

ENLARGEMENT OF THE EU: HOW CAN FINANCIAL SERVICES CONTRIBUTE?

Summary: The important presence of foreign institutions – particularly in the banking sector and through foreign direct investments (FDI) – in the accession countries is proof of the relative confidence in their will and ability to converge towards EU standards. Their banking sectors nevertheless remain weak in terms of assets. This is quite understandable in countries characterised by low credit and capital markets financing. The banking sectors in the eight eastern and central European accession countries have a comparatively low concentration of assets, loans and deposits in their banking systems. There are several reasons for this: a short history of market economy in those countries, significantly lower wealth and, until recently, too high interest rates. Interest rates have decreased sharply during the last couple of years and local economies are benefiting from that, but it is still likely to take some time for those countries to reach the EU averages in terms of economic development and concentration of resources in local banking sectors. Nevertheless, there is great optimism that the accession country banking sectors will be able to fully realise their potential for supporting economic growth and macroeconomic stability.

1. Background

There are just six months left to the establishment of EU25. According to the Accession treaty, EU membership also requires a further step: adoption of the euro. This is anticipated within the decade for several of the accession countries, while others may join at a later stage. A single currency means a single monetary policy, from Warsaw to Athens. Every member might therefore benefit from its neighbours' economic convergence towards sustainable growth and price stability. Fortunately, the correlation between economic growth and financial sector development seems greatly positive. For most of the new members, economic growth still largely depends on FDI (foreign direct investment), mostly coming from the current EU15 countries and institutions. But, particularly in the current rough economic time, FDIs depend above all on investors' confidence. And among the factors of trust, the reliability of the financial sector is one of the most important.

2. Key issues

A. Accession countries are just at the end of a first development phase after the fall of the Iron Curtain.

More than a decade after the collapse of the communist regimes, the transition from state-controlled to market economies has been successful. The accession countries now show a clear trend of convergence towards EMU for most of the Maastricht criteria. As their growth prospects will depend more and more on domestic demand, foreign investors nevertheless regard with some suspicion the twin-deficits (budget and trade balances).

Until now, the small size of their economies – when they join the EU, they will only represent 4% of the EU25's GDP – has limited the size and the growth potential of the new members' financial and capital markets. But the evolution of the financial infrastructure, towards more competitiveness, should help and sustain broader markets. Launched some ten years ago, the privatisation process in the banking sector is almost complete and much necessary consolidation has occurred; with the exception of the three Baltic States, the candidate countries show a diminishing number of banks. Meanwhile, fresh capital has been invested, such that foreign

investment in the banking sector amounts to 60% of total FDI stock (while it is estimated at some 20% in the euro zone). Therefore, no one can doubt that foreign confidence already exists, even if these banks still face higher risks than those operating in the EU15. As a consequence they achieve higher interest margins, and higher returns on equity than their western counterparts.

In a way, the current drawbacks of banks are their opportunities. In each candidate country the level of total assets in the banking sector is very low when compared with the GDP: between 30 and 100%. In the EU15, the ratio was 265% in 2001. This shows that many opportunities still exist for interested investors. Investors will be attracted by the substantial growth potential given the banks' low involvement in the financing of the economy: on average domestic credit amounted to some 40% of GDP, much lower than the 140% level within the current EU member states. Lower administrative costs (notably wages) and higher margins compensate the current low concentration of assets, loans and deposits. Wages of bank employees are expected to gradually increase to present EU levels while on the other hand margins are likely to shrink to present EU levels. Simultaneously asset, loans, and deposit concentration will increase (as local economies will develop quickly) allowing banks from the accession countries to develop and prosper. Finally, one should note that an advantage exists as the high foreign presence in the banking sector also leads to the local availability of services provided by cross-border operators (which is not yet fully the case in EU15).

A weakness nevertheless remains: accession countries' capital markets play a minor role in most of them. The average stock market capitalisation of accession countries amounted to 16% of GDP in 2001, less than 25% of the levels seen in the euro zone (72%) and even less than that of the US. The government bonds markets are still less developed, and when bonds are issued, they are often short-maturity bonds which are held to maturity. Corporate bonds markets, finally, are negligible. Overall, it can be said that most of the accession countries took tangible steps in recent years towards building a capital market (e.g. by introducing bond laws) and as accession came closer, they worked further on aligning their regulatory framework with the *acquis communautaire*. However, their capital markets remained shallow in most cases, because of limited demand and/or supply for bond and equity financing (e.g. lack of an institutional investor base, lack of a long-term benchmark, a general lack of long-term capital, lack of collateral). Accession should bring full integration in the EU securities markets, with natural benefits for the accession countries such as access to a wider investor base and greater competition among service providers and intermediaries.

B. Financial Services contribution will create additional GDP and more stability

Looking from the outside, the Accession Countries may have had the impression that the EU market, which they are on the verge of joining, is already a full single entity. But as we know, that is not yet the case. While the EU markets are integrated in certain well-defined areas, they are far from being integrated in other areas. To remedy this situation, the EU has launched the FSAP, introduced a new regulatory process in the securities area (the Lamfalussy process) and established new bodies for harmonising and adopting (CESR, ESC). Whether the FSAP measures are effective or not in uniting and improving the market, will in turn determine the extent to which the accession countries will be able to reap the benefits of being part of the single market.

