Introduction

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The creation of a single European financial market is an objective that, to a considerable extent and in a formal sense, has already been attained. By 1990 the European Union had abolished most restrictions on international asset holdings. This means that EU member states are obliged to allow residents of other EU countries and of third countries to own national 'domestic' assets. Firms, for instance, have the right of establishment anywhere in the Union. At the same time, restrictions on the national asset composition of private and pension portfolios have been lifted. The Maastricht Treaty, which came into force in 1994, elevated the principle of internal and external capital mobility in the European Union to treaty status.

Financial market liberalisation leads to a more international investment strategy on the part of institutional as well as individual investors. On the institutional side, we expect financial market integration to cause investment funds to allocate a larger share of their overall portfolios to foreign assets, inside as well as outside the euro area. Larger foreign shares in investment portfolios logically lead to larger shares of national assets being owned by foreigners. Hence, foreign ownership of all kinds of assets – including bank assets, government bonds and equities – is expected to increase with growing financial market integration. The logic of international portfolio diversification would imply that the foreign ownership of some assets – and exchange-traded securities in particular – could approach 100 per cent, at least for some of the smaller EU member states. This would be a startling outcome, and also one for which many policy-makers seem not to be fully prepared at present.

De jure financial liberalisation has contributed to financial market integration in Europe in several ways. Figure I.1 shows the evolution of the level of international financial integration for an aggregate of industrial countries and for a sub-aggregate of EU member countries between 1991 and 2001, using an index developed by Lane and Milesi-Ferretti

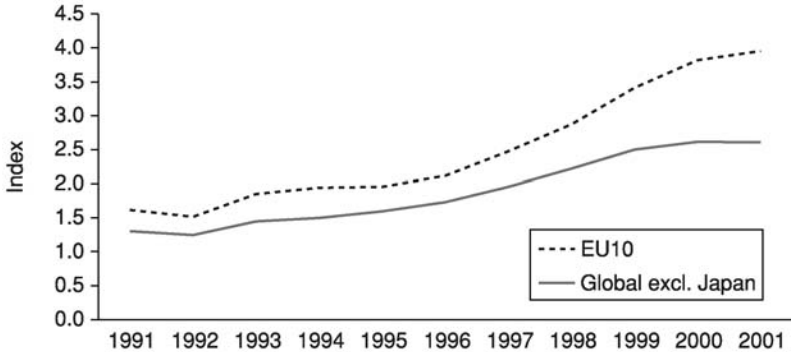

Figure I.1 International financial integration.
Note: The EU10 countries are Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Spain and the United Kingdom. The group referred to as 'global excl. Japan' consists of the EU10 countries plus Australia, Canada, New Zealand, Switzerland and the United States.

(2003).[1] This index measures the sum of foreign assets and foreign liabilities as a ratio of GDP.[2] Figure I.1 demonstrates a strong positive trend, with a marked acceleration from the mid-1990s onwards. EU member states demonstrate above-average levels of international financial integration.

Although it is masked by the aggregate data, there is considerable cross-country variation in the degree of international financial integration and the relative importance of equity versus debt components. Table I.1 displays the country data for the most recent year available (2001, but 2000 for Sweden). The data reflect high foreign ownership rates for several asset classes in Europe. For instance, the foreign ownership shares of the equity of non-listed firms for Western and Eastern Europe are calculated to be 19.2 and 44.2 per cent respectively in 2000, as reported in this volume. In comparison, the foreign ownership shares of the equity of exchange-listed firms in Western and Eastern Europe are calculated at 27.0 and 14.2 per cent respectively in 1997. In contrast, Cai and Warnock (2004) report a foreign ownership share of US-traded equity of only 5.4 per cent in 2000. Especially in recent years the foreign ownership of exchange-traded shares in Europe has increased significantly, with foreign ownership exceeding 70 per cent of exchange-traded shares in Finland in 2000. Price-based measures of financial market

[1] See also chapter 5 in *The EU Economy: 2003 Review* (European Commission, DG ECFIN, 2003).
[2] The membership of these aggregates is determined by data availability.

