WAITING FOR ACCESSION

THE EU ENLARGEMENT PROCESS IS IN FULL SWING, BUT WHAT WILL BE THE IMPLICATIONS? **STEFAN WALTER** LOOKS AT THE KEY ISSUES AND THEIR SIGNIFICANCE FOR TREASURERS.

The European Union (EU) will shortly be facing its most extensive enlargement since its foundation, at least in terms of the number of new members. Up to 10 countries are likely to join simultaneously in 2004 – that is, all candidates currently conducting negotiations, except Bulgaria and Romania. These two countries are expected to join later, and for Turkey, which has also been awarded the status of candidate for membership, a date to commence negotiations has still to be announced.

ACCESSION PROCESS. According to the timetable agreed upon by EU authorities, the Commission will name in October the countries that it regards fit for enlargement. After the formal decision in December, the Accession Treaty will be signed in early 2003. If the Accession Treaty can be ratified in the old and new member states, requiring referenda in some cases, before the end of 2003, the new members can formally join the EU on 1 January 2004. If this is not possible, formal admission is likely to be postponed until 1 January 2005 at the latest.

Risks regarding the timetable are manifold. For example, negotiations on agricultural policy may be difficult to finalise in the few weeks after (a possibly new) government has taken office following the German national elections on 22 September. After all, enlargement has an impact on net financial contributions by countries such as the UK and Germany. The other big risk is Ireland: if the Irish people refuse to support the Nice Treaty in a referendum for a second time, the Union would be in disarray.

STRONG GROWTH POTENTIAL. If everything goes to plan, the number of EU member states will soon rise from 15 to 25. As the prospective new members are small – with the exception of Poland – and their standard of living falls far short of the EU average, the EU population will grow by only 20% and the EU's GDP will rise by only about 5% in nominal terms. Average income per capita is less than half the EU average, even on a purchasing-power-parity basis. However, the EU candidates are a group with solid growth performance. Again, with the exception of Poland, they achieved growth rates of between 3.5% and 6% (Baltic States) in 2001, despite a mini-recession in the EU, with growth of just 1.7%. The former star performer Poland suffered from a less-than-optimal policy mix, resulting in just 1% growth in 2001 and 2002.

Economic growth in the accession countries is likely to outpace EU growth by at least two to three percentage points for some time.

Residual risks to EU entry

- Ireland does not ratify the Nice Treaty by autumn 2002
- Crisis over Cyprus issue
- Negotiations on Common Agricultural Policy (CAP) not included in time
- Political backlash in individual accession countries
- Ratification of Accession Treaty not finished before end-2003

THE 10 CANDIDATES FOR ACCESSION

Country	Population (m)	GDP[1] (ebn)	GDP per capita[2]
Cyprus	0.8	9.5	86
Czech Republic	10.3	55.0	59
Estonia	1.4	5.5	38
Hungary	10.0	50.3	51
Latvia	2.4	7.8	30
Lithuania	3.7	12.2	33
Malta	0.4	3.9	56
Poland	38.7	171.0	40
Slovakia	5.4	20.9	48
Slovenia	2.0	19.5	69
Total	75.1	355.6	47[3]
EU-15	379.0	8523.9	100

[1]Gross domestic product 2000. [2]Calculated at purchasing power parity, EU=100. [3]Average weighted by GDP.

Support for sustainable growth is expected to come from further growing direct investment, financial support by the EU after membership and the dynamic effects of participation in the Single European Market. Future membership in the euro area will also be helpful with the abolition of the exchange rate risk in trade with EMU members, which will lower transaction costs and allow participation in a huge, liquid financial market.

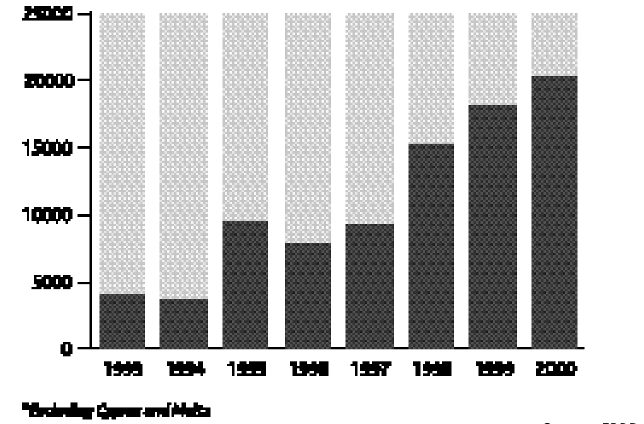
WELCOME OPPORTUNITIES. Countries are already strongly integrated in the EU markets because the Union, foreshadowing later accession, has liberalised its trade with the eastern countries in a comprehensive manner over the last decade (see *Figures 1* and *2*). This has led to a marked expansion of trade between EU member states and candidate countries. On average, about 60% of the latter's foreign trade is conducted with the EU-15. But the new market has opened up welcome opportunities for EU member states as well. For example, British exports to the candidate countries rose from \$2.6bn in 1993 to \$6bn in 2000, an increase of 130% in seven years.

