"INTEGRATION OF EUROPEAN EQUITY MARKETS: IMPLICATIONS OF STRUCTURAL CHANGE FOR KEY MARKET PARTICIPANTS TO AND BEYOND 1992"

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I. INTRODUCTION

Despite significant historic inter-European economic linkages, the single most striking feature of Europe's stock markets, taken as a whole, is their diversity: in size, structure, regulation, taxation, trading practices, and operational efficiency. While the EEC's legislative efforts should remove some of these differences through harmonization of various standards, certain market peculiarities may undoubtedly continue to remain.

This diversity, however, can be characterized as both a strength and a weakness. The strength resides in the opportunity for individual European markets to specialize in the delivery of particular products and services. The weakness lies both in the possible inability of European markets to play a unified and significant role in the global equity market and in the obstacles that this diversity could impose on the very integration process fostered by the EEC.

What does an aerial photograph of European equity markets present to the viewer? What may the same photo look like by the middle 1990s? What features should be likely to change and what factors seem to drive those changes? If the viewer is one of the key equity participants, what implications should he draw for his own strategy for the coming decade?

In answering these critical questions, we examine first, in Section II, the evolving market structures and dynamics of European equity markets and evaluate the on-going initiatives of the EEC for creating an integrated securities market by year-end 1992. Section III presents, in the form of a prognosis, the various possible implications of the above discussed trends in European equity markets, for key market participants, namely, stock exchanges, financial intermediaries, and retail and institutional investors.

II. EVOLUTION OF EQUITY MARKET STRUCTURES AND DYNAMICS

With the notable exception of the U.K., European equity markets have historically assumed a secondary role in private sector financing in comparison to the bond and bank debt markets. A fragmented market structure kept nearly all Continental equity markets rather emaciated and country bound. This somewhat stagnant and lackluster situation has been rapidly evolving over the 1980s. And certain projected developments should further invigorate European equity markets by accelerating two mutually reinforcing processes: individual market modernization and innovation on the one hand, and European financial integration on the other. But what are these beneficial factors that are causing this clear change in market structures and dynamics?

Up to the middle 1980s, two discernable factors of change appear to have affected individual European equity markets: the world-wide advances in technology and telecommunications applications in most areas of the securities industry, and competition among key European financial centers in vying for a role as the European "link" in the increasingly global issuance and trading of securities.

Over the past five years, these factors mingled with five other key "drivers" which appear to have emerged, some of which were spurred in varying degrees by the EEC initiatives in the securities field: 1) the increased liberalization and modernization of stock exchanges, 2) the growing use of equity funding as an efficient financing alternative, 3) the expanding scope of financial intermediary activity, 4) the continuing development of equity-linked derivatives and 5) the rising importance of European institutional investors. Let's examine these interlinked factors.

1. Liberalization And Modernization Of Stock Exchanges.

Continental exchanges were traditionally characterized by cumbersome listing and disclosure requirements, armchair trading practices, and inefficient clearing and settlement systems. Over the past few years, various national "self-reforms" have begun, especially in major Continental markets (West Germany, France, and the Netherlands). These reforms could be termed as a competitive reaction to the rapid liberalization and modernization efforts of London, New York, and Tokyo and a growing fear among Continental exchanges that once an "intangible" market consolidates itself in one location the competitive lead-time of that location will be hard to recapture in a market characterized by rapid technological evolution.[1]

The major exchanges now have, or are working towards, relaxed listing/disclosure requirements for firms and membership requirements for brokers/dealers. The exchanges are also promoting the application of technology in trading (especially in block trading) and in clearing and settlement procedures, replacing fixed with negotiable commissions for transactions, and establishing various equity-related derivative markets to expand their scope of activities.

