Integration of Financial Markets Is Bright Spot for Sluggish Europe

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Don't discount Europe. Its inflexible labor market may be weighing on the economy, but greater financial integration across the euro area is continuing at a steady pace, setting the foundation for economic growth. And while many in Europe look uneasily eastward toward cheap labor and low-cost goods, others see the opportunities of a wide-open market. Meanwhile, professional sports organizations -- in particular, soccer (or football, as the rest of the world knows it) -- are eyeing Asia, hoping to win over the minds, hearts and wallets of new fans. These were among the topics discussed during the recent Wharton 2005 Global Business Forum European Conference.

At a panel session titled, "Europe Going Forward: Integration and Growth," three panelists agreed that integration of markets and regulatory bodies is a key factor in Europe's ability to grow. Riccardo Guglielmetti, CEO of Wall Street Italia, a web-based business news service, began by looking at productivity, focusing specifically on why such large gaps exist between the U.S. and Europe. While GDP has hovered between 1.5% and 2% in Europe over the last 10 years, he said, it averaged around 3.1% (or 4% if you take out 2001) in the U.S. during the same period. Guglielmetti suggested that the biggest culprit in Europe's productivity lag is the labor market, particularly labor unions, which have a stranglehold in Western Europe. In the U.S., "if you fail somewhere you can very quickly recycle yourself and start someplace else."

Another problem is the strong resistance to closing or even restructuring companies. Guglielmetti cited the airline industry as an example. "Pan Am and TWA were the closest things you had to national carriers, but we all know what happened to them," he said. Yet many European carriers have not met similar fates, despite heavy losses and inefficient operations. The protections offered to this industry and others constrain economic progress, he noted.

According to Luca Zerbini, a team leader at Bain, his European clients tend to have four distinct areas of interest: innovation and product development, strategic sourcing, cross-border M&A activity and private equity. The good news on the innovation side, said Zerbini, is that significant cross-border activity is leading to innovation. Nokia, for example, uses technological capabilities from Northern countries, design from Italy and additional technologies from the U.S. Similarly, Airbus uses avionics from France and the UK, and flight control technology from Germany and the U.S. On the other hand, investment in innovation is still low in Europe, said Zerbini, with the private sector investing 40% less than its U.S. counterparts.

On the sourcing side, the main question is: How can Europe compete with China? "Many of our clients feel they have to move entire factories there," he said. "We try to get them to think about moving *functions* instead." Mergers and acquisitions continue to pose problems in Europe due to differing regulations and cultures (both business and national). "It's extremely complex to do mergers within Europe," said Zerbini. "For many companies, it's easier to go outside of Europe altogether, while others choose M&A partners within their own borders." On the positive side, Zerbini sees great opportunities in the private equity market in Europe for at least the next five to ten years, due in large part to continuing privatization across Europe and transitions in family-owned firms.

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Admittedly, integrating the economies of 25 countries is no easy task, said Christian Varin, managing director of Cobepa, an investment company based in Brussels and Amsterdam. Among the obstacles he cited is the lack of a single financial market in Europe. "There is no one regulatory body, whether for banking, the stock market or securities. As a result, there are different regulations from country to country. The whole body of securities exchange doesn't work." Except for the bond market, which is unified, tax systems are not unified, leading to tax competition between certain countries. For example, France has a high wealth tax, while Belgium does not tax capital gains on stocks. One bright spot, said Varin, is the euro, which he characterized as having had "an enormous positive effect." However, he also suggested that the "one-size-fits-all" concept behind the euro has certain shortcomings, in particular the fact that nations as different as Greece and Finland share the same currency and have to live with one interest rate.

Nervousness about the West's ability to compete, particularly in the face of a quickly developing China, dominated the Q&A discussion. Varin agreed with Zerbini's estimation that investment in R&D and innovation in Europe is perilously low. "If you look at the numbers, the biggest challenges will come from Asia, particularly India and China," said Varin, adding that "after 50 years of Communism [in China] there is a lot of revenge to be taken." Varin suggested that the only way to stay ahead is to have the best possible education system and invest in R&D, a strategy the Chinese already follow.

Asked whether he felt Europeans were ready to give up the social protections they have long enjoyed in exchange for a more robust economy, Varin hesitated. The strong safety net put in place in Europe after World War II "has come at a high price," he said, although he balanced his comment by citing the 35 million Americans living below the poverty level. "Europeans will have to make some sacrifices," he predicted, adding that a retirement age of 56, which is standard in some European countries, is "completely absurd."

