



F&C Management Limited
Exchange House
Primrose Street
London EC2A 2NY

Telephone +44 (0)20 7628 8000
Facsimile +44 (0)20 7628 8188
www.fandc.com

Market Review

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Without walls: how Europe has adapted to East-West unity

As Germany prepares for the celebration of the 20th anniversary of the fall of the Berlin Wall, F&C analyses the event that changed the face of Europe

Summary:

- **Russia : a hybrid between state-dominated economy and free market - energy powerhouse**
- **East meets West in widest EU enlargement ever**
- **ERM forerunner of the Single Currency**
- **The new millennium: from the dot.com bubble to the credit crunch**

On November 9th, 2009 Germany will celebrate the 20th anniversary of the fall of the Berlin Wall, a far-reaching event that few deemed possible even a few days before it happened. The fall of the Berlin Wall was the catalyst for the reunification of Germany, famously expressed by the late German Chancellor Willy Brandt: "What belongs together is now growing together". But it also heralded the dismantlement of the Eastern Bloc*, the collapse of Communism behind the Iron Curtain, the end of the Cold War, and the rise of globalization. Beyond the geopolitical implications of the fall of the Berlin Wall, the end of the partition of Europe laid the foundation for major economic changes on the European continent.

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Russia: a hybrid between state-dominated economy and free market

In 1985, reform-minded Soviet leader Gorbachev introduced openness ([glasnost](#)) and economic restructuring ([perestroika](#)) in the Soviet Union, paving the way for the dissolution of the USSR late 1991. This marked the emergence of the Russian Federation, as the main political power in the region and one of the fast growing developing economies, the so-called “R” in the BRICs.

Under President Boris Yeltsin, the country underwent wide-ranging reforms including privatisation of companies as well as market and trade liberalisation. Former apparatchiks had the opportunity to buy large stakes of key strategic companies, which led to the building of oligarchic business empires.

Gareth Morgan, Emerging Equities manager and Russia specialist at F&C Investment, explained: “The stock market in corporate Russia remains narrow in terms of investable sectors, mainly the energy and natural resources segment controlled by either the state or oligarch shareholders in companies such as Gazprom, Rosneft and Lukoil. There is no culture of entrepreneurship like other emerging markets.”

The collapse of the Soviet Union has also resulted in an issuance boom for the London Stock Exchange from new Former Soviet Union companies (FSU), with volume growth from overseas issuers seeking secondary listings outstripping domestic financings. Karina Litvack, Head of Governance & Sustainable Investment at F&C, said: “The light touch “principles-based” approach that prevails in the UK proved very appealing to foreign issuers, but also gave rise to a two-tiered system. UK-domiciled companies were held to the relatively stringent UK Combined Code as it applies to all Primary Listings. However, non-UK issuers, many of them FSU companies, went for Secondary Listings, which were only required to meet EU Directive-minimum standards.” She added: “This risked diluting the reputation of the London market, as FSU companies brandished LSE listings that stood for far less than a full primary listing. Following the IPO of Rosneft in 2005, F&C became concerned about this trend and appealed to the FSA to introduce better clarity and higher listing standards for foreign issuers.”

In particular, F&C called for issuers to be differentiated on the basis of the quality of their governance and disclosure standards rather than their country of domicile. Litvack added: “Instead of Primary Listings for UK issuers and Secondary Listings for others, F&C called for Premium and Standard Listings, to be open to all issuers. “After a full consultation, the FSA announced recommendations in October 2009 which match our requests. This will enable any FSU company to enter the market at Standard level with lower, EU Directive-minimum standards if it wishes to, and to migrate to a Premium Listing if and when it is ready. In doing so, it will benefit from the enhanced reputation, investor loyalty and capital valuation that comes with adopting higher standards of governance and disclosure.”

Energy powerhouse

In the immediate years following the collapse of communism, the economic situation deteriorated until the Russian debt crisis in 1998 (see comparative chart below), from which point it has improved considerably. Today, Russia enjoys the status of a major emerging market and a dominant player in the global mineral and energy supply. In 2008 it held 6.3% of the world's proven oil reserves with 79bn barrels. It is however believed that this represents a low estimate and that the true reserve base could be up to 300bn barrels. Indeed, the country's strong economic growth over the last 10 years has been in largely fuelled by the steady rise in oil prices during the same period.

Russia also holds 23.4% of the world's natural gas. In Europe alone, 26% of the natural gas supply comes from Russia. Its soil abounds in iron ore, nickel, coal, gold, diamonds, zinc, aluminium, titanium and copper to name but a few.

