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How Europe is saving

1. Glut of banknotes from the end of this year

In six months from now, one of the greatest logistical exercises in financial history will begin. Cash in the 12 EMU countries will be replaced by Euro notes and coins. The transition period is very short: For just two months it will be possible to exchange existing currency; thereafter there will be very strict preconditions for replacing the old notes and coins. The European banking system will face a great challenge during these two months, as despite the ever-increasing importance of “virtual money” like credit and debit cards, a reliable supply of cash still forms the backbone of a smoothly functioning economy. Bottlenecks with queues at banks or even the rationing of currency exchange would be the last thing needed to establish trust in the new currency as it finally becomes available in the form of cash.

For investors and other observers generally interested in economic matters, this exchange operation is interesting from various perspectives. Firstly there is the fascination with the logistical aspects of the last chapter in the introduction of the single European currency. Something special always seems to happen at the end of the year: In 1998/99 the computer programs across Europe had to be expanded to deal with the Euro as a parallel currency, then came the millennium problem and now we are having to organise the storage of notes and coins. But that’s not all: When the whole of Europe takes its cash out of the drawers and from under the mattresses, the issue of security must not be underestimated. Current or potential bank robbers will certainly not be booking their holiday during January and February next year! Forgers who specialise in Lira, Pesetas, Francs or Marks will also need to pull their finger out, as they will not be able to exchange their forgeries for hard currency much longer. Respectable citizens, particularly bank tellers and cashiers in supermarkets and jewellers should already start checking cash even more carefully.

The transition to the Euro as a physical currency will certainly leave its mark on the financial policies of the European Central Bank. We predict a generosity based on the situation at the end of the year, in a similar vein to the approaching millennium problem at the time. Lower short-term interest towards the end of the year must therefore not be taken at face value. Remember: The withdrawal of liquidity through the central banks before the millennium had severe consequences, even in the long-term bond sector. History could repeat itself once again from around March 2002. The ECB will have to carry out whatever measures the prevailing economic situation demands of it.

The third aspect is, in our view, the most interesting. Current predictions from many quarters claim that after years of a decreasing Euro foreign exchange rate, the turn-around will be achieved by the reality of a physical currency in the form of seven notes and eight coins. Not until something can be touched and put into wallets and purses, will it be trustworthy, symbolise intrinsic value and therefore be spent, kept and saved. This argument does make a valid point. Money per se doesn’t actually have any value. Only the *belief* that a piece of paper or metal will provide a valid means of exchange in the future gives money its potency. Belief is closely linked to symbolism, a fact which appears to have been underestimated when the introduction of a single European currency was at the concept stage. This was, after all, the work of technocrats.

But wait a minute: The absence of this symbol during the introductory phase of the single currency – is this really a sufficient explanation for the Euro’s dismal exchange rate progress during the first year of its existence (the trade-weighted foreign exchange rate has now lost 16 per cent of its value since introduction)? And if not, can we expect a turn-around when the symbol becomes a manifestation? We doubt that these things are so simple and therefore want to deal with the

issues surrounding Europe in greater depth in this issue of Investment Review.

Our analysis is linked to the anticipated glut of old Lira, Peseta, Franc and Mark banknotes. Cash transactions, keeping and exchanging foreign currencies and maintaining accounts in other countries and tax systems – this has all been part of a long- lasting European tradition; it has been an important part of the way the „European system“ works. It has also been also an important part of the way individuals protect themselves from all kinds of incalculable risks which have historically made the continent an exceptionally dangerous place. The exchange exercise in the coming winter will put an end to this tradition. In its place will come a system of constructivism which is actually supposed to improve the protection of the individual. However, the weakness of the Euro since its introduction begs the question as to whether any trust has actually emerged. On the contrary, is it not plausible that the cause of the Euro's weak start is of an *endogenous* nature, i.e. that it lies with the Europeans themselves and has much less to do with the international capital markets than is always attributed to them? Or put another way: Can the weak Euro not be attributed to people "voting with their feet", i.e. systematically removing their capital?

