



June 5, 2001

Bulletin

Current economic and monetary issues**EU enlargement and migration – what's the problem?**

The European Commission has presented its proposal to restrict the freedom of movement for workers from Central and Eastern Europe on the eastern enlargement of the EU. Any interested observer is bound to be puzzled. Once again, Germany's politicians are taking a defensive line, when they ought to be actively promoting liberalisation and encouraging its acceptance. (Page 3)

From transition to integration: Poland's progress towards the EU

In the eyes of most economists, Poland is a model of successful reform thanks to the impressive economic momentum it has generated and the speed of structural change. When the prospect of full Polish membership in the EU became tangible, the transition paradigm began to be supplemented by the integration paradigm. Contrary to repeatedly voiced doubts, Poland will probably be ready for accession very soon in economic terms. All the same, it would be wrong to overlook the challenges to economic policymakers during the adjustment process. (Page 5)

EU structural reforms: no time for complacency

In the future strategy unveiled at the Lisbon summit, the EU set itself the objective of becoming the most dynamic economic area in the world. However, that growth impetus is currently in danger of waning, as is the EU's drive for market-oriented reforms. Europe's economy and society need more room for individual responsibility and initiative so the major assets of the EU – the single market and the euro – can become the backbone of sustained economic strength. (Page 17)

M&As in the financial industry – a matter of concern for bank supervisors?

The current wave of consolidation among financial firms is beneficial from an economic point of view since the necessary structural adjustments will lead to a higher degree of efficiency in the financial sector. The critical attitude of bank supervisors seems largely unconvincing, particularly when less weight is attached to transitory problems. On the other hand, the current reorganisation of the industry has important implications for banking supervision, especially since existing supervisory structures might turn out to be inadequate. (Page 25)

Editor:

Michael Wolgast
+49 69 910-31709
michael.wolgast@db.com

Publication Assistant:

Burgitta Scheurer
+49 69 910-31711
burgitta.scheurer@db.com

Deutsche Bank Research

Frankfurt am Main
Germany

E-mail: marketing.dbr@db.com

Fax: +49 69 910-31877

DB Research Management

Axel Siedenberg
Norbert Walter



EU enlargement and migration – what's the problem?

What would Adam Smith have said to his students if he had lived to see the end of the Iron Curtain after the years of Communism? He would have spoken of a new chapter in "The Wealth of Nations," a new round of wealth gains for all, thanks to the integration of markets and the new freedom of movement for goods, services, labour and capital in a region historically linked by cultural and economic ties.

*But what have we Europeans made of this unique opportunity? Decisions have been timid and petty-minded. The proposals from the EU Commission to restrict the freedom of movement for workers from Central and Eastern Europe on the eastern enlargement of the Union are a case in point. The old member states would be allowed to limit or even totally prohibit migration of labour from the accession countries for up to seven years. Any interested observer is bound to be puzzled. Are these not the same people who are demanding that the candidates accept the *acquis communautaire*, which includes granting full rights for free movement of capital, i.e. for the purchase of firms, real estate etc. in the accession countries?*

The debate is perturbing on grounds of principle. But even more incredible – against the background of the current discussion in Germany on immigration, and the introduction of the so-called "Green Card" – is that Bavaria's Prime Minister Edmund Stoiber and Germany's Chancellor Gerhard Schröder are among the advocates of a delay before labour can settle freely in border areas, and that the Commission is ready to serve these demands. The numbers of employees coming from new member countries would probably be too low in any case to make up the shortage of labour in Germany caused by the country's demographics; and there is no way they would be sufficient to resuscitate Germany's chronically overstrained social-security system.

Why, then, this – more than dubious – development? It would be facile to say it is all the politicians' fault (though election tactics certainly come into it). There is still alarmingly little popular support for the eastward enlargement of the EU. It is still only too easy for political interests to play on fears of all things foreign. And the old lament that newcomers will exploit the social-security system and threaten people's jobs has still not died down. Opening the borders cannot, of course, mean extending Germany's social-security system to cover the population of the new member

states – we should have learned our lesson from German unification. But experience with labour migration shows that, provided immigrants are not lured by excessive social benefits, it brings economic advantages for all. It leads to higher tax revenues, reduces the strain on social-security systems, and generates stronger economic growth and new jobs.

Once again, though, Germany's politicians are taking an ominously defensive line, when they ought to be actively promoting liberalisation and encouraging its acceptance. Economic theory provides a number of tenets that are certainly worth considering:

- Instead of bowing to pressure from interest groups, it would be better to compensate those who lose out (in the short term) from deregulation. This could be one way to make full and immediate freedom of movement acceptable to certain border regions.
- Ludwig von Mises had a dictum that interventions tend to multiply on top of themselves. Already, there are calls also to limit the accession countries' freedom to provide services. The door would otherwise be open to "abusive evasion" of the restrictions on the movement of labour, say the organisations representing the German skilled trades. Would it not have been easier, and more honest, not ever to have started all the talk of economic integration, free markets and free trade in the first place?

What I would really like to see, though, is academics, citizens and business alike coming out in active support of a market-oriented economy and openness, rebuffing the eternal critics and advocates of delay. What I would like to see even more is the new EU citizens, the young talents from Poland, Slovakia and Hungary, holding up a mirror of market economics to us Western European pharisees so that we are finally revealed for what we are: market-economy preachers who engage in cheap protectionist practice.



From transition to integration: Poland's progress towards the EU

When Poland embarked on a comprehensive reform programme in January 1990, the forecasts of most economists were gloomy. Hungary and (what was still) Czechoslovakia were tipped to be the future Central-and-Eastern European 'tiger' economies rather than this sprawling country, dominated by heavy industry and agriculture, whose robust Christian-Socialist trade-union movement had led the opposition against the Communist regime. A decade later, such prognoses need to be revised to some extent: thanks to the impressive economic momentum it has generated and the speed of structural change, Poland is now regarded as a model of successful reform.¹ The reform process in Poland gained a clear orientation in the wake of the country's 1994 application for EU membership: 'readiness for accession' became the strategic objective driving the change-over to the new system. How far has Poland come on the road leading to the EU? Is the country ready in economic terms for accession? Doubts about Poland's suitability are repeatedly voiced from within the European Commission as well as in certain European capitals. And it is indeed indispensable, against the background of the 'hot phase' of accession negotiations and preparations, to ask how close the largest EU aspirant now is from both a political and an economic point of view to the goal of EU membership, and what challenges remain to be met.

Achievements of Poland's transition course

Numbers provide the most eloquent testimony to Poland's economic success in recent years: by racking up average growth rates of nearly 5% in the period from 1992 to 2000, the country has managed to increase aggregate economic output by 50%. The equivalent figures for the Czech Republic and even for Hungary look modest in comparison. Per-capita GDP (converted on a purchasing-power-parity basis) leapt from EUR 4,500 in 1990 to EUR 8,500 (or 40% of the EU average) in 2000, and inflation was brought down to below 10% over the same period. Despite the danger of contagion effects from the upheavals which brewed in the Czech Republic and Russia, the country has so far avoided a currency crisis: the Polish currency, the zloty, has indeed appreciated continually against the German mark and euro in real terms.² Poland's aggregate economic output admittedly continues to be comparatively low when calculated on the basis of current exchange rates: the roughly 39 million inhabitants generated a gross domestic product of EUR 180 billion in 2000. That is approximately one-third of aggregate economic output in Spain, a European economy with a comparable population.

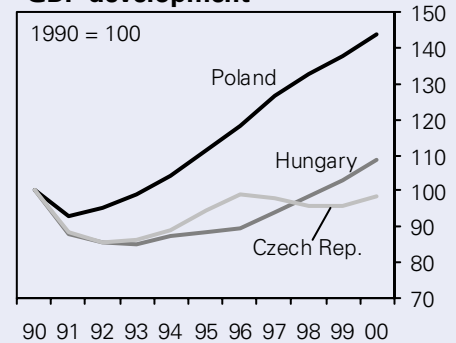
What 'ingredients' have gone into Poland's recipe for success?

- First and foremost, it is important to point to the dynamic corporate sector, which constitutes the power-house of the Polish economy: in the wake of the comprehensive liberalisation measures

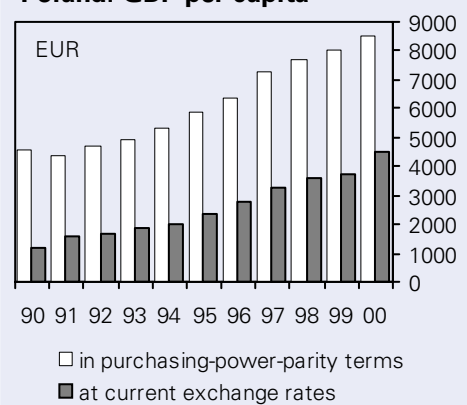
¹ For a detailed study of the reform process in Poland see M. De Broeck/V. Koen, The "Soaring Eagle": Anatomy of the Polish Take-Off in the 1990s, IMF Working Paper 00/6, 2000.

² The zloty appreciated by over 50% since 1993, adjusted on the basis of the consumer-price index. If the trend in the exchange rate is deflated by the rate of change in unit wage costs, however, the real exchange rate of the zloty turns out to have remained practically the same on account of high annual productivity growth.

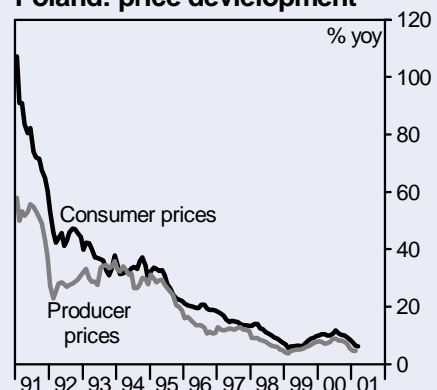
GDP development



Poland: GDP per capita



Poland: price development



and the macroeconomic stabilisation brought about within the framework of 'shock-therapy', newly-established private-sector corporations – rather than state-owned enterprises, which were only haltingly privatised – became the growth engine driving the economy. Speedy liberalisation of the foreign-trade sector and a well-functioning legal system have provided the necessary underpinning for the successful expansion of these Polish start-ups.

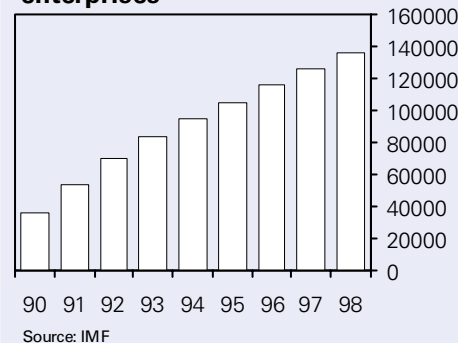
- The decision by the Paris and London Clubs to forgive around 50% of Poland's foreign liabilities in 1994 helped to fuel a sharp jump in foreign direct investment, which in turn was the main pillar of the investment boom that materialised in the mid-1990s.
- Stringent reforms and substantial foreign investment have enabled the financial sector to be gradually reorganised. Because of such restructuring, it was possible to avoid the kind of systemic crises which have taken such a heavy macroeconomic toll on other countries in transition.
- An active social policy has cushioned the impact of the reform process on the population and secured popular support for the reform policies.³

Foreign policy geared to a 'Return to Europe'

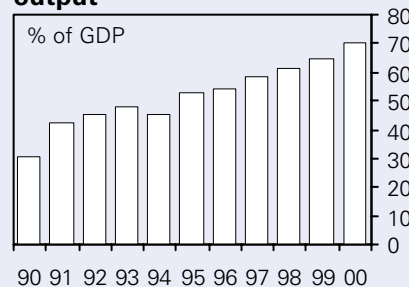
Poland's foreign-policy alignment has not lacked clarity over the past decade. In this country which constitutes part of the Central Europe that prior to the revolution of 1989 was, in the words of Milan Kundera, 'geographically in the centre, culturally in the west and politically in the east of Europe', a cross-party consensus quickly emerged that a 'Return to Europe' was the order of the day. From a domestic-policy point of view, the integration of Poland into the OECD and NATO was perceived as an important dual milestone on the road to membership of the European Union. At the same time, Poland has always been at pains to build good relationships with its neighbours to the east. Close ties with Ukraine, whose independence is regarded in Poland as a guarantee that Russia will not attempt to establish a new hegemony in Eastern Europe, are one of the paramount constants of Poland's *Ostpolitik*.

On the domestic-policy side, the situation has calmed down after the turbulence of the first years of reform under the highly individual leadership of President Lech Walesa. The reformed Socialist party already returned to power in 1993, and – contrary to fears in many quarters - did not harm the reform process. The incumbent, Mr Walesa, lost the presidential election of 1995 by the smallest of margins to his Social-Democratic challenger Aleksander Kwasniewski, which meant that the former movement for democracy had lost both key government positions within five years of the revolution. To general surprise, however, the heterogeneous centre-right factions managed to reunite under the banner of "Solidarnosc" (AWS) in time for the parliamentary elections of 1997, taking over the reins of government after their electoral victory. At the moment, opinion polls are suggesting that there is going to be another change of government after the parliamentary elections scheduled for this September. The fact remains that it is unlikely that preparations for

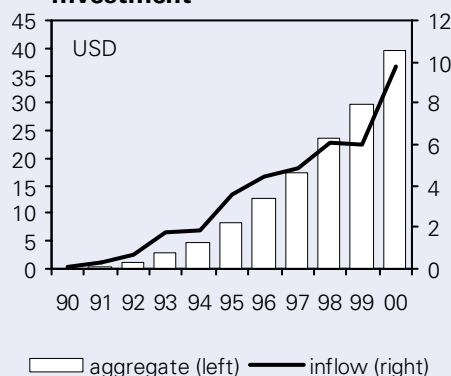
Poland: Number of private-sector enterprises



Poland: Private-sector share in aggregate economic output



Poland: Foreign direct investment



³ Income distribution in Polish society, measured in terms of the so-called Gini coefficient, has remained virtually unchanged over the past decade thanks to the emergence of a broad middle class. Cf. M. Koane and E. Prasad, Poland: Inequality, Transfers, and Growth in Transition, Finance and Development, Vol. 38/1, 2000.



accession would slow down or that the markets would become jittery in the event of victory going to the Social Democratic party SLD, headed by Leszek Miller.

The end of the Solidarnosc era?