Table I.1. *Overall cross-border exposure – country data*

	Sum of foreign assets and foreign liabilities as percentage of GDP	Sum of FDI and portfolio equity assets and liabilities as percentage of GDP	Net foreign assets as percentage of GDP
Austria	3.2	0.6	−0.2
Belgium	6.6	2.4	0.6
Denmark	3.1	1.3	−0.2
Finland	3.6	2.0	−0.9
France	3.6	1.7	0.1
Germany	3.0	1.0	0.1
Greece	1.5	0.2	−0.4
Ireland	15.0	6.1	−0.1
Italy	2.0	0.5	0.0
Netherlands	6.7	3.1	−0.1
Portugal	3.3	0.8	−0.4
Spain	2.4	0.9	−0.2
Sweden	3.2	1.6	−0.3
United Kingdom	6.5	2.0	0.0

Note: Figures refer to 2001 for all countries apart from Sweden, for which data refer to 2000.
Source: European Commission, DG ECFIN (2003).

integration also point to increased integration in recent years. Money market and also government bond yield differences in the euro area, for instance, have narrowed since the advent of the common currency, the euro.

Financial market integration is expected to yield a range of economic benefits. Foreign direct investment (FDI) leads to a rationalisation of production as firms aim to exploit their firm-specific technological advantages internationally. The international application of best technologies by multinational firms should enhance labour productivity everywhere and ultimately lead to higher returns to capital and higher wages. Improved international portfolio diversification, in turn, helps individuals – and also countries – to attain higher welfare by smoothing consumption in the face of asymmetric or country-specific productivity shocks.

Financial market integration may already be yielding significant benefits in terms of higher productivity and more effective international risk diversification. Further gains will be realised in the years to come, as economic agents continue to adjust to the reality of international capital mobility. However, policy-makers as well as private agents need to adjust to realise the full potential benefits of financial market integration. In the days before capital mobility, countries determined their tax and legal regimes governing capital ownership more or less in isolation, neglecting open-economy considerations. These policies mostly affected the domestic owners of national assets, thereby limiting the potential for creating international policy externalities. In the last decade or so EU countries have experienced almost complete international capital mobility, which is putting the spotlight on the implications for foreign investors of national regimes towards asset ownership. In fact, some of the shortcomings of national policy autonomy in the tax and legal areas are now becoming apparent.

With increased cross-ownership of assets, part of the incidence of capital income taxation rests on the foreign owners of national assets. In other words, part of the corporate income tax can effectively be exported to non-resident owners. International ownership of assets thus introduces an incentive for countries to increase their corporate income taxes. Some economists predict that foreign ownership will reach high levels for small open economies in the future, and consequently that tax exportation could lead to taxation levels that are 'too' high. On the other hand, increased tax competition among member states may contribute to the opposite outcome — that is, taxation levels that are 'too' low. Recently, several member states have reduced taxes on capital income significantly. At present, it is unclear which of these opposing forces will dominate in the future.

A second policy-related problem stemming from increased financial market integration is that countries may be more inclined to excuse defensive measures against hostile takeovers. The reason is that with capital mobility, a bidder for a national firm is more likely to be a foreigner. Hence, defensive measures that effectively increase the agreed takeover price for foreigners may force foreigners to pay more to acquire domestic assets. Some aspects of corporate law can thus be equivalent to export taxes on the sale of national assets in their impact on asset prices. Such implicit asset export taxation may be rational from a national political economy perspective, but it may prevent efficient international mergers and acquisitions from taking place and hence be undesirable from an EU perspective.

