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# EUROPEAN MARKET COMMENT: EUROPE AMALGAMATED PROMISES AND CHALLENGES OF THE NEW EUROPEAN UNION

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#### **One Banner, 25 Countries**

In Copenhagen in early December, politicians in continental Europe accomplished a feat that surpassed even the ambitions of Charlemagne in the ninth century. The European Union (EU) admitted ten countries to its ranks: Czech Republic, Hungary, Cyprus, Poland, Slovenia, Malta, Slovakia, Latvia, Lithuania, and Estonia. The EU also offered the prospect of entry to Romania, Bulgaria, Turkey, and eventually the Balkan states. By dint of pen, rather than the customary weaponry of sword, arrow, and rifle, they put an end to 50 years of Cold War divisions by uniting territories from Ireland to the Baltic Sea to the Aegean Sea. Once it officially becomes effective as of May 1, 2004, the new EU will comprise 25 countries, more than 450 million people, and a \$9.3 trillion economy.

The enlarged EU offers great promise as well as significant political and economic challenges. Posing an existential problem worthy of Jean-Paul Sartre, in terms of beliefs, background, and desires, the enlargement will transform the notion of what it means to be European. A slightly more tangible issue concerns whether the new EU's vast economic, historical, and cultural diversity will ultimately prove too variegated a mosaic upon which to build common economic policies. For example, relative to the existing EU the ten accession countries are less affluent, largely because agriculture contributes a substantially larger share to their GDP.

The increasing number and diversity of member countries means that the Union must urgently address how it should function and operate. One of the first tasks of the new EU will be to overhaul its constitution, including redesigning its already cumbersome decision-making body. Should the EU become a federal state with stronger central decision-making powers, or improve its existing model of deepening intra-regional integration? If the enlarged EU continues to give individual countries the right to veto certain proposals, the legislative process could grind to a halt.

### **Economic Promise and Challenges**

From an economic standpoint, accession countries are motivated to join the EU because they want to increase their standards of living to levels enjoyed by existing members. The existing EU offers a vast market for these countries, especially in its specialties of farm products, textiles, steel, and chemicals. In addition, between 2004 and 2006 the accession countries will receive roughly \$40 billion in grants and subsidies from existing members.

The immediate economic benefits of membership may prove disappointing, as many of the formal barriers to trade and investment have already been removed. In addition, the EU's economic malaise should it persist for the next several years could also be a drag on cross-border capital and economic

flows. Furthermore, joining the EU, as with most clubs, comes with certain conditions and obligations. The Maastricht Treaty contains criteria concerning an aspirant's government deficit, capital flows, and administrative capabilities, as well as inflation level, long-term government bond yields, and participation in the Exchange Rate Mechanism. Some pundits worry that the process of integration will increase the vulnerability of the new entrants to the pressures of competition and macroeconomic shocks.

Many analysts agree that the issue of adopting the euro holds the potential for many pitfalls for the entire EU, because the process of moving toward a single currency area can be quite disruptive to such an economically diverse region. While accession countries will become members of Economic and Monetary Union (EMU) when they join the EU, they cannot adopt the euro until after at least a two-year qualifying period for satisfying the Maastricht convergence criteria. This means that 2006 is the earliest date when new entrants can adopt the euro, and some countries are expected to do so as quickly as possible. Many analysts worry that even the intervening three to four years may be too short a period to fulfill the convergence criteria without sustaining great costs.

Germany's Bundesbank published a working paper that highlights the risks of overly hasty adoption of the euro.<sup>1</sup> The paper discusses several potential sources of inflationary pressures, which amid the constraints of a common monetary policy could ultimately push the entire Continent into recession. Not only is structural inflation in most accession countries higher than in the current EU, but countries that attempt to quickly catch up with economic levels of the existing EU will probably see an increase in their real exchange rates. Inflationary pressures could also ignite if economic growth of accession countries were to surpass that of existing members. A hike in policy interest rates by the European Central Bank (ECB) in order to contain inflationary pressures could push existing members into recession. Compounding these potential pitfalls is the slow decision-making process of the current ECB, which will certainly grow even more deliberative with the addition of at least ten national central bank governors.

### **Investment Implications of the Accession**

Just as the process of integration remains indeterminate, so too are its consequences for equity markets. For example, MSCI has yet to decide how the new EU will affect its indices, particularly its EMU and Emerging Market Free (EMF) indices. Given individual market's low level of capitalization, high degree of concentration, and low degree of liquidity, as well as the underdeveloped state of their overall financial infrastructure, it is possible that specific markets could experience heightened volatility

<sup>&</sup>lt;sup>1</sup> "Pitfalls in the European Enlargement Process—Financial Instability and Real Divergence," by Helmut Wagner, Discussion paper 06/02, Economic Research Centre of the Deutsche Bundesbank, February 2002.

whether only a handful of buyers enter the market or a large number of index funds and benchmarksensitive managers move up to benchmark weights (see the table that follows). However, it is also quite plausible that incorporating the ten new members will constitute a mere blip on trading screens, particularly if major indices exclude the most illiquid securities in these markets.

