ISSA 12 EU Expansion - Impact on the European Capital Markets

Prof Dr Norbert Walter
Deutsche Bank AG

[Slightly edited transcript, prepared by the ISSA Secretariat]

Ladies and Gentlemen

Almost everyone of you, being part of an international audience, sees Europe from a different perspective. Some of you are sitting in the middle of it, others at the periphery, others again are looking at it from outside, from close by or from far away. It might be very difficult for you to understand my passion for Europe. Indeed, it is a very personal one. I am turning 60 this year. I am the first in my family who lived through two generations of peace, partnership and prosperity. And this is only because Europe has learned to become Europe, rather than a collection of nation states. My two grandfathers turned 25 and 27, respectively. They both are buried in Verdun. My father was fighting with weapons in France and in Russia. My generation is the first one that benefited from a development that too few people today appreciate for what it is. So, that is my very own background and it will resonate within me forever.

2004 is a very important year for the European Union. The EU enlarged from 15 to 25 member countries. The appetite of countries in the region which are not yet in the European Union, is big enough to easily predict that, by 2010, we will be a club of 30.

The extension this year was important in terms of numbers and quality. Finally, those countries which always belonged to Europe both in terms of culture and economic orientation, but which were separated by ideology, are now coming back. The countries which joined this spring, are quite large in terms of geographical extension, and the population that was added - some 80 million - is also quite substantial compared to the 350 million we were before.

The new countries, since they were deprived from taking part in the division of labour for fifty years, did not develop. However, they were not developing countries. Their income resembled that of developing countries, but in all other respects they were not. Socialism can be blamed of many things, but not of neglecting the education of the population. However, educating the people was the very underpinning which led to the overcoming of the system. At the end of the day, if someone can think and act independently, based on investment and human capital, that ends the collectivist system.

The GNP contribution of the new member states is quite minimal, they enlarge the EU pile by about 5%. Being integrated into Europe is not terribly important economically for the big countries in Western Europe, nor for the world at large, but it is absolutely crucial for the countries concerned. It may be difficult for other world regions to understand why we would then care so much about a population of 80 million. The reason is simple: It is their homecoming.

I will address the following points in my remarks:

- I will look into the status quo and give you a few numbers - not many;
- I will ask what has to be done;
- I will discuss the euro as one of the instruments to integrate the capital markets;
- I will look at the role of the banking sector, the bond and stock market; and finally,
- I will touch on the future financial supervisory and regulatory structure for Europe.

Foreign direct investment

The prospect of EU membership already meant something during the period when it was a perspective only. The perspective alone had significant implications on the integration of the financial markets. The most obvious and important case was foreign direct investment. The target region, size and quality of direct investment was guided by the perspective of a country becoming a member of the EU. Portfolio investment, by contrast, is far less developed and shows considerable differences from country to country in Central and Eastern Europe.

Another important factor, before the joining of the applicant countries, was what happened in the banking sector. The banking sector in Central and Eastern Europe today, does not resemble anything of what it was ten years ago. A revolution happened. The share of foreign ownership of banks in the region is astounding and unique.

Two thirds of the net capital inflow in Central Europe was foreign direct investment. This was the driver of the integration process. It meant that the financing was very stable over time and that helped a great deal to allow those countries to run considerable current account deficits. That in turn meant that they could modernise and invest, to a degree and level that would otherwise have been absolutely impossible.

When talking about foreign direct investment it is very important to recognise that it is not only about capital. Along with foreign direct investment always comes the transfer of management know-how, and access to the networks of those companies which invest in Central and Eastern Europe. Their know-how and networks were made available to the new production locations almost over night. All of a sudden, those countries were hooked up, via their Western investors, to the division of labour around the world.

There has been a slowing down of foreign direct investment in 2003, and there was a debate on whether that trend would continue despite the accession of those countries to the Union. At the moment, those worries are rather fading.

The level of foreign direct investment in Central and Eastern Europe, compared to the target countries' own GDP, is very high. For instance, the level in the Czech Republic, Hungary and Estonia, in percent of their GDP, is higher than that in China. Lithuania and Slovakia come quite close. In a worldwide comparison, only Brazil and Chile have higher levels. In Chile, for instance, it is 70%. So far, the principal investors have been the large Western companies. Small and medium sized companies have remained on the on the sideline. Now with EU membership, that segment is expected to become more active as well. The smaller companies start to realise that travelling from Berlin to Poland takes less than an hour.