Along similar lines, one may argue that the internationalisation of asset ownership may constitute a barrier to improved investor protection in the form of, say, improved information flows to investors and the guaranteed independence of company boards. The reason is that, for publicly traded companies, the management and controlling shareholders are often domestic, while foreigners are more commonly minority shareholders holding some shares as portfolio investments. In this scenario, improved investor protection will prevent domestic parties (i.e. management and controlling shareholders) from taking advantage of foreign parties (i.e. foreign, atomistic investors). In this instance, the gains to be reaped from improved investor protection will, to a large extent, accrue to foreign residents because stock prices will start to reflect the improved investor protection. Thus, the incentives for countries to improve investor protection may be reduced after a significant foreign ownership share of the common stock of exchange-listed firms has been established. On the other hand, there are strong reasons for countries competing for foreign capital to improve and maintain their attractiveness by offering a good corporate governance structure.[3] Thus, we would expect the future to tell us which of these opposing forces will be the stronger one.

It is possible to argue that the problems related to the tax and legal treatment of asset ownership may get worse *after* a substantial foreign ownership share has been established. This suggests that, ideally, countries should get their national tax and legal regimes in order *before* establishing full international capital mobility. However, free capital mobility has now been enshrined in the Maastricht Treaty, and hence policy-makers no longer have the luxury of discussing the optimal ordering of policy moves when considering financial market liberalisation. Rather, policy-makers today face the challenge of establishing a tax and legal regime governing asset holdings that is the proper one for the European Union as a whole in the face of free capital mobility.

In practice, we see considerable variation across EU member states both in terms of capital income taxation and in the areas of the law and corporate governance. This suggests that some countries may be able to institute better policies than others, perhaps by establishing and upholding an international reputation for the proper treatment of international investors. As indicated, tax and legal policies regarding asset holdings potentially have some inherently 'beggar thy neighbour' aspects, in that they may advantage domestic residents (either public or private) at the expense of foreign residents. This suggests that policies that are appropriate for Europe as a whole cannot be established by reputation building at the national level alone. Policy coordination at the European level will be necessary. Indeed, following the corporate debacles of Enron and

[3] This argument is stressed in chapter 5 in *The EU Economy: 2003 Review*, (European Commission, DG ECFIN 2003).

other firms in the United States, the European Union introduced a Corporate Governance Action Plan in 2003 aimed at improving corporate governance by strengthening shareholder rights through improving access to company information and facilitating voting *in absentia*. Also, the roles of independent non-executive directors and the board's accountability for the company's financial statements are to be strengthened. Similarly, coordinated policies to prevent excessive exportation of corporate income tax can be envisaged at some point in the future.

Judging from the above account, much has already happened and much is continuing to happen concerning the internationalisation of asset ownership in Europe. This volume brings together ten expert contributions that shed light on the significance and evolution of foreign ownership in today's Europe. It contains – in addition to this introduction – six 'horizontal' chapters dealing with a particular aspect of foreign ownership for several countries, followed by four country studies that examine a variety of aspects of foreign ownership for individual countries. The book is divided into three parts. Part I deals with the legal framework regarding foreign ownership in the European Union. It outlines the development of restrictions on foreign ownership in the Union and focuses on European aspects of takeover regulation. Part II is concerned with a range of recent developments regarding foreign ownership. These include how foreign ownership affects labour markets and corporate tax policies. Evidence on the extent of international portfolio diversification in the Union is also presented. Its ultimate impact on the smoothing of national consumption aggregates in the face of shocks to GDP is considered as well. Part III contains four country studies for Sweden, Finland, the United Kingdom and Italy. These case studies focus on several aspects of the process of asset internationalisation for the country in question.[4]

Part I The legal framework

A detailed account of the legal framework pertaining to foreign ownership of assets within the European Union is given in the chapter by Raes. His starting point is the Treaty of Rome, which established the free movement of goods, persons, services and capital when it came into force in 1958. However, progress concerning the free flow of capital

[4] The focus in this volume is on the internationalisation of asset ownership in Europe. Aspects of the evolution of ownership from a global perspective have recently been examined in the contributions in Mork (2005).

was slow. The full liberalisation of purchases and sales of financial assets and financial services did not become part of EU law until 1990. The Maastricht Treaty instituted full freedom for internal and external capital movements in the Union in 1994.