2. Ireland as a signal

The population of Europe very rarely has the chance to express its opinion on specific issues, and even this is confined to just a few countries. Something unimaginable for the Swiss: not being able to vote on whether to build a new nursery school or on the country's future security policies. What is sometimes regarded in Switzerland as politics too close to the people, or a burdensome obligation with far too many delaying tactics available for any number of vested interests, has proved to be a major weakness in the EU. The formation of the EU as an amalgamation of nation states with parliamentary systems of government practically excludes the influence of direct democracy and, by its very nature, leads to the remoteness from its citizens which is so often a cause of complaint. Furthermore, the European Parliament, Council of Ministers and EU Commission only represent an incomplete depiction of the individual member states' parliamentary systems. The result is a kind of cabinet politics with lots of opportunities for bilateral, secret or semi-secret agreements. This does not increase trust in the European system.

It's even worse when an occasional referendum actually does take place, due to the constitutional requirements of an individual EU member country. This really doesn't fit in with the scheme of things. The rules of the game for the (Eastern) expansion of the EU had been agreed in Nice, after having forced the smaller member states to relinquish some of their power - then along comes a disruptive factor, in the form of direct democracy, threatening to completely destroy all the plans. This is what happened in Ireland a couple of weeks ago with the referendum on the Nice agreement. The people of Ireland, who thanks to enormous liberalisation efforts (and not primarily due to EU structural subsidies, as is often claimed), have managed to achieve a considerably better standard of living and economic growth rate, obviously had no desire to see this progress watered down.

Whichever way you see the issues themselves, whether or not you find the Eastern expansion EU important and positive – relevant for our question as to why there is a lack of trust within Europe are not these issues, but the remarkable situation that the entire EU seems to assume that Ireland is bound to correct its position sooner or later. For their part, the French premier and German chancellor made quite open statements indicating this opinion directly after the "disturbing" Irish referendum result, as if they had the right or indeed the power to simply reverse constitutionally-binding, democratic decisions.

In the case of Austria, the legitimacy of the European anxiety certainly merits discussion, even among those who believe that the measures taken were misguided, exaggerated and unsuitable. In the case of the Irish referendum, there is absolutely no case for a reaction of this kind. Every EU citizen understands the message loud and clear: The disregard shown here for a small member country can be applied to individual citizens of this Union at any time, with far more damaging consequences.

The absence of a constitution which determines the rights of individual citizens and countries, as well as restricting the power of the central authority in a credible and permanent manner, increasingly invites retribution which, according to our theory, is reflected in the foreign exchange rate of this organisation's currency. The EU has written a *monetary constitution* for the Euro without actually having a *constitution of its own*. Prices – and exchange rates represent nothing other than prices – are a question of the expectation of future value by all the market's participants. The Euro is suffering from an "impotence

discount" of subdued expectations regarding its future value, due to constant confirmation of the view that the governing powers hide behind their cabinet walls and are likely to restrict the rights of individual (especially smaller) member countries, as well as those of individual citizens, at some time in the future. The comparatively prosperous member countries appear to be in particular danger. Is it simply a coincidence that, as of today, England and Norway have not joined the monetary union? If we compare these countries with prosperous individuals, or those that would like to become prosperous, it is easy to reach the analogical conclusion: The EU is a system with pronounced mechanisms of expropriation and dilution.

3. The lack of alternatives

In order not to attract criticism that the Review has departed from the righteous path of political abstinence, we must add that the rights and experience of the individual (namely the smaller) European states, as well as the citizens of Europe, in respect of their currencies were certainly no better without the multilateral EU system. Only someone blind to history could ignore the dramatic infringements against countries and individuals which took place during the twentieth century. The EU *is* a reply to the terrible chapters of two European World Wars. And there is a kind of higher European *reason of state* that justifies certain restrictions on individual countries and citizens. An alternative to the process of European integration is hard to imagine and somewhat unreal.

The recognition of the fact that alternatives to the process of European integration are probably lacking and that a return to a multi-nation muddle is virtually unimaginable must not, however, be equated with the acceptance of every construction error within the European system. If these construction errors can additionally be defined as the probable cause of the continuing loss of value of one of the world's major currencies, the criticism (which is often also politically motivated) must be converted into razor-sharp economic analysis. From an economic perspective, as well as for investors, it is not unimportant to be aware of the exchange rate prospects for the investment currency Euro and why particular developments may be expected.