2. Growing Use Of Equity Financing Alternative.

Traditionally relegated to a step-sister role vis-à-vis bond and debt funding vehicles, equity funding has emerged recently as a viable alternative for corporate financing. And while in the past debt markets tended to crowd out or dominate new issuance in capital markets, there are indications that the future may see the co-existence of both forms of financing. For example, during the three-year period 1985-87, new issuance of domestic equity has more than doubled (from ECU 25 billion to ECU 64 billion) and new issuance of Euro-equities, that is, shares isssued in the Euromarkets, has more than tripled (from ECU 3 billion to ECU 10 billion).[2]

Several reasons can be identified for this trend.

(1) Many governments are undertaking privatization programs in order to liberalize the economy and raise capital. These efforts have been assisted by buoyant stock markets over the past decade. Between 1985 and 1987, approximately ECU 35 billion was raised in Europe from the sale of shares in public sector corporations.

(2) The restructuring of European industries is on the increase and has spawned numerous spin-offs, recapitalizations, equity market floatations of leveraged buy-outs and the like. Preparations for 1992 are expected to further encourage such activity. In addition, the demand side is being reinforced by increasing pools of institutional equity capital looking for higher returns often via investments in the once neglected "mezzanine" and equity components in structured transactions.[3]

(3) The liberalization of listing and disclosure requirements mentioned earlier is tempting many companies, especially in the upper-end of the middle market, to diversify their liabilities away from a dependence on their traditional banks. This nascent trend towards increased use of equity financing is likely to be aided by specialized financial intermediaries focusing on this higher margin customer segment (vis-à-vis the large corporate market).[4]

(4) Universal banks after 1992 may be restricted, by EEC legislation under proposal, as to the amount of shares of any particular company they can hold; off-loading of such paper may accelerate in the next few years to comply with the liklihood of the approval of these requirements and hence may promote secondary market liquidity.[5] In fact, in some countries, as Germany, where banks have held on to major quantities of corporate shares for decades, this

off-loading process can in some ways be construed as a form of privatization.

3. <u>The Expanding Scope Of Intermediary Activity</u>.

One of the prime reasons for the traditional lack of liquidity in most Continental exchanges has been due to regulations that have prevented intermediaries both from trading and positioning shares for their own account and engaging in market making activities. In turn, this created little incentive for these intermediaries to be well-capitalized to cope with positioning risk.

Two factors are working to change this situation: (a) competition from London is forcing many Continental exchanges to review their prior stance of "investor protection" as the ostensible reason for prohibiting own-book trading/positioning and (b) the proposed EEC directive on investment services which, in essence, should enable universal banking (allowing brokers and dealers to offer their services freely across Europe and be supervised under their home country regulations). As these factors materialize, the role of European equity market intermediaires should evolve towards the U.K., U.S., or Japanese models.

4. <u>The Development Of Equity-Linked Derivatives</u>.

The traditionally fragmented nature of Continental equity markets, coupled with a dearth of innovative financial intermediaries, limited the development of equity-linked derivative products. Most underlying equity markets had poor liquidity, few investors were sufficiently sophisticated to demand "finer" tools in portfolio management, and in certain countries the regulatory authorities perceived little difference between gambling and financial futures and options.

As major Continental centers began to vie with London in serving as a "global link" in securities markets, the innovation, structuring, trading, and consequent market-making in derivative products came to be viewed as a means of building competitive advantage. While London may currently be ahead of other European centers in terms of the level of activity (with its London Traded Options Market and London International Financial Futures Exchange), Paris (with its Marché à Terme International de France and Marché des Options Négociables de Paris), Amsterdam (with its European Options Exchange) and Frankfurt (with its over-the-counter stock option market) are all vigourously trying to retrieve some of the business that had earlier drifted to London.[6]

5. Rising Importance of European Institutional Investors.

Various factors are converging to boost the role played by European institutional **investors.** These factors are expected substantially to change the concept of portfolio management from a traditionally passive buy-and-hold strategy of top-notch paper (typically bond paper) to one that is popularly referred to as "dynamic asset allocation" on a pan-European scale. In addition to the improvement in Continental equity market structures--which should provide a more efficient arena for institutional investors--two further key reasons can be identified.