As described by Raes, the legal framework allows a number of exceptions to free capital movements, thus restricting foreign ownership. These restrictive measures are based on Community laws, on agreements between the Union and individual member states, and on the Organisation for Economic Co-operation and Development (OECD) and General Agreement on Trade in Services (GATS) frameworks. Restrictions on the free flow of capital may, according to Community laws, be based on several grounds, 'general interest' considerations being perhaps the most pertinent to current policy-making. Under this heading we find a set of nationally applied techniques to prevent or reduce foreign ownership, such as 'golden shares', limits on share voting rights, veto rights concerning mergers and acquisitions, etc. Raes also deals with third-country restrictions adopted by the Community, and with international cooperation concerning capital flows. Finally, he notes that the abstract rules of the Maastricht Treaty are being clarified by crucial decisions by the European Court of Justice. Thus, case law is currently in the process of evolving in this field.

Barriers to international takeovers that one member state considers to be in the 'general interest' may stand in the way of the restructuring of corporate Europe – a process that is commonly deemed necessary to improve overall production capacity. The legal barriers to such a restructuring have become more glaring since the introduction of the common currency and the elimination of across-the-board capital controls. The solution appears to be an EU directive on takeovers.

In their chapter, Berglöf and Burkart point out that large differences in corporate governance among EU member states, in particular between the UK system and those of Continental Europe, have made it difficult to establish pan-European takeover directives. Attempts by the European Commission to get legislation passed by the European Parliament failed in 2001.

To get things moving again, the Winter Group, set up by the European Commission, examined these and related issues in a set of reports published in 2002.[5] The Winter Group advocates more contestability of corporate ownership and a more level playing field for takeovers by suggesting a mandatory bid rule and a break-through rule. The latter rule is to enable a bidder who has achieved a qualified majority of equity

[5] See European Commission (2002) – 'the Winter Report'.

to overcome statutory defences, including any differentiation of votes. This break-through rule proved controversial and was subsequently dropped from the Commission's draft directive on cross-border mergers. In the final directive the break-through rule and the defensive measure provisions were reinserted, but as optional items.

After describing the prevailing systems of ownership and control in Europe, Berglöf and Burkart make an assessment of the impact of various proposals for pan-European takeover rules, based on a survey of empirical and theoretical work on corporate governance and on takeovers. Here they identify a number of trade-offs and inconsistencies. In short, every step towards a common system will impact differentially across the member states due to differences in initial conditions. In their conclusions, Berglöf and Burkart stress that existing corporate governance structures in Europe have evolved into complex and interdependent systems. We should not expect the search for a common system to be an easy one. They suggest that national as well as EU takeover regulation should aim primarily at improving transparency as a way of fostering corporate governance in Europe.

Part II Recent developments

Firms engaging in FDI combine international technology and product knowledge with local labour. Thus, FDI can be expected to affect national labour markets. Indeed, one major potential benefit of inward FDI is improved labour market opportunities for local workers. Scheve and Slaughter set out to evaluate the impact of inward FDI on European labour markets in their contribution. After reviewing recent trends in US foreign direct investment in Europe, they conclude that it is unclear whether multinationals increase the relative demand for high-skill labour in host countries. There is substantial evidence, however, that multinationals pay higher wages, even after controlling for plant characteristics such as plant size. This wage premium may reflect higher worker productivity due to the superior technology or business practices used by multinationals. Alternatively, multinationals may pay higher wages due to greater job insecurity.

Scheve and Slaughter argue that multinationals that operate in more competitive international markets may display a relatively elastic labour demand that at the same time is subject to shocks in the international market place. As a result, local labour market outcomes at foreign-owned plants may be more variable. Indeed, they find that worker insecurity in the United Kingdom, as perceived by the workers themselves, is positively correlated with the FDI share in their industry of employment.

As evidence of international rent sharing, Scheve and Slaughter further discuss the finding that worker compensation at foreign plants appears to be influenced by a multinational's worldwide profitability.