At this point, we would like to add a short personal digression from the commentator. A couple of months ago he had the opportunity of meeting Vanden Abeele, the EU commissioner responsible for taxation issues. When asked whether the EU commission saw a connection between the non-investor-friendly EU taxation plans and the lacking attractiveness of the Euro, he replied that the commission was not at all interested in the foreign exchange rate of the Euro due to the high proportion of internal EU trade. What a contrast to the recent retraction initiative by the new US government from the OECD tax harmonisation! The Americans argued on the basis of its businesses' inherent appetite for capital and that it was necessary for the Dollar and the American capital market to remain attractive. Europe obviously doesn't need any capital…

If there are no sensible alternatives to European integration, then we must at least consider alternatives to the present organisation of the system and its personnel. The lack of alternatives in political direction and the real predominance of socialist concepts is one of the main differences between Europe and America. Every few years the USA proves that it is capable of voting out presidents and their followers. There is no comparable process in Europe. As previously mentioned: A constitution is lacking and because of this, there is also a lack of trust.

4. Arabesque and filigree

One of the problems surrounding the lack of trust is that the Europeans had, more or less, come to terms with the ways of the old multi-state regimes, ways which have no place in the new order of things and are indeed being actively fought by the new system. It is for precisely this reason that the new system is disliked, disbelieved and mistrusted. We have already mentioned the major exercise in exchanging banknotes. The delicate network with which the Europeans find a little security outside their own economic, legal and tax system will become partially redundant. Rigorous fiscal control will make the German citizen's bank account in Luxembourg an extremely risky venture. With its intention of introducing cross-border procedures for reporting interest payments between tax authorities, the EU wishes to destroy the delicate network which has developed during the twentieth century, based upon the aim of individual security and provision for the future within another economic, legal and tax system.

The traditional European system, with its typical economic infidelity in other countries and the filigree network of business, some of which belongs to the black economy, has not been particularly attractive to economic analysts. There are obviously hardly any figures available and we

therefore have to rely on estimates. Depending on the country, it is assumed that the black economy comprises 10 to 25 per cent of the gross national product. Or put another way: The proportion of wealth created outside the legal fiscal system is extremely relevant to general prosperity. There is no doubt that in countries like Italy, business activity would have come to a halt if the citizens simply carried out their "official" job, instead of beginning to work "properly" early in the morning or after leaving their workplace.

The existence of a black economy on this scale can partially be explained by the high level of taxation in most European countries. A person who has to pay 50 per cent or more of his income in tax has no incentive to work and, more significantly, not much chance to put something aside; he is practically denied the chance of saving.

5. The micro-economy of illicit money

We don't believe that high tax burdens alone sufficiently explain the massive increase in investments outside people's own countries. The obvious benefits of lower or totally absent taxation on the capital and the interest it generates are flanked by serious disadvantages. Investment management fees in the offshore sector are typically higher than for the onshore sector, as the institutions involved enjoy a (limited) monopoly due to their special situation, i.e. they can take great advantage of the difference between the marginal tax rate that the foreign investor would otherwise have to pay in his own country and the fees charged in the offshore sector. It goes without saying that lawyers, accountants and other parties all take their cut of the margin. But the fees aren't the only problem. The level of interest in offshore business is often somewhat lower, as it takes account of the fact that there are no withholding taxes.

A further, more significant disadvantage of offshore saving is the difficulty involved in obtaining the capital if it is needed. Or put another way: *Usually*, capital invested outside the home country's system is effectively *unusable*. It is, of course, available to economies as accumulated capital through institutions like the Euro Market or through portfolio investments in shares. (It's worth mentioning the double standards of the treasuries here: On the one hand they try to tax every Mark and Pfennig, whilst on the other, they raise capital from offshore markets without batting an eyelid). For offshore customers wishing to accumulate capital, the door is always open. However, if any money is saved in this process, it is likely to be an insignificant amount.

In addition, the danger of being caught by the penal authorities has increased dramatically in recent years. The state's growing appetite for money has been accompanied by a tendency to criminalize tax offences. The democratic legitimisation of tax laws has placed tax evasion on a par with other punishable offences like fraud, theft etc. The "capital refugee" therefore finds himself in the same category as drug criminals and the mafia. Money laundering for everyone, so to say.

You can look at it however you want to: The micro-economic figures wouldn't add up if there were not a further, more significant reason for offshore saving. As the financial and factual disadvantages of accumulating capital outside the home country's system clearly outweigh the absence of taxation, what could be another, additional, significant reason?

Where individuals behave in a loss-making manner, it is always worth looking at the *insurance consideration* when making micro-economic analyses. Insurance is defined, economically speaking, by the situation in which a probable loss is substituted by a definite loss. This means that individuals are prepared to accept costs (definite losses), in order to put themselves in a better position in the case of possible losses. Every fire or accident insurance works like this. You pay the premiums, thereby suffering definite losses, but obtain financial security in the unlikely event of damage occurring.

