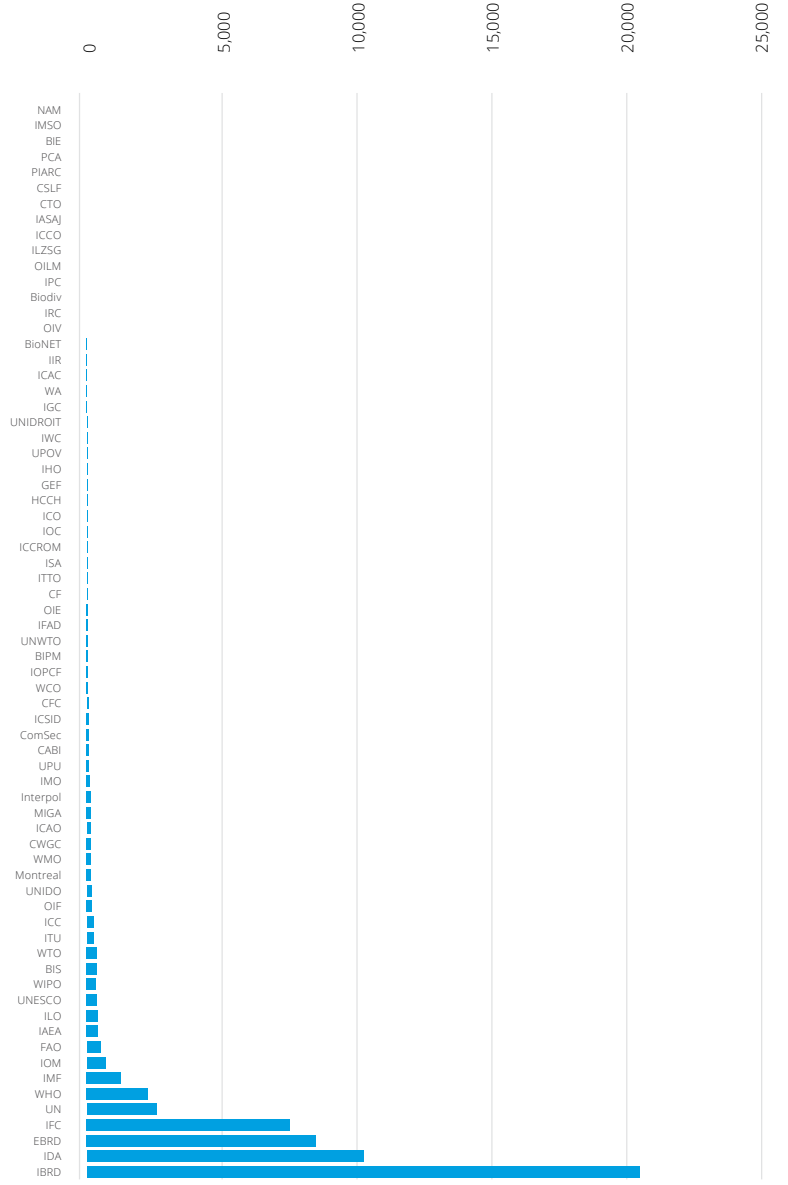
Bank for International Settlements (BIS)
BioNET International (BioNET)
Bioversity International (Biodiv)
CAB International (CABI)
Carbon Sequestration Leadership Forum (CSLF)
Common Fund for Commodities (CFC)
Commonwealth Foundation (CF)
Commonwealth Secretariat (ComSec)
Commonwealth Telecommunication Organisation (CTO)
Commonwealth War Graves Commission (CWGC)
Cultural Property (ICCROM)
European Bank for Reconstruction and Development (EBRD)
Food and Agriculture Organization (FAO)
Global Environment Facility (GEF)
Hague Conference on Private International Law (HCCH)
Intergovernmental Oceanographic Commission (IOC)
International Association of Supreme Administrative Jurisdictions (IASAJ)
International Atomic Energy Agency (IAEA)
International Bank for Reconstruction and Development (IBRD)
International Bureau of Weights and Measures (BIPM)
International Center for the Study of the Preservation and the Restoration of
International Centre for the Dispute of Investment Settlements (ICDIS) *
International Civil Aviation Organisation (ICAO)
International Cocoa Organization (ICCO)
International Coffee Organizations (ICO) *
International Cotton Advisory Committee (ICAC)
International Criminal Court (ICC)
International Criminal Police Organizations (Interpol)
International Development Association (IDA)
International Exhibitions Bureau (BIE)
International Finance Corporation (IFC)
International Fund for Agricultural Development (IFAD)
International Grains Council (IGC)
International Hydrographic Organization (IHO)
International Institute for the Unification of Private Law (UNIDROIT)
International Institute of Refrigeration (IIR)
International Labor Organization (ILO)
International Lead and Zinc Study Group (ILZSG)
International Maritime Organisation (IMO)
International Mobile Satellite Organization (IMSO) *
International Monetary Fund (IMF)
International Oil Pollution Compensation Funds (IOPCF)
International Organisation of Vine and Wine (OIV)
International Organization for Legal Metrology (OILM)
International Organization for Migration (IOM)
International Pepper Community (IPC) *
International Rice Commission (IRC) *
International Seabed Authority (ISA)
International Telecommunication Union (ITU)
International Tropical Timber Organization (ITTO) *
International Union for the Protection of New Varieties of Plants (UPOV) *
International Whaling Commission (IWC) *
Multilateral Fund for the Implementation of the Montreal Protocol (Montreal)
Multilateral Investment Guarantee Agency (MIGA)
Non-Aligned Movement (NAM) *
Organisation Internationale de la Francophonies (OIF)
Permanent Court of Arbitration (PCA)
United Nations (UN) *
United Nations Educational, Scientific, and Cultural Organization (UNESCO)
United Nations Industrial Development Organization (UNIDO)
Universal Postal Union (UPU)
Wassenaar Arrangement on Export Controls for Conventional Arms and Dual-use Goods and Technologies (WA) *
World Customs Organization (WCO) *
World Health Organizations (WHO)
World Intellectual Property Organization (WIPO)
World Meteorological Organisation (WMO)
World Organisation for Animal Health (OIE)
World Road Association (PIARC)
World Tourism Organization (UNWTO)
World Trade Organisation (WTO)