A second major advantage of FDI is that multinational firms contribute corporate income taxes to national treasuries. In fact, high rates of foreign ownership in local firms may provide countries with an incentive to impose relatively high corporate income taxes, as part of the corporate income tax burden is effectively exported. In their contribution, Denis, Huizinga and Nicodème report some evidence that foreign ownership and effective rates of corporate taxes are indeed positively related across Europe. The positive impact of foreign ownership on taxation may have prevented a 'race to the bottom' in corporate income tax rates in Europe so far. It may turn into a challenge for policy-makers if foreign ownership rates continue to increase in the future. For the year 2000 the average foreign ownership share in Europe is reported to be 26.7 per cent for firms without an exchange listing. There are reasons to expect this number to grow in the future.

Denis, Huizinga and Nicodème also present some evidence on the determinants of the foreign ownership of non-listed equities. Among these determinants are indicators of the quality of a country's corporate governance and of its rule of law. Specifically, foreign ownership rates appear to be higher in countries with weaker investor protection. The reason may be that multinational firms – subject to relatively high-quality home-country investor protection standards – have a comparative advantage when operating in countries with lower standards. The tendency for countries with weak shareholder protection to attract high rates of foreign ownership may provide these countries with an incentive to improve investor protection in order to avoid completely losing control over their private sectors.

The mirror image of the internationalisation of national physical assets is the internationalisation of investment portfolios. Adjaouté, Danthine and Isakov ask whether the investment portfolios of Europeans are now better diversified than they were five or ten years ago, and whether trends towards increased international diversification have been accelerated by the advent of the euro. The evidence they present points towards some favourable, if modest, changes. The elimination of currency-matching requirements within the euro area has certainly led institutional investors to increase their holdings of international securities. This has been accompanied by a strong convergence of yields on EU government securities.

Similarly, there is evidence that equity risk premia across European stock markets are converging. For firms in countries with hitherto high-risk premia, this convergence has brought a reduction in the cost of equity capital. The introduction of the euro is reported to have led to a shift in the investment strategies of European equity investors from focusing on country portfolios to focusing on Europe-wide industry portfolios. Such a paradigm shift makes sense if the introduction of the euro has significantly reduced the country-level risk associated, for instance, with national currencies. The authors do, in fact find some evidence that in recent years a strategy of combining industry portfolios could have performed better than the old method of weighing country portfolios. An exclusive focus on industry risk, however, would leave some opportunities to diversify risk internationally unexploited, even in the current euro area. Changes in investor behaviour and asset price formation have so far not led to a strong correlation of consumption growth rates across European countries. This suggests that significant progress can still be made in asset diversification in Europe.

Kalemli-Ozcan, Sørensen and Yosha examine in detail whether the recent rise in financial integration in Europe, including cross-border holdings of financial claims and cross-border ownership of firms, has contributed to risk sharing and consumption smoothing. They start from the fact that capital markets allow individuals as well as countries to separate production (output) and consumption decisions. Hence, in principle, capital markets can provide a mechanism for risk sharing, or 'macroeconomic insurance'. In line with this, the authors explore empirically the extent of risk sharing within the European Union through net factor income flows – being the difference between GDP (the value of the aggregate production within a country) and GNP (the value of aggregate production owned by residents of a country). Their econometric tests for the EU member states show that, in most recent years, financial integration across member states has buffered asymmetric shocks in a way identical to the pattern reported for the United States. Furthermore, risk sharing is rising in the euro area, although it is far less pronounced than in the United States. They expect this rise to continue in the future.

Finally, turning to policy conclusions, Kalemli-Ozcan, Sørensen and Yosha recommend measures to foster financial integration within the European Union. Such measures will lead to improved risk insurance, thus facilitating adjustment to country-specific shocks in the Union.

Part III Country studies

This part presents case studies of the evolution and impact of foreign ownership in four European countries: Sweden, Finland, the United