At the same time, EU companies have considerably boosted direct investment in the region. The main motive is market expansion – that is, setting up shop for serving the respective domestic market – just take Poland with its population of roughly 40 million. Cost considerations play a role too: wage costs are substantially lower, at €3-€4 per hour in the Czech Republic, Poland and Hungary, and the workforce well-educated and well-trained, although productivity lags behind. Foreign investors are taking specific interest in the automotive, automotive supplies, electronic manufacturing, energy and telecoms sectors. In the banking sector, more than half of the candidate countries' banks in terms of assets are owned by foreign banks, mainly from the EU. This has led to a sharp increase in efficiency in the financial system, including the import of cash management know-how corresponding to the demand for state-of-the-art tools by treasurers from multinational corporations (MNCs).

JOINING THE MONETARY UNION? There is one point that is often misunderstood: accession to the EU will not automatically result in membership of the European Economic and Monetary Union (EMU). Certainly, new members will be obliged to participate in the EMU. They will not be granted the 'opt-out' that the UK and Denmark achieved in the negotiations. In fact, none of the accession states wants such an 'opt-out' – on the contrary, most of them would prefer to join the euro area as soon as possible. According to European institutional authorities, all candidates will have to meet the same Maastricht criteria that applied for the first group, and which will also apply to those EU countries (the UK, Denmark and Sweden) that may want to join the euro area at some point in the future. Besides monetary (price stability and low interest rates) and fiscal (budget deficit and government debt) criteria countries will have to prove that they can get by with a stable exchange rate. This will have to be demonstrated by a two-year membership in the exchange rate mechanism (ERM) with the euro without devaluation. With the convergence test being taken three or four months thereafter, new EU members cannot enter EMU until three years after accession – that is, earliest in 2007.

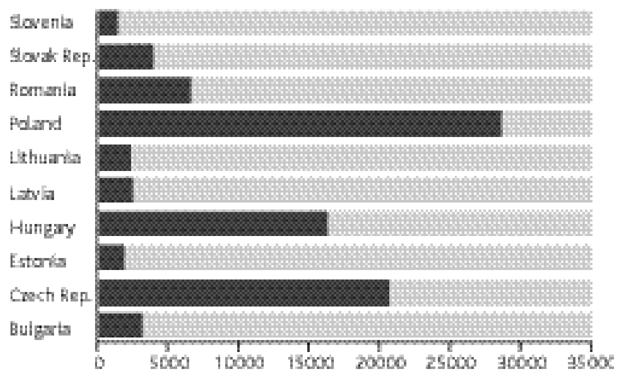
Eventual EMU membership has already had an impact on exchange rate strategies. Increasingly, more countries have elected to use the euro as an anchor for their exchange rate policy – three of the smaller countries, Estonia, Lithuania and Bulgaria, even operate euro currency boards that function well. The interest rate convergence game the markets played in the run-up to the euro launch in 1999 has already resumed, possibly somewhat prematurely. At any rate, there is not that much material available in the bond market which could serve as a pawn in the game.

FIGURE 1
FOREIGN DIRECT INVESTMENT IN CANDIDATE COUNTRIES* (\$M).



Source: EBRD

FIGURE 2
TOTAL FOREIGN DIRECT INVESTMENT 1993-2000 (\$M).



Source: EBRD

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PROGRESSING LIBERALISATION. Financing of trade and capital transactions has become much easier in recent years. Countries are required to fully liberalise their foreign capital flows by the time of entry into the EU and they have asked for, and been granted, only a few exceptions and transition periods, such as in real estate. The candidates are well on the way to fulfilling this requirement and most capital controls have already been lifted. Foreign exchange transactions have been fully liberalised in the Czech Republic for some time and in Hungary since last summer. Poland is expected to follow suit by the end of this year. In the former two countries, companies are allowed to have accounts abroad without central bank permits. So far, this has not been the case for Poland where liquidity management transactions are also impeded by a stamp duty on intercompany transactions.