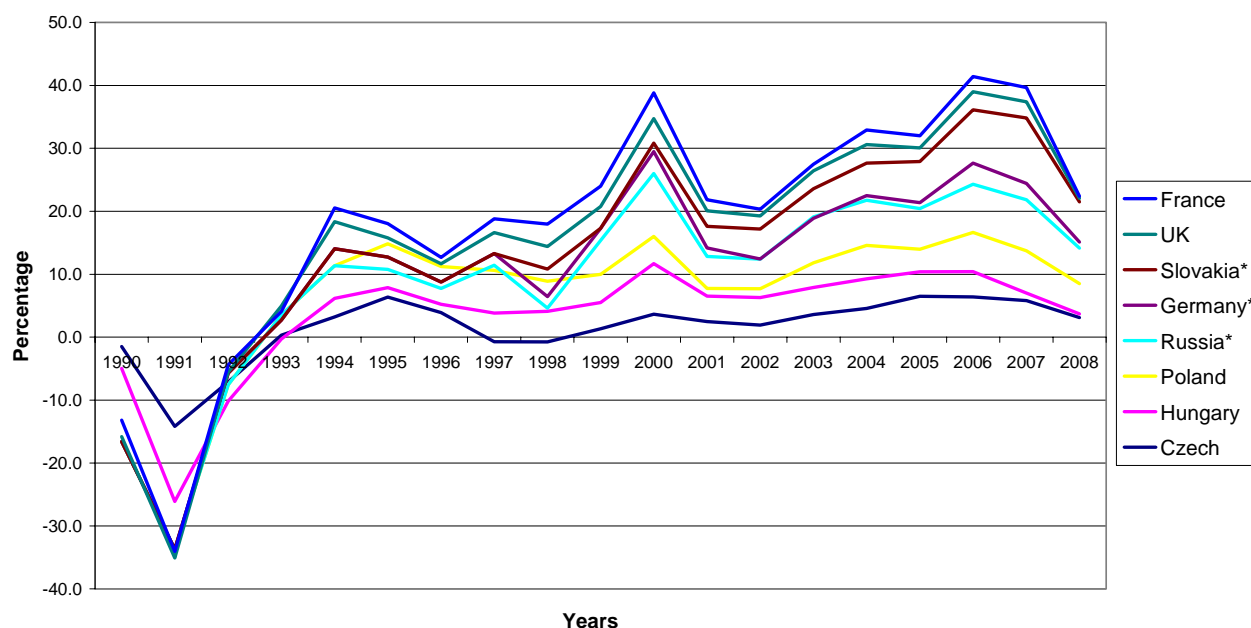
East meets West in widest EU enlargement ever

Political developments such as the Velvet Revolution in Czechoslovakia, the EU enlargement with Eastern European countries and the Baltics and the economic growth these countries have enjoyed since, would never have happened without the fall of the Berlin Wall.

The Ostmark was demonetized when the German Democratic Republic was incorporated into the German Federal Republic on October, 3rd 1990, celebrated as their National Day since. The then Chancellor of German reunification Helmut Kohl allowed former East Germans to convert their Ostmarks into Deutschmarks at par, creating a short term bubble in East Germany. There were two or three post reunification boom periods which saw massive investments and soaring consumption. The enormous costs of reunification were borne mostly by Germany. From 1991 to 2003 the west spent 4 to 5% p.a. of its GDP yearly on the east, which initially made up more than 50% of East German GDP. David Moss, European equities manager at F&C, said: "Germany's GDP since the early 1990s has been lacklustre, lagging behind many European countries. Twenty years on, the former East German region is still poorer than the West and has certainly benefitted from the reunification less than expected. In many respects the fall of the Berlin Wall was more beneficial to Eastern countries and Russia than it was for Germany economically" (see chart below).

In the early 1990s a part of West German production quickly moved to East Germany but, because of the exchange rate at par, was transferred to Central Europe. First to the Czech Republic and Slovakia, more recently also to Rumania and Bulgaria. Besides Austria which historically had strong ties with some Eastern European countries, Germany, as a big export nation, has been a major beneficiary of the growth in Eastern Europe owing to its geographical situation.

Annual real GDP figures since 1990



*GDP figures for these countries are not available dating back to 1990

Sources: HSBC / Eurostat

Post reunification East Germany became *de facto* part of the European Community in the new reunified Germany, not increasing the number of states. By virtue of the Maastricht Treaty the European Community later became the European Union. After Austria, Sweden and Finland became full members in 1995, Eastern European countries, the Baltic states as well as Malta and Cyprus joined the EU between 2004 and 2007, bringing the total number of EU members to 27.

ERM forerunner of the Single Currency

The concept of a European Single Currency had been thought about with the introduction of the European Rate Mechanism (ERM) in 1979 as part of the European Monetary System. Its aim was to reduce exchange rate variability, in preparation for the European Monetary Union which led to the creation of the Euro. In some respects some of the stresses around the reunification had an impact on the ERM because of the strength of the German economy post reunification. A lot of countries tried to stay in the ERM including the UK which was forced to come out the programme in 1992, two years after joining the club.

