

ENTER THE EURO -

International capital markets prepare for a reconfiguration

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The birth of the euro in the format of a hard currency has been hailed as an event without parallel in the modern history of the world. After a three-year period of operating as a recognised world currency for non-cash transactions, euro banknotes and coins were put into circulation for the first time on 1 January 2002.

It is seldom indeed that the world can witness an event of such profound significance: philosophers, historians, politicians, business leaders, bankers and economists have all shared in the wide-ranging commentary on the new euro.

Peace dividend

From a philosophical perspective, the euro may be regarded as a dividend that has resulted exactly 50 years after six European countries established a post-war community aimed at avoiding the potential for armed conflict. The European Coal and Steel Community (ECSC) entered into force in 1952 under the strong leadership of Adenauer (Chancellor of West Germany) and Schuman (Foreign Minister of France).

The aim of the ECSC was to pool French and German coal and steel resources in such a way that war between the two countries would thereafter be virtually impossible. Various subsequent institutional structures were put into place in Western Europe's quest for peace and the promotion of economic and social progress, culminating in twelve countries sacrificing a piece of their sovereignty to become the world's largest region with a uniform currency

It will remain a glowing tribute to the euro area that its common currency was, *ad initio*, essentially a peace initiative. In his Nobel Peace Prize address of 1954, Albert Schweitzer made a passionate plea for the world to prevent the horrors of the two first world wars. He saw the solution in a somewhat utopian resurgence of the spirit of humanitarianism, based on ethical values.

In the course of Schweitzer's dissertation, he disagreed with the broad view of Immanuel Kant, who, in his *Perpetual Peace*, had envisaged a period in which democracy would replace monarchy and where formal institutional arrangements between nations would be able to prevent war.

Fifty years hence, the views of Kant seem to have been vindicated by the events surrounding the launch of the euro, at least in societies that have achieved a certain level of socio-political and economic progress.

Economic muscle of the EU

Although the United States of America (US) boasts a larger level of total output than the European Union (EU), the fifteen EU countries represent, by far, the world's largest single trading market. The value of total EU imports in 2001 is estimated at \$2.6 trillion, almost twice the figure of \$1.4 trillion for the US.

In terms of gross domestic product, the US produced an estimated \$10.4 trillion in 2001, compared to the EU's \$8.6 trillion. In population terms, the EU market is significantly larger than the US (378 million people, compared to 287 million people) but the US enjoyed a higher per capita GDP in 2001 than the EU (\$36 000, compared to \$23 000). Table 1 compares the GDP per capita of the US to the figures for the EU member states (excluding Luxembourg).

Table 1: Per capita incomes – EU and US (2001)	
Country	US \$ '000
US	37
Denmark	34
Ireland	30
Sweden	28.5
Netherlands	27
Finland	26
UK	25.5
Belgium	25.5
Germany	25.5
Austria	25.5
France	24
Italy	21
Spain	16
Greece	12
Portugal	12

Little doubt exists that the euro is the only currency in the world capable of challenging the US dollar as the barometer of international capital market activity. The ease with which the euro was introduced as a non-cash currency and the subsequent increase in the demand for euro-denominated capital market transactions have already combined to guarantee the euro's position as the world's second-most influential currency.

Add to this the future scenario of thirteen new candidates for accession to the EU, and it appears inevitable that the euro will, one day, eclipse the US dollar in terms of financial and economic importance in the world economy.

Table 2 depicts the value of output of the current EU member states for 2001 (excluding Luxembourg).

Table 2: Value of output – EU (2001)	
Country	US \$ billion
Germany	2 060
UK	1 470
France	1 420
Italy	1 200
Spain	630
Netherlands	430
Belgium	260
Sweden	240
Austria	210
Denmark	180
Finland	140
Greece	130
Portugal	120
Ireland	110

Balancing integration and sovereignty

Arguably the most strategic success of the EU over the past sixteen years has been the establishment and fine-tuning of a single market. What has been particularly remarkable, is the ability of the EU to pursue its aim of integrating national economies in such a way that national identities have been preserved.

Since 1985, the EU formally established a European dimension to the way in which its 15 member countries conduct their economic affairs. This integration has also cautiously entered the political arena, but care has been taken to preserve the rich diversity of culture, language and tradition of the different European communities. In this process, the EU often used the slogan “The new structures that are being built do not lead to the destruction of the old”.

Table 3 depicts the sequence of events throughout Europe’s post-war history that has led to the institutionalised European Union of 2002.