This solves the puzzle of capital accumulation in the offshore sector: Offshore money has little, at least much less than generally assumed, to do with tax advantages, but provides a form of insurance for the individual against the organisation to which they, as citizens, belong. Just in case this organisation turns against them one day. The most important point is that the intention of the EU to solve their inarguably massive offshore problem under the banner of tax harmonisation, which they deem necessary, is tantamount to operating on the wrong patient with the wrong instruments. It's not about tax, it's about a whole lot more.

6. Good reasons for mistrust

In item 4, we mentioned the way European citizens dealt with the multi-state regimes during the twentieth century. With arabesques in other neighbouring countries and a filigree network of smaller or larger tricks to bypass the tax and customs officials, they made personal provision for their future, come what may. This worst case

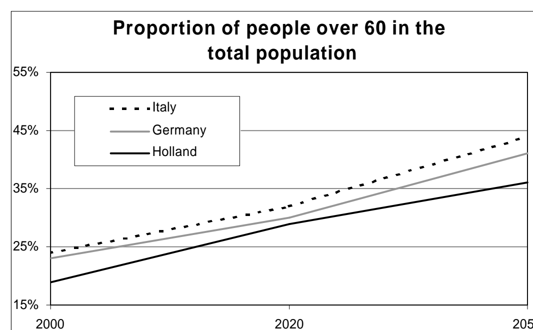
scenario actually occurred a number of times throughout history. The Germans lost their entire savings through two devaluations and suffered a falling exchange rate after their reunification with the GDR. It is beyond question that the country to which they belong has turned against them more than once. The results in Italy and France aren't much better. Until recently, Italy suffered from periods of severe inflation, similar to those still seen in Turkey. Inflation is a typical endogenous illness of automatic immunity. Its objectionable nature can go much further: The subtle structural violence of devaluation and inflation can, in certain situations, lead to the use of real violence. As recently as the seventies, whole families were imprisoned in Portugal, not because they had broken any laws, but because they were prosperous. That was during the period of communist government. If people like this placed money in banks abroad, who could blame them? Taxation is certainly not the reason for this type of personal saving!

Will we now be told that instead of and indeed to prevent developments of this nature in individual member countries, the EU guarantees freedom, regulates the European domestic market and has provided the Maastricht currency agreement. History is history and it should remain so. Obviously, nobody would wish this were not so. However, to remove all traces of mistrust, the most important problems surrounding the sensitive issue of individual personal provision for the future must be solved.

They haven't been.

7. The demographic time bomb.

If one element of economic interrelation is relatively easy to predict, it has to be the population structure. Apart from natural catastrophes and wars, the birth rates in specific societies remain relatively constant or follow a particular long-term trend. By taking the birth rate and the tendency of its change, coupled with figures for life expectancy, which are similarly predictable, it is possible to calculate the main demographic data for the years 2020, 2030 and right up to approximately 2050. In some European countries (Germany, Italy and Spain), very low birth rates are immediately noticeable. They are far below the rate of 2.1, which is necessary for perpetual reproduction. At the same time, life expectancy is increasing at a fairly constant rate. It is estimated that average life expectancy in the OECD countries will be 82 by the year 2050; in some parts of Europe this figure is already close to being achieved. The proportion of over-sixties in the total population is therefore set to rise dramatically.



Source: Deutsche Bank Research; own graphics

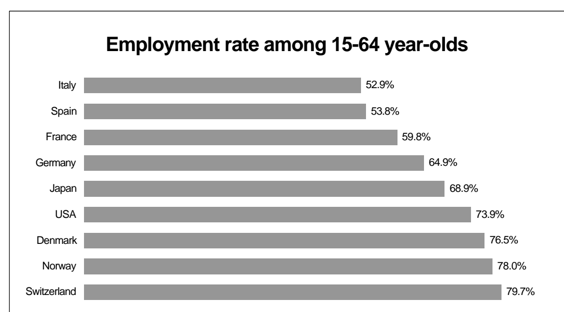
The impending increase in the percentage of old people has been known for some time and has provided material for countless seminars, workshops and international conferences on the theme of the “ageing society”. There is hardly a business for whom this development is not relevant – just think of life insurance companies, the travel branch or the entire health care sector. How and where can money be made with this new population structure in the future and where are the potential risks?