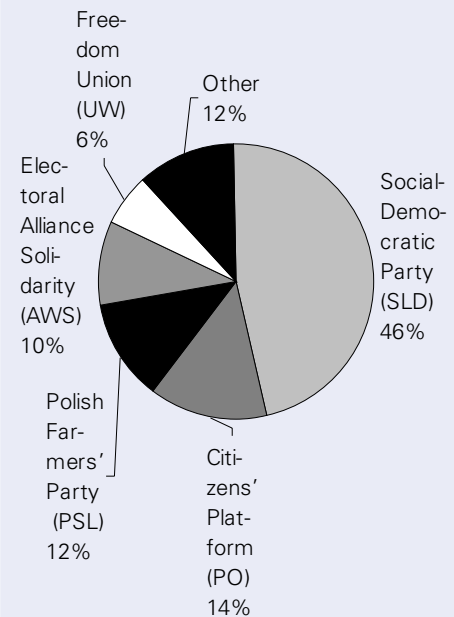
The party landscape has undergone further tectonic shifts in the run-up to the parliamentary elections. Above all in the Conservative camp, the power of anti-communism to create a sense of identity has waned in view of the credible change of course accomplished by the Social Democrats, and internal struggles between the neoliberal and Christian-Socialist wings have moved to centre stage: the ideological and denominational patterns which moulded the Polish political-party system for so long have lost much of their hold. And now that the 'Citizens' Platform' has been established by prominent representatives of the Solidarity Movement and the liberal Freedom Union, a new force has come into being beyond the old battle-lines, whose pro-integration, neoliberal programme does not have the ideological ballast accumulated from fighting yesterday's wars, and furthermore appeals to the new middle class. If the Electoral Alliance Solidarity – and thus the meritorious old trade union – should forfeit its dominant position to the right of centre, a political era would have come to an end.

The ultimate strategic objective of accession to the EU has been a lucky expedient in Poland in that it has helped to ensure the stabilisation of the political-party system: for the Left, the prospect of EU membership spelt the opportunity to generate an open, European social model in competition with the underlying national-Catholic tendency in post-Socialist Poland. In return, left-wing politicians were prepared to go along with the necessary economic modernisation of the country. By contrast, Conservative groupings viewed the prospect of accession as a chance to accelerate the economic-reform process, even at the expense of diminishing Poland's national autonomy. It is noteworthy in this connection that the loss of sovereignty induced by accession to the EU has provoked less resistance than many onlookers expected: misgivings about new limitations on precious autonomous statehood are not that much more widespread in Poland than they are in many countries in Western Europe. There are grounds for the conjecture that the economic problems encountered during the transition period have undermined the faith in the omnipotence of the nation-state model in Poland as well.

From transition to integration

When the prospect of full Polish membership of the Brussels institutions became tangible in the mid-1990s, the transition paradigm began to be supplemented by the integration paradigm. What had been a complicated, tortuous transition from one system to another thus became a clearly-focused quest to become 'fit for accession'. To that extent,

2001 parliamentary elections: opinion-poll projections for the various parties*



* as of April 2001

Source: TNS OBOP

EU integration as a new paradigm in the reform process

⁴ The EU set the criteria for new members at the meeting of the European Council in Copenhagen in 1993: the preconditions for the admission of new member countries are (1) that the accession candidates in question are democratic states under the rule of law and (2) that they have functioning market economies, which are capable of coping with the competitive pressure in the Single Market. Finally, new members must (3) be in a position to adopt and implement the Community's legal structures ('acquis communautaire'). The European Commission measures how much progress the accession candidates have made in terms of meeting the criteria in its annual Progress Reports. With the help of so-called twinnings (= accession partnerships) and aid programmes (PHARE), it has furthermore been attempting to support the accession preparations of the EU aspirants. The wording of the accession criteria, the annual Progress Reports and information and support projects can be found on the Internet at <http://www.europa.eu.int/comm/enlargement>

the accession criteria imposed by the EU have had an anchor function whose importance for Polish economic policy should not be underestimated.⁴ In practical terms, the transposition and implementation of the large body of EU legal provisions otherwise known as the *acquis communautaire* are bulking largest in Poland's accession preparations and causing the biggest problems. The precise terms governing the implementation of EU law in connection with Poland's accession are the object of the accession negotiations which Poland and the EU initiated in 1998. By now, all 29 chapters of the *acquis communautaire* have been opened and 15 have already been completed, i.e. provisional agreement has been reached in the areas in question regarding the date on which the full *acquis* is to be adopted. What is more, there is no disagreement that the relevant EU legislation has got to be introduced; as a rule, the only thing which is being negotiated about is the duration of possible transitional periods.

Initially, the task of adapting thousands of national legal provisions to bring them into line with European law overtaxed the Polish legislative process. It was only in the spring of 2000 that the pace of legal convergence accelerated appreciably with the setting-up of the so-called 'Grand Committee for European Issues' at the level of the Polish parliament. This new parliamentary committee is charged with scrutinizing all bills connected with accession and with making proposals to parliament regarding implementation.⁵ In this way, the accession preparations are being shielded from day-to-day political in-fighting at the level of specialised committees. As a result, the odds are very favourable that the accession preparations can be kept out of the forthcoming election campaign.

Accession negotiations have entered the 'hot phase'

Although the Nice summit failed to live up to the great expectations it had generated, the EU does now formally regard itself as being capable of enlargement. Nice has provided a 'road map' from the European Commission governing the way forward for the negotiations, but has also caused the accession process to move into a qualitatively new phase. That this is the case is likewise evident from the growing interest demonstrated by the member states, which previously had largely left the concrete business of conducting negotiations to the European Commission. Where it was previously not possible to measure how far a candidate had come on the road to accession by looking at the number of chapters which had been opened and completed, the question as to whether the respective chapters have been closed in line with the European Commission's time-schedule is now becoming the yardstick measuring the degree of progress made. This in turn has put Poland under greater pressure not to lag behind other countries in terms of success scored on the negotiations front. The more concrete the time-schedule and the closer the projected date of accession, the better the principle of 'peer pressure' – i.e. mutual competition between

⁵ In conjunction with the competent ministries, the 'Interministerial Committee for European Integration' elaborates a 'National Programme for the Adoption of the *Acquis*' (NPAA) every year, which has to be approved by the Council of Ministers. The practical business of drafting the legislation and restructuring the administration is then coordinated on the basis of this guideline, which runs to several thousand pages. Along with legal convergence, the evolution of appropriate administrative capacities has become a second main focus of accession preparations, the reason being that the European Commission is monitoring not only the formal adoption of EU law but also the capacity of the countries concerned to implement it in administrative and judicial terms.

Adoption of EU law is the object of the accession negotiations

Legal convergence is speeding up

The European Commission's priorities in the accession negotiations

H1 2001:

- Free movement of goods, persons, services and capital
- Company law
- Culture and audio-visual media
- Social affairs and employment
- Environment
- Foreign relations

H2 2001:

- Competition
- Transportation policy
- Energy
- Taxation policy
- Customs union
- Agricultural policy (in particular animal and plant health)
- Fisheries
- Justice and home affairs
- Financial supervision

H1 2002:

- Agricultural policy (unsettled questions)
- Regional policy and structural instruments
- Budget
- Institutions
- Miscellaneous

the various EU aspirants – functions: in the few months since the Nice summit, Poland has been compelled by the progress achieved by its peers at the negotiating table to abandon a whole range of demands for transitional periods in order not to allow the lead enjoyed by other candidates for accession to increase too much, which would give fresh fuel to speculations that Poland might possibly not join in the first wave of eastward enlargement. Further adjustments in negotiation positions look likely to be forthcoming in the near future, since in the post-Nice period, negotiations have entered the decisive phase from the point of view of content too.

From the Polish perspective, three problem areas are likely to dominate negotiations in the slightly less than two years which remain:

- First come **politically sensitive topics**: freedom of movement for workers and the liberalisation of capital transactions in connection with the acquisition of real estate have now become hotly debated political issues in Poland too. On the one hand, the Polish population attaches great symbolic importance to freedom of movement; on the other hand, opening-up the EU labour market for Polish workers is regarded as a significant component part of the economic modernisation of the country. The Poles will probably be able to live with the transitional solution put forward by the European Commission in April of this year – a flexible procedure according to which freedom of movement within the entire EU would become possible after five (or, at any rate, a maximum of seven) years while national regulations could already lead to wide-ranging liberalisation measures even before the end of the period in question.⁶ The preconditions here are that this arrangement does not discriminate against Polish workers vis-à-vis those from other countries knocking on the EU door and that the emigration of urgently needed skilled workers (the 'brain-drain' effect) is forestalled. The Poles are also aware of the political constraints which probably shaped the European Commission's proposal to a greater extent than economic considerations. If the regulation governing the freedom of Polish companies to offer services is given a liberal construction (and this particular freedom is probably of comparable economic importance for Poland to the freedom of movement for workers), this would help to increase political acceptance of the overall package among the population. The regulation governing the acquisition of real estate by foreigners is by now a more or less equally strongly politicised theme. Referring to anxieties among the population about a 'sell-out' of their country and to tangible problems in connection with the forthcoming agricultural reform, Poland is calling for a transitional period of 18 years prior to complete liberalisation. Given that this issue does not touch on any significant interests from the point of view of existing EU members and given that Poland would probably be able to make do with a shorter transitional period, an agreement should prove possible. Not much can admittedly be expected to happen in advance of the upcoming parliamentary elections.
- The second problem area in connection with the accession negotiations probably concerns the **integration of Poland into EU policies**, above all into the Common Agricultural Policy and into the

Freedom of movement and acquisition of real estate are at the centre of public interest

The European Commission's proposal regarding freedom of movement has been shaped by political constraints

Freedom of services also a matter of importance

Integration into EU-programmes is not going to come cheap

⁶ For details on the European Commission's option paper see also B.Böttcher, "How free should EU freedom of movement be?," Deutsche Bank Research Frankfurt Voice, March 26, 2001. Well-founded studies into this problem assume that migration levels will be relatively slight. In view of the probable shortage of skilled workers in Germany, it is also questionable whether a transitional period lasting a maximum of seven years is in the interests of the German economy (cf. Deutsches Institut für Wirtschaftsforschung (DIW), The Impact of Eastern Enlargement on Employment and Labour Markets in the EU Member States, Berlin and Milan 2000).

EU's Structural Policy, which together account for 80% of the overall EU budget. According to the principle 'equal duties, equal rights', Poland is demanding to be completely integrated into the system of direct aid for farmers and at the same time calling for access to subsidies from the Structural Fund, which gives rise to political conflicts with those existing EU member countries which are currently net beneficiaries.⁷ This problem can probably only be solved within the context of an overall financial package which is also acceptable to the southern countries in the EU.

- The third problem area is likely to be constituted by the chapters in which adoption of the *acquis* would cause Poland and Polish companies serious **financing problems**. Above all in the fields of environmental and labour protection and in the transportation-infrastructure sphere, where EU standards very clearly reflect the higher level of development of Community economies, investment running into the billions would be necessary to enable Polish companies to meet the benchmarks in question. It is true that gradual convergence, steered by means of transitional periods, would be more economically meaningful than a rapid implementation, since it would allow the investment outlay to be distributed over a longer time-scale. But this would mean that Polish corporations would enjoy a competitive advantage relative to their counterparts in the old member states for a certain length of time. A compromise will have to be arrived at here, involving the stipulation of realistic transitional periods.

It will not prove possible to solve every individual problem within the time-frame laid down by the European Commission's 'road map'. In view of the fact that there are a whole series of cross-connections (above all financial, but also political) between the single chapters, it seems relatively probable that negotiation packages will be put together when the deadline has been reached, allowing the contentious issues to be dealt with and solved together.⁸

When will Poland join the EU?

Given the many imponderables inherent in the enlargement process, the EU has not so far been prepared to name concrete dates for accession. What is certain is that every step to make the 'road map' more concrete can probably be counted on to accelerate rather than slow down accession preparations and economic momentum in Poland. A first enlargement wave without Poland seems unlikely on political grounds. Political and economic stabilisation of the region, the strategic objective of the EU's enlargement policy, would be difficult to imagine if what is by far the biggest country in the region were not integrated at an early date.

The European Commission's 'road map' optimistically assumes that the accession conferences will have been wound up by 2002. If allowance is made for the fact that the ratification process can be expected to take roughly 18 months, the first accessions could hardly take place before 2004. Given that delays in accession negotiations could crop up

⁷ On the problem of agricultural policy cf. also Monitor EU Enlargement No. 4, Deutsche Bank Research, May 2000.

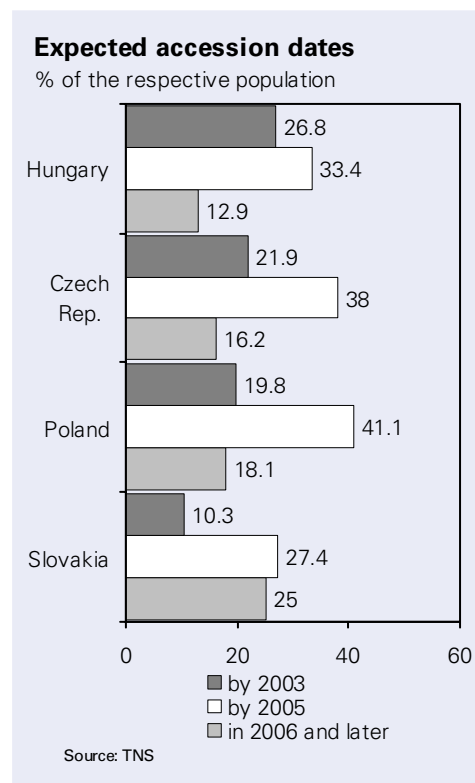
⁸ Cf. the exposition by A. Mayhew, Enlargement of the European Union: An Analysis of the Negotiations with the Central and Eastern European Candidate Countries, Sussex European Institute, Working Paper No.39, 2000.

Conflicts with existing net beneficiaries

High investment expenditure, e.g. in the fields of environmental and labour protection, ...

... should be distributed over a longer period of time

Package solutions are likely



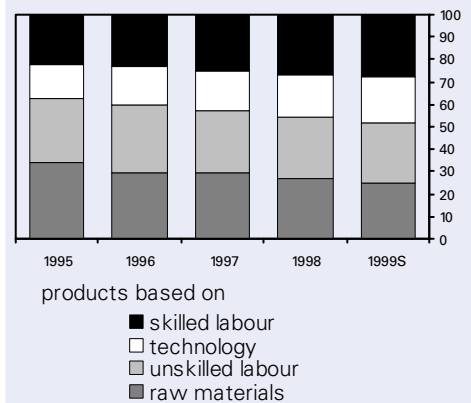
in 2002, a year in which elections are scheduled to take place in Germany and France, 2005 should be pencilled in as the baseline scenario for Polish accession – as part of a “big-bang enlargement” encompassing all eight Central-and-Eastern-European accession candidates, with the exception of Bulgaria and Romania.⁹ At least unofficially, the Polish government also seems to be taking its bearings by this timeschedule. Although the target date of 2003 is still officially being adhered to, with the legislative agenda being planned accordingly, President Kwasniewski recently described “accession by 2005” as being realistic.