***IGOs without Boards**

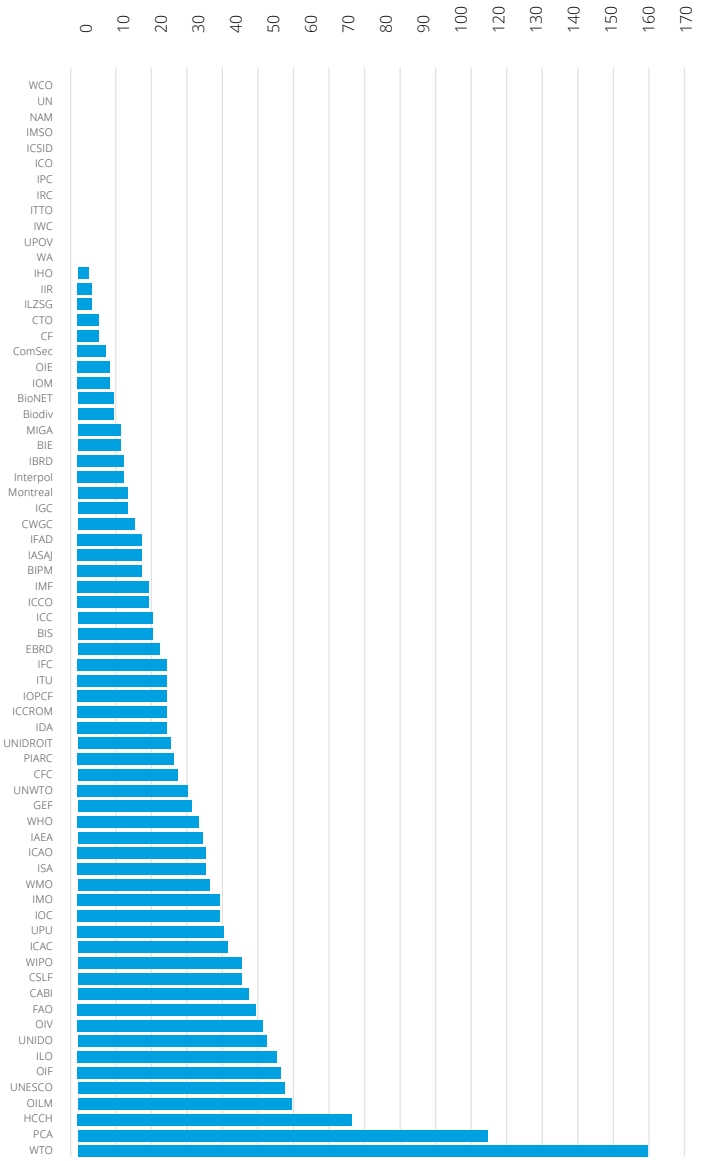
Annex 2: Personnel



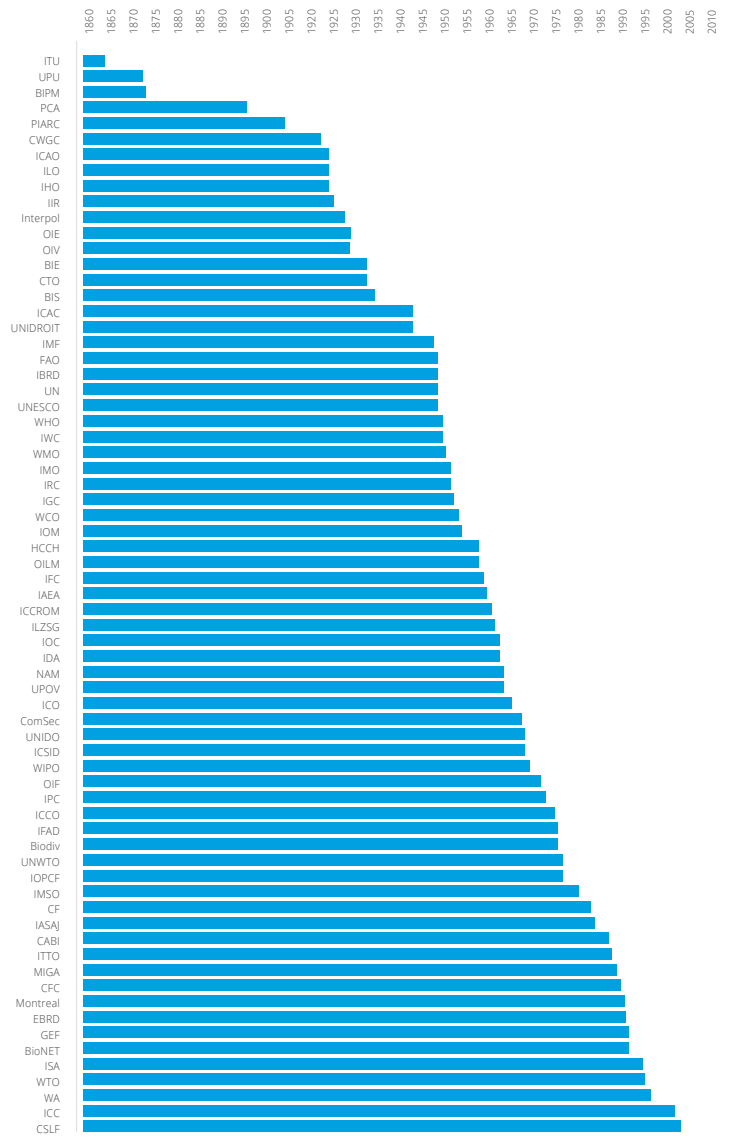
Annex 3: Budget (Million)



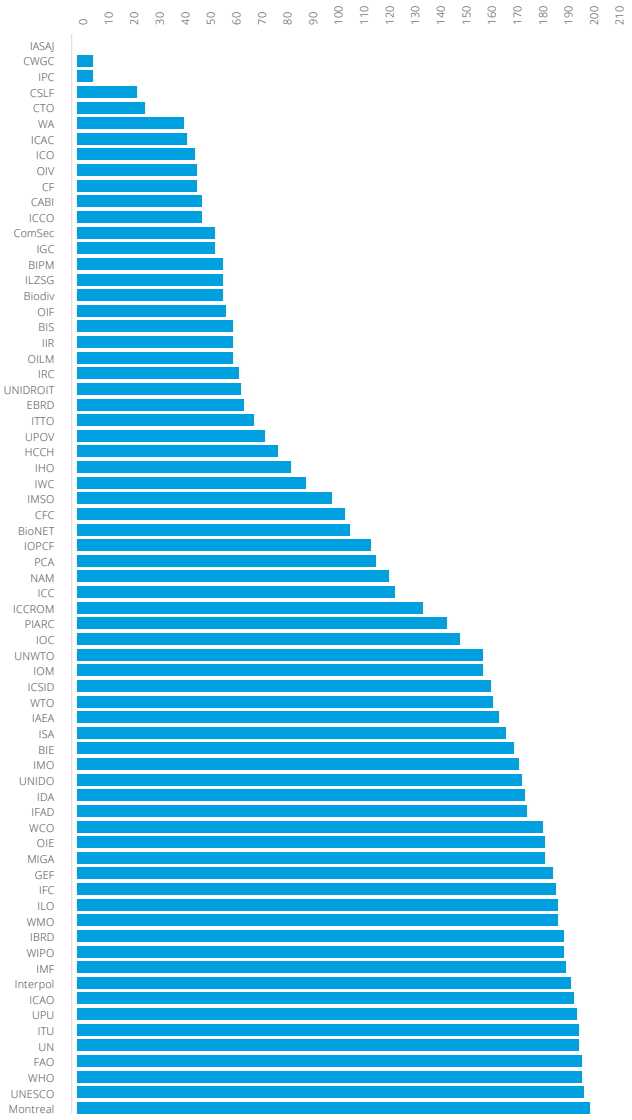
Annex 3: Board Size



Annex 4: Creation Year



Annex 5: Number of Members



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PART 4

The Future of EU Integration

4

Chapter 12

A Tale of Two Cities: Ideas and Narratives to Relaunch Integration

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Professor of Law and Jean Monnet Chair
ESADE