First, pension plans in most European countries are increasingly shifting from a redistribution system to a capitalization system. In the former system, contributions made by current workers are immediately redistributed to current pensioners, whereas in the latter system, funds collected today are invested for future distribution according to certain investment criteria, many of which stipulate the possibility for equity investments.[7]

Second, the EEC directive on the free movement of capital, coupled with continued national deregulation in allowing institutional investors to increasingly place larger percentages of their assets abroad, should encourage these investors to seek risk-diversification opportunities through a wider range of investments throughout Europe.

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In summary, these five interlinked factors are working at differing speed to revitalise and redefine the character, structure and dynamics of the European equity markets. In this light, the EEC's efforts in the field of securities markets may be viewed as further accelerating these competitive factors. Let's briefly review them.

Unlike the banking sector where indirect barriers (different standards in each country) are the biggest obstacle to pan-European offering of services, the securities field is also burdened with direct barriers. Exchange controls, while being phased out in most EEC countries, made multi-country portfolio investing extremely difficult. Numerous exchanges had (and many still do) regulations preventing foreigners from being licensed as brokers. In some countries (as Germany and Belgium) in order to offer just securities trading it used to be necessary to offer a full range of services. Insurance companies and pension funds in many countries are limited as to the amount of foreign securities they are allowed to hold. These various tangible barriers were on top of the numerous differences in practices and regulations in European securities markets that we discussed earlier.

The EEC directives in the securities sector attempt to create a level playing field for intermediaries and investors.[8] A vast effort to define standards and harmonize practices is currently underway. If successful, this effort will bring about a number of development such as more efficient and standardized rules for: 1) admissions to exchanges, 2) listing of company particulars, 3) publication of prospectuses, 4) control of insider trading, 5) disclosures of major ownership changes, 6) regulatory scrutiny, in addition to, 7) enabling investors to purchase shares in mutual funds across Europe and, perhaps most importantly, 8) enabling intermediaries licensed in one EEC state to offer pan-European securities services without obtaining further approvals. In this sense, one can perhaps point to the Investment Services Directive as being the "mother directive" of the securities field, not unlike the Second Banking Directive applicable in the banking field and after which it is modeled.

It is likely that these directives, most of which concern "standardization" or "harmonization" of regulations and practices, will be approved in some form or another. There would be little vested interest for any one country to vigorously oppose, in theory, the creation of a level playing field. Nevertheless, the actual enforcement of some of these directives could prove to be a thorny problem.

For instance, in order to realize the disclosure of large shareholdings directive, honesty on the part of the shareholder will need to be relied upon in some countries (e.g., France and Germany have bearer securities cleared electronically). And the directive on insider trading, despite its efforts of defining "insider" will in all probability create monitoring nightmares. It is therefore likely that the EEC will need to create a strong-arm agency like the SEC in the U.S. with a mandate from the EEC for monitoring compliance across European equity markets. There may be strong opposition to such a move in certain countries (especially the U.K. which has long had a "self-discipline" philosophy).

III. IMPLICATIONS FOR KEY MARKET PARTICIPANTS

Capitalizing on these developments and opportunities will demand the formulation of new strategies and the acquisition of new skills for each of the three major groups of equity market participants: national stock exchanges, financial intermediaries, and retail and institutional investors.

For each group, surviving and prospering in the 1990s will mean undertaking a realistic assessment of the implications of these developments, both on a macro and micro level, in order to formulate new strategies or acquire new skills. But this endeavor is not an easy one. And nor do the implications that may be drawn on the European or global level readily lend themselves to quick generalizations which are valid at all country levels and which in turn translate into "generic strategies" applicable to all members within any one group.

We noted above that the five interlinked factors of change are working at different speeds. This is especially evident on the country level where the "variability" of the impact of these factors is a function of national regulatory peculiarities and equity market practices which in turn create different local equity market environments when viewed from the European perspective.

The success of any individual institution within each group depends less on the concoction of "the one best strategy" or the rapid acquisiton of "the latest skill". Rather what is needed is an ability to constantly gauge changing competitive factors in order to develop flexible and "evolvable" strategies that enable these institutions effectively to manage (and appropriately gain from) the rapid evolution in European equity markets. It is with this in mind that readers should evaluate the direct relevance, for their particular institutions, of the following macro implications.