Moss continued: "The Euro is another political and economical melding of Europe. As Europe has come together in the last 20 years, most Western European countries but also some Eastern European countries such as Slovenia have joined the Eurozone. However the economies of the wider EU remain very different.

Despite the funnel effect of the integration even in the Eurozone strong differences persist between Germany and the previous faster growing countries such as Ireland and Spain which are experiencing the greatest slowdown.”

The new millennium: from the dot.com bubble to the credit crunch

Although the dot.com bubble spanning from 1998 to 2001 is not a consequence of the fall of the Berlin Wall, its occurrence lies mid way in the chronology of events between 1989 and the current financial crisis. Moss argues that without being global the high tech bubble had some global influence as it hit Western economies and the Far East. “This brief period of time saw the Germans who never had an equity investment culture before buying massively into the asset class on the Neuer Markt and Nasdaq”, he commented.

Ten years later, the German and Russian economies were not spared from the recession triggered by the global financial crisis.

Compared to other countries, such as for instance the UK, Germany has however fared relatively well during the recent credit crunch. Its banks were not too leveraged and the level of personal savings has always been high. Moss explained: “We believe that the European economic growth has now passed the low point and that more countries will emerge from recession as we move forward. Germany is one of the best positioned countries by virtue of its quite good financial situation and a new government under Angela Merkel, who grew up in East Germany, eager to push reforms. However, at the aggregate Eurozone level we expect GDP growth to be lacklustre well into 2011 as consumers de-leverage and Governments start to reduce the enormous budget deficits they created to reduce the effects of the crisis”.

Oil-rich Russia, on the other hand, has suffered from the collapse in commodity prices early this year, which contributed to a sharp correction in Russia’s GDP estimates. However, recent data suggests that the Russian economy was past the worst in the second quarter, with the recovery in commodity prices and exports being the major drivers leading the country out of the crisis. Morgan added: “Longer term we would like to see reforms focused on developing domestic savings rates and tackling bureaucracy and corruption, which would encourage entrepreneurship and ultimately help diversify the market away from the dependence on resources. A both ageing and declining population has long term implications for Russian competitiveness, as a shortage of skilled workers takes their toll on the economy.”

***Eastern Bloc: Soviet Union:** Russia, Belarus, Ukraine, Moldavia, Latvia, Lithuania, Armenia; Azerbaijan; Georgia; Kazakhstan; Kyrgyzstan; Tajikistan; Turkmenistan; Uzbekistan, Estonia - **Satellite states:** East Germany, Poland, Hungary, Bulgaria, Rumania, Czechoslovakia. **Yugoslavia:** Serbia, Croatia, Montenegro, Kosovo, Macedonia, Slovenia, Bosnia-Herzegovina. **Albania**

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Press enquiries – 0207 011 4600

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|------------------|------------------------|----------------------|
| Véronique Sant | Communications Manager | +44 (0)20 7011 4278 |
| Paula Garrido | Communications Manager | +44 (0)20 7011 4190 |
| Jennifer Donohoe | Communications Manager | +44 (0) 20 7011 5017 |
| Sarah Godfrey | Communications Manager | +44 (0) 20 7011 4215 |

Notes to Editors

F&C Investments

- F&C Asset Management (F&C) is an independent London Stock Exchange listed asset management group with around 100,000 shareholders.
- F&C traces its origins to 1868 with the launch of the Foreign & Colonial Investment Trust, the first ever publicly listed investment fund. Foreign & Colonial Investment Trust remains a client of F&C.
- F&C is an active fund manager with a multi-specialist investment model where individual teams have strong accountability for their products and processes. The group is also an active shareholder with a leading franchise in governance and sustainable investment.
- F&C manages £99.2 billion (€108.5 billion) of assets** for a diverse range of institutional, insurance and retail clients across all major asset classes – equities, bonds, cash and property – as well as alternative and specialist product classes such as Socially Responsible Investment funds, hedge funds, private equity funds and Liability Driven Investments. F&C invests globally and has been a longstanding investor in emerging markets.
- F&C REIT Asset Management is the group's global property asset management business. It was formed in 2008 from the merger of F&C's property division and REIT Asset Management. F&C REIT operates from offices in London, Dublin, Munich, Mumbai and Stockholm.
- F&C manages assets principally from three investment centres: London, Amsterdam and Edinburgh. The group has a global office network spanning a dozen countries: China (Hong Kong), France (Paris), Germany (Frankfurt & Munich), India (Mumbai), Ireland (Dublin), The Netherlands (Amsterdam), Portugal (Lisbon), Sweden (Stockholm), Switzerland (Geneva), UK (London, Edinburgh, Dorking) and the United States (Boston).

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- In March 2009 F&C signed a Memorandum of Agreement with Hua Xia Bank, one of China's twelve nationwide joint stock commercial banks, to establish a joint venture fund management company in China in which F&C will have a 19.5% interest.

** As at 30 September 2009.

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