BY ELIZABETH POND

A New Financial SUPERPOWER?

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THOUGH EUROPE CLOSELY RESEMBLES THE UNITED STATES in many ways, it is by no means its equal in the management of financial instruments. U.S. stock, bond, and derivative markets are by far the biggest, most liquid, most flexible, and most complex in the world. European bourses, by contrast—with the partial exception of Britain—have been small, segmented, and illiquid. Even taken together, they are only two-thirds the size of the U.S. stock market. Current German stock market capitalization is only 38 percent of GDP, by contrast to 138 percent in the United States and 163 percent in Britain. While half of British private-sector financial assets were in equities in 1996, only 20 percent of private funds were similarly placed in more conservative Germany, France, and Italy.

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Effects of Economic Union in Europe

As European Monetary Union introduces a continent-wide financial market in Europe, along with a corresponding altered investment mentality, all that will soon change. EMU, as the final step in establishing Europe's single market, is already acting as a catalyst in Europe's boardrooms and chancelleries. Within a decade—barring some euro catastrophe—Europe should become the second financial superpower, in accord with its wealth. Europe's 30-plus segmented stock exchanges are beginning to merge and expand their scope. Even before British accession to EMU, the large London and small Frankfurt exchanges have begun an "alliance" that will allow shares to be traded at both locales, and the French, Italian, and Spanish bourses are waiting to join in.

Toward a New Equity Culture

Europeans are also rapidly developing an American-style equity culture. They are heeding the constant cry of their own liberal reformers that they must emulate American entrepreneurs. The characteristic continental capitalist model of in-house bank financing of corporations is giving way to less cozy (and cheaper) equity and loan flotations on the British and American model. Remaining regulatory barriers are slowly being pulled down; German banks are being permitted a wider range of investment activity; obsolescent German and French requirements that borrowers originate deutsche mark– or franc-denominated issues in their domestic market are falling by the wayside. Italian mutual funds have begun to attract big money. Germany's long-delayed tax reform is inching forward toward lowering corporate rates and dropping the bias that has previously rewarded investment in real estate over productive investment.

So far Europe lacks the independently managed pension funds that are a mainstay of U.S. stock investment; pensions have been largely state-run, pay-as-you-go schemes, with legal restrictions more or less confining them to safe, low-yield domestic bond issues. This branch, too, should now develop rapidly as retirement pay adjusts to the demographic realities of aging populations and tight government budgets.

Europewide Competition

These changes, and others, all follow from EMU's unification of European capital markets and forcing down of costs as the new transparency translates old lira and franc and peseta prices into the same easily compared euro prices, compelling companies to match the lowest price or else lose sales. Anticipating these shifts, industrial stalwarts like Hoechst, Veba, and BASF have already carried out aggressive cost-cutting and moved substantial manufacturing to cheaper Central European, Asian, and Latin American factory sites. A wave of mergers and acquisitions paralleling the American trend has begun. Firms like the Swedish-Swiss ABB engineering conglomerate, which have thought globally for more than a decade, are seen as models. The old priority on national champions is becoming increasingly passé; transnational mergers are producing corporations in various sectors that will be able to hold their own on the world market.

Volkswagen—despite threatening to pull out of its new plant in eastern Germany if the European Commission enforced its ruling against excessive subsidies from the state government of Saxony—not only outbid BMW to purchase the venerable Rolls-Royce, but went on to buy the equally renowned Lamborghini, and this after having earlier bought the Czech Skoda and Spanish Seat. Airbus, with French, German, British, and Spanish participation, is turning into a major rival of Boeing. Even defense industries are uniting across state borders—though more slowly, with frequent setbacks, and against French resistance. The new Eurofighter is a German-British-Italian-Spanish collaboration; Germany and Spain will shortly be producing joint tanks, Germany and Sweden joint missiles; the Nordics are buying helicopters together; and the threat that British Aerospace and Daimler-Benz Aerospace might merge without them has goaded the French to privatize Aerospatiale in order to join in.

The shakeout has not yet overturned small and medium-sized firms, the inner core of Germany's economic engine and the sector that must provide the jobs for redundant workers from the slimmed-down giants. But even here change is beginning—and will presumably be carried forward by the sons and daughters who are now inheriting post–World War II family businesses from their founding fathers and, less frequently, mothers. Venture capital is appearing even in risk-averse Germany, as the success of the country's thriving Neuer Markt, the exchange for innovative start-ups, attests. Germany's profusion of little banks is on the verge of consolidation to fewer, more efficient banks, with more solid capitalization.

Across Europe and Beyond

Indeed, the economic ferment in the EMU extends across Europe. A new openness to experiment prevails as central European countries privatize telecommunications, energy, and other natural monopolies on their tabula rasa, or skip the pay-as-you-go stage of pensions in favor of full funding—then export these ideas back to Western Europe. There is unprecedented curiosity about how Ireland shifted from a classic land of emigration to one of immigration, or how Poles, with a standard of living less than a third that of France, are financing those pension funds, or how Dutch employers and employees worked together to generate part-time jobs that please everyone.

And although the ongoing merger fever has to some extent pitted the United States and Europe against each other, to American businessmen, the striking thing about the new Europe is the opportunity it presents for American investors, especially given the current soaring dollar and slumping euro. Unlike Japan, Europe holds its economy

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open to outsiders, and some German officials argue that agile U.S. firms have profited even more from the developing European single market than have less supple European companies. Citibank, for one, has gained a leading position in Germany by pioneering functions that domestic banks have been slow to offer. U.S.-based international accounting and management and even law firms are moving into, or expanding in, Europe.

The current burst of restructuring and realignments already includes major transatlantic investment and mergers. Daimler-Benz was the first German company to be listed on the New York Stock Exchange—and to obtain the listing it was willing to adopt U.S. accounting standards and greater financial disclosure than the secretive German corporate world practices. It is producing automobiles in Alabama—and its rival BMW has assembly lines in South Carolina. DaimlerChrysler will soon be a household brand in America. Bertelsmann, the world's third-largest media conglomerate, recently bought out Random House and now represents many of the top authors on best-seller lists in the United States. The Star transatlantic (and transpacific) airline alliance is now competing with the "oneworld" transatlantic (and transpacific) alliance. The first transatlantic law firm merger brought Salans Hertzfeld Heilbronn Christy & Viener into being in 1999, with offices in Paris, London, New York, Warsaw, Moscow, and Almaty.

As European businessmen become more American—and as EMU's transparency, reduced transaction costs, and economies of scale take hold—European firms will also become more competitive with American firms. In theory, this is all to the good. Europe will be following the path the United States took in the late 1980s and early 1990s in streamlining, restructuring, and regaining the competitiveness it had lost to Asia. Europe's competitiveness will in turn drive the next round of innovation in the United States, and American and European consumers and investors alike will benefit from such benign rivalry.

In practice, of course, the European rejuvenation is sure to distress North Carolina textile spinners, Indiana steel workers—and House Minority Leader Richard Gephardt. The advantages of open world trade will not be as obvious to many Americans as they are to Germans who buy summer houses in Tuscany or Greeks who run pizza parlors in Sweden. Once the U.S. economy ends its phenomenal present roll, resentment could lead to a protectionist backlash; aggrieved Americans could easily view themselves less as advantaged consumers buying bargain imports than as workers who have lost their jobs to "unfair" foreign competition. The precise political outcome may depend on just how many Tuscaloosa automobile assemblers train in Germany and come back with the sense that what is good for Europe is also good for America. ■