To what extent is the Polish economy ready for the Single Market?

Poland can only be successfully integrated into the EU Single Market if the economy is ready to take the heat of competition. With this in mind, the EU has made corporate-sector competitiveness a prerequisite of accession. In the European Commission’s eyes, the Polish economy will be ready ‘in the near term’ to cope with the competitive pressure prevailing in the Single Market. The time-horizon is the decisive point in view of the speed at which structural change is taking place. Assuming that accession takes place in the middle of the decade, there should still be enough time to eliminate any remaining doubts. On balance, an assessment of the competitiveness of the Polish economy yields a positive verdict:

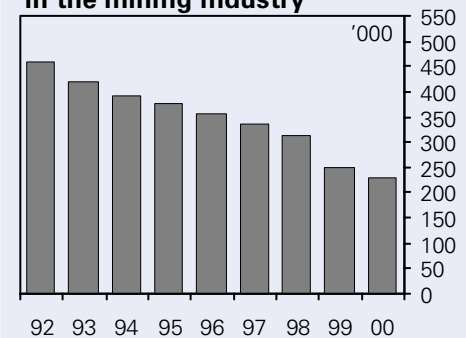
- Given that it has by now been almost completely liberalised, the Polish **export sector** is already thoroughly exposed to European and international competition. 70% of aggregate Polish exports are shipped to the EU. As trade with the EU has expanded, the structure of Polish exports has changed. Poland has transformed itself from an exporter of agricultural products and raw materials into an exporter of industrial and consumer goods, a field where wage-cost advantages alone do not secure competitiveness. Technology-intensive products, and goods which can only be manufactured with the use of qualified labour, have now become the engine fueling export growth, accounting for half of total shipments.¹⁰
- In view of the large number of foreign companies with a presence in Poland, competition on the **Polish market** has been lively for some time now. Studies have concluded that companies located in Poland display a degree of competitiveness which measures up to the standard in certain EU member countries.¹¹ This is true above all of the numerous small and medium-sized enterprises, three-quarters of which are now operating in conjunction with foreign partners. However, there are still problems with respect to subsi-

Poland: Exports to the EU according to product categories (%)



Source: World Bank, DBR

Poland: Number of employees in the mining industry



Source: Biuletyn Statystyczny

⁹ Participation in the European elections scheduled for the spring of 2004 (a scenario brought into play at the Nice summit) would also be conceivable if the treaties had been signed but not yet ratified – and would thus be compatible with full membership from 2005 onwards. Cf. Monitor EU Enlargement No. 3, Deutsche Bank Research, March 2000.

¹⁰ World Bank, Poland: Trade and Foreign Direct Investment: Will Exports Recover?, Washington D.C. 2000.

¹¹ W.Quaisser, Außenhandel und Wettbewerbsfähigkeit der MOE-Länder in einer erweiterten Union, Osteuropa-Institut Munich, Working Paper No. 223, 1999; cf. also OECD, Summary Indicators of Product Market Regulation, Economics Department Working Paper 226, 1999.

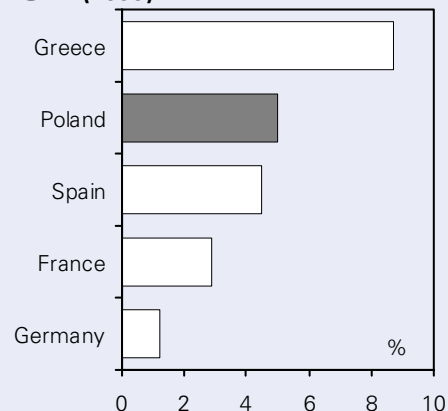
dies and the effectiveness of the supervisory body overseeing competition policy. On an annual basis, Poland disburses state aid to companies and regions corresponding to 1-2% of GDP (above all in the form of exemptions from taxes and social-insurance contributions), but this is not out of line with the EU average of 1.2% (1998). Nevertheless, harmonising the way in which subsidies are granted in Poland with the requirements of EU competition policy will remain a task on the agenda in the medium term.

- The biggest question-marks are hanging over the competitiveness of Polish **heavy industry and agriculture**. According to IMF calculations, annual losses corresponding to up to 1% of GDP are being racked up in the mining sector alone, which still has a payroll of over 200,000. On the other hand, the pace of structural change is considerable – by comparison with Western Europe in particular. Both the number of pits and the volume of coal extracted have halved over the past decade. 60,000 mining jobs were lost in 1999 alone. The knock-on effects for the labour market were cushioned by a successful programme launched by the World Bank. The constellation is even more problematic in the steel industry, which is plagued by overcapacity. The plan here is to reduce the number of employees from the current level of over 80,000 to around 40,000 by 2003 within the framework of privatisation. A comprehensive reform programme has still to be developed in the case of the agricultural sector, which is dominated by unproductive small and medium-sized farms. Although its share in national GDP is comparable with that of the Spanish agricultural sector, it still accounts for as much as 15%, or thereabouts, of the Polish workforce. At present, only a small proportion of the sizeable volume of budgetary expenditure earmarked for agriculture is being channelled into modernisation. In view of how heavily agriculture is regulated within the EU, however, the question as to whether small Polish farms will prove competitive hinges not least on the shape of the EU's future agricultural policy.
- Given that consolidation took place early on and that ample foreign-direct-investment flows are available, the Polish **financial sector** is in good shape. In terms of the aggregate balance-sheet total, 70% of the banking system is currently in foreign hands. The equivalent ratio for the insurance industry is also in excess of 50%. It is of course true that the cumulative balance-sheet total of all Polish banks only corresponded to 62% of GDP at year-end 1999, which is still considerably below the EU average of 210% and reveals how much catching up Poland still has to do. In terms of inherent stability, on the other hand, the Polish banking system can keep up not only with other accession candidates but also on an international level.¹² Average capital ratios in the Polish banking sector came to an impressive 12.6% of total assets in September 2000.

Financial-market convergence

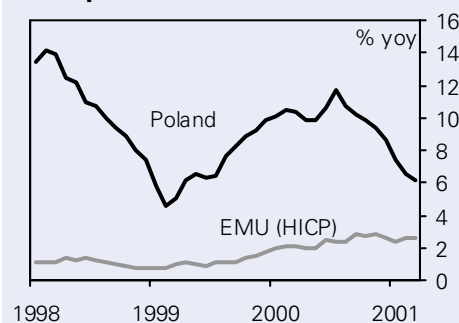
Apart from preparations for accession to the EU, another of the strategic tasks of Polish economic policy is to gain entry to the European Monetary Union (EMU). In principle, EMU is part of the EU acquis. Poland will therefore be asked to participate in EMU if the entrance

Agriculture as a percentage of GDP (1999)



The employment level in the steel industry will have halved by 2003

Inflation rates* in Poland as compared with EMU



*) Consumer price index

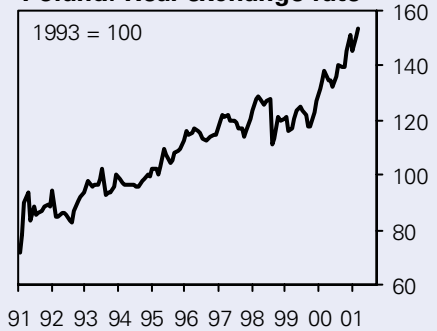
¹² This was also the conclusion of the IMF's so-called Financial Sector Assessment Program (cf. IMF, Poland: Article IV Consultation – Staff Report, Country Report 01/56, April 2001).

criteria are fulfilled.¹³ Given, however, that a member country is obliged to take part in the Exchange Rate Mechanism (ERM II) for at least two years prior to joining EMU, Poland can only become part of the euro project at least three years after accession to the EU, i.e. in around 2007/2008. In any case, the country is currently still a long way from meeting the EMU convergence criteria relating to the inflation and interest-rate levels: the inflation rate was running at a shade over 8% at the end of 2000, and yields on ten-year government bonds were standing at 12% p.a., more than twice as high as those on comparable German government paper. Meeting the Maastricht criteria is not of course a prerequisite for accession to the EU; it can nevertheless be assumed that a slow process of convergence with the EMU level will take place in the coming years.

If it is also taken into account that rapid productivity growth could lead to real appreciation of the zloty in the future too, which continues in any case to be clearly undervalued in purchasing-power-parity terms, it does not come as a surprise that investors discovered the Polish market as a convergence play some time back. Numerous "convergence funds" are investing there in the hope of seeing a decline in interest rates. The sharply inverted yield curve (the yield on long-dated paper is about 400 basis points lower than rates at the short end) illustrates the extent to which convergence expectations are already reflected in the markets.

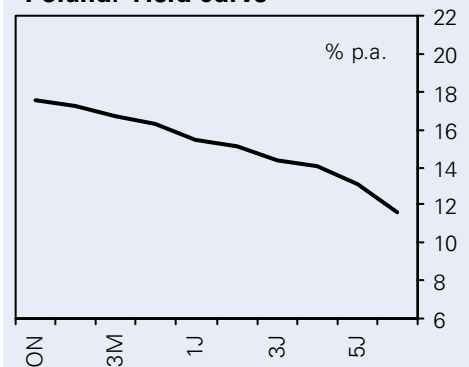
The Polish National Bank's decision this April to switch from a crawling-peg regime (involving a fluctuation margin and a predetermined monthly depreciation rate) to a system of free exchange rates has provisionally brought to an end the debate in Poland as to which currency regime provides the best preparation for EMU.¹⁴ Still, it would be wrong to underestimate the requirements which the currency regime has to meet in the run-up to participation in EMU: the goals of disinflation and nominal interest-rate convergence imposed by the Maastricht criteria have to be attained in an environment of liberalised capital markets. In particular the consequences deriving from the phasing-out of the remaining controls on the movement of capital continue to be unclear. Admittedly, Poland has already made more progress on liberalising capital movements than Spain, for example, had done by the early 1990s. However, comparative studies point to a distinct increase in potentially volatile portfolio investment, whereas it was long-term foreign direct investment which held centre stage in the past.¹⁵ The upshot could be short-term inflows and outflows of speculative funds, leading in turn to

Poland: Real exchange rate*



*) relative to the EUR, based on consumer prices

Poland: Yield curve*



As of May 28, 2001

*based on interbank money-market rates and government-bond yields

¹³ For a detailed examination of the terms of EMU integration see Monitor EU Enlargement No.1, Deutsche Bank Research, September 2000.

¹⁴ Arguments concerning the pros and cons of Polish participation in EMU usually take their bearings by the optimal-currency-area theory: the economic advantages of participation in a monetary union will outweigh the disadvantages whenever close trade ties and similar economic structures mean that there is only a low probability of asymmetric shocks. Initial quantitative analyses demonstrate that Poland would already derive more advantages than it would suffer disadvantages from membership of EMU. Cf. on this score G.Kopits, Implications of EMU for Exchange Rate Policy in Central and Eastern Europe, IMF Working Paper 99/9, 1999; R. Coker et al., Exchange Rate Regimes in Selected Advanced Transition Economies – Coping with Transition Capital Inflows and EU Accession, IMF Policy Discussion Paper 00/3, 2000; J.Mortensen/S.Richter, Measurement of Costs and Benefits of Accession to the European Union for Selected Countries in Central and Eastern Europe, Wiener Institut für Internationale Wirtschaftsvergleiche, Research Report No. 263, 2000; P.Masson, Monetary and Exchange Rate Policy of Transition Economies of Central and Eastern Europe after the Launch of EMU, IMF Policy Discussion Paper 99/5, 1999.

¹⁵ C.Buch, Capital Mobility and EU Enlargement, Weltwirtschaftliches Archiv, Vol. 135, No. 4, 1999.

sharp fluctuations in the exchange rate and to problems in the domestic financial sector and – on a worst-case scenario – in the real economy as well.

From the Polish National Bank's point of view, however, the advantages of floating the exchange rate outweigh the disadvantages. For one thing, volatile capital flows are also problematic under a fixed-exchange-rate regime. For another, risk premia rise in the case of floating exchange rates and there is an incentive to hedge open currency positions. Furthermore, the initial ERM II parity can be determined in the market, which could well enhance confidence in the currency further down the road. But there are also unmistakable disadvantages: domestic economic policy is exposed to the volatility in international financial markets. It remains to be seen whether this will have a positive effect by bringing about greater transparency or whether an economic policy oriented towards the longer term will be held in thrall to short-term mood-swings. The hefty exchange-rate of fluctuations witnessed over the past twelve months give some idea of how difficult the task could turn out to be.

The challenges of the next few years

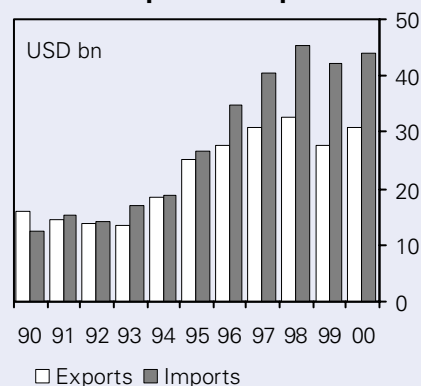
There are good reasons to believe that Poland and the other EU aspirants will work up a considerable level of economic momentum in the run-up to the enlargement deadline. Lower sovereign risks, improved investment conditions and the fruits of the reforms which have already been implemented could boost investment activity and cause growth to ratchet up again to 6-7% per annum. All the same, it would be wrong to overlook the challenges to economic-policymakers which are set to materialise during this adjustment process.

The parallel policy goals of real and nominal convergence – i.e. to catch up quickly on the GDP-growth side while at the same time getting inflation and interest rates down into line with the relevant Maastricht criteria – could well prove more difficult to reconcile than has been assumed: in the foreseeable future, Poland can expect, for structural reasons, to have to cope with inflation rates distinctly in excess of EU levels. The causes for this are only partly to be found in the gradual decontrolling of the remaining prices still administered by the public sector. Price increases in non-tradable goods, which are typical in economies in the process of catching up quickly, could prove a bigger problem.¹⁶ The corollary is that high real interest rates may be necessary to get the inflation rate down to a Maastricht-compatible level within a few years in spite of the price reductions which will come through in some fields as a result of widespread deregulation and of a moderate wage policy. The obvious consequence of higher real rates is lower GDP growth and therefore a slowdown in the catch-up process. From the point of view of a possible EMU convergence test in 2007/2008, the Polish National Bank's medium-term inflation target of 4% by 2003 looks decidedly ambitious.

Problematic developments cannot be ruled out regarding the external balance either. Although it is true that Polish exports have recently been registering double-digit growth rates, it is quite conceivable that import

Are the parallel policy objectives of real and nominal convergence compatible?