1. <u>National Stock Exchanges: Leveraging Comparative Advantages Under A Two-Tiered Market Structure</u>.

Numerous factors indicate that the continuation of current developments in European equity markets should lead to the formation of a two-tiered market, with London playing a role as the "hub" center for Euro-equities issuance and trading and with the other major Continental exchanges serving as "satellite" centers of varying importance.

London's continued predominance appears to stem from four factors: (1) scale and scope of equity market activity, (2) established cross-linkages to bond, bank debt syndication, and foreign exchange markets, (3) early technology investments for effective data procesing and trade execution and settlement and (4) the combination of the first three point which leads to London's competitive advantage in block-trading, in market-making, and importantly, in developing deeper and wider equity derivative markets.

In light of this situation, the following question is frequently raised: if major European corporations in the next decade, having "outgrown" their home markets, are advised by the financial intermediaries to issue (with subsequent trading of) their equities in London, what roles can be foreseen for Continental exchanges? Should they attempt to duplicate London's role? Or, should they specialize and, if so, in what segments?

Trying to duplicate London's decades-long consolidated position would be a long, arduous, and most probably a futile effort. Some exchanges have hoped that by focusing on a line of equity derivative products, they would have a "back-door" means of recapturing London's business. Yet, it is hard to see how national exchanges can rely on this route alone to build a long-term, profitable, and viable strategy, especially if significant underlying activity for the upper-end of the market (the most likely type of shares for derivatives) resides in London.

We argue that the investments in technology and on-going self-regulation undertaken by Continental exchanges are beneficial and, in some cases, long overdue. But we also argue that Continental exchanges should not make them in the hope that major national corporate equity issuance and trading will tend to stay with home exchanges (or that the business that once drifted to London will soon flow back). Instead, such investments should be made in order to foster the development of an efficient arena for the listing, issuance, trading, and clearing/settlement of small to middle market corporate equity paper. The business of large, often multinational, corporate paper may hence be viewed as peripheral activity for Continental exchanges (in their capacity as satellite centers for smaller trades and occasional "packaged trades").

In this sense, the realistic alternatives open to Continental exchanges are specialized in terms of "customer", rather than "product" segments (interestingly, this customer specialization role is not unlike that played by certain smaller U.S. exchanges which have tended to focus on regional start-ups and new issuance and trading of middle market companies). This double-tiering of European equity markets and consequent specialization for London and Continental exchanges implies different mind-sets and skills.

London will need to continue to foster a market that is conducive to larger corporate issuers, the major intermediaries that serve them, and the large institutional investors that frequently undertake massive block-trading. In this context, it is critical that the on-going debate within the ISE, as to the merits of the order-driven versus quote-driven systems (or some combination of the two) be resolved in a manner that does not dampen the attractiveness of London as an efficient pricing and trading center of large European corporate equities.[9]

Continental exchanges, while continuing to modernize and liberalize, will need increasingly to focus their efforts on their "captive" market of small to middle market corporates, the national intermediaries that serve them, and the assorted group of predominantly national retail and institutional investors that are more likely to (and capable of) evaluating the investment risk of such small capitalization equities. Informational and operational efficiency are key market factors for enhancing liquidity in such equities. This implies that these exchanges may need to grant more flexible listing and disclosure regulations for such companies, the possibility of own-book positioning of such shares for intermediaries adequately capitalized, and more streamlined trade execution, and clearing and settlement systems to encourage investor interest and activity.

2. <u>Financial Intermediaries: Deciding To Whom, What, Where, And How To Play In European Equity Markets</u>.

The proposed EEC directive on investment services will enable a larger group of financial intermediaries to perform a wide range of securities activities across the twelve European capital markets. Increasingly, market practices and regulations will be harmonized throughout Europe. This environment will be dramatically different from that which now prevails, especially on the Continent, where brokers/dealers are a