12

> *Our words make our worlds. To choose our words is to choose a form of life. To choose our words is to choose a world. To oppose words is to oppose a form of life and a world. To change words is to change a form of life and a world."*
>
> *Philip Allott, Eunomia, 1990*

This chapter borrows its title from the novel by Charles Dickens in order to describe two European "cities" that are very different from each other. Through them it aims to present ideas and narratives that can be useful for understanding European integration as a whole, presenting a critique and relaunching it in our time.

Each of the two cities represents an approach to the future of European integration, as bearers of a Utopian component, an ideal that gives meaning to "Europeanism" at very different historical moments.

Arrival in the first city, formulated by Jean Monnet and Europe's other "founding fathers," took place at the beginning of the 21st century. The initial steps were taken under exceptional circumstances, in the wake of World War II and under the threat of a new world war, a context that strongly molded the European project.

Today, the task at hand cannot be based on taking the same road again, and treading it in the same way, but rather on charting a new path and proposing another way of traveling together, that leads to the second city, as a metaphor for a pro-European vision adapted to our own time.

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* José M. de Areilza is the Secretary General of the Aspen Institute España.

* A previous version of this chapter was published as a Working Paper at Elcano Royal Institute 10/14, (September 2014) and as an article in the Aspen Journal of Ideas (September-October 2014).

THE FIRST CITY: A EUROPE THAT RESCUES ITS STATES

A Dinner in Paris

On October 13th, 1955 the Action Committee for the United States of Europe began to operate in Paris under the direction of Jean Monnet. The association's headquarters were at 83 Foch Avenue, in the apartment the French politician shared with his brother-in-law. Monnet would spend many hours around the long table in the dining room, piled with stacks of papers, accompanied by his former collaborators from the European Coal and Steel Community (ECSC), Max Kohnstamm and Jacques Valmont, and supported by a team of secretaries overseen by the able Madame Miguez.

The Committee was the old cognac merchant's personal response to the failure of the European Defense Community (the Pleven Plan, actually the umpteenth Monnet Plan), wrecked in De Gaulle's France in late August of 1954 by a disappointing vote in the National Assembly. Following this political setback, Monnet decided not to serve again as president of the High Authority of the ECSC. After having stepped down, he decided to work independently to relaunch integration.

The Committee, funded primarily by Monnet's American friends, proposed to create a favorable political environment between the parties and trade unions of the ECSC's six member states in order to establish two new European Communities, one for atomic energy and the other a common market. At the same time, the Committee studied and drafted improvements to these projects in order to link them to the Community that was already in existence. The idea of launching two further Communities had been devised by Minister Paul Henri Spaak in what was termed the "Benelux Memorandum." In fact, the Belgian politician had all but reproduced the plan prepared by Jean Monnet and Pierre Uri before withdrawing from the High Authority of the ECSC.

Spaak sent Monnet the final version of the memorandum accompanied by a hand-written note that said "this is your baby" (Hackett 1995). Spaak was heading the intergovernmental working group that was to develop and implement the document, approved by the ministers of foreign affairs, with certain reservations, at the Messina Conference on June 1st, 1955. Antoine Pinay spoke on behalf of France to express his opposition to reindustrializing Germany beyond coal and steel. Adenauer's representative, meanwhile, was not entirely convinced of the idea of jointly managing nuclear power for peaceful purposes (Euratom). The Soviets, meanwhile, conveyed to the Messina forum their firm opposition to any further progress in the efforts to promote European unity.

Monnet continued to believe that both the German problem and the reconstruction of the European economy should be resolved through the continent's economic and political integration. To make the process work, states needed to transfer real decision-making capacities to common institutions rooted in a supranational principle, wielding authority superior to that of national governments. The idea was to follow the model of the ECSC, the first tangible result of the Schuman Declaration of 1950, which Monnet also drafted.

Monnet's ability to bring together groups of people capable of formulating and promoting projects governing the relationships between states was already legendary on both sides of the Atlantic. Over the preceding 25 years, he had developed an extraordinary skill: accessing the circles of power in Washington where, in the upper echelons, everyone knew everyone else. In fact, Monnet was more synchronized with the Americans than with many Europeans. The two Americans who most helped him bring the ECSC to fruition, Secretary of State Dean Acheson and High Commissioner for Germany John McCloy, continued to support him through various philanthropic and foreign-policy organizations once back on Wall Street.

Ever since his youth, when both geography and his region's economy pushed him toward the Atlantic and the Anglo-Saxon world, Monnet had developed a special relationship with the US. Over time, the relationship proved to be his primary source of power. He admired the vitality of American society, its unlimited confidence in individual projects, its openness to change, and its ability to carry out its own social and economic transformations (Monnet 2010, 45-46). In his business life, he gave short shrift to ideologies or nationalities and preferred to focus on what each individual could contribute to his plans, based on long-term objectives and ideas. Monnet had a sense of urgency and historic need. He had always been an internationalist, and this took precedence over his Europeanism. He only acted in the public sphere at times of war or in post-war situations, during exceptional times when new solutions were required that were perhaps unthinkable during periods of stability.

John Foster Dulles, secretary of state under the Eisenhower Administration, was an old friend of Jean Monnet's. Their relationship dated back to the Versailles Conference in 1919, during which both had served on the Reparations Commission along with John Keynes. Dulles and Monnet were born in the same year: 1888. After their first meeting,

they worked on various financial projects in the public and private sectors: Dulles with the New York law firm Sullivan and Cromwell, and Monnet with the consultants Murnane & Monnet, which Dulles himself had helped to establish. Despite the former's austere and Calvinist temperament and the latter's penchant for the good life, they got along very well. After World War II the Republican lawyer was a senator for a few months and then served at the State Department, where he was entrusted with negotiating the peace treaty with Japan. He had not shared the Democratic administration's resolute support for the Schuman Plan and the first European Community, the ECSC. But in his book *War or Peace*, published in 1950, Dulles argued that the enlightened interest of the US lay in strongly pressing the Europeans to move towards unity, in the context of a Cold War of whose ultimate consequences no-one could be sure. He had also supported the recently-failed European Defense Community, endorsing all the theses of the Truman Doctrine regarding the need to contain Soviet expansion, starting with Europe.