The integration of the banking landscape has been particularly high. In the Czech Republic and Hungary, the percentage of banks under foreign ownership is 85%, the same applies to Estonia and Lithuania. In Poland, which is the largest of the new countries, it has reached 70%. This set-up has large implications. It means that those countries' banking institutions got Western standards overnight. In Germany, we still have a state sector in retail banking that is close to 50% and the German Social Democratic Party staunchly defends that position and does not listen to any advice from Brussels. Against that, the Central and Eastern European development is very bold indeed. It is something we should at least respect, if not admire. It has helped to stabilise the system. Most probably, it will help to make the capital allocation process very efficient. The precondition of course was a strict policy to privatise the banking sector.

Portfolio investment

Portfolio investment in the Eastern part of the European Union is not as integrated and not as relevant as of yet. Portfolio investment, measured in percent of GDP, is only significant in Estonia and Hungary. It remains below 1% in all other countries. However, the trend is positive and there are processes that expedite the trend.

There are countries that have been extremely reliable in terms of debt service, like Hungary. In the last few years, bond yields worldwide went down dramatically. For many years, generations of bond dealers were used to yields of 7% and more. With this perspective gone in the mature markets, they began to look around for new investment opportunities. They found for instance in Hungary a reliable country offering yields that contained a large spread over yields in Germany, namely about 4.5%. That counts when people are hungry for yield.

The question is how the portfolio investment process will develop. I would not exclude that it will be a bumpy road. Until last year, everyone expected that all new countries would adopt the euro as soon as possible after joining the Union. As we see today, there is some hesitancy on the part of the new countries. Not everybody is convinced that the euro is as good an idea as it seemed before. The crucial institutions of Western Europe, including the European Central Bank and academic circles argue as well that countries should not join Euroland too early. Doing so would take away one instrument of flexibility which is now still in their hands. After this discussion emerged, the convergence process which was in full swing until last summer, with ever more stable exchange rates and interest rates in the applicant countries converging towards the very low level of Western Europe, came to a halt and has even reversed in some cases. Right now the international analyst community is again looking into the specific merits and characteristics of each country, judging whether or not they are still on a convergence course.

I personally believe that the majority of the new countries would be best off, if they joined the euro very soon, i.e. by 2007 or 2008. Those few which do not have a stability culture yet and are not capable of developing one soon, may join later but they should not postpone that move beyond 2010. I am aware that my view is generally not shared in those countries, nor in the ECB, nor in Western academia. There is one exception: The political leadership in Poland, many members of which are US-educated, made the decision to join Euroland as soon as possible.

There are countries which have more difficulty to join by 2007. For instance, Hungary does not have the stability culture required yet. They do not have the cost discipline yet that is in line with Western Europe and therefore, having the same currency as Western Europe would mean that Hungary would run the risk of becoming non-competitive quite soon. On the other hand, I would advise the three Baltic states, the Czech Republic and Slovenia to take the leap soon.

In the European Union, everyone has to subscribe to the full liberalisation of the capital markets and capital flows. Most Central and Eastern European countries have actually done that already. Liberalisation of course implies that you get a more mature financial market soon. The flip side of the coin is that you become much more vulnerable with respect to interest rates and exchange rates. Therefore, not only does this new regime necessitate a sound economic policy. It necessitates that you have stable political circumstances, which is not yet the case everywhere to the same degree. Many of those countries saw a change in government and of the basic political orientation every four years. Each time a left wing government comes to power, the financial markets worry that the country will take a turn towards capital redistribution. If a conservative government comes to power, they fear that market protection will emerge. So we have constant uncertainty, which makes it difficult to pursue a long term policy. On the other hand, it was quite amazing to see how straight the policies towards integration in Europe were actually maintained throughout the tenure of many governments.

Not everyone will be on board of Euroland by 2007 or 2008. In some cases in will certainly take until 2010, perhaps longer. It is very obvious that, for the bond and stock markets in the new countries to reach a maturity that compares reasonably well with that of Western Europe, let alone the US, will take a long time. And we yet have to find out how long it will take in the new countries to meet the requirements of the Financial Services Action Plan, which the old members of the European Union achieved only just now.

The euro

Nobody can be in Euroland sooner than two years after accession to the EU, because each state has to be a member of the European Exchange Rate Mechanism (ERM) for a full two years without tensions and without enforced devaluation of its own currency. The candidates must also meet the other convergence criteria of Maastricht.