Poland: Exports & imports



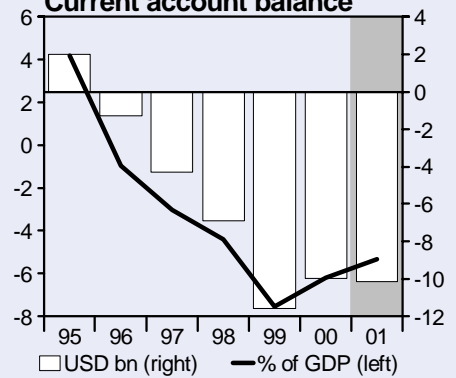
¹⁶ This is the so-called Balassa-Samuelson effect, describing sharply divergent productivity-growth trends in the production of tradable as against non-tradable goods in emerging economies, which nevertheless lead to uniform wage increases across the entire economy in question and thus to price rises in the case of non-tradable goods as well. The currencies of such countries tend to appreciate in real terms, which does not however necessarily imply a loss of international competitiveness.

growth will continue to be more-than-proportionate in the medium term. As in the case of southern EU member states, progressive economic modernisation will probably engender a rapid increase in capital-goods imports.¹⁷ By way of comparison: the merchandise-trade deficit in Spain tripled in the ten years from 1980 to 1990, and it took a similarly boisterous increase in tourist revenue to ease the situation on the current-account side. Without doubt, Poland does not have the same kind of potential for service exports. Since persistently high current-account deficits can therefore be anticipated in spite of rising transfer payments from Brussels (the current-account deficit corresponded to 6.2% of GDP in 2000), the question arises as to whether these can be funded by foreign-direct-investment flows. It is true that the Polish market is likely to exercise a growing attraction on foreign investors, with so-called greenfield-site investment continuing to post rapid growth; at the same time, however, capital flows in connection with privatisation projects are going to decline. The most likely assumption, then, is that inward direct investment into Poland is set to stabilise at a high level and that the growth rates chalked up in the past cannot be maintained.

One opinion among economists is that fiscal policy is the instrument best suited to containing excessive current-account deficits. But the fact remains that it would be a major political endeavour to push through an overly restrictive budgetary policy in the coming years: on the expenditure side, a substantial amount of new investment will have to be made in connection with the adoption of EU law, above all in the environmental, transportation and agricultural fields. According to World Bank estimates, bringing the Polish economy into line with the EU's environmental-protection directives alone will cost between USD 31-57 billion. Even though aid will be forthcoming from Brussels, a large proportion of the costs in question will have to be borne by the public sector. Estimates conclude that the transposition of the entire *acquis* will involve annual adjustment expenditure of up to 5% of GDP.¹⁸ It is an open question whether countervailing fiscal-policy measures will prove politically viable, and indeed whether the consolidation measures planned at the moment (a balanced budget has been projected for 2003) are realistic.

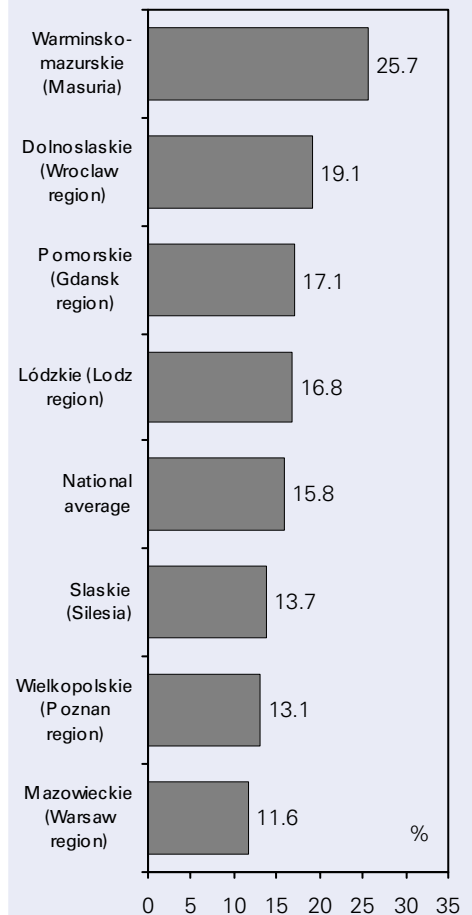
Last but not least, the consequences of the structural change taking place in rural regions could turn into a serious political problem. Although there is full employment in the city of Warsaw, eastern parts of the country – marked by agricultural structures – are having to contend with unemployment rates which in some cases exceed 30%. Unfortunately, labour mobility is very low in Poland. At the same time, it stands to reason that the eastern regions are going to profit far less from Poland's integration into the EU than their western counterparts. It will be the task of a forward-looking structural policy to deliver political stability in the face of the growing gulf between the east and the west of the country, but also to come to terms both with budgetary constraints and with the restrictions of EU competition policy.

Poland: Current account balance



Poland: Unemployment rates in selected regions

(as of March 2001)



¹⁷ A similar development cannot be ruled out in the area of consumer-goods imports, either, if consumption behaviour reflects expectations of a future rise in the standard of living.

¹⁸ Cf. A. Mayhew, Financial and Budgetary Implications of the Accession of Central and Eastern European Countries to the European Union, Sussex European Institute, Working Paper No. 33, 2000.

Conclusion

Thanks to the successful nature of the reform process, there can be no doubt that Poland today is one of the most advanced accession candidates. Nevertheless, the problems in certain spheres seem to be greater than in the case, say, of the Czech Republic or Hungary. It is important, however, to take a differentiated view here: with respect to many issues which are critical from the enlargement point of view, the real obstacle on the road to the EU is not the relatively unfavourable state of play in Poland but rather the sheer size of the country. Poland has a larger population than all the other EU aspirants, taken together, who have a serious chance of joining in the first enlargement wave: the problems cropping up when it comes to integrating new members are frequently less acute in the case of other accession candidates not on account of structural differences relative to Poland but because similar difficulties become *quantités négligeables* due to lower population levels. By contrast, the financial and politically sensitive questions connected with the eastward enlargement of the EU are concentrated, as though in a lens, in the case of Polish accession – and are generating corresponding political heat. This would also explain why Poland's accession negotiations regularly provoke a greater degree of controversy.

The political challenges will even increase when the accession process enters its final phase: many difficult compromises will have to be reached and made intelligible to demanding electors in both the EU and the accession countries. What matters from the point of view of Poland's reform-oriented politicians is to ensure as concrete an accession scenario as possible in the years remaining. Eastward enlargement of the European Union is a lengthy and technocratic process, in which landmark decisions all too often seem to disappear in inexorable mills of detail. What is essential is that the EU does not forget in the course of detailed 'micro-level' negotiations to what extent a positive economic trend would support the political logic of eastward enlargement. It would be disturbing if the EU's negotiation positions during the final countdown to enlargement were to increasingly become captive to the short-term political agenda and to the election schedule. Not least in view of what has happened in the five new federal states of eastern Germany, it must be obvious that the best way to keep the costs of the enlargement process low is to ensure that Poland's impressive economic momentum is maintained.

Moritz Schularick, +49 69 910-31746 (moritz.schularick@db.com)

A successful transition, but still a rough road to EU integration

Poland's sheer size ...

... makes the sensitive key enlargement issues manifest

A concrete accession scenario is important for reform-oriented politicians in Poland

A dynamic economic trend would support the political logic of EU enlargement

The EU's negotiation positions must not become captive to the election schedule

EU structural reforms: no time for complacency

The EU member states and the European Commission continued to demonstrate self-confidence at the summit held in Stockholm in March, claiming that the European Union remains on a robust growth path despite the less favourable economic environment which is currently prevailing internationally. And it is a fact that the EU economy is likely to expand more vigorously than its US counterpart in 2001 for the first time in a decade (DBR forecast: EU +2.2%, US +1.5%).

However, this is only one side of the coin. After a “completely satisfactory” year, in which the EU racked up the highest growth rate since 1991 (3.3%), economic activity is now cooling to an unexpectedly pronounced extent in Europe too.¹ Even the current forecasts are undergoing revisions. As a result, the European Union’s lead over the United States should not blind one to the reality of the situation: it appears that the momentum of the domestic economy is not strong enough to enable the EU to extrapolate last year’s growth trend, which was fuelled above all by external factors (the weak external value of the euro, and the favourable state of economic activity in the US).

But it was precisely the generation of such momentum which was the objective that the EU Heads of State and Government envisioned at the summit held in Lisbon in the spring of last year when framing their future strategy for the Community: the idea was that the EU should, by 2010, become “the most competitive and dynamic knowledge-based economy in the world – capable of sustainable economic growth with more and better jobs and greater social cohesion.” Average economic growth of 3% (a figure last achieved in the 1970s), the creation of 20 million new jobs and a participation rate of roughly 70% were the targets being aimed at over the period in question.

On the basis of the conclusions of the Lisbon summit, EU member states are committed to liberalising their markets and modernising the “European social model”, with the main emphasis falling on four policy areas:

- Employment and social cohesion;
- Innovation and the promotion of a knowledge-based society;
- Economic reforms and liberalisation measures; and
- Improvement of the underlying corporate environment.

Responsibility for the successful completion of this substantial agenda essentially lies with the individual member states, and with the European Commission to the extent that corresponding directives have to be proposed. The plan is that jointly agreed and partially quantified objectives should be striven towards by the various member countries, which will be free to choose between competing means to the end in question (“new open method of coordination”). Such an approach takes account of the fact that EU member states display different structures, for example in terms of labour markets, and recognises that reforms have to be geared to the specific conditions prevailing in the individual nations. Developments in the various areas are being monitored with the help of structural indicators, and the policy conducted in the individual mem-

EU growth has been driven by external factors

| Real GDP growth (%) | | | | |
|---------------------|---------|-------|-------|---------|
| | 1961-70 | 71-80 | 81-90 | 91-2000 |
| US | 4.2 | 3.2 | 2.9 | 3.2 |
| EU-15 | 4.8 | 3.0 | 2.4 | 2.0 |
| DE | 4.4 | 2.7 | 2.2 | 1.9 |

| Unemployment rate (%) | | | | |
|-----------------------|---------|-------|-------|---------|
| | 1961-70 | 71-80 | 81-90 | 91-2000 |
| US | 4.7 | 6.4 | 7.1 | 5.6 |
| EU-15 | 2.2 | 4.0 | 8.9 | 9.9 |
| DE | 0.7 | 2.2 | 6.0 | 8.2 |

Reforms need to be geared to specific national structures

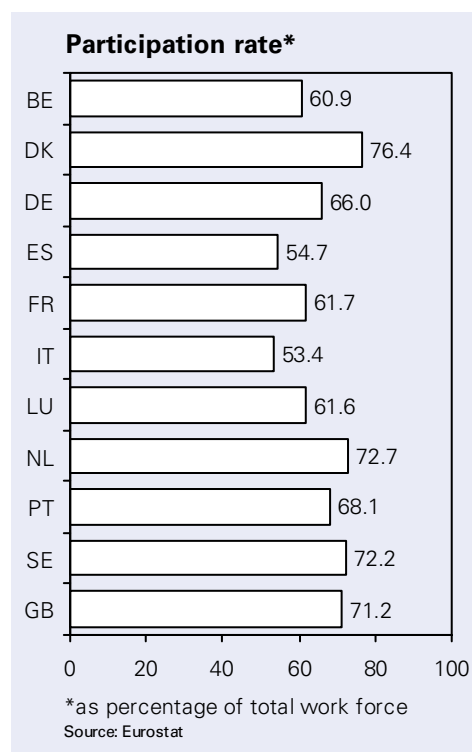
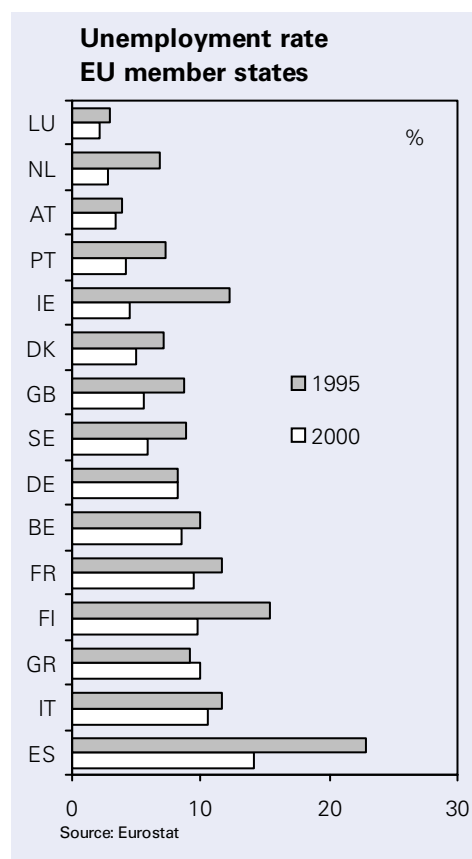
¹ It must, however, be noted that the path of the national economies differs in the EU, with Ireland, Finland, Greece, the Netherlands and Spain growing at a distinctly above-average rate and Italy and Germany bringing up the rear.

ber states is subject to performance evaluations.² Past experience has already shown that no member country has found optimum answers across the whole spectrum of economic policy to the current challenges; first one member and then another sets the pace or comes up with new solutions to the problems concerned. An approach which involves observing developments across the individual member countries right down to the level of individual economic-policy measures is therefore meaningful. What is more, benchmarking and best-practice comparisons – with international competitors as well – can give rise to peer pressure, ensuring that a pro-growth and pro-innovation economic policy will be pursued on a European basis even without precise central coordination and harmonisation of measures.

It was agreed at the Lisbon summit that the progress made within the framework of the future strategy was to be consolidated every year at the respective spring meeting of the European Council and that any need for further action (including the coordination of schemes with time schedules) was to be identified. The first opportunity for such an exercise arose in March of this year in Stockholm, in the course of Sweden’s EU Presidency.³ It became obvious that the expectations aroused last year by the governments of the member states about an imminent resolute change of course in European economic policy, combined with redoubled reform efforts, had not been fully met.

Employment and social cohesion

Labour markets are the main focus of the measures relating to employment and social cohesion. And it is indeed the case that the employment situation above all is regarded by the general public as an indicator of the EU’s economic strength – even though the EU does not have competences of its own in this domain.⁴ Roughly 2.5 million new jobs were created in the course of 2000. The EU-wide unemployment rate has fallen to the lowest level since 1991 on the back of the buoyant growth which has been registered. Moreover, the participation rate has climbed from 60% to more than 63% over the past three years. These are pleasing improvements. Nevertheless, the unemployment rate (8.4%) was still twice as high last year on this side of the Atlantic as in the United States (4.0%). At the same time, more people in the United States are integrated into the work process than on an EU average: the EU employment rate is almost 10 pp below its US equivalent.⁵ It must also be emphasised that the increase in employment recently



² Roughly 40 structural indicators have been agreed on for the four policy areas, 27 of which are statistically available for EU member states (and the US). In some cases, the remaining indicators still need to be evolved. Then there are key indicators relating to the macroeconomic environment. For information on the individual indicators, the way they are defined and their availability cf. the Communication of the European Commission COM (2000) 594.

