Introduction Arnoud W.A. Boot, January 31, 2008

Roundtable – How Dutch is the Dutch Economy: Challenges of Foreign Investment

In the ten minutes I have for my introduction, I will not dwell on the virtues of international capital markets, and international capital mobility in particular. To the extent we do not like it, it is a fact of life.

Foreign investments: nothing new

What type of foreign investments do we typically distinguish? The typical distinction is between real investments (foreign direct investment – FDI) and pure financial investments (loans, more passive portfolio investments in shares and bonds). FDI (foreign direct investment) is essentially buying control of foreign companies and/or the creation of new businesses with foreign capital. This has been looked at quite a lot in the context of developing countries. While, the benefits of this have been obvious (knowledge transfer, employment, etc.), some concerns have been raised about potential perverse effects such as foreign control of knowledge (potentially at the expense of local development), and financial engineering type leveraged transactions which could impose substantial risk on the country involved and allow foreigners to buy up assets with very little 'real' money. Surprisingly, these type of issues now start worrying developed countries. I will come back to this.

Financial investments have been discussed quite a lot in the context of stability, again focusing particularly on developing economies. In the extreme financial investments are considered 'hot money'. 'Hot money' typically involves rather short term oriented debt flows and portfolio equity investments. Such money can be easily withdrawn in the face of a crisis, and actually trigger such crisis.[1] As the Asian, Mexican and the Latin American debt crises have shown macro imbalances, weak institutional structures together with a massive dependence on 'hot money' can create significant instability. It is clear that the strong institutional structures in the Netherlands together with the current account surplus make us rather immune to the potential risks of 'hot money'. Portfolio equity investments are typically less destabilizing. These refer to for example investments in equity and bond markets.

Foreign control is key for discussion today

The discussion today is very much about the effects of control over domestic businesses by foreign investors. This is most related to the case of foreign direct investment sketched above, however more of a continuum has developed between FDI (which implies control) and investments in equity markets that may start out passively but can turn activist. This is indeed precisely what has happened at least in the public opinion: investors in the equity markets have become more vocal and seek influence (hedge funds) or buy up outright control (private equity). And next to this we have sovereign wealth funds that seem to behave more like passive investors in equity markets but may assert control via

[1] The typical argument goes that FDI, contrary to purely financial investments (loans etc.), cannot be easily withdrawn, and thus is more long term oriented.

investments in private equity firms and hedge funds; or alternatively their sheer size and growth, together with their already sizable minority positions in various businesses, make us wonder about what they might do next.

An issue is how important private equity firms, hedge funds and sovereign wealth funds really are. This is difficult to answer. Just looking at sovereign wealth funds, they look massive with up to 3 trillion Euro in total assets, but how important is this if total assets on the worlds' exchanges amount to over 160 trillion? And how to look at the issue of control. In the public opinion hedge funds are 'control hungry', but in reality virtually 99% of hedge funds are passive investors. Thus there is substantial nuance needed in interpreting the importance and positioning of these investors. Nevertheless, we do see a mobilization of shareholders and a more pronounced involvement.

If it comes to foreign ownership note that this is nothing new. The majority of shareholders in Dutch AEX companies is foreign. This is a fact of life. Actually, in this context it is interesting to ask the question what is a Dutch corporation? What we typically have in mind is to look where the headquarters are of the company, or where the company is incorporated. While having such headquarters here is undoubtedly of distinct value (i.e., lots of spin-offs, particularly in professional services), the physical presence of these large AEX companies for the country has diminished (their operations have become more international, outsourcing developments, etc.). So in terms of direct employment, for example, these companies have become much less important to the domestic economy. This is not meant to trivialize their importance, which would be wrong (particularly also considering the spin-offs), but does have a meaning. In particular, new business creation is becoming more and more important particularly for a country like the Netherlands.

Control issues more dominant in the Netherlands

I will now focus on particular threats to the Netherlands. As a caveat, I cannot emphasize enough that The Netherlands has always benefited from being an open economy and is a net-investor abroad. So more than others, we should applaud FDI.

Control issues may have become more of a concern to The Netherlands than elsewhere because of some rapid changes in the Dutch business sector:

- Opening up of the 'national establishment'. While it is tempting to define control along the ownership dimension, Dutch firms have become less 'Dutch-controlled' along several other dimensions. One of the most important ones is undoubtedly the nationality of the leadership in Dutch businesses. Only in the last few years we see their boards becoming more and more international. In a sense, Dutch business, while it had always been internationally oriented, was up to recently extremely parochial in their nationality of leadership. One could broaden this possibly: effectively a relatively small close knit group if individuals, the 'national establishment', was running the larger Dutch businesses.

- The Dutch corporate sector was protected with extensive legally oriented control measures essentially curtailing shareholder control (and solidifying control by the ‘establishment’). International developments (also at the EU level) have led to the dismantlement of these measures. However, Dutch businesses have a rather open shareholder structure which now makes it easy to buy control. This has made Dutch businesses very sensitive to control contests. That is, contrary to all other continental European countries, The Netherlands has little stability in the shareholder base of companies, meaning little protection offered by cross-holdings, pyramid structures and other ‘shareholder pacts’.