The Maastricht Convergence Criteria

The convergence criteria were the five conditions set that countries had to meet if they wanted to take part in full economic and monetary union. They were:

1. Inflation:	**No more than 1.5% above the average inflation rate of the lowest three inflation countries in the EU**
2. Interest rates:	**The long-term rate should be no more than 2% above the average of the three countries with the lowest inflation rates**
3. Budget deficit:	**No more than 3% of GDP**
4. National debt:	**No more than 60% of GDP**
5. Exchange rates:	**Currency within the normal bands of the ERM with no re-alignments for at least two years**

Their government debt has to be below 60% of GDP. Practically none of the applicant countries run into trouble with their debt level. The bigger problem is the deficit to GDP ratio where some countries are very considerably above the 3% level, some as high as 6%. Hungary is a case in point.

In a number of cases, the countries have difficulty fulfilling the Maastricht criteria because so far they have not yet developed a bond market with maturities long enough to talk about a long term interest rate. That is something that needs to be looked into and that implies the development of the micro economic structures of those capital markets. And finally, it is the inflation criterion. No country may enter Euroland with an inflation rate higher than 1.5% above the Euroland inflation rate, which is about 2% right now. That means an applicant must reduce its inflation rate to below 3.5% which might be quite difficult for a country like Hungary.

So, the deadlines are not fixed. They are dependent upon the achievements of the countries that already have made it into Euroland. Our educated guess today is that by 2007, Estonia, Lithuania, Slovenia and Cyprus will be on board. We assume that the Czech Republic will be on board shortly thereafter; its particular obstacle is the high budget deficit. Slovakia and Hungary may not make it on a number of fronts, and the fact that they have major elections in 2005 does not make their situation any easier.

Euroland consists of only 12 of the 15 old EU members. Denmark, Sweden and the UK are "pre-ins" in the old club. The very fact that the perspective of these three "pre-ins" not to be on board anytime soon, makes the convergence effort and the convergence possibilities of the applicant countries more complicated. While two of the three "pre-ins" (Denmark and the UK) have got a special clause allowing them to legally stay out, none of the new members of the EU will get any such special treatment. They will neither get any "discount" for admission, nor will they get any permission to stay outside. Whenever they fulfil the criteria they will practically be forced to become members of Euroland immediately. The same would apply to any future applicant countries as well. This is important to know.

A few countries, the Baltic states for instance, have pursued an economic policy that involved managing their currency according to a currency board system. They used the German Mark as their anchor currency for as long as it existed, and the euro after it came into existence. For them to now join the ERM is a step backward. They have already had more fixed relationships to a currency system than they will have during the initial phase to prepare for Euroland participation. That is an almost stupid system but, since the European Central Banks and other relevant institutions in Europe do not like exceptions, the way towards adopting the euro for those countries is not open to negotiation. They cannot factually introduce the euro by taking a shortcut.

There is one more issue I want to address with regard to the euro: What should the conversion rate be for the new countries with which to join the system? What is a fair rate, who identifies it?

At the end of the day, it is the Council of Finance Ministers that sits together and fixes the rate. Of course, they would want to see exchange rates that are acceptable to both the markets and the politicians alike, and if there are no tensions, there is no difficulty to do that.

But we have seen on occasion, that politicians do have special interests. If you come from a country with a high inflation rate, you may be interested in buying stability, by choosing a certain exchange rate. In this case, you would pick a relatively high exchange rate to go into the system. If you do that, you may find yourself with a problem the UK found itself in, in 1992. Probably that is not wise. The alternative is to choose an exchange rate that makes you extremely competitive so that your country's goods and services sell easily in the new markets and you quickly win a substantial market share. By doing so, you would gain momentum in your economic growth rate. You would do that if you felt that nothing else helps you more in gaining momentum in employment and growth.

Since the new countries are so small, it is not terribly exciting for the other side to worry deeply about the appropriate rate. Factually, it is up to the acceding countries to pick a rate they feel comfortable with. That is very different from the first wave of Euroland members where the question of the "right" rate was a very important one, and a highly political issue. I am amazed at how little politicking takes place today about this issue. There is almost no discussion. We probably ought to give it a little bit more attention. With hindsight, many experts believe that the cause of the difficulties Germany faces today, may be that Germany joined the euro system with too high an exchange rate. I do not personally share that view. However, it is certainly sound advice to think "ex ante" - before the event, rather than after the event.