However, looking at society as a whole, there is an entirely different issue. Who will be working and paying for whom in ten, twenty or more years? How will the so-called active proportion of the population behave towards the inactive? Despite the euphoria surrounding automation and further increases in productivity, we must be under no illusion: Work will still have to be done in the year 2050. And maybe even more so than today. The millions of very old people will need looking after and robots will not be sufficient for the task.

Meanwhile there are some suggested solutions to the problem of an ageing population. Some tend towards immigration policies, others towards increasing working years. Both appear to be somewhat far-fetched. A conference at the Institute for World Economics in Kiel calculated that if we are to maintain the current ratio between working people and pensioners, the population of Europe will need to increase by 400 million to 1.2 billion by the year 2050. Taking the negative birth rate into account, this would mean immigration of around 500 million people. Political arguments are not required to illustrate that this is simply impossible.

Extending the number of working years is the other logical solution suggested for dealing with the problems of an ageing population. For example, linking the age of retirement to the prevail-

ing figure of life expectancy is something suggested by scientists. The problem is that real events are moving in the opposite direction: There is hardly a country which is prepared to discuss raising the retirement age. And there's worse: The so-called active population is actually far more passive than most people assume.



Source: OECD; own graphics

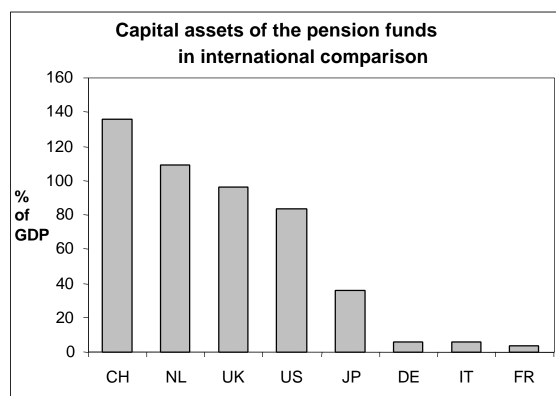
Between the ages of 55 and 65, the employment rate is significantly below 50 per cent in many countries. In other words, there are considerably less "actives" who have to support the "passives".

8. The issue of financing

The counties of Europe, most of whom have a socialist tradition, mainly have systems of provision for old age whose main emphasis lies in financing current pensions from current contributions, rather than capital funding. The contribution procedure requires the "active" proportion of the population to finance the inactive generations of children, young people and pensioners. Deductions from gross earnings provide the funding for transfer payments to pensioners. Children and young people are mainly provided for by internal family transfer funding (at least for the time being?)

Capital funding systems are based on individual or, more or less, collective consumer sacrifice in favour of accumulating capital. Collective pension plans are generally known as the "second pillar", whilst individual, tax-advantageous private pension plans are referred to as the "third pillar". The "fourth pillar", i.e. individual saving at ones own responsibility is, however, hardly mentioned in government pension planning concepts – and in relation to tax breaks most certainly not.

The main European countries, that is Germany, France, Italy, tend strongly towards the contribution procedure. The following graph shows the total pension fund capital as a percentage of GDP. In Germany, 82 per cent of pension income stems from the "first pillar" (i.e. current contributions) and other sources of transfer finance. Italy is the only country in which the ratio is even more extreme.



Source: Deutsche Bank Research

If we combine our demographic knowledge with the pension systems of the main EU countries, it is not difficult to draw the conclusion that this amounts to one of the *great weaknesses* and, at the same time, one of the all-decisive political challenges for the *European Community*. A continuation of the present social policies, wangling their way through every possible political promise, can and should not happen: The transfer burden on the ever-decreasing proportion of the active population in the coming decades is just all too obvious. Ever-increasing percentages of transfer deductions from gross earnings will place such a burden on employment costs that stagnation will occur well before the necessary growth rates are achieved.

A third line of argument for solving the problems surrounding the ageing society is the combination of the first two (i.e. immigration and raising the retirement age) with economic policies geared markedly towards growth. Economic growth is equivalent to increased productivity and increased productivity only occurs when investment conditions are good. Furthermore, investment is only possible if enough capital is available. Which brings us to the key question regarding the further development of Europe, to defining the reason for the systematic weakness of the Euro and onwards to the main focus of this Investment Review.