MSCI EMU, as currently defined, includes only developed markets. Therefore, it is possible that none of the accession countries will become part of the index until they meet MSCI's criteria for developed markets. MSCI does not use a fixed schedule for determining whether to include a market in its developed markets indices. Instead, it relies on a variety of factors that indicate sustainable and lasting development of its equity market and economy. The most common of these is per capita income. On this basis alone, in 2000 Cyprus and Slovenia were more affluent than Spain, Portugal, and Greece, which are included in the existing EMU index. Even if Cyprus and/or Slovenia were included in MSCI EMU, which is doubtful given the other criteria for inclusion, the volatility of the index would probably change very little, given their small market-cap size relative to that of the overall index (though of course these two individual markets would likely be significantly affected) (see the table that follows).

In addition, including the accession markets would probably have minimal affect on the volatility of the MSCI EMF Index. The index already includes the region's largest three markets by relative market cap to MSCI EMF—Hungary, Poland, and Czech Republic. After this trio, Slovenia is the next largest by relative market cap (1.8%), but the market caps of the remaining six drop off sharply, underscoring the likelihood that MSCI EMF would have little or no trouble digesting any of these markets.

Beyond speculating about when and if accession markets will be incorporated into an index, each country must address crucial longer-term issues: when it will adopt the euro and whether it will adequately prepare for cross-border competition and a distinctly different macroeconomic environment. The nature of these adjustments will carry wide-ranging consequences for the entire Union as well-the extent to which the integration process will strain the common economic and monetary policy and whether the ten entrants will ultimately boost or pull down the region's economy. Whether the transition is smooth or turbulent will largely influence whether Europe can meet expectations of becoming a leading equity market.

		As	As of November 30, 2002	er 30, 2002				
						Ma	Market Cap Ratio (%)	(%)
		Trading	Number of				Market	Market
	Stock Exchange and	Commencement	Listed	Market Cap	GDP	Market	Cap/EMF	Cap/EMU
Country	Official Index	Date	Companies	(USD Millions)	(USD Millions)	Cap/GDP <sup>1</sup>	Market Cap	Market Cap
Cyprus	Cyprus Stock Exchange CSE General Index	3/29/96	152	4,937.99	8,697.89 <sup>2</sup>	70.20 <sup>2</sup>	0.92	0.28
Czech Republic	Prague Stock Exchange PX 50 Index	4/6/93	81	15,422.04	56,423.94	16.92	2.86	0.86
Estonia	Tallin Stock Exchange TALSE	6/3/96	13	2,223.97	5,280.80	28.08	0.41	0.12
Hungary	Budapest Stock Exchange BSE BUX Index	6/21/90	49	37,264.00	52,361.24	51.60	6.91	2.08
Latvia	Riga Stock Exchange Dow Jones RSE	7/25/95	62	704.30	7,549.05	9.22	0.13	0.04
Lithuania	National Stock Exchange LITIN-G	9/14/93	48	1,442.51	11,834.22	10.23	0.27	0.08
Malta	Malta Stock Exchange MALTEX	1/1/92	12	1,245.56	3,564.67 <sup>2</sup>	38.03 <sup>2</sup>	0.23	0.07
Poland	Warsaw Stock Exchange WIG All-Share Performance	4/16/91	202	28,219.20	174,597.30	14.98	5.23	1.58
Slo vakia	Bratis lava Stock Exchange SAX	4/6/93	508	2,500.18	20,522.01	17.00	0.46	0.14
Slovenia	Ljubljana Stock Exchange SBI 20	3/29/90	135	9,547.47	18,810.35	29.50	1.77	0.53
Sources: Baltic Stock E: Monthly Report, Cyprus Lithuania: Monthly Bulle Capital International, Inc.	Sources: Baltic Stock Exchanges: Monthly Statistics, www.borzamalta.com.mt (12/20/02), Bratislava Stock Exchange: Monthly Statistics, Budapest Stock Exchange: Monthly Report, Cyprus Stock Exchange: Monthly Digest, International Monetary Fund, Ljubljana Stock Exchange: Monthly Statistical Report, National Stock Exchange of Lithuania: Monthly Bulletin, Warsaw Stock Exchange Monthly Bulletin, and Thomson Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.	stics, www.borzamal Digest, Internationa ange Monthly Bullet	ta.com.mt (12/2 I M onetary Fund in, and Thomso	0/02), Bratislava St. d, Ljubljana Stock Ex n Datastream. MSC	ock Exchange: Mon cchange: Monthly Sta Mata are copyrigh	thly Statistics atistical Report ted by and pr	, Budapest Sto t, National Stoc oprietary to M	ock Exchange: k Exchange of organ Stanley
Notes: EMF is re Hungary, and Polar	Notes: EMF is represented by the MSCI Emerging Markets Free Index EMU is represented by the MSCI Economic Monetary Union Index. The Czech Republic, Hungary, and Poland are three of the ten accession countries in the MSCI EMF Index.	ing Markets Free Incountries in the MSCI	dex. EMU is re [EMF Index.	presented by the M	[SCI Economic Mor	netary Union	Index. The Cz	ech Republic,

**EUROPEAN UNION ACCESSION COUNTRIES: STOCK EXCHANGE DATA** 

<sup>2</sup> GDP data are as of December 31, 2000.

<sup>1</sup> Gross Domestic Product (GDP) and Market Cap/GDP Ratio data are as of December 31, 2001 unless otherwise noted.

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