On the eve of the Atlantic Council's meeting on December 17th, 1955, held in Paris, Secretary of State Foster Dulles spoke privately with Jean Monnet (Hackett 1995). The Frenchman's main concern involved the UK's attempts to scuttle the plans for the two new communities, Euratom and the Common Market, which London had spurned even before they had taken shape. The British government proposed merging cooperation and integration initiatives into the Eurostat-OECD, the Council of Europe, or the Western European Union – in fact, any formula that eschewed the supranational principle and its implications for the integration process.

Dulles fully supported Monnet's idea of expanding the Community through new projects in six countries (a few days later, Dulles asked President Eisenhower to take the issue up with Britain's Eden and Macmillan so that they would refrain from boycotting the initiative). He advised the Frenchman to give priority to, and to shore up, the Common Market first, and only then to address Britain's demands for a free-trade area with the European bloc. The American insisted that the creation of a market was the essential strategic project. Monnet, in his view, was placing too much stress on Euratom and should avoid devoting his capacity for persuasion to what was a secondary cause. The Frenchman thanked the American for his help, and on the way to dinner with his collaborators made a mental note to make sure that bottles of his family cognac should be sent to offices of Eisenhower and Foster Dulles before Christmas Day.

After dinner they spoke about how far European integration might one day be taken. Dulles was more optimistic than his Democratic predecessor, Secretary of State Dean Acheson, another long-time friend of Monnet's, who in March of 1950 had remarked in

a speech, with his usual brilliance, that "in Europe neither the people nor their rulers are prepared for a Federation." After all, Dulles argued, the objective of a Federation had been made explicit in the Schuman Declaration, and was accepted by the six founding countries. Monnet was sincere and pragmatic: what concerned him at the time was ensuring peace through a new economic interdependence based on shared prosperity. The problem was not what political model Europe should have (on this issue, calculated ambiguity was advisable), but rather how to overcome the resistance of European states, particularly France, when it came to pooling and organizing sufficient human and material resources at the European level. This would solve problems too great for each individual state to confront, and all in a situation in which Europe's organization was subject to profound American and Soviet influences (Reuter 1968, 13). Paul Reuter, Monnet's chief jurist and one of the authors of the ECSC Treaty, told Dulles that integration was different from cooperation and not comparable to classic federalism, which was based on other solidarities and balances between different levels of government. European solidarity could not be taken for granted and had to be built, step by step, upon a foundation of facts. Federal checks and balances did not make much sense given the urgency of building the Communities, which called for the centralization of powers "characteristic of the modern economy" in their spheres of action, in line with the finest tradition of French interventionism.

Reuter continued to set forth his two theses: integration implied the exercise of functions previously reserved to the state and national representatives in Community bodies were to make decisions based on simple majorities alongside others who had decision-making powers without being representatives of any state. The resulting law was to be of direct application, without the intermediation of national governments, and all should be subject to a highly developed legal system, guaranteed by a Court of Justice. Thus, the ideas of "integration" and "Community" were original and could not be easily classified politically. The term "supranational" could even result in a "premature federal stain." In the words of the French jurist, there was no other path than "faltering invention" (Reuter 1968, 29-30).

Arriving at the First City

Almost 60 years after the talks in Paris between Monnet and his American friends, the achievements of integration are such that none can doubt that it has been a historic success. The Utopia formulated by Monnet's generation was far beyond expectations. It is true that integration has not been linear, as it has been rocked by economic determinism based on the neo-functional analyses used to explain the European

Communities during their inception. The road has proved to be far more complex and uncertain. The role of national governments and supranational institutions like the Commission and the Court of Justice has been highly significant, as has the impact of historic and economic changes on the continent, such as the end of the Cold War, an ageing population, global market pressures, and so on.

Overall, European integration over this long period has been an exercise in successful pragmatism. Despite the anxiety generated by the Eurozone crisis, the Union's political value is still very high today. It is the most advanced example of regional economic integration and a paradigm in the development of institutions capable of managing problems common to an entire network of states in the context of globalization.

It could be argued that by the end of the 20th century, Europe had brought into being the Utopia inspired by the ideals of shared peace and prosperity which Jean Monnet and the other founding fathers entertained in the 1950s. Reconciliation between former enemies came about in the market and through common policies, supported by a Community of Law based on such fundamental values as non-discrimination on the grounds of nationality. Balances between the Community's institutions functioned as curbs on the new European power, as well as checks and balances between the level of European government and the national democracies. Brussels' institutions have established effective limits on economic protectionism and extreme nationalism.

Ultimately, member states were rescued from themselves by a new European legal and economic discipline that they themselves had desired. In the late 1980s, the historian Alan Milward thoroughly investigated the historical origins of the Communities and explained to what extent the founding of Europe involved a rare convergence of national interests and cosmopolitan ideals. Integration was approached as a "European rescue of the nation-state," i.e., a project governments accepted in the interest of their people, in need of economic reconstruction through a market on a European scale, while the governments themselves developed their social states at the national level (Milward 1992). The Communities saved nation-states from obsolescence.

Political Fatigue

When the 21st century began, a very successful Union was in place from a historical point of view. However, it was now devoid of any Utopian aspirations. It began to be taken for granted as merely part of the landscape. The old ideals of shared peace and

prosperity had been achieved and were no longer motivating factors. Thus, the Union was a victim of its own success: weary and on the defensive, it was unable to find the resources with which to reinvent itself as a project and to relaunch integration on a new basis in the pursuit of a worthy Utopia. A disconnection between the past and the future is not unique to *European* integration. Every dynamic process ends up losing steam and every creative project exhausts its possibilities. And, in politics, the corollary is that all power becomes increasingly oligarchic.

The three core projects of this century's first decade illustrate how integration has come to lack the dynamism and ambition of yesteryear.

The single currency was launched, but its *raison d'être* was justified in political terms that were neither unified nor convincing. This failure was mirrored by the institutions developed to make it sustainable, as the financial and economic crisis revealed.

The negotiation process for a European Constitution between 2002 and 2004 failed, aggravating public mistrust and sapping the political power of a Union that was beginning to feel drained.

The Union's enlargement in 2004 and 2007, which almost doubled the number of member states, did not have the desired effect of relaunching the European project, but instead simply generated fear and misgiving.