³ In the report it presented to the Spring Meeting of the European Council, the European Commission provided an overview on the progress reached (and the shortcomings not yet eliminated) in the previous twelve months and formulated ten main focuses of action for Stockholm: “Realising the European Union’s Potential: Consolidating and extending the Lisbon Strategy,” COM (2001) 79, 7.2.2001. The London-based Centre for European Reform has graded the progress made to date within the framework of the Lisbon Strategy C+, cf. Edward Bannermann, The Lisbon Scorecard, Centre for European Reform Working Paper, March 2000.

⁴ The Commission does however set up annual employment-policy guidelines which EU member states have to take into account when shaping their individual national policies.

⁵ The gap relative to the US is largely due to the difference in the participation rate for women and older workers. Despite the pick-up in economic activity, the participation rate of workers aged between 55-64 in the EU continues to be low: on average, only just over one-third of this age category is in employment. According to the Stockholm summit, the participation rate in this segment is to be raised to 50% by 2015.



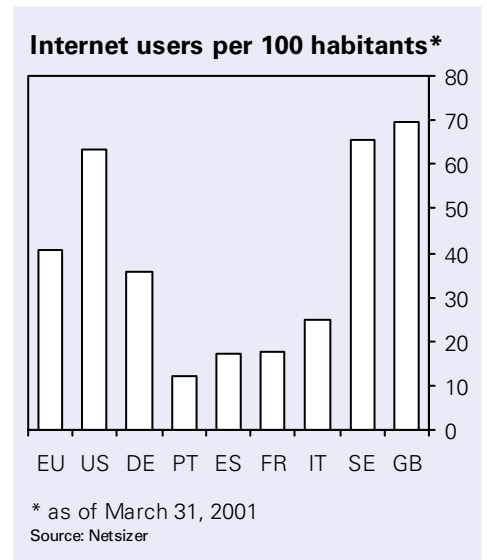
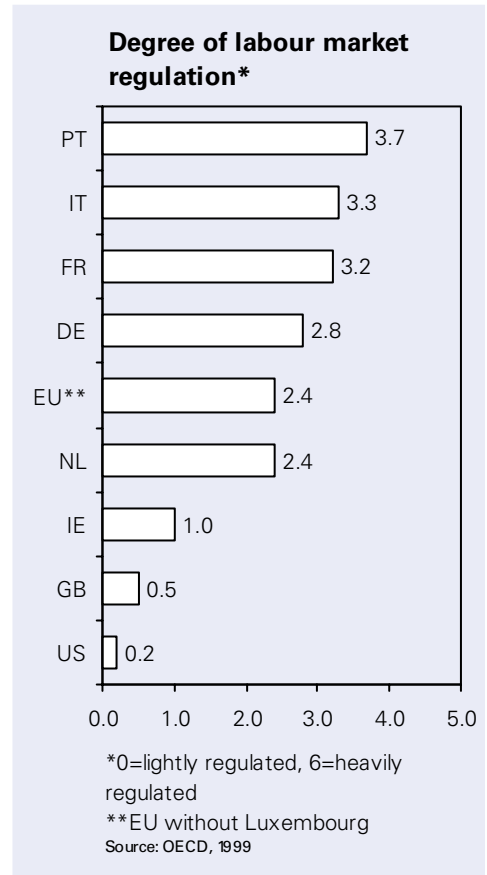
recorded in the EU has largely been a function of the economic upswing, and it is therefore only logical that this process should be going into reverse now that the economy is slowing. By contrast, the United States could until recently point to a positive trend in employment even during the economic cooldown which started last year.

Far-reaching reforms designed to eliminate the structural weaknesses afflicting European labour markets have still not been effected to an adequate extent.⁶ EU labour markets remain relatively heavily regulated, in terms of both government interventionism and agreements reached by the two sides of the collective-bargaining process. Politicians in very few countries have dared to try to come to terms with costly social-insurance legislation. Indeed, the decisions reached on the employment-policy front in Germany (including the legal entitlement to work part-time) point unmistakably in the wrong direction and therefore run counter to the “spirit” of the Lisbon summit. Another point is that the tax burden on labour inputs continues to be far heavier in Germany and in other EU countries than it is in the USA. And there is still a considerable need for political action on the qualifications side, which is after all the interface between the goal of a high employment rate and the development of a knowledge-based society.⁷ It would appear that the “peer pressure” brought to bear by the implementation of successful measures in other countries has not proved particularly effective as yet, at least not in this sphere. To recognise this is not, however, to advocate that the EU should acquire competences of its own in the field of employment policy.

Nonetheless, it is desirable that the European Commission should undertake to make European labour markets more open, not least with a view to reducing regional bottlenecks. As little as 0.4% of the EU population (or roughly 1.5 million persons) moves to another member country each year with the aim of working there. Inter-state mobility is more pronounced in the United States, where the equivalent ratio is 2.4%. On the other hand, the US ratio is surprisingly low when one considers that the American citizens in question move within a homogeneous language area and within a single social system. In the EU, by contrast, language continues to constitute a barrier to mobility. But regulatory obstacles – the fact, for instance, that mutual recognition of professional qualifications does not function properly in practice – are another important factor preventing EU citizens from uprooting themselves. The non-portability of social benefits and the different tax treatment of pension entitlements in the various member states are further problems.

Innovation and the promotion of a knowledge-based society

Even though the euphoria surrounding the new economy is waning, efficient use of the internet remains an indispensable prerequisite if the EU is to prove competitive. The Old World has made up a good deal of ground on this score. Over the past twelve months, the share of EU households with internet access has more than doubled, although internet penetration is still distinctly lower than in the United States (at 28% as against 47%). Companies’ e-commerce capabilities have also



⁶ When assessing employment policy, as well as the other topics which have been addressed, it is important to take into account that the overall statements about the EU disguise pronounced differences between the member states.

⁷ Almost 80% of all new jobs are being created in sectors which presuppose advanced secondary-school education. However, the structural indicators disclose that numerous young people do not acquire these qualifications.

improved. IT markets are not only growing more rapidly than the individual national economies (the exception which proves the rule here is Ireland); they are now growing faster than their counterparts in the United States too. In some segments, when it comes to mobile-telephone penetration for example, Europe is actually in the lead. However, it is imperative that swift progress be made towards framing a transparent and meaningful legal framework for e-business, as envisaged by the e-Europe Action Plan.

At the same time, European corporations need to take more advantage of the potential unlocked by the new technologies and step up their innovation endeavours. There is obviously a gap between self-image and reality if more than 50% of European corporations describe themselves as innovative while less than 10% of EU-wide sales are accounted for by new products. As a share of sales, the research expenditure of European companies only comes to 60% of the level disbursed by their opposite numbers in the United States.⁸ Where 5.9 out of every 1,000 workers at US companies are researchers, the equivalent figure for the EU is just 2.4 (Japan: 6.3). A higher level of investment activity would also help to narrow the considerable productivity gap between the EU and the US.

It has to be said, moreover, that the research environment in the United States is superior in many fields, as the decision by European companies to conduct research activities on the other side of the Atlantic makes clear. The 1990s witnessed an appreciable brain-drain, with researchers leaving the EU for the US (1997: 83,000). Last but not least, duplication, insufficient coherence and fragmentation of research activities diminish the effectiveness of the wide-ranging technological know-how which is available within the EU.⁹ It is therefore essential, for example, that the planned regulation governing a European Community patent (a meaningful alternative to the various national patents, which could cut the high cost of patent applications in the EU) should come into force as quickly as possible.

Economic reforms and liberalisation measures

The core task facing the EU remains the realisation of the single market, which has not yet truly been "completed". Admittedly, substantial progress has been achieved in many areas: the phasing-out of obstacles to cross-border trade, the opening-up of markets and increasing price transparency are showing up not least in lower levels of price differentiation between the various markets. By way of example, the "fluctuation margin" capturing the differences between the highest/lowest price for goods and services in individual member states and the average EU price was still as high as +/-18% in 1995; by 1999 it had narrowed to +/-14% (cf. chart). The introduction of euro notes and coins and the concomitant increase in transparency can probably be counted on to give a further boost to price competition. Nonetheless, the potential of the single market has still not been exhausted. Not the least important yardstick here is provided by surveys which reveal that many companies are dissatisfied with the way the single market functions – and this is partly because single market legislation is only being hesitantly and unsystematically implemented into national law in some cases.

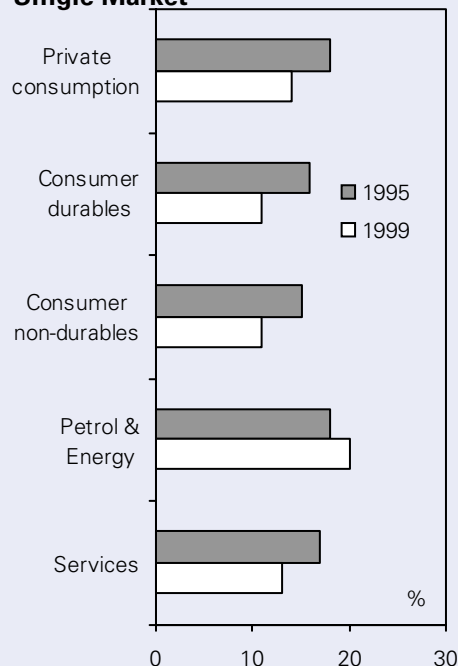
⁸ The EU's "deficit" in terms of private-sector and public-sector research expenditure relative to the US increased from EUR 40 bn in the mid-1990s to EUR 75 bn in 1999.

⁹ On benchmarking with respect to research and innovation and the evolution of a scoreboard for innovativeness see "Innovation in a knowledge-driven economy", COM (2000) 567.

It is imperative that companies step up their research efforts...

...and political decisions are needed to improve the quality of the research environment

Price differentiation within the Single Market*



*Differences between the lowest/highest price and the average EU price (incl. VAT)
Source: European Commission



Above all the creation of a common market for services, which by now account for around three-quarters of EU GDP, needs to be pushed ahead with. In one of the most rapid pieces of law-making witnessed in recent times, the European Commission, the European Parliament and the member states have created the preconditions for the deregulation of the so-called "last mile", thus clearing the last hurdle to completely liberalised telecommunications markets.¹⁰

The success story constituted by the liberalisation of the telecom sector should act as an incentive, causing comparable measures to be initiated in other spheres. The fact is, however, that member states have not met the obligations agreed at Lisbon, above all with respect to energy markets. On a de jure basis, two-thirds of the electricity market and three-quarters of the gas market have by now been opened up for large-scale consumers; but many complaints can be heard to the effect that, in reality, there is still no free market access in the various member countries.¹¹ No agreement could be reached in Stockholm neither concerning the Commission's concrete time schedules in this field nor with respect to postal services, the fragmented aviation architecture ("Single European Sky") or public procurement policy.¹² Alleged national interests have stood in the way of the common cause of opening up markets. Furthermore, appeals to 'services of public interest' mean that a large part of the services market threatens to remain closed to competition. It is therefore imperative that the advantages deriving from the opening-up of markets – i.e. distinct price reductions, greater choice and higher quality of services for both industry and consumers – are not nipped in the bud by entitlement mentality at the national level.

A particularly significant objective formulated at Lisbon is the creation of a single financial market by 2005.¹³ Various legal provisions make it more difficult and more expensive for companies to raise capital, erode the returns accruing to pension funds as well as other investors, and blunt investor interest in cross-border financial investments in the euro area. For example, there are currently roughly 40 different regulatory authorities responsible for securities markets in the EU. In the run-up to the Stockholm summit, a group of experts headed by Alexandre Lamfalussy came up with proposals¹⁴ for necessary reforms. Essentially, they called for a more speedy legislative procedure, arguing that the EU cannot afford in view of the high degree of complexity and rapid evolution of financial markets to have such slow decision-making channels leading from the elaboration of proposals to actual market implementation and to the amendment of already existing regulations – an argument which undoubtedly applies, to a lesser extent, to other areas of decision-making in the EU as well. At any rate, there are no indications to date that the measures needed if the creation of a single financial market is to be accomplished on schedule have in fact been taken.

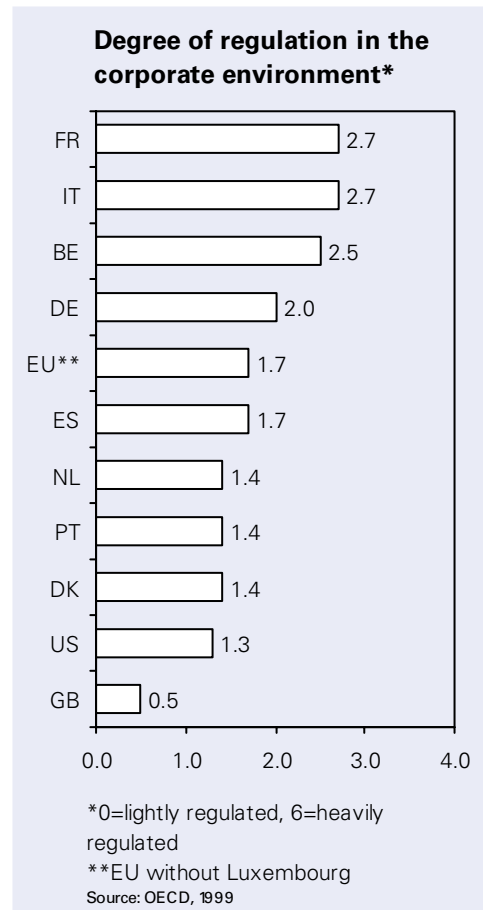
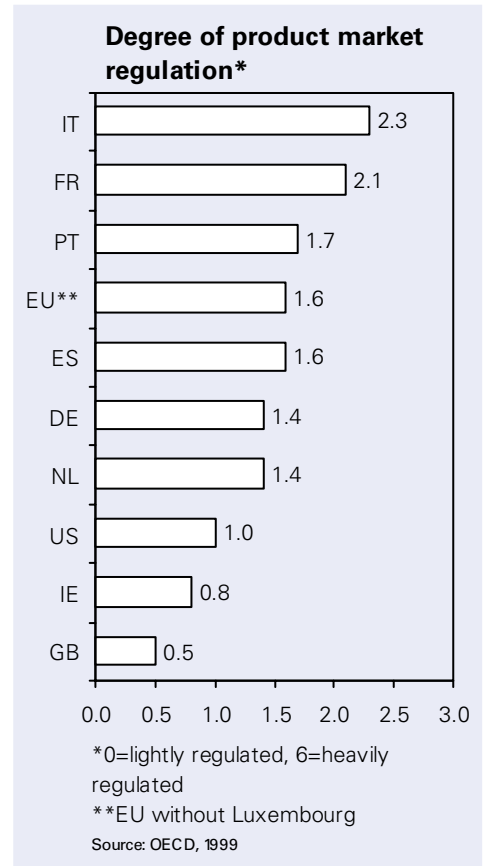
¹⁰ The cost of access to the internet – which is up to three times as high in the EU as in the US – is regarded as the greatest obstacle to more widespread use of information and communication technologies. Appreciable price cuts in local charges are expected to emerge from the deregulation of the "last mile".