The European Central Bank

A few words about the European Central Bank under the new circumstances: The ECB today is a club governed by a Governing Council which consists of six members of the Executive Board (also called "Directorium"), and as many governors of national central banks as there are members of Euroland. Today we are twelve, so today's council is twelve national central bank governors and six members of the Executive Board. If the rules remained unchanged, and every new member would add its national bank governor, then the relationship between the Executive Board and the central bank governors would keep changing in favour of the latter. In other words, the periphery would gain at the disadvantage of the centre. I believe that this is not an ideal recipe for formulating a sound monetary policy at the European level. We have to look into new ways for appointing a Governing Council under the prospect of having 25 members of the European Monetary Union by 2012 or so. We have not found the answer so far. We have looked into the model of the Federal Reserve in the US, there are other models as well. In my opinion, we should not insist on a system where each and every nation is represented in the Governing Council. We need a council whose composition is based on the professional quality of its members, not on their passports. But getting there will be a long process and I believe that, for an interim period, we will be left with some US Federal Reserve-type system. A recent proposal by the ECB points into that direction. The disadvantage of the proposed system is that it is very complicated and thus may appear intransparent. And Germany and France would be very unhappy about it, as they would not be permanently represented in the council anymore. That would be something they have great difficulty to live with.

The banking systems in the applicant countries

The banking systems in the applicant countries are still rather underdeveloped in comparison to the Western European countries. The total assets of the banking sector in relation to GDP in Western Europe is 250%. In countries like Lithuania it is not even 30% of GDP, in Poland less than 50% and even in the most developed ones, like in the Czech Republic, it is only a figure in the area of 90%. This indicates that the financial market development of Central and Eastern Europe is way behind hat of Euroland; and even Euroland itself cannot boast a very well developed financial system.

Further development is therefore necessary. It is very obvious that the new member countries got a fresh start. The extent of foreign ownership represents a very good basis indeed, but there is a lot still to be done. Where? For instance in the retail bank business. In Poland, only two out of three people have a bank account. With the communist past, very few people ever had a chance to get a loan. So, consumer loans and mortgages are business lines where huge growth can be expected; we estimate double digit annual growth rates for the foreseeable future. A third, very important sector for growth, is old age provisioning. Central and Eastern Europe suffers from the same demographic problems as Western Europe. But the new member countries generally have no state pension systems. So, funded private schemes are important and have to be developed. Corporate loans for small and medium sized companies also offer a great potential. It is obvious here that the banks are in difficult territory, since those companies do not have an established track record. The banks yet have to develop sound systems on which to base their pricing. Circumstances call for high risk premiums and that implies that there is difficulty to get this business off the ground. It would not be realistic to expect quick jump starts in this field.

I mentioned before that bond and stock markets are even less developed. Their average market capitalisation across the region is 16% of GDP while the average market capitalisation in Euroland is 72% of GDP. This gives you an idea of the size of the gap. In many cases, the first issuers in this market will be companies coming from the West. Most of those do not need initial help, they are already part of the international capital market. They could place new issues in Central and Eastern Europe to fund their activities in those new markets, on the basis of already developed institutional set-ups.

Financial regulation

Obviously, capital market regulation in the new member countries is designed and developed according to Western European institutional and regulatory standards. The European Union is providing the design. The question is: Are the new countries capable at all of implementing these rules and regulations? The answer is that they are only able to do so if we are willing to help them to set up the necessary services. Becoming compliant absorbs much of their resources. Many of the applicant countries had difficulties to translate the *Acquis Communitaire* - the rules the European Union already processed and they had to accept when joining it. That project alone used up virtually the full translation capacity of those countries for four years. Today, we struggle for example to find Maltese translators for the European Parliament or for the translation service of the European Commission. All available translators are fully absorbed with these tasks, and we have not even started on the financial regulatory work. This will just add to the burden of the very same people. Also, those countries simply do not have the tax accountants and compliance officers like we do in our institutions. We should be aware that it will take quite some transition time to allow them to catch up in this process.

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Concluding remarks

European Union enlargement and capital market integration is in full swing. It is a process with considerable potential and of huge importance for the new member countries. It is certainly a job for us, the more mature countries, to help them complete the process. At the same time, being part of the process opens up opportunities for us. We can partially benefit from the profits the providers and consumers in the new markets derive from the integration process.

Not everyone will be on the same track. Integration will be a staged process, some members will come on board earlier, some later. But for sure the process is totally irreversible and it will extend beyond the 25 countries quickly. In 2007 or 2008, Rumania and Bulgaria may have joined, Croatia may also join before 2010. Europe is a construction site. It is fun to be on a construction site. Of course, not everything runs always cleanly and smoothly when work is in progress. There are frictions and rumblings but there are opportunities at the same time.

One final remark: While studying all that, we should not lose sight of the global dimensions of this process. Therefore I would like to mention to our Chinese friends: all the addition to Europe is not even 10% of your population. So, let's not lose sight, particularly we in the business world should not lose sight. We should always consider the dimensions of new markets and put the expected opportunities in the right perspective.

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