Table 3: The Road to the Euro	
DATE	EVENT
1952	European Coal and Steel Community (ECSC) enters into force (Belgium, France Germany, Italy, Luxembourg and the Netherlands)
1958	European Economic Community (established by the treaty of Rome) enters into force (same countries as the ECSC)
1973	Accession of Denmark, Ireland and the United Kingdom
1981	Accession of Greece
1986	Single European Act establishes a single market. Accession of Portugal and Spain
1990	Stage one of Economic and Monetary Union (EMU) in the European Community (dismantling of barriers on the flow of capital)
1992	Formation of the European Union
1994	Stage two of EMU (aimed at monetary and fiscal stability and convergence)
1995	Accession of Austria, Finland and Sweden
1998	Formation of European Central Bank (ECB)
1999	Stage three of EMU (introduction of the euro and the transfer of monetary competence to the eurosystem – comprising the ECB and the national central banks of the participating countries)
2002	Introduction of euro banknotes and coins and replacement of the national currencies in the euro-zone (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain)

Key to the successful creation of a single market was recognition of the principle of subsidiarity, where decisions are taken at the closest possible level to the citizen. Another factor in the EU's success has been a powerful demonstration effect, with citizens enjoying increased freedom of movement, experiencing increased consumer and investment choice in the range of goods and services available to them, and witnessing the expansion of prosperity to all the regions of the EU.

A new political economy

History has shown that the transfer of powers from individual states to a supra-national body does not necessarily guarantee a benevolent result. In the case of the euro-zone, the intentions behind its creation are clearly based on the principles of the new political economy, essentially characterised by deregulation and the strengthening of markets.

In this process, a remarkable degree of macroeconomic convergence has taken place with regard to most major indicators, including GDP growth rates, inflation, balance of payments flows, interest rates and fiscal deficits. In fact, five EU member states boasted budget surpluses in 1999, as illustrated by table 4.

Country	%
Ireland	2.8
Denmark	2.2
Finland	1.9
Luxembourg	1
Sweden	0.3
UK	-0.7
Netherlands	-1.3
Belgium	-1.3
Spain	-1.8
Portugal	-2
Germany	-2.1
Austria	-2.2
Italy	-2.2
France	-2.4
Greece	-2.5

Until recently, European countries were often criticised for replacing national protectionism by a pan-European protectionism. Information released by the Organisation for Economic Cooperation and Development (OECD) confirms that the EU is making progress on reducing the subsidies it pays to its agricultural sector. The latter issue has long been a bone of contention for farmers in developing countries, who argue that EU countries (and the USA) deliberately provide an unfair advantage to their own agricultural sectors – one of the relatively few areas where developing countries do possess competitive advantages.

According to the OECD, the average annual agricultural subsidies in the US amounted to \$68.2 billion in the years 1986 to 1988 and \$96.3 billion between 1998 and 2000. This represents an increase of more than 40%. The comparable figures for the EU were \$111.1 billion and \$119.2 billion, an increase of only 7%. Between 1999 and 2000, agricultural subsidies in the EU fell from \$129.5 billion to \$103.5 billion, a decline of 20%.

At the centre of the process of economic policy disarmament lies the transfer of certain powers to the European Central Bank (ECB), the formation of which was provided for in the Treaty of Maastricht in 1991. The twelve participants in the euro-zone no longer have the right to pursue inflationary fiscal and monetary policies, protectionist trade policies or the boosting of exports through currency devaluation.

In a certain sense, the ECB's task is simple: price stability. In practice, however, it has taken a fairly lengthy period of macro-economic convergence to arrive at a point in the history of the EU where no realistic prospect exists of an asymmetric recession within the Union. It is no surprise that the achievement of such a measure of economic stability has been accompanied by a steady increase in per capita incomes in the region. Between 1992 and 2000, the average annual per capita income for the EU increased by 55% (from \$14 800 to \$23 000).

Business implications

The superlatives for the EU's achievements could certainly go on. From a business perspective however, care should be taken not to underestimate the effects of a reconfiguration of international capital markets. The introduction of the euro represents a shift in the international financial order of seismic proportions, which will inevitably pose new threats and present new opportunities to globalising companies. Some of them will be briefly examined.

1. Contractual arrangements

Contracts that were concluded in the eleven legacy currencies will require scrutiny to determine whether a particular non-euro zone country's laws would treat the contract as terminated due to the introduction of the single currency. Hedging arrangements may require particular attention.

2. Price stability

Little doubt exists that the ECB will do everything in its power to avoid undue inflation in the euro-zone. A realistic prospect exists for long-term price stability in the region, which will spill over to some extent to trading partners. In the case of South Africa, which sources more than 40% of its imports from the EU, this will imply the virtual absence of imported inflation. (A local currency depreciation will, of course, upset this positive scenario).