¹¹ The EU-wide electricity market has an estimated volume of roughly EUR 150 bn, only 8% of which is traded on a cross-border basis.

¹² EU-wide public procurement has a volume corresponding to over 10% of EU GDP (slightly below EUR 1,000 bn). Only a small proportion of this procurement volume actually is put out for tender, and an even smaller proportion is put out for tender on a cross-border basis. When the pace of EU-wide competition heats up, the public authorities should have considerable scope for cost savings in this sphere.

¹³ Over 40 measures designed to eliminate existing obstacles are proposed in the Financial Services Action Plan.

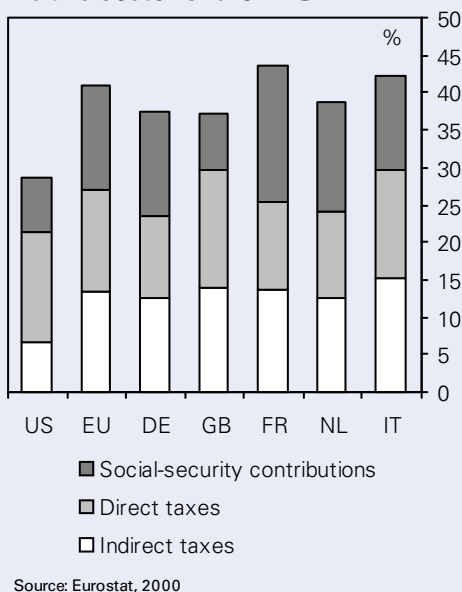
¹⁴ Final Report of the Committee of Wise Men for the Regulation of European Securities Markets, Brussels, 15.2.2001.



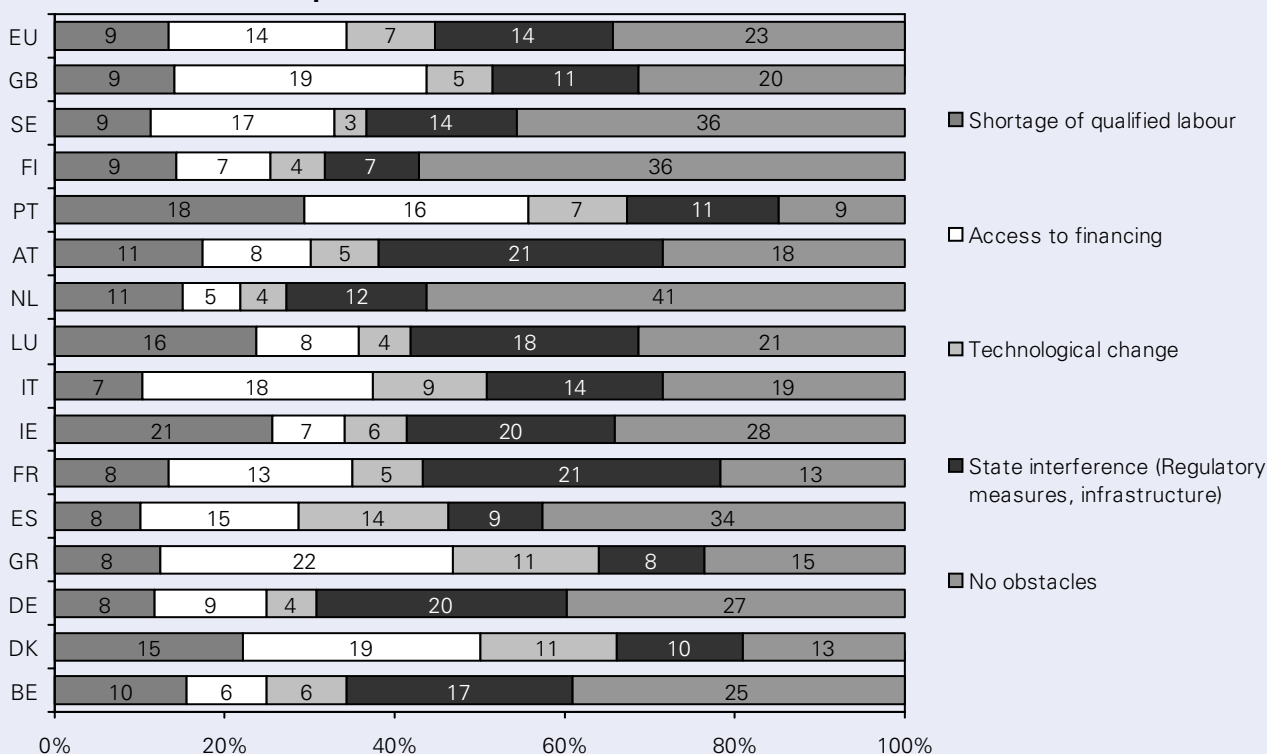
Improvement of the overall corporate environment

Hopes that the new economy would turn out to be a catalyst for new corporate structures and higher growth momentum in Europe have given way to disillusionment. However, this is due less to the (absence of) available potential than to the illusion which has hitherto been prevalent in the European political arena that the new economy paradigm could reduce the need for structural reforms or even render them superfluous. The point is that structural reforms are a pre-requisite for the new economy to materialise and that Europe needs to concentrate even more on promoting corporate initiative rather than putting obstacles in its path. Surveys of companies demonstrate that there continues to be a great variety of deficiencies in this department.¹⁵ Not only is the ratio of taxes and social-security contributions to GDP still disproportionately high; the EU is still a long way from honouring its pledge to create a “transparent, simple and effective regulatory environment” for companies.¹⁶ The national regulatory jungle continues to be dense, and is tending to get even denser in some member states (the reform of the legislation on worker participation in Germany is a case in point). It is also of paramount importance to set up a European legal framework which would make it easier for companies to do business on a Europe-wide basis. The European company statute which has been agreed on is an important step in this direction and should further the – cross-border – restructuring of Europe’s corporate landscape. For this

Public-sector share in GDP



Obstacles in the corporate sector*



* Results of a survey of European companies
Source: EU Commission, Benchmarking Enterprise Policy, SEC (2000) 1842

¹⁵ Survey results are documented, inter alia, in “Benchmarking Enterprise Policy,” SEC (2000) 1841.

¹⁶ In a large-scale study, the OECD has attempted with the help of over 150 indicators to estimate the impact of the regulatory environment on the competitive situation of a given country: “Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation,” OECD Working Papers No. 226, Paris 1999.

to be a realistic option for companies, however, above all tax questions still need to be speedily settled. An EU regulation governing corporate takeovers has not yet been promulgated either – and it has been only recently that Germany has questioned the consensus which was reached with such difficulties.

More courage needed on the reform front

A key merit of the future strategy unveiled at Lisbon is that it permits a reality check for European (summit) rhetoric in the form of transparent and largely objective criteria (the so-called structural indicators) and concrete time schedules. Anyone taking stock after one year cannot but feel rather sceptical. Declarations of intent and monitoring procedures conceal that the obligations entered into at Lisbon to further develop the single market have not been met and that the impetus associated with the future strategy is already in danger of waning in the first year of implementation. What is even more problematic is that the Stockholm get-together of EU Heads of State and Government, billed as a “Growth and Employment Summit”, has failed to provide any clear signals of how the EU’s future should look in terms of economic and social policy. The much-vaunted “modernisation of the European social model” is largely limited to attempts to preserve the status quo. The majority of EU member states are far removed from the goal of achieving “well-designed and well-functioning social-protection systems”. Given that the quality of the landmark decisions which have been reached is inadequate with regard to *Ordnungspolitik* (market oriented policy), it comes as no surprise that the pace of growth is once again flagging, that financial markets are still sceptical and that the euro is still weak. In its current shape, the European economy will scarcely be able to defy the retarding effects emanating from the economic downswing in the United States, even though it is true that goods and labour markets in certain member states have by now become more flexible.

The EU is not managing to translate its biggest assets – the common single market and the common European currency – into sustainable economic momentum. For one thing, decision-makers keep succumbing to the temptation to reduce the pace of economic reforms and consolidation endeavours in phases when economic activity is robust.¹⁷ For another, the leitmotif of European integration is absent in many national – and, more specifically, economic-policy – decisions: one case in point is the lack of coordination between policymakers which was evident when it came to responding to last year’s run-up in oil prices.

Finally, there is a danger that the existence of so many “building sites” in the EU makes it impossible to perceive what is really important. As a matter of priority, the EU and its member states need to

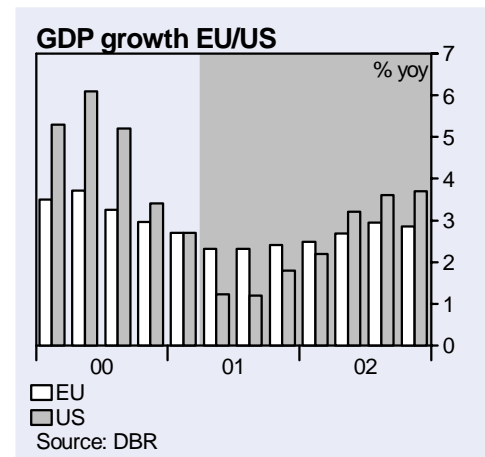
- do all in their power to increase employment by enhancing the qualifications of employees and promoting mobility and flexibility at the labour-market level;
- liberalise the not yet deregulated areas within the single market rigorously and simultaneously;

¹⁷ The progress made in terms of consolidating public finances in EU member states is largely due to increased revenues in conjunction with lower investment and interest rate expenditure, and only to a lesser extent to a reduction in government consumption expenditure. Such a strategy is not suited to the task of imparting growth stimuli on a sustainable basis. What is more, in such conditions an economic turndown will problematically limit the room for manoeuvre available to fiscal-policymakers. A “qualitative” consolidation of public finances is also imperative.

Impetus to follow the Lisbon obligations is waning within the EU ...

... and at the same time ...

... the retarding effects of the slowdown in the US economy are taking their toll



- create the framework for a common market for financial services and venture capital, keeping to the deadlines which have been set;
- prune the regulatory jungle in favour of a pro-innovation, pro-growth environment for companies; and
- radically modernise the European social model.¹⁸

It is important that the Community's economic-policy strategy is consistent, i.e. that European initiatives and national decisions are in line with the same – liberal – economic philosophy. Europe's economy and society need more scope for individual responsibility and initiative. However, in almost all spheres where action is required, decisions have to be taken at a national level. Whether we are talking about making labour markets more flexible, reducing the burden of taxes and fiscal charges, liberalising the markets for postal services and energy or about streamlining bureaucratic structures and implementing deregulation, it is up to the member countries to make the corresponding improvements. Even though it is the Commission's function to initiate legislation, the economic (and political) future of the EU can only be shaped at the national level. The EU as a whole can only be as good as its constituent member states. That said, the individual members should be spurred on in their endeavours by the positive examples set by fellow members, and should show greater ambition in the contest which will reveal who has the best economic credentials.

EU member states should show greater ambition in the contest for the best economic credentials

Barbara Böttcher, +49 69 910-31787 (barbara.boettcher@db.com)

¹⁸ This also implies a modern conception of the role of the social partners as well as a consensus in societies to enable better coordination between family and career.

M&As in the financial industry – a matter of concern for bank supervisors?

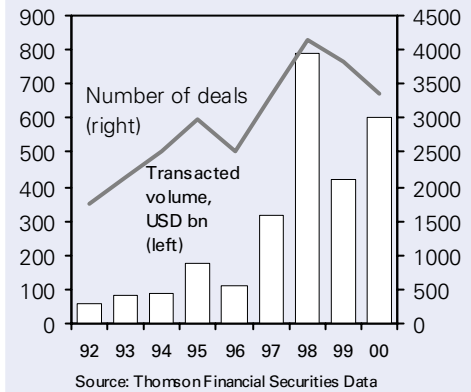
Merger and acquisition activity among financial firms world-wide has increased sharply in recent years (see chart), with deals of unprecedented scope and scale grabbing the headlines. The bulk of the M&A activity still consists of domestic mergers, involving firms competing in the same segment of the financial services industry (mainly banks). However, along with a sharp increase in the average size of single transactions, the share of cross-border M&As has risen significantly (see chart). Also, the creation of financial conglomerates – i.e. of groups operating in more than one sector of the financial industry – is constituting an increasingly important part of overall activity, with *bancassurance*, which combines banking with insurance business, as a prominent example¹. As a result, a significant number of large, and in some cases increasingly complex, financial institutions has already been created, and both more cross-border deals among large players and more transactions across the different sectors of the financial industry seem to be in the offing. Indeed, in view of the scope of the changes driving financial sector consolidation, the current extraordinary wave in M&A activity can be expected not to come to an end before a substantial further restructuring has taken place.

M&As have positive implications for the industry involved. They are an indication that market participants are responding and adapting to pressures for change such as globalisation and deregulation of markets, the advent of new technologies and product innovations and increased shareholder pressure for strong financial performance. In this environment, size offers a whole variety of strategic advantages, which in the financial sector range from the ability to handle what is now a standard lot in underwriting of securities issues or big syndicated loans and the advantages of a strong customer base in trading activities to massive economies of scale and scope in transaction banking, distribution and marketing as well as asset management. For example, the possibilities for cross-selling can only be utilised in the context of a sufficiently large institution, possibly involving firms in different segments of the industry. This is illustrated by *bancassurance*, with banking and insurance products being sold through one single distribution network, possibly consisting both of the traditional systems of bricks-and-mortar branches or selling through agents and new distribution channels, and with significant economies of scale in asset management. Another reason for cross-sector consolidation is the increasing complexity of products (e.g. in the context of the current pension reform in Germany). Finally, consolidation, especially through conglomeration, implies a diversification of risks and less volatility of profits over time.