The pending step of integration, namely strengthening the Union's external dimension, was inadequately dealt with, despite official speeches that proclaimed that the Lisbon Treaty of 2007 was the great leap forward. The Union is still not an entity that effectively defends its own interests in a globalized world undergoing an accelerated transformation.

One of the obstacles to the European project's reinvention is the mindset that Joseph Weiler has called "political messianism." On the way to the first city, part of the legitimation of European integration was a sense of mission and historical destiny. In an exceptional situation such as that faced by post-War Europe, it was the road to the Promised Land. The European dream generated an idealism and the feeling of an epic feat among certain governmental elites. The result was a tendency to overlook deficiencies in the Communities' democratic credentials, an issue the Union has only partially addressed. Once the first city had been reached, messianism was no longer the way forward. Still, the sense of a "historic mission" resurfaced as empty rhetoric in some of the efforts to articulate what Europeanism should consist of today (Weiler 2012, 256).

The project's realization and exhaustion occurred without the Union making a qualitative political change to establish itself as a democracy outside the state, and without a single "demos," which is no small task. It is true that since the Maastricht Treaty's ratification in 1992, a much-needed debate began about how to justify, from a democratic perspective, the increased exercise of power in Brussels. In fact, one of the ways to view European integration since then is to conclude that it has reached what Kalypso Nicolaïdis calls its "Tocqueville moment" (Nicolaïdis 2005). Following in the footsteps of the enlightened Frenchman, we Europeans have begun to ask ourselves the tough questions addressed by all democracies: in our case, how to overhaul a supranational project – the economic and political integration born in 1950 – carried out by a select few – and aimed primarily at rescuing states from themselves.

The Union faces this "Tocqueville moment" of staking a claim to legitimacy as a new power following the faltering of the social contracts based on the welfare state, the profound mutation undergone by the continent due to the disappearance of one of its blocs, and the acceleration of economic globalization. Brussels and Europe's national capitals have made decisions, such as setting up the single currency and promoting the Union's eastward expansion, which have transformed the Union's very nature and made it even more necessary to fortify its political process. However, not enough steps have been taken to achieve a Union that is truly "owned" by its citizens. National and European elites, excessively shielded by the opacity with which they operate in the Union's various institutions, have failed to successfully engage in a democratic debate on the Union itself.

As explained by Francisco Rubio Llorente, the European integration project has typically been justified as a function of national power: "in question is not so much the emergence of a new and free power, as the creation of a limit on already existing powers. This creation needs to be justified, or legitimated, but this is a new need: not the need to democratically legitimise a new power, but rather to legitimise the existence of a set of limits on democracy" (Rubio Llorente 1999, 2-9). In our time, a paradigm shift has become necessary and the task ahead is to legitimize, as such, a new European power.

A Strange Governance

The financial and economic crisis of 2008 found the Union undergoing another crisis, of a political nature, which materialized as growing citizen indifference and criticism of the institutions in Brussels, which had yet to advance any compelling formulation of a new European Utopia.

It has become a commonplace that this period exposed a glaring lack of leadership and vision with regard to the European integration process. Less attention has been focused on the fact that the common currency has survived the worst ravages of the powerful financial markets. This survival is rooted in important reasons of a political, and not just economic, nature. Despite four years of mutual hesitation and mistrust, the world's markets have maintained their confidence in Europe's single currency, even in the depths of recession. No government in the Eurozone has decided to abandon ship, despite the vessel's manufacturing flaws, and neither have we veered towards a euro restricted to fewer states. And with varying degrees of success, the redesign of the economic and monetary union, to increase its solidity and credibility, is underway.

However, these exceptional years, during which the common currency was on the verge of disappearing, has led to a return of the intensified elitism that characterized the first stage of European integration as well as to the traditional trend of justifying integration on the basis of results. The process' elitist nature has intensified as the euro crisis has encouraged leaders to seek refuge in the policies of their national capitals.

Germany has acquired a new degree of prominence. During the crisis years, it all but imposed its own social contract upon the Eurozone's other members. This model was based on austerity, sacrifices, savings, and a clear distrust of both the financial markets and of transferring new competencies to the Union. It should be noted that Berlin has not acted on an imperial mindset, but rather with an inward-looking intent. Germany's categorical imperative has been "to resolve the crisis playing by the rules," which has sometimes given rise to a dangerous abstraction, overlooking the context of each country upon which Germany's constitutional identity has been projected. Germany feels that the design of the common currency threatens its sovereignty, which it seeks to defend. Today's most sovereign member state, Germany, would prefer to be left alone than to lead, but when leading, it does so by example and by projecting its way of doing things on the single currency's new rule book.

In this situation, integration is all too often understood as legal and financial discipline imposed not at the European level, but by certain member states on others. A sharp division has been drawn between creditor and debtor countries, giving rise to tensions and grievances between them, while the institutions and the "Community of Law" have weakened at the European level along with the normal functioning of democracy at the national level. This is due to the fact that during the early years of the crisis, it was assumed that the rescued countries were the problem, along with Italy and Spain. This turned out to be a flawed diagnosis. The root of the euro crisis was not the debt of

certain countries, but rather the monetary union's flawed design. Its central institutions lack the instruments necessary to ensure stability, the correction of imbalances, and survival in the event of a crisis (Torreblanca and Areilza 2013).

During the euro crisis, the Parliament lacked a leading role, its political deliberations were not centralized, and the Commission lost the capacity of initiative in both the European Council and the Eurogroup, where Germany's position was decisive. The counterweight to Berlin was the European Central Bank (ECB), more than any other institution. Despite all this, pro-European positions have prevailed in all Eurozone capitals, due to a deep conviction that integration is the future. But to have weathered the storm is not enough.

The transfer of new powers and resources to the Union, without which the single currency would not be viable, has become more necessary and, at the same time, more difficult (Torreblanca and Areilza 2013). Restoring the euro is proving to be an uphill battle, but the main problem is not a lack of leadership. Neither is the solution as simple as implementing the appropriate economic policies. Rather, the problem has deeper roots, related to the need to renew and restore the vision of a European Utopia.

The good news is that through a peculiar form of governance, including measures that have not always been well coordinated at the European and national levels, valuable time has been bought during which it has been possible to undertake new political and economic reforms. In this regard, it is essential to know where we want to go. The common currency crisis has accelerated and at the same time complicated the political debate that is essential to relaunching integration. The Utopia of perpetual peace between Europeans – the *raison d'être* of the Communities – is now being taken for granted. When anti-European populism leads to sustained grumbling, it is time to remember that nothing is won forever and that laying the foundations to construct a new ideal makes the pursuit of unity attractive once again.