3. Freeing up of markets

The EU remains committed to further trade liberalisation, which will manifest itself in lower or abolished tariffs, as well as lower levels of protection for its agricultural sector. Due to the enormous size of the EU's import trade (\$2,6 trillion), extravagant growth margins can be achieved in this market by developing country exporters. Agri-processing and a variety of medium-level value-added manufacturing industries stand to gain the most from further trade reform in the euro-zone.

4. Deregulation – the second wave

As the thirteen new candidate countries for EU-membership continue to reform along the Maastricht Treaty prescriptions, a second wave of deregulation and privatisation will be experienced in central and Eastern Europe. This trend will gather momentum over the next

two to five years and will offer a wide variety of new business opportunities for globalising companies – from export and import trade to outward and inward foreign direct investment.

5. Increases in Mergers and Acquisitions

Merger and acquisition (M&A) activity in Europe has already increased dramatically in the wake of the euro's launch in 1999 and this trend is bound to continue. Figures compiled by Thomson Financial Securities Data Company reveal that the European share of the global corporate restructuring market increased from 36% in 1989 to 51% in 1999, totaling \$868 billion. This increase in M&A activity reflects a drive towards economically more efficient companies throughout the EU, facilitated by a freeing up of capital markets over the past decade. In the process, EU multi-nationals have enhanced their global competitiveness.

6. Increased investment management activity

The past decade has witnessed steady growth in Europe's share of the world's asset management industry. The region's share of assets under management by managers with portfolios of more than \$100 billion had increased to 40% by 2000. Ingo Walter and Ray Smith of the Stern School of Business at New York University have predicted that the EU will continue to grow as a centre for investment management activity.

7. Focus on shareholder value

The 1999 bid by Vodaphone to take over Mannesmann for nearly \$130 billion was not only the largest ever takeover bid in history, but Mannesmann's reaction also represented a sea change in the approach towards cross-border mergers by EU corporations. Mannesmann's chairman did not resort to traditional anti-takeover measures and committed the company to a decision that would reflect the principle of shareholder rights and the maximisation of shareholder value. Marian Kelly and Paul O'Grady of PricewaterhouseCoopers have advised their clients that the euro-zone's investment environment is reacting positively to the freer movement of capital and they foresee a new emphasis throughout the region on increasing shareholder value.

8. Corporate bond market growth

In contrast to the government bond market, where the EU is on parity with the US in terms of its size, the euro-zone corporate bond market is estimated to be one-sixth the size of the US. This is bound to change fairly dramatically over the next decade as a result of a growing trend away from bank financing towards capital market financing. The latter is being facilitated by the replacement of fragmented national markets with a high-capacity euro-zone market, as well as the scrapping of national investment restrictions. Increased demand for assets denominated in euros can also be expected from pension funds and life insurers in the US and Japan, which will tend to lower the cost of capital for euro-zone corporations.

9. Heightened equity market activity

The total equity market capitalisation in the EU was estimated at approximately \$8 trillion in 2000, representing only half of the size of the US equity market. In Germany, the largest economy in the EU, the equity market capitalisation/GDP ratio was only 37% of the ratio for the US (2000 figures). The market for euro-zone equities is expected to grow rapidly as investors search for higher yields and diversification and as the EU's stock exchanges consolidate and introduce more efficient trading systems.

10. Risk management reform

International risk management products and services are extremely sensitive to changes in the institutional capital market environment. As a rule, heightened volatility equates to higher risk and the creation of new risk management products. The introduction of the euro is certainly a threat to this industry, particularly the derivatives exchanges. The disappearance of exchange rate differentials and the convergence of interest rates have combined to introduce more stability and predictability in Europe's capital markets. A shift of capital market expertise from these markets towards the small capitalisation equity market is likely to occur.

Conclusion

Not since the establishment of the US dollar 210 years ago has there been any other realistic contender for the position as the world's dominant currency. The euro has irrevocably changed this scenario. Within the next five years, the EU could be enlarged to include 13 other countries, representing a far bigger economic unit than the US and with double its population. The shift in leadership on political economy from Cambridge to Chicago during the 1970s reflected the stronger stance of the US on dealing with impending globalisation, the freeing up of markets and the fostering of the spirit of entrepreneurship.

Europe can be proud of the fact that it has narrowed the gap on the requirements for the new political economy. Be prepared for a shift in the global centre of economic gravity from New York to Frankfurt!