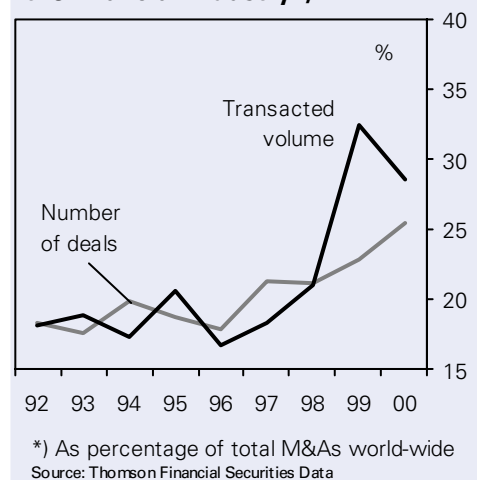
From an economic point of view, the drive to attain cost savings, revenue enhancements and a smoothing of income volatility in the process of financial consolidation should be welcome, since it implies both a reduction in excess capacity and the achievement of a higher degree of efficiency in the financial sector. In addition, at least *prima facie* the stability of firms and therefore of the whole sector should benefit from the process of market participants adjusting to the new business environment.

¹ *Bancassurance* has recently come back to the focus of public interest in Germany as a result of the surprise announcement of a merger between Allianz AG (the world's third largest insurer) and Dresdner Bank (ranked 22nd world-wide in terms of total assets).

M&As in the financial industry world-wide



Share of cross-border M&As in the financial industry*)



M&As have obvious advantages from an economic point of view ...

Despite these obvious advantages, the attitude of bank supervisors towards financial-sector restructuring has remained sceptical², mainly for three reasons:

- Based on the results of a large body of research by academic economists and business consultants, the authorities question the “success” of M&A transactions among financial firms.
- Also, and in sharp contrast to what one would assume *prima facie*, bank supervisors are concerned that the process of consolidation might have a *negative* impact on the stability of the financial system.
- Finally, though less pronounced, the apprehension expressed in public-sector comments on M&As among financial firms also extends to the fear that liquidity in inter-bank markets might shrink given the diminishing number of market participants and ever more netting within the larger financial institutions.

Most of these arguments have some truth. However, when scrutinised more closely, the critical attitude of the authorities seems largely unconvincing, at least from a longer-term perspective. Especially, transitory problems which arise in the process of consolidation should be given less weight, compared to the long-term benefits of financial-sector M&As. On the other hand, the current reorganisation of the industry, and especially the increase both in cross-border M&As as well as in transactions across financial sectors have important implications for bank supervisors, since the existing structures of financial supervision might very soon turn out to be inadequate, given the large and unprecedented structural changes in the financial industry.

“Success” of bank mergers

The concern of bank supervisors that market participants might systematically over-estimate the advantages of M&As and under-estimate the downside risks associated with the process of restructuring is based on a large body of empirical studies by academic economists and business consultants. These studies attempt to measure either the potential benefits of mergers in general (mainly by trying to identify the prospective economies of scale and scope) or the “success” of a specific merger at some point in time after the deal was completed. In this latter category, various yardsticks are used, including the repositioning of the merged entity in terms of cost and profit efficiency or the development of simple balance sheet ratios or of the valuation of the new company in the stock market (in both cases, compared either to initial values, or to a benchmark taken from the industry as a whole, or to the strategic goals stated on the announcement of the transaction).

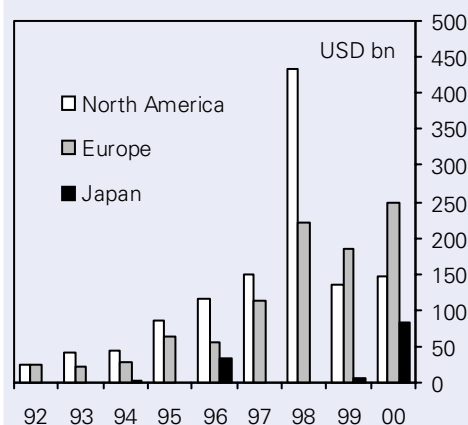
In general, the results of these studies lead to the conclusion that most mergers fail to add value³ either in the form of superior stock price performance or in the form of cost and profit advantages of the com-

² In January 2001, the “Ferguson Report” – a major study on the possible effects of financial consolidation on matters of policy concern commissioned by the finance ministers and central bank governors of the G-10 nations, which adopts a critical attitude towards financial sector M&As – was released to the public (Group of Ten, “Report on Consolidation in the Financial Sector”, January 2001, also available at www.bis.org, www.imf.org and www.oecd.org). The scepticism of bank supervisors both in Germany and at the BIS level was also expressed in various speeches and publications.

³ Due to the complexity of the studies, and the variety of techniques used, it is difficult to give concrete numbers backing this result. Some consultants claim to have found that 2/3 of all mergers fail to achieve the proclaimed strategic goals, others say that only one transaction out of four is advantageous, or that only 30% have added value, as measured against a benchmark.

... however, the attitude of bank supervisors has remained sceptical

Regional M&A activity in the financial industry



Source: Thomson Financial Securities Data

Ex post results of M&As seem to contradict the arguments in favour of a restructuring and to belie the motivations given by practitioners



bined institution. Moreover, especially in the US, most large-scale M&As in banking have even resulted in the destruction of shareholder value, as defined in terms of market capitalisation. Also, it is claimed that economies of scale can be clearly identified for small and medium-size banks only, and that there is no numerical evidence on any economies of scope. In sum, the empirical results for M&As in the financial industry seem both to contradict the (theoretical) arguments in favour of a restructuring and to belie the motivations given by practitioners.

In the eyes of bank supervisors, the empirical findings might support the view that the management's judgement of potential M&A transactions must be biased, and that mergers might be partially driven by factors outside the realm of economic efficiency (e.g. the imitation of prevailing management trends, or purely tactical moves). If true, this assessment would provide a strong argument in favour of the authorities' sceptical attitude. However, there are also a number of potential explanations why the empirical findings need not necessarily be in contradiction to the industry's view that M&As constitute a healthy process of economic adjustment:

- In part, the results mirror the difficulties of successfully managing a merger between two financial firms. Indeed, the choice of partner, the due diligence process, a quick and thorough implementation of the deal and effective integration management – especially the ability to combine cultures and motivate teams, as well as to provide extensive external information to the customers – are decisive in attaining the strategic goals of the transaction⁴. The observation that in a number of cases mergers have been badly managed, can, however, not be taken as evidence against the case for financial sector M&As in general.
- The emphasis on the fact that on average, or in most cases, M&As do not lead to significant improvements, is not to say that there cannot be or have not been quite a number of extremely successful deals which provide powerful pieces of counter-evidence. Therefore, as an alternative to discussing financial sector consolidation as a whole on the basis of statistical averages, it might be more appropriate to look at the relevant determinants of the respective post-merger performance of financial institutions.
- By definition, M&A transactions have to be viewed as long-term projects. In the short run, the costs of merging are admittedly very high: most of the benefits will only fully materialise in the medium to long term. By contrast, the time horizon of most empirical studies is very short (in many cases only 1 or 2 years).
- Also, many M&As have been designed with a view to preparing for the advent of challenges which have not yet fully materialised, so they still have to stand the test in the future. Moreover, as things stand today, current regulations – which might however be corrected – have in many cases (especially in cross-border consolidation) prevented financial institutions from reaping the full benefits of the deals.

⁴ For example, in a recent report, the International Labour Organisation argued that the high failure rate of M&As in the financial services sector could be significantly reduced if top management paid more attention to the views and welfare of employees (International Labour Organisation, "The Employment Impact of Mergers and Acquisitions in the Banking and Financial Services Sector", Geneva, February 2001, also available at www.ilo.org). A study by KPMG, the accounting consultancy, suggests that, for M&A transactions, the chances of success would rise by a quarter if satisfactory attention were paid to cultural issues.

However, there are a number of explanations for this discrepancy:

1. The observation that mergers have been badly managed, is no evidence against the case for M&As in general

2. M&A transactions have to be viewed as long-term projects

3. Many M&As have been designed with a view to preparing for the advent of challenges which have not yet fully materialised

Besides, for an outside observer it might also be somewhat surprising that bank supervisors are concerned with the “success” of M&A transactions at all, i.e. that they devote their attention to whether, or to what extent, business leaders in the financial services industry are taking the right decision when they initiate an M&A, at least as long as other concerns – relating to the core mission of the supervisory authorities – do not come in. Bank supervisors should be concerned whether the current M&A activity might pose a threat to efficient risk management and supervision, and whether ultimately the stability of the financial system itself might be at risk. Given these legitimate concerns, it might, however, be more appropriate to proceed directly to discussing the implications of the current process of financial-sector consolidation for risk management and financial-sector stability⁵. As it turns out, while the arguments of bank supervisors in this realm cannot be dismissed entirely, they seem however greatly exaggerated, and should not provide a valid argument against a further restructuring of the financial industry.

Implications for risk management and financial system stability

A standard argument is that in the event of intensifying competition, and excess capacities in the financial industry, some market participants might be tempted to engage in excessive risk-taking in order to make up for declining profits, thereby endangering the soundness of the financial system. In this context, M&As should be viewed as a means of enhancing system stability, since they provide a natural way of mopping up excess capacity without having to wait for market exits as a result of bank failures. At present, however, bank supervisors are concerned that the process of consolidation might have a *negative* impact on the stability of the financial system. They fear that during the process of integration, or in the context of large, and in some cases increasingly complex, financial institutions in general, the management might lose control over financial risk. Also, they are concerned that “market discipline” (i.e. the control of credit markets over the financial soundness of borrowers) might be weakened due to the increasing complexity of large institutions and that concentration and moral hazard (in the context of institutions which have allegedly become “too big to fail”) might generally increase the fragility of the banking system⁶.

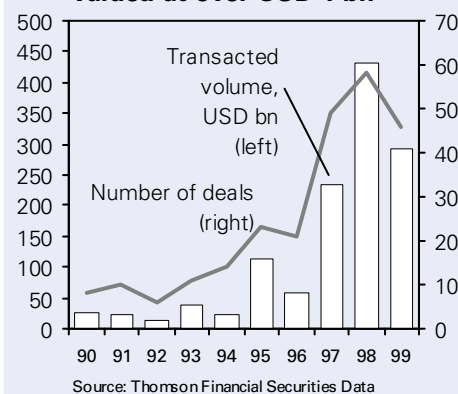
These concerns are not totally unjustified, since undisputedly most of the underlying arguments do have some truth. However, when put in a wider context, and especially emphasising the longer-term perspective as opposed to a short-run consideration of transitory issues, most of the authorities’ preoccupations seem greatly exaggerated:

- Clearly, in a bank merger, and especially in the case of a large-scale cross-border transaction, the transitory period of integrating two businesses and two separate risk management systems represents a phase of heightened operational risk. The process of consolidation therefore calls for a high level of responsibility in bank management. However, even though operational risk is a serious issue, and should be minimised, it would be a mistake if, for this reason, banks were in the future to renounce any internal or external restructuring.

⁵ One exception for this is that bank mergers or, more generally, mergers among financial firms usually need approval from the competition authorities, so these authorities might have to weigh the (prospective) efficiency gains against issues of market power. However, under a clear division of tasks, this should not be a concern for supervisory institutions.

⁶ Another concern of bank supervisors is that current shareholder demands might be excessive and that this could induce too much risk-taking by some international banks. However, this concern is more of a general nature, and goes far beyond the issue of M&As in the financial industry.

Financial-sector M&As valued at over USD 1 bn



Bank supervisors are concerned that the process of consolidation might have a *negative* impact on the stability of the financial system

Concerns of banking supervisors are greatly exaggerated

- In general, large institutions will be able to maintain a superior level of risk management, compared with small and medium-size units. Whereas large banks have at their disposal the human and financial resources and the expertise needed for the establishment of modern, professional state-of-the-art risk management systems, this is not always the case at smaller firms. In addition, larger institutions can balance comparatively larger risks much more easily, owing to the size and diversity of their portfolio. Obviously, there have to be adequate internal structures to ensure efficient use of the size advantage in risk management.
- The idea that consolidation might weaken “market discipline”, since credit analysts find it easier to pass judgement on a large number of smaller firms rather than on one big, and potentially complex, institution, may have some truth. On the other hand, professional analysts will probably learn to deal with complexity so that full “market discipline” will soon be re-established. Also, one could argue that consolidation, and especially any resulting increased complexity of financial institutions, will to some extent raise both the demand by markets participants for and the supply by institutions of information regarding a firm’s financial condition, and that the authorities might even stimulate a development along these lines through a sharp step-up in transparency requirements. The resulting rise in disclosures would very likely improve the quality of assessment of a firm by other market participants and encourage market discipline, thus lowering company-specific risk and increasing financial stability.
- The assertion that a higher degree of concentration in the banking sector would necessarily lead to more instability in the financial system is not fully convincing, either. At least as far as market or credit risk is concerned, the exposure of a multitude of smaller institutions to adverse developments or events is hardly to be preferred over that of a smaller number of bigger banks, especially since, given a very large number of small players, the re-allocation of risk and the interaction of expectations will at least to some extent lead to similar balance sheet structures. On the other hand, if, in the context of a multitude of smaller banks, the risk profiles differ widely and some parts of the banking sector might be shielded against certain adverse events or developments, this implies that other banks/parts of the banking sector will be even more vulnerable, so that it is hard to assess the overall effect on the stability of the banking system. Also, very importantly, the decisive ratio between underlying capital and exposure will not necessarily vary substantially with the degree of concentration in the financial system or in the credit markets. However, admittedly, with respect to operational risk or reputational/liquidity risk the existence of large banks with a significant market share might imply a higher degree of systemic risk⁷, compared with a large number of independently operating small banking entities⁸.

Top M&A deals in the financial sector 1996-2000

| | Transaction value (USD bn) |
|---|-------------------------------|
| Citicorp/Travelers | 72.6 |
| Dai-Ichi Kangyo/Fuji/ Industrial Bank of Japan | 70.9 |
| Bank America/Nations Bank | 61.6 |
| NatWest/Royal Bank of Scotland | 38.5 |
| Wells Fargo/Norwest | 34.4 |
| JP Morgan/Chase Manhattan | 33.6 |
| Associates First Capital/Citigroup | 31.0 |
| First Chicago/BANC ONE | 29.6 |
| SBC/UBS | 23.0 |
| General Re/Berkshire Hathaway | 22.3 |

Source: Thomson Financial Securities Data

Large institutions will be able to maintain a superior level of risk management

“Market discipline” will not be weakened

Assertion that a higher degree of concentration in banking would necessarily lead to more instability in the financial system is not convincing, either

⁷ If a big institution is facing adverse reputational or operational events, the degree of systemic risk will normally be higher. Moreover, in the case that a large and complex financial institution becomes seriously distressed – which can never be ruled out entirely – consolidation may have increased the likelihood that the winding-down of the institution will prove difficult and could be disorderly, especially if supervisors from different sectors and the central banks of more than one country are involved. The authorities would therefore be well advised to step up current efforts in co-operation and to provide some contingency planning for such an event, possibly in co-operation with the private sector.