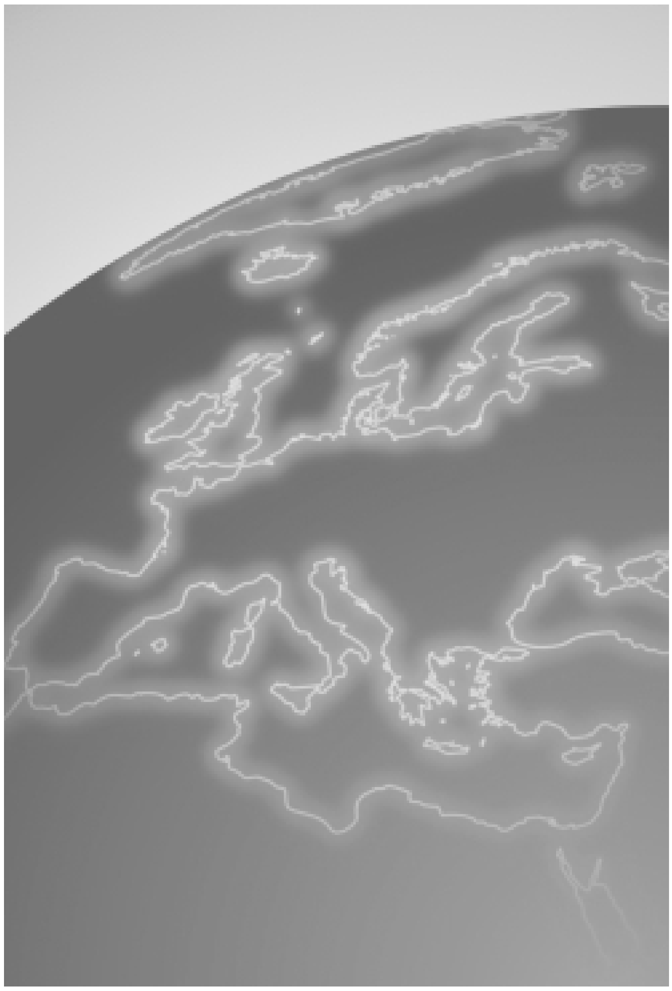
An interesting feature of that of Hungarian market worthy of thorough analysis is the Hungarian Offshore Companies (HOCs). Hungary developed the HOC concept in an effort to establish an environment conducive to business and to provide conditions for making that country a regional centre in Central Europe for companies engaged in certain financing, licensing and trading activities. Generally, Hungary is viewed by treasurers as a suitable candidate for establishing a regional hub, for example, as a shared services centre or as a regional head office.

IMPLICATIONS FOR THE TREASURER. Expectations are set for further rapid growth in the accession countries. In many aspects, these countries are in a similar position as Spain and Portugal were when they entered the EU in 1986. In the 10 years following its entry, Spain's GDP almost doubled in real terms and industries benefited both from the inflow of EU funding and foreign direct investment.

Exchange rate risks remain an issue. For the UK treasurer the exchange rate risks are twofold: observing the exchange rate of the respective country versus the euro, plus the euro rate to sterling. Exchange rate swings have been substantial with some currencies. Lately, it has been the Polish zloty that has been exhibiting strong volatility, due to Poland's change to flexible exchange rates and the rising uncertainty about Poland's macroeconomic policy. Foreign exchange management will become easier when candidate countries have joined the EMU. In addition, EU membership is likely to improve the risk assessment of candidate countries: there is a common understanding in the markets that EU members are better protected against financial crises than others. In fact, the CE-3 (the three most advanced and largest Central European countries – Poland, the Czech Republic and Hungary) have already gained an improved risk rating well before formal membership.

On a corporate level, MNCs have initiated a management know-how transfer by implementing management information systems, project management tools and by introducing new management methods. On the treasury side specifically, Deutsche Bank is seeing increasingly more requests for proposals on cash management for subsidiaries, particularly in CE-3 countries coming from MNCs' centralised treasury functions, quite often as addendum to an existing pan-European solution. Products in demand are customer access solutions and local and cross-border liquidity management for those countries where no regulatory or economic obstacles remain.

The relationship between treasurers and banks in Eastern European countries is clearly evolving. As an example, treasurers are challenging their banks to clarify all aspects of cash management pricing and commissions, as well as float or FX margins. They expect their banks to advise on potential streamlining and rationalising their cash management, and on hedging of country-specific risks



such as FX or local currency interest rates. Treasurers are starting to request from their banks – but also value and pay for – the same quality of solutions and high levels of customer service as they do in Western Europe. This gives banks in these Eastern European countries ample room for marketing differentiation. In turn, treasurers are starting to face up to the fact that banks are increasingly providing working capital financing only if fee business is awarded. They are also differentiating on debit interest margins also for MNC subsidiaries, depending on internal ratings. The EU discussion is apparently lifting the curtain in front of a treasury territory previously neglected.

MORE THAN FREE-TRADING. While it is true that significant benefits in terms of exports, sourcing and direct investment have already been reaped well before formal enlargement, there are still ample opportunities. EU enlargement is obviously being driven by politics and the challenges in economic policy should not be underestimated. But the concept makes economic sense, and the abolition of border controls and other non-tariff barriers to trade will give impetus to even closer integration. It is now up to the politicians to ensure that the widening of EU membership will trigger a further deepening of the Single European Market.

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