9. Accumulation of capital is lacking

Our guess is that EU citizens are aware of just how hopeless their current pension systems are, or that they at least suspect it. This is the reason why so many of them arrange security outside their own country, despite taxation or indeed by

avoiding it. We will return to the correlation between Switzerland's position in respect of its bank secrecy laws and the EU at the very end of this review.

The predominance of transfer-oriented pension systems is, in our view, the cause of a *further structural weakness* of the old continent in comparison with the United States: Europe accumulates too little capital. Due to the fact that a large proportion of private income not destined for consumer spending is not saved, but used to pay transfer contributions (similar to tax), the potential for saving and thereby for accumulating capital is drastically reduced. There is a close correlation between saving, accumulation of capital, investment and economic growth. The higher the capital flowing from savings activity, the more an economy is willing to invest. The latest research shows that promoting higher savings by reducing or even eliminating certain income taxes (including "pillar 1" pension contributions) has a previously underestimated effect on the accumulation of capital and the tendency of a society to invest.

Europe's businesses, including the small and medium-sized ones, are traditionally funded extensively through bank loans. There is only a partial supporting capital market. The lack of this capital is maybe the most obvious sign that there really is a difference between capitalism and socialism.

Our predictions on this matter tend to be of a *pessimistic nature*. Firstly, based on political and economic considerations, we can hardly believe that the political establishment in the EU and certain member countries will really make a serious effort to move away from their pension contribution procedures. The contribution procedure subjugates its citizens. The negotiations required in 10, 20 or more years to re-assess the allocation arrangements between the different generations will extend the leeway and power of the political system. People who are interested in maximising their political power have absolutely no incentive to shake up the current structures. Even when obvious disaster is imminent, and it is, structures like this prove to be amazingly resistant. On the other hand, capital cover and holding private capital resources would lead to free and responsible citizens. All knowledge of political theory points to the fact that this is not the aim of the political establishment (unfortunately, this is also irrespective of their political shade…)

The differences between the current capital assets of the pension funds in the main EU countries and, for example, England or Holland, are an indication of a different direction: It would not be surprising if Brussels started an initiative to "harmonise pensions". The aim would be, as ever, to achieve "a level playing field" within the EU domestic market; the effect would be robbing Peter to pay Paul.

It will be interesting to see how far the recognition of fundamental structural differences will influence the British decision on whether or not to join the monetary union. North of the English channel there is a booming capital market, in much the same way as there is across the Atlantic. In their own interests, the British are unlikely to sacrifice their hard currency, their pension system and their capital market. However, these developments will have a major influence on the future exchange rate of the Euro.

10. And what about Swiss bank secrecy?

Up until now, we have done our best to avoid bringing Switzerland into the "filigree network and arabesques". However, it is certainly the case that Swiss banks are one of the most popular destinations for Europeans to save and provide for their future, according to the considerations defined above. As a non-member of the EU and having its own currency, Switzerland provides ideal conditions for accumulating capital outside the customer's own respective country.

We have tried to show analytically that fiscal considerations (meaning tax evasion) do not represent the main incentive for Europeans to accumulate capital outside their own system. On the contrary, experience shows that foreigners in Switzerland often invest in financial instruments (e.g. shares) which are also not taxed or hardly taxed in their own countries! But as we said: for the time being, the European doesn't have much reason to change his mistrust of his own system. The demand for places in the world where "ultimate private capital" can be accumulated will remain.

From this perspective, *Switzerland will increase its importance as a financial centre*. If the politicians proceed with their bank reporting procedures, the filigree network within the EU won't have much chance of survival. This begs the question as to whether Switzerland will be able to resist the obvious pressure from Brussels, which is likely to increase in the future. The Swiss government has told EU that it is prepared

to negotiate on a tax on interest payments. However, bank secrecy is sacrosanct. On March 4th the Swiss people voted in a referendum, with an overwhelming majority against fast-track membership of the EU and for the current position, confirming Switzerland as a financial centre.

If our micro-economic assumptions, as detailed here, are correct, i.e. that fiscal considerations are only part of the reason for placing "money in Switzerland", then the Swiss position regarding a (moderate!) taxation of interest payments is certainly consistent. The real correlation between the existence of bank secrecy and the inability of Europe to find a credible solution to the problem of pension funding, as well as accumulating enough capital for its economy, may cause some headaches and annoyance here and there, if the arguments are actually taken seriously. Unfortunately, there is more incompatibility than many people may like to admit.

KH, 11th July 2001