The second stage on the road cannot simply be a continuation of the preceding one. Unlike the post-war era, the challenge is no longer to make nation-states become member states of a Union. Rather, it is to establish and flesh out the role of the new European power – legitimate, limited, and effective – and make it fully compatible with national democracies which, in turn, will reap the benefits of European legal and economic discipline.

THE SECOND CITY: A EUROPE RESCUED BY POLITICS

Today, Europe is the problem as much as its member states. It is necessary to legitimize a new power that cannot be justified merely on the basis of its transformation of nation-states into open and prosperous member states. The time has come to evolve toward a strengthened European political community, though limited in its material expansion and compatibility with national democracies. The states that make up the Union face the problem of meeting the challenges posed by today's world, in which none of them can effectively defend their interests on their own. Sovereignty, the compulsion to have the last word, is blind to a country's future. There is a European society with common traits that suffices to justify this paradigm shift.

The journey to the second city requires the formulation of a new European Utopia providing a *modus operandi* similar to that which characterized the first plan, drawn up during an exceptional era. Elitism, a sense of historical destiny, excessive technocracy, and the pre-eminence of diplomatic negotiations – again, elements very much present in the redesign of the euro – are counterproductive when it comes to reinventing integration. Of course, the political dimension, materialized in institutional forms, still calls for prestigious leading figures that are seldom or never suspected of acting on the basis of national biases. The first requirement for these leaders would appear to be personal prestige. That is, the founders' reconciled Europe. But neither the Union nor the Eurozone can relive their past nor aspire to survive as projects based essentially on a certain kind of enlightened despotism.

In order for the EU to regain momentum, it is necessary for it to become a public forum through which to formulate a new ideal: a distinct European narrative, mobilized in favor of integration. As stated by Javier Gomá, ideals are essential: they establish a target and, by virtue of their attraction, they propel the moral progress of societies (Gomá 2011). Even when it fails, the pursuit of well-defined goals at least ensures that significant progress has been made.

With a view to generating this new Utopian impulse, 21st century Europeanism should be based on three axioms. The first is to make progress in European integration compatible with the member states' national projects, i.e., to demonstrate that progress towards integration is compatible with the demand for political and economic modernization. The second is to make decision-making subject to democratic processes within a Union

with enhanced democratic credentials. The third is to respond to the desire most Europeans harbor: making the Union a global player in the face of the accelerated transformation of the surrounding world.

A European Project Compatible with National Democracies

During the German election campaign in September of 2013, some moderate voices called for European integration not to dominate public debate or to be a ubiquitous issue, in an effort to dispel the idea that everything – both good and bad – emanates from Brussels. In essence, they were calling for democracy at the national level to retain its full force, all the while taking into account the European context. The President of the German Constitutional Court explained this in vivid terms when he recognized that his worst nightmare was to wake up one day and realize that his Parliament no longer made decisions because everything was to be voted on at the Community level.

In this regard, we should learn from German democracy and its political, legal, and economic debate on the mutations produced by the euro's redesign. At the same time, the German tendency to impose a unilateral vision on the development of the Union is worthy of criticism. Rather, Germany should articulate a convincing proposal for the union of member states and their citizens, as all too often the German approach generates imbalances and ends up suppressing the European debate.

The government in Berlin, however, is right about insisting on assigning maximum importance to discussing what new policies ought to be transferred to the European level. It is essential to thoroughly address how much integration citizens want, thereby getting all participants to accept the new rules of economic governance, which, in its renovated form, must be sustained both in new national social contracts and in a European pact.

In the founding fathers' original plans, a high degree of economic integration was compatible with the preservation of national identities. Therefore, each new Community power had to be justified, legal and political mechanisms to regulate this progressive centralization had to be created, and democratic life was to be developed at the European level. Little by little, however, Europeans developed a mentality according to which any and every new Community action was good news, as if we were riding a bicycle on which we had to keep on pedaling to avoid falling over. Only when the Maastricht Treaty in 1992 was to be ratified were democratic debates first held to justify the continuous transfer of powers to Brussels.

A certain determinism is exerting its influence on the current situation. Simplistic solutions to the problems of the single currency tend to be based on calls for leaders to centralize in Brussels – almost overnight – all kinds of powers and resources in order to bolster economic and monetary integration. Yet, while continuing to act with the diligence the situation requires, the classical democratic question of how much integration each state really wants cannot be sidestepped. Instead of uniting people, as Jean Monnet believed the European dream should, the common currency has sparked serious hostility. It is essential that its reconstruction reflect a widely shared and thoroughly debated vision of the European project.

Moreover, centralizing new powers to strengthen economic governance should not lead to an unlimited amassing of authority in the EU's hands. A "union of general competences," should it come to pass, would not enjoy legitimacy in the people's eyes. Thus, mechanisms should be established to make it possible to renationalize some policies when this represents a desirable European decision. The idea of a Union with wide-ranging and flexible power – but with limits – would make it possible to maintain full compatibility between national and European democracies. Only a model of "equilibrium of enumerated powers" would ensure that the stress between center and periphery is beneficial to both levels of government. The effect would be to "get off the bicycle," as Fidel Sendagorta once proposed, to regain voters' confidence and to address citizens' demands without relinquishing vigorous democracy at either the national or European levels (Sendagorta 2005).

At the national level, political and economic reform should gain importance, not by imposing European institutions, but rather by national capitals taking better advantage of the opportunities offered by the Union. Spain should learn from German democracy. Although the Union has an impact on almost all of Spain's economic and social life, Spain in fact contributes little to the formulation of a vision for Europe. In Spain, the desire for "more Europe" sometimes reveals that what it wants is for others to govern it. This childish longing has recently been accompanied by a certain scepticism, which is just as counterproductive, of a Union that is unable to solve all of its problems, starting with its complex and unstable state, based on a system of *Comunidades Autónomas*.[2]

In this regard, constitutional reform in Spain, a pending task, would have to be based on its status as a member state of the Union, a legal and political reality that offers valuable

[2] Spain's *Comunidades Autónomas* (autonomous communities) are regional government divisions which were granted considerable powers and authorities on demand under the country's 1978 Constitution.

guidance. An overhaul of Spain's territorial model would be more feasible if it were to be based on how the state's will is applied to European issues, how the internal market's integrity is preserved, and how Community law is more effectively and coherently applied.

If we want a new Europeanism to take root, it is also essential for member states to contribute to fostering integration, moving beyond the defense of their short-term interests that the economic crisis brought to the fore. One of these proposals should be the political development of the concept of European citizenship, originally a Spanish initiative, but today stalled at an embryonic stage. This complementary status of member state nationality is based on a cosmopolitan ideal that could inject both reason and moderation into the Spanish territorial debate. Given that this ideal essentially entails belonging simultaneously and harmoniously to different collective identities, it makes European integration fully compatible with a commitment to the projects of the Union's various nation-states.