The Most Popular Sport in the World

While many conference participants expressed concerns over increased competition from Asia, others see big opportunities in the East. One unlikely market looking to expand in Asia is professional sports. Esteve Calzada, chief marketing officer for Fútbol Club (FC) Barcelona, reported that Japan and China are a major focus for his team. While soccer -- or football, as the rest of the world knows it -- may be the most popular sport in the world, it is still a novelty in many Asian countries, he said. Clubs like FC Barcelona are fighting for the hearts and loyalty of millions of potential new fans, which can eventually translate into big revenues for teams.

According to Calzada, FC Barcelona has undergone a major organizational transformation since 2002 when revenues were €123 million ($148 million), losses €73 million ($88 million), and debt was roughly €186 ($225 million). In 2005, the team's earnings were €240.2 million ($290 million), web traffic has tripled, television revenues are up and the team is headed toward a zero deficit. In a telephone interview, Gavin Hamilton, editor of *World Soccer News*, said that many of the changes at FC Barcelona were instituted by the club's newest president, Joan Laporta, who was elected in 2003. "He ran for the position as someone who wanted to be more democratic," said Hamilton. "He was an upstart in many ways, and has taken a very different approach from the previous president, who ran the club in a more autocratic style."

Calzada, who joined the club in 2004, has been part of its transformation from the beginning. A major shift in the industry, he said, finds clubs moving from their traditional role of organizers of local events (much like a circus) to an entire entertainment concept, like Walt Disney. When it came time for FC Barcelona to innovate, it had the option of following an evolutionary path or a revolutionary path. The club chose the latter, applying strict cost control measures while at the same time making major investments in the team to generate immediate income. The new business plan, called the "virtuous cycle of football," breaks the club into three major areas: business activities involve new and growing sources of revenue, cost control, and sound financials. This feeds into sports activities, such as winning

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championships and signing the best players, which in turn feeds into social activities, like building and strengthening the fan base and capturing attention in the news media.

Recognizing the importance of the news media in generating interest and therefore revenues -- through ticket sales, sponsorships, TV deals, image rights and merchandising -- a member of the audience asked how important a player's country of origin is for the club's marketing efforts. "It would be a nice temptation to have a Japanese or Chinese player to generate exposure," said Calzada, "but our number-one priority is sporting skills. In our case, that supercedes where a player comes from." This strategy seems to have paid off, with FC Barcelona now home to international names like Eto'o and the 2005 European Footballer of the Year, Ronaldinho.

An "Ideal" State of Full Integration

Putting a macroeconomic frame around the discussions of the day, Lucas Papademos, vice president of the European Central Bank (ECB), provided an overview of Europe's current economic situation and some clues as to where it's headed. Like many of the panelists, Papademos addressed financial integration in the euro area, saying, "It is not only necessary for the single monetary policy, but it is also desirable because it facilitates the efficient allocation of capital and contributes to growth and employment."

Papademos reminded the audience that in the United States the concept of full financial integration -- financial institutions, markets and infrastructures -- is considered a given, "something self-evident." For example, there are few, if any, restrictions on conducting business or offering financial services across state boundaries. Europe, in contrast, is only gradually approaching similar conditions, he said, "conditions in which we could speak of a single, fully integrated European financial market."

The ECB considers a market fully integrated if all potential market participants with the same relevant characteristics face a single set of rules when dealing with financial instruments or services, have equal access to financial instruments or services, and are treated equally when they are active in the market. The evolution towards this "ideal" state of full integration, said Papademos, "affects financial markets, infrastructures and institutions simultaneously."

He offered a brief report card of where the various markets are along the integration continuum. He noted that within the money market the integration "is virtually complete," with overnight lending rates in the euro area countries virtually identical since the introduction of the euro in 1999. The bond market has also achieved a high degree of integration, due mainly to the disappearance of intra-euro area exchange rate risk and the convergence of long-term inflation expectations across countries. As a result, national government bond yields have converged considerably, and a single corporate bond market has emerged, allowing companies to issue debt on the capital market to a euro area-wide investor base.

In contrast, "equity markets are still largely defined within national contexts," said Papademos, "although a gradual process is underway to overcome the current fragmentation." In addition, integration within the banking sector is still quite uneven, despite consolidation among European banks, which has taken place mainly within national borders. While the commercial side has seen much progress -- with euro area banks increasingly granting loans to foreign banks in other euro area countries -- retail banking is a different story altogether. There, according to Papademos, "lending activity across borders remains very limited, at less than 4% of the total." This is due in part to banks wanting to be near customers, as well as differing national regulatory arrangements, practices and product characteristics. As a result, mortgage rates, for example, vary much more from country to country in the euro area than they do across states in the U.S.

Papademos concluded by saying that the ECB sees financial integration as being essentially market-driven. "It is for financial institutions themselves to reap the benefits of open markets and a single currency by offering their services beyond the borders of the national economy."

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