Further financial integration also means that credit and the capital markets will gradually supersede foreign direct investment as a means of financing accession country economies.

Funds currently allowed to invest only in EU securities, for example, will see their investment opportunities broadened, which is also good news for the candidates' securities markets. Moreover, the development of the government bond market will provide benchmarks for corporate bond issues, of which the current weakness is partly due to a lack of liquidity.

Last year, the European Financial Services Roundtable estimated the potential benefits of financial integration for the EU15, in terms of GDP, as additional growth of around 0.5% pa. Although such estimates are difficult to make and to assess, they can nevertheless be applied to the candidate countries.

A more developed and competitive financial sector will lead to increasing product choice, especially in small countries with limited supply. Falling prices will result from economies of scale, particularly in the funds industry where cost savings are welcome at the time of pension-system reforms. Lower margins, resulting from additional competition between banks, and deeper capital markets will mean cheaper financing costs for industry. A well functioning financial sector will mobilise domestic savings, will favour efficient investments, and favour good corporate governance. There is no doubt this will be translated in higher GDP growth figures.

Moreover, the transition from a "foreign direct investment model" to a more "domestically financed economy", will most likely reduce the dependence of the accession countries on the EU15 as far as the financing of their economies is concerned, even at the same time as their economic interdependence – through an integrated Single Market - will likely increase. FDI has been and will continue to be crucial for the 10 Accession Countries (over EUR 40 billion will be transferred in the next two years), but it is now time for a growing financial autonomy.

C. Remaining challenges

These optimistic prospects should not hide the remaining challenges. For the EU15, the main challenge is to ensure the effective completion of the whole FSAP on time. As for the candidates, they should ensure the removal of the remaining barriers faced by the EU15 financial services providers. They also should insure stability safeguards against uncontrolled risk; expansion into new customer and products areas (e.g. bank loans to households and SMEs) will hold new risks difficult to monitor, and will require upgraded management capabilities towards good bank governance, the appliance of strong supervision rules, the adoption of International Accounting Standards, etc. Moreover, the 10 new entrants will have to ensure a good and safe functioning of growing capital markets if they want to preserve investor confidence.

Last but not least, the financial sector will be the main sector concerned when the accession countries swap their national currencies for the euro. This is likely to occur within the decade for several of the new members, even if the Maastricht criteria are sometimes seen as incompatible with the Exchange Rate Mechanism II (ERMII)¹. The decision when to join EMU is one that will depend on the particular circumstances of each of the new members. Whenever they decide to join the single currency, their financial industry will benefit from the current euro zone members' experience in currency-transition.

¹ The EMU-candidate currencies effectively have to stay for two years in a waiting room where their fluctuation margins will be +/- 15%.

Conclusion

For the European Union, 2004 will be a milestone in its history. Enlargement will be successful if 2 conditions are fulfilled. The first one relates to the political willingness of all member states to avoid institutional disputes, likely to affect the functioning of the Union. The second one is clearly economic. Higher employment and welfare will be reached through more stability, economic growth and convergence across the EU-25. This can only be achieved if confidence remains. A sound, stable, and efficient financial sector will be a key factor in this, acting as a transmission mechanism for directing important investments – domestic and from abroad – into the new members' economies.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

Steering Committee

Pervenche Beres, MEP
Robert Goebbels, MEP
Chris Huhne, MEP
Giorgos Katiforis, MEP
Piia-Noora Kauppi, MEP
Olle Schmidt, MEP
Alexander Radwan, MEP
Peter Skinner, MEP
Theresa Villiers, MEP

Chairman Financial Industry Committee

Paul Arlman
Federation of European Securities Exchanges
Rue du Lombard 41
B – 1000 Brussels
Tel: 0032 2 551 01 80
Fax: 0032 2 512 49 05
E-mail: arlman@fese.be

Secretary

John Houston
Houston Consulting Europe
Av. de la Joyeuse Entrée, 1-5
B – 1040 Brussels
Tel: 0032 2 504 80 40
Fax: 0032 2 504 80 50
E-mail: secretariat@epfsf.org

Founding Members

Richard Balfe MEP
C.A. Gasoliba I Bohm MEP
Robert Goebbels MEP
Chris Huhne MEP
Othmar Karas MEP
Giorgos Katiforis MEP
Piia-Noora Kauppi MEP
Astrid Lulling MEP
Ria Oomen-Ruitjen MEP
John Purvis MEP
Alexander Radwan MEP
Karin Riis-Jorgensen MEP
Olle Schmidt MEP
Peter Skinner MEP
Charles Tannock MEP
Theresa Villiers MEP

Financial Industry Committee

ABN AMRO Bank
Association for Investment Management and Research (AIMR)
Association of Private Client Investment Managers and Stockbrokers
Banco Bilbao Vizcaya Argentaria
Barclays
Deutsche Bank AG
European Banking Federation (FBE)
European Mortgage Federation (EMF)
Euroclear
European Federation of Accountants (FEE)
Federation of European Securities Exchanges (FESE)
Fortis Bank
Futures and Options Association (FOA)
Goldman Sachs International
International Swaps and Derivatives Association (ISDA)
Lloyds TSB
London Investment Banking Association (LIBA)
Morgan Stanley
Nordea Bank
San Paolo IMI Bank
Société Générale
Svenska Handelsbanken
UBS AG