Democracy for the Union

The second vector of this new Europeanism would require shedding any nostalgia for the integration that has already been accomplished, acting decisively to transform European governance today. It is not enough to move forward once again towards a "Europe of results." The transfer of new powers to the EU can only be justified by improving its system of government in democratic terms, based on the acceptance of a new social contract between Europeans designed to resolve the tensions and political and economic imbalances that have caused so much uncertainty in the European project. Renovation would involve allowing further transfers of powers essential for redesigning the euro, in exchange for the democratic and political reinforcement of Community institutions (Torreblanca and Areilza 2013).

Brussels' institutions must govern more visibly and publicly, instead of just formulating policies. The objective should be to improve the quality of democratic debate in Europe, with greater transparency, intelligibility, accountability, and progressively, competition between different European visions of the common good.

Fostering a vigorous democracy at the European level should lead to discussions at the Community level about the kind of Europe we want. Fritz Scharpf has observed that to a great extent, the present Union is rooted in a liberal political model and not a republican one (in reference to Community political philosophy). Its priority is

the protection of individual economic rights. In addition, the model aims to establish limits on the exercise of European power by means of an institutional system based on multiple vetoes, thereby enshrining a pluralist model rather than one based on a pan-European majority (Scharpf 2012). Given the current ground rules and the lack of a clear electoral mandate, Scharpf argues, the Union cannot promote the common good and nor can it solve many problems that its states are unable to tackle on their own. This analysis is particularly accurate in tracing the general outlines of the European political model, but incorporates a vision that is too demanding with regard to the necessary degree of common identity. Ultimately, it proposes a state-based model applied at the European level (Weiler 1999).

The Union can only lay claim to the status of a "democracy outside the state" by recognizing the absence of a demos, and by not seeking to improvise a sense of common identification comparable to that felt in a unitary state. Therefore, more creative imagination must be invested in the field of politics in order to respect pre-existing national identities while simultaneously further developing the creation of a polis in the European sphere to reflect both the diversity and common features of European society.

The most pressing question remains how the Union can one day constitute an advanced democracy, enjoying legitimacy and incorporating at the European level all the democratic traits of Western political systems, without having to necessarily evolve toward a European state.

It must be recognized that the size of the European political community makes it difficult to achieve this democratic quality. At present, the Union is structurally remote from Europe's more than 500 million citizens. There is no example worldwide of a democracy incorporating mechanisms to ensure deliberation, transparency, accountability, and the efficient management of public affairs for such a large and diverse population. At the European level, it is difficult to fully honor the required standards of representation and citizen participation, and it is a daunting task to generate public opinion about the issue. We face a certain structural impediment that hinders the establishment of an advanced democracy.

At the same time, there are reforms which should be tackled now that the urgent demands of the euro crisis are over. The European institutional system does not yet allow a debate on electoral mandates or responsible government. It would be advisable for the Commission's possible development models to include its transformation

into a European Cabinet, fusing the positions of Commission and European Council president. The Cabinet should be capable of acting as a European government and of putting into practice a platform generated in the European elections, as well as of dissolving the assembly and holding elections, or of being compelled by Parliament to go home. The European Parliament, meanwhile, is part of the solution, but it also tends to claim a degree of representativeness greater than it really has. The reorganization of the assembly at Strasbourg, with formulas such as half of its deputies being elected in European elections and the other half being national deputies appointed by their parliaments to serve as European representatives would improve the European debate and enhance accountability. Rather than a step backwards, this could be a way of reconnecting and harmonizing national and European democracy.

Making political decisions at the European level has become more difficult as a result of the increasingly technocratic nature of policy at all levels, which is a result of globalization's impact. The process of global economic integration has augmented the power wielded by interest groups of experts who understand each other because they speak the same highly technical language.

Since the 1970s, we have witnessed the rising power of "sub-national" agents within the Union. As explained, many European policies are decided by individuals with sector-based loyalties who are neither motivated nor guided by any notion of European or national interests. Globalization has accentuated this narrow, technocratic, and fragmented view of the terms of European public debate. Supranational and intergovernmental viewpoints are not enough when it comes to understanding the EU's current and future development. In many EU negotiations, the decisive agents involved pay little more than lip service to European or national loyalties: what they really seek is to advance specific projects entailing specialized technical considerations. This "infranationality" prevails in Brussels, as it does in the capitals of all Western countries, and makes it possible to resolve, with some degree of effectiveness, certain transnational problems related to the extensive regulation of internal markets and foreign trade.

But these communities are both opaque and unaccountable, thus generating the impression that both Europeanization and globalization severely undermine the power of states while failing to transfer power to democratic institutions and political processes above the national level. It is as if power has disappeared, lost amidst the inner workings of committees and agencies which, like black holes, absorb political visions, powers, and aspirations. In addition, their fragmented debates, focusing on concrete problems, typically involve complex issues reserved for genuine experts.

The solution is not to wield national legitimacy as a counterweight to the communities of experts at the European level or to curb their tendency to present highly political decisions in technical language. Rather, these hundreds of committees and their necessary contribution to governance should form part of a system of checks and balances, combining representative institutions with other organs which do not work based on the majority principle. Both models of exercising power should be subject to effective accountability. To better regulate these processes and make them more transparent, and for them to offer more equitable access to stakeholders, neither federal nor constitutional reform is necessary.

No political reform would be complete without reinforcing the status of the Union's citizens, so that members of European society share a series of substantive rights and duties derived from a vision of civic values guiding Europe's institutions. This would give rise to a more clearly expressed identity and European loyalty that would reinforce and strengthen the loyalty felt towards states and regions. Europe's citizens, by definition, would be people of different nationalities and the Union would not succumb to the temptation of trying to evolve towards an unnecessary and counterproductive objective of statehood.

European identity should serve to guide the exercise of power at the European level, but without seeking to replace national or regional identities: these, European legal and economic discipline should help to refine and update. Neither does it make any sense to define who we are as Europeans in terms of opposition to other identities, such as the American or Muslim societies, to mention two recent temptations: it would be a mistake to foster outbreaks of continental nationalism.

Fulfilling what was expressed in the Treaty on the Functioning of the EU, namely that "[t]he citizens of the Union shall enjoy the rights and be subject to the duties provided for in the Treaties," is one way to strengthen European citizenship. For now, however, the treaties do not establish any real duties (Weiler 1999). We should devise different ways to strengthen Europe's citizens' sense of belonging. An initiative in this regard could be the creation of a European system of volunteers, going beyond the small steps that have been taken so far.

The aim would be to instil in the minds of Europe's next generation, who believe that the advantages of belonging to the Union are unrenounceable, a sense of duty so that they devote some time during their lives to the service of others in projects of a European scope. To this end, the Union could create a system to certify and recognize as "European service" the thousands of volunteer activities already underway in the 28 member states, and those of European origin being carried out all over the world.