My interpretation of these changes is not that these were undesirable, rather the speed and openness of the country have made it difficult for business leaders to respond and adapt to the new realities. This offers also a warning against rapid policy responses. To some extent, we are going through a process of learning and readjustment to the new realities. Nevertheless, developments in this transition phase might be irreversible. To that extent, care should be taken. This particularly applies to irreversible changes in ownership of ‘sensitive industries’. I also envision the need to make some changes in Dutch corporate governance.

Some other issues, in part related to these changes described above, warrant special attention particularly for smaller countries:

- An immediate implication of the changes above, together with the largely foreign shareholder base of large Dutch corporations, is that these businesses will become less and less attached to The Netherlands. So we are by definition more vulnerable than others to ‘losing’ headquarters of large businesses.
- Other developments may add to this. In particular, the political dimension in international business will in my view only become more and more important. Global large businesses may benefit from being headquartered in larger countries. What I have in mind is, for example, that governments in large countries can lobby more effectively (e.g. Sarkozy going to China…).
- In any case, small countries depend more heavily on coordinated international policy responses.[2]

Policy issues

We can distinguish general issues and issues particular to The Netherlands. Let me be first discuss some general issues.

General issue: transparency

Yes it is important that there is greater transparency in private equity, hedge funds and sovereign wealth funds. It is very difficult to put these three groups in separate boxes however. For example, sovereign wealth funds invest via private equity firms and hedge funds. So if we are worried that their potential, but not proven, political agenda leads to distortive pressures, we should follow the ‘chain’ of their investments because they might be using a private equity fund for their political agenda. Obviously, this can never be solved perfectly. And, actually, sovereign wealth funds might be the least of a problem. That is, we know them, but what about all other investors that might or might not be

[2] An important exception is that small countries may benefit more from playing games with tax rates

acting on behalf of a country or another self-interested party with conflicting interests? This suggests that we should seek to address the issue of shareholder intend much more in general.
Just to defend sovereign wealth funds a little more: so far they have played an extremely helpful role. And if we really do not like them we need to get to more balanced current accounts in the Western world….

General issue: leverage

This is an important issue as well. Leverage has become a primary financial engineering tool throughout the financial world. The current debt crisis is just one example of the risks inherent in this process. I am open for suggestions how this should be dealt with in the context of the financing of corporations in general. I am not very optimistic on how to do this. Choosing an appropriate financial structure is a business decision. However, two things should be done:

i. Taking excessive and unwarranted risks is subjected to certain legal procedures. A Board of Directors has certain responsibilities in this respect. From a national perspective we can (and should) strengthen the position (and liability) of the Board of Directors, but preferably this should be done internationally since corporations can choose where to incorporate themselves.

ii. Leverage is subsidized by the tax authorities (deductibility of interest payments). Financial engineering has made this totally undesirable. Many private equity transactions that claim extensive deductibility of interest payments, do not involve 'real' debt. The debt is 'reengineered' equity. Such subsidy invites an irresponsible financial policy.

Other issues for The Netherlands

The key policy issue for national governments – including the Dutch government – is to redefine the scope of public policy. Designing effective domestic policies in a globalized world with globalized businesses is more difficult than in a closed economy. This is nothing new and we have already been confronted with this for a very long time.[3] However, the current reality makes it even more difficult.

Let me highlight a few issues:

i. "Sensitive industries". Define public policy objectives very clearly. Make a very clear choice on ownership. 100% government ownership in for example critical infrastructure might be important. In many cases however public policy objectives can be safeguarded ("geborgd") with legislation.

ii. Relatedly, the sustainability of hybrid organizations becomes more and more difficult. What I mean is that a clear distinction between public (often non-commercial) and private (commercial) activities is gaining importance. That is, make clear choices about

[3] For example, we have a long tradition in this country with giving workers' councils ("ondernemingsraden") extensive rights. In some companies (the so-called "structuurvennootschappen") we have given these councils the right to nominate non-executive board members. For multinational corporations with extensive foreign operations we cannot dictate such arrangements (and thus we have amended the legislation accordingly – weak regime 'structuurregeling').

what should remain in public domain and what can be relegated to the private sector. Anything in between is difficult.

More in general define the public domain. This is the core of national autonomy in a globalized world.

Final thought

The Dutch economy has been modernized enormously. Efforts that have been made should be applauded. But in my view, in many cases we have optimized within "our traditional system". And the question now is, whether the next leap forward requires changes in the system. More specifically, typical national arrangements (some with the private sector) become increasingly unsustainable. While we have made changes, in a sense optimized within the limits of the various Dutch models, we now need to ask questions about the models. This sounds abstract, 'Dutch models' of what? Depending on (political?) preferences everyone has probably his or her favorite example. My favorite example is the Dutch pension system which is an unique 'Dutch model' with enormous strengths. However, the model is not sustainable. This does not mean that we need to abandon it. No, for sure not. But rather, in stead of protecting 'the model', we should protect its strengths and accept that that might lead to a different model.