- Finally, the argument that large institutions could incur (excessively) high risks because they were “too big to fail” is backed by little empirical evidence. While there are a handful of (famous) examples of public intervention in a crisis situation at a large financial institution (e.g. Continental Illinois), the evidence for “too big to fail” is far from clear, and in many cases, there was no public support, or the intervention was limited to orchestrating an orderly liquidation (LTCM). Moreover, no bank manager will deliberately gamble in the markets, and risk the financial soundness of his bank, on the grounds that he thinks the institution might be a candidate for a public bail-out, since, in most cases, a public bail-out will imply heavy sanctions both for the bank’s shareholders and for the bank’s management. In sum, “Too big to fail” does not imply any form of moral hazard that would have a significant impact on the degree of risk-taking by large banks⁹.

Argument that large institutions could incur (excessively) high risks because they were “too big to fail” is backed by little empirical evidence

The impact on market liquidity

Finally, bank supervisors are also concerned that M&As among financial firms and a reduction in the number of market participants might have a negative impact on market liquidity. Even if “market liquidity” is hard to define¹⁰, and despite mixed evidence from statistical indicators, there is a broad feeling among market participants that financial markets have remained less liquid than they were before autumn 1998. One of the explanations that is being put forward in this context is that “market liquidity” has shrunk because, in many inter-bank markets, the number of market participants has diminished.

The “liquidity” of a financial market very often hinges crucially on the willingness of certain market makers to take on positions, thereby equilibrating supply and demand over time. The size of the market makers’ “inventories” (and spreads) will mainly depend on their assessment of the risks involved, and will be limited by the market makers’ own capital. Therefore, at least in a simple theoretical model, a merger between two market makers should *not* affect liquidity in the respective market¹¹, at least as long as the process of consolidation is not equivalent to a reduction in existing excess capacities (if it is, a reduction in liquidity would anyway only represent a reversion to “normal” levels) and provided that the process of consolidation does not lead to the creation of an oligopoly or even a monopoly in the relevant market.

A merger between two market makers should *not* affect liquidity in the respective market

⁸ However, one might also argue that the risk that such events could actually endanger the stability of the respective institution as a whole is much smaller in the context of sufficiently large firms, since, given a certain negative event, a small institution might very soon not be able to handle the impact of this event anymore, whereas large institutions could more easily digest adverse events up to a certain size.

⁹ The issue of “Too big to fail” is discussed in more depth in M. Wolgast, “Too big to fail” – effects on competition and implications for banking supervision, Deutsche Bank Research Frankfurt Voice, May 31, 2001, also available at www.dbresearch.com.

¹⁰ Usually, “market liquidity” is discussed in terms of “tightness” of bid-ask spreads, “depth” (as measured by the impact of large orders on prices) and “resilience” (i.e. how quickly prices are brought back to “equilibrium” after temporary deviations). Often, the trading volume is used as a proxy for market depth. However, strictly speaking, high trading volumes do not necessarily imply a high degree of “liquidity” since prices may still be very volatile even if market turnover is high.

¹¹ In a more sophisticated model which includes the operational costs of market making, one might even argue that a consolidation among market makers might reduce fixed costs and therefore – *ceteris paribus* – increase market liquidity.

Consequently, the perceived reduction in market liquidity should rather be attributed to other reasons – and there are plenty of them. For example, a revision of banks' assessments of the risks of market making seems very plausible in the aftermath of the events in autumn 1998, i.e. after the Russian crisis and the fall of LTCM. Also, a reduction in the trading activities of non-market makers (e.g. institutional investors or large corporations) may have contributed to the decline in "liquidity" independent of a consolidation among financial firms. A third explanation would be that ever more netting within the large financial institutions has given rise to the impression that the "liquidity" in the markets is shrinking. In sum, the supervisors' concerns over financial consolidation need not necessarily be endorsed on this point, either.

Consequently, the perceived reduction in market liquidity should rather be attributed to other reasons and not to M&As among financial firms

Challenges for bank supervisors

While the concerns of bank supervisors seem exaggerated, the scope of the current world-wide restructuring exercise in the financial sector has, conversely, important implications for financial supervision. One is that in order to react to the growing number of large cross-border M&As and the creation of increasingly complex financial institutions, a host of measures need to be taken to enhance current supervisory practice in this field. Second, and more importantly, going far beyond the current framework of financial supervision, there is a need to discuss the question whether the existing structures, and especially the double fragmentation of supervisory institutions (by national borders and between financial sectors), are still adequate when large financial firms operate on a global scale rather than within one single nation state, and when the borders between financial sectors have become increasingly blurred. In a way, rather than being (academically) concerned about what M&As imply for the institutions supervised, bank supervisors should be concerned with the implications for their own institutions, or with the necessary reactions and with adapting to the new environment. A general ban on mergers is definitely not a realistic alternative, especially given the implications for efficiency and economic welfare.

A host of measures need to be taken

General ban on mergers no realistic alternative

As a first step, and within the current framework of financial supervision, the authorities should seek to improve existing policies on a number of points¹²:

- In the realm of regulation and prudential supervision, internal risk management must be encouraged, thus lowering the probabilities of both an individual firm experiencing severe financial difficulties and of a systemic crisis. A critical component of the efforts towards more effective risk-based supervision of financial institutions should be risk-based capital standards (as is the stated objective of the Basel II proposals).
- In order to enhance "market discipline," i.e. the control of credit markets over the financial soundness of borrowers, the authorities should adopt a firm stance on requirements for better transparency and disclosure¹³, in order to enable investors and creditors alike to correctly assess the risk profile of the respective institution. Efforts in this field can to some extent benefit from the current endeavour

Encourage internal risk management

Enhance "market discipline" ...

¹² Most of these recommendations are also put forward in the G-10's Ferguson report.

¹³ The issue of financial disclosure is discussed in various publications by the Basel Committee on Banking Supervision. Recently (January 2001), the recommendations of a private-sector working party on public disclosure, set up at the initiative of the major US regulatory agencies and chaired by Walter Shipley, retired chairman of Chase Manhattan, were released to the public (available at www.frb.gov).

to promote world-wide accounting conventions. No doubt universal acceptance of international accounting standards would provide significant progress in financial transparency, and would thus be of some help in promoting market discipline. However, beyond these potential achievements, (large) financial firms should be encouraged, if not obliged, to regularly disclose their risk exposures¹⁴, risk management processes, control procedures and business strategies – as postulated under the Basel II proposals – as well as substantial information on loan accounting, trading and derivative activities and credit risk in line with the respective recommendations of the Basel committee. Also, in addition to complex regular disclosures, it should be discussed whether (large) financial institutions might be required to reduce this wealth of information to a common statistical template, in order to facilitate easy comparisons by outsiders.

- Both crisis prevention and crisis management could be improved by additional communication and co-operation among central banks, finance ministries, and the range of other supervisors, both domestically and internationally¹⁵. Especially, with the emergence of large and complex financial firms operating on a global scale rather than within one country, the danger has increased that, in case of serious financial distress of such an institution (which can never be ruled out entirely for any market participant), the winding-down could be disorderly and hence pose a threat to overall financial stability. Since the default of a global player would affect the banking system in more than one country, the bail-out operation cannot be assigned to the authorities in the home country of the respective bank only. In an extreme case, the systemic risk created by such a failure might even arise in host countries only, and the costs of bailing out a very big institution might be very large relative to the resources of the home country. (Often, this latter phenomenon is labelled “too big to be rescued”, as opposed to “too big to fail”). Therefore, there is a case for stepped-up efforts to understand the implications of working out large and complex financial institutions in trouble as well as for augmented contingency planning in this field on a multi-lateral basis, possibly in co-operation with the private sector. There needs to be some form of an international scheme – an institutionalised system of co-operation – for dealing with large-scale bank failures¹⁶, possibly based on the initiative of important supervisors and possibly also involving private-sector institutions¹⁷. This holds especially true for the increasingly integrated banking industry in

... through qualitative improvements in transparency and disclosures

Stepped-up efforts to understand the implications of working out large and complex financial institutions and augmented contingency planning in this field

¹⁴ The “third pillar” of the new capital adequacy framework consists of a series of disclosure requirements concerning risk exposure. Linking the use of the internal-ratings-based approach for credit risk to disclosure will give these recommendations some force.

¹⁵ In the USA, the Federal Reserve in its capacity as supervisory authority started as early as in the mid-1990s to develop a special programme to monitor large, complex banks, which it formally implemented in 1999 (see “Supervision of Large Complex Banking Organizations”, Federal Reserve Bulletin, February 2001, pp. 47-57). Part of its approach is increased cross-sector cooperation with other US supervisory bodies and improved international cooperation, such as in the Basel Committee for Banking Supervision. Another example of current efforts in this domain is the “task force on the winding down of large and complex financial groups” under the aegis of the Basel committee, set up at the request of the Financial Stability Forum (FSF).

¹⁶ This proposal has recently been put forward in an article by Stephen Lumpkin, Senior Economist at the OECD (OECD Financial Market Trends, No. 75, March 2000, pp. 138-139).

¹⁷ The institutional design of private-sector involvement in this realm is discussed in more depth in M. Wolgast, “Too big to fail” – effects on competition and implications for banking supervision, Deutsche Bank Research Frankfurt Voice, May 31, 2001, also available at www.dbresearch.com.

Euroland¹⁸. Moreover, a central element in the design of policies and operating procedures for acting promptly to resolve a potential crisis would be how to act in ways that minimise moral hazard.

In a broader perspective, however, and going beyond the present framework of financial supervision, the current wave of consolidation among financial firms raises the question whether the existing supervisory structures are still adequate. Sometimes, it is asked, for example, whether the new entities might not be “too big to comprehend”, referring to the fear that current structures of financial supervision might not be able to cope with the challenge of effectively monitoring large global financial players due to the scope and complexity of their operations. Of course, the authorities can try to overcome the deficiencies of the present system by further enhancing co-operation and exchanges of information within the current division of responsibilities between home and host supervisors (through memoranda of understanding) and, within a single country, between the various functional supervisors, and by further expanding the existing, already opaque network, creating ever new fora and contact groups. Also, the new EU directive on financial holdings is the example of an attempt to mend some of the most prominent deficiencies of the current system. Still, even if the present system were not in contradiction to the objective of safeguarding financial stability – which is, however, subject to substantial controversy¹⁹ – one might still ask whether it is efficient in the sense that, by pursuing the legitimate objectives of financial supervision, it should create a minimum of negative repercussions on the financial industry itself. A key concern in this context is ensuring that national and functional financial sector regulation does not frustrate the ability of firms to capture the benefits of consolidation.

These conditions are definitely not met by the current supervisory structures. Rather, apart from differences in corporate law, accounting rules and taxation, institutions involved in cross-border M&As will experience vast differences in prudential rules and practices, including the licensing procedures and documents requested in that connection²⁰. Indeed, the patchwork of regulatory systems can generate redundant, inconsistent, and tedious regulatory and reporting requirements which put a heavy burden on business operations across borders or across the traditional functional sectors of the financial industry. Moreover, the present regulatory regime can create tensions as firms attempt to satisfy inconsistent and often overlapping national and functional regulatory requirements, and multiple and inconsistent rules lead to competitive distortions since the principle of competitive neutrality – “same business, same risk,

Are the existing supervisory structures still adequate?

A key concern: ensuring that financial regulation does not frustrate the ability of firms to capture the benefits of consolidation

Patchwork of regulatory systems puts a heavy burden on cross-border or cross-sector business operations

¹⁸ This point has also been emphasised by the BIS (70th Annual Report [1999-2000], pp. 140-141): In certain situations, the current allocation of responsibility to national authorities might create incentives not fully in line with the stability needs of the area as a whole. In the absence of appropriate burden-sharing mechanisms, such situations could – according to the BIS – complicate the timely elaboration of a policy response and might even lead to a “bias towards inaction”.

¹⁹ Apart from the OECD and the BIS publications cited above, concerns about whether the current supervisory structures are keeping pace with the changing financial landscape in Euroland are also raised in a recent IMF Working Paper (WP/01/28, “Euro-Area Banking at the Cross-roads”, pp. 56-66). With respect to the EU single financial market, the opposite view that the stability of the financial system was not negatively affected by the current structures of supervision was maintained in the “Brouwer Report” produced by a working party of central bank representatives and other high-level European officials (Report on Financial Stability, EU Economic Paper No. 143, May 2000).

²⁰ In the financial sector, even the framework and conditions for obtaining approval for an M&A transaction from the competent authorities differ widely across countries and are subject to considerable uncertainty.

same regulation" – is violated more often than not. Also, the development of hybrid financial products combining insurance and saving/investment elements raises issues concerning the maintenance of a level playing field between different types of financial operations in different sectors of the financial industry.

For these reasons, a major challenge for financial supervisors will be to consider a fundamental restructuring of the existing regulatory framework which – as a minimum – would have to consist of a further development of the lead-regulatory concept and the creation of more homogeneous risk-based supervisory standards applied across financial sectors. With respect to putting an end to sectoral supervision, it is to be welcomed that the institutional consequences, i.e. the need for a single, cross-sectoral regulator, have been acted upon in some countries, most notably in the UK, and recently also in Germany²¹. For globally operative financial institutions, international acceptance of the current European model with minimum standards, mutual recognition and co-ordination would represent immense progress in comparison to the present situation. In Europe, by contrast, after the launch of the euro and the creation of the single market for financial services, the next logical step would be the establishment of a single European regulator for financial firms operating in this market.

Of course, political and legal realities may mitigate the opportunity to create such new supervisory systems. Especially, the creation of a single European supervisor in the form of an agency requires strong political will. (Besides, it must also be endowed with the necessary resources to support it.) In the long run, however, fundamental changes in the markets and in the financial industry – of which the current wave of M&As is just one facet – will make these moves inevitable, and it would be better not to have to wait for calamity to strike before the issue is addressed seriously.

Michael Wolgast, +49 69 910-31709 (michael.wolgast@db.com)

Fundamental restructuring of the existing regulatory framework ...

... requires strong political will

Better not to wait for calamity to strike

²¹ Other examples include Finland, Sweden, Denmark and Ireland, or – outside the EU, and primarily in reaction to recent episodes of financial crisis – Korea and Japan. The integration of national regulators is also being discussed in France and in Switzerland.

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Deutsche Bank Research
Marketing
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

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