To grant this recognition, the Union could request that European voluntary service be performed by teams made up of citizens from different countries, so that they might learn to work together in the service of their societies. The Union could also make a concerted effort to ensure that European voluntary service acquires prestige and includes a practical aspect through its acceptance, evaluation, and promotion by schools, universities, and employers.

The democratization of institutions and the support of citizens should help to avoid the distraction of producing constitutions, declarations of rights, and reflections based on a statist mentality in which we ask ourselves to what extent the Union should evolve towards a European federation. The essential hurdle to the project's unity, sovereignty, cannot be tackled directly through a constitutional amendment, but rather indirectly, through economic stimuli (which may fail, as in the case of monetary integration) and by legitimizing a new European public space through politics.

Each federal experience is different and the common features of federalism are few. Thus, there is no ideal paradigm or type of federation (Kalypso and Howse 2001). The Union already possesses some federal features that are unique and limited. First of all, its law is applied by European and national judges whose decisions prevail over national law. Also, its decision-making, largely based on the majority principle, applies both in the European Parliament and in the Council of Ministers. One can also speak of federalism with regards to its flexible distribution of competencies. Almost all the powers of the Union and its member states are shared, their actual extension being negotiable, day by day, by representatives of the states and the Union, as in any contemporary system of cooperative federalism.

The Union, however, is not and nor should it aspire to be a state-type federation, as it lacks social legitimacy and its citizens' direct loyalty. Some have proposed the formulation of a "two-speed Europe." The nucleus of such an effort would be dedicated to the economic governance of the common currency. However, political tensions between the two concentric circles, along with the threat to the integrity of the internal market and Community law, the two networks that create interdependence and European unity, would prevent this project from working (Piris 2011).[3]

The Union is already a legal federation based upon a political confederation. The Community model defines this organizational novelty and European policy: an institutional

[3] Jean-Claude Piris has formulated a non-federal, more realistic alternative to establish these "two speeds." But, ultimately, it fails to go beyond providing creative legal solutions to the challenge of strengthening the Eurozone with its own institutions and regulations.

and legal architecture created over the course of 60 years, with a dynamic combination of supranational and intergovernmental political elements under the growing influence of more technocratic decision-making, previously called "infranational" in these pages. It is true that redesigning the single currency calls for new elements typical of an economic federation: banking supervision, fiscal union, and mechanisms to ensure financial stability. But the Union of tomorrow must counterbalance this centralization with improved representation and accountability mechanisms, as well as with decentralization in areas in which European action is no longer demanded by the public.

A European Global Player

A third vector of the Europeanism of the future involves addressing the challenge, recognized for some time now, of making the EU a truly global player. One of the serious shortcomings of early Europeanism was its desire to make Europe an island of perpetual peace: the inhabitants of this island failed to observe its neighbors and understand globalization trends which exert competitive pressures on its welfare states.

Once again, the idea of dressing the Union as a superpower in anything that is not tailor-made must be ruled out. José Ignacio Torreblanca has called for a Union which acts as an introvert rather than an extrovert, perceiving that if we fail to undertake this transformation in a multipolar world, we run the risk of European irrelevance. Most of the problems to be faced by European society in the coming years will involve solutions designed and negotiated beyond our borders. We cannot allow others to make these decisions for us. The sum of just half of all European efforts, still uncoordinated today, in the field of economic governance, diplomacy, security, and defense, would be enough to achieve this goal (Torreblanca 2011).

European external action is usually analyzed on the basis of an assessment of European capabilities, an evaluation that emphasizes its lack of resources and institutions with political will. Typically added to the equation are the unilateral and insufficient actions carried out by certain states, which are incapable of resolving their problems, jealously safeguard their power as international players, and wax nostalgic about their past as world powers. The Union, however, has some important resources in both foreign policy and external action, though it must incorporate more and better national actors and processes into these tasks (Espinosa 2010).

A European process that coordinates and includes national stakeholders and better legitimizes European decision-making is needed. It is not only the EU's common

policies, but also its external action, which must be democratized in order to overcome its technical language, elitism, fragmentation, and lack of coordination.

The EU's most troubling shortcoming is its lack of foreign policy support through its security and defense policy, an area in which capacities and political will are clearly lacking. Its biggest advantage is the fact that public opinion demands more European external action. The potential of a Union not inspired by a state model to gain prominence as a global actor in the world is very great and, little by little, this decision-making should generate a sufficient European identity.

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The alternative to the renewal of the Utopian component of European integration is an increasingly debilitated Union marred by greater inequality between its states and greater public indifference towards its institutions and legislation. The Community of Law and the internal market, which have required so much effort to establish, may yield their pre-eminence to a set of intergovernmental agreements. This trend, prominent in the euro's redesign, is difficult to apply and, at the same time, very demanding with the reforms that debtor states are to undertake in response to European mandates.

Considering the divisions and tensions that would lead to a frayed Union in the medium term, it is necessary to redeem the central idea of integration as an ethical project whose primary purpose is to unite people. The path towards a new Utopia must be different from the first journey. Now, the Union must be reformed by placing emphasis on the material restriction of its powers, on politics and democracy at the European level, and on taking steps to make the Union an effective global actor. Using these three axioms as its foundations, it is possible to generate a new European ideal.

We can still learn, at the same time, from the organizational capacity and audacious long-term thinking of Jean Monnet. But the debate on how to pursue a new Union must be capable of engaging and inspiring not just the national and European elites, but also its citizens, transforming the European polis.

The task of building and propagating the new Europeanism is now up to a new generation, for whom membership in the Union is as natural as the digital world, sunsets, and the changing of the seasons. The European challenge of our time was well summed up by Goethe: "now you must prove yourself worthy of what you have inherited from your parents."

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ESADE

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ESADEgeo-CENTER
FOR GLOBAL ECONOMY
AND GEOPOLITICS

The objective of this book is to examine the global context within which European businesses operate, scrutinizing in depth how global and European politics, investment flows, and institutions affect these firms, and offering strategies adapted to these circumstances. Some of the questions studied include: How do global trends impact European firms, and is being part of the European Union a mitigating factor? How do today's political and institutional developments in Europe affect businesses there? How do investments flow across the globe, and where and how do they arrive and leave Europe?

With a first chapter written by Javier Solana, former European Union High Representative for the Common Foreign and Security Policy, this twelve-chapter volume is built up of original and applied research on these issues. This book was developed as part of a larger project, Mainstreaming EU Knowledge in Business Studies and Strategy (MEKBiz), funded by the European Commission and hosted by ESADE Business School, which aims to promote discussion, research, and teaching on EU issues. The project is part of the Commission's Jean Monnet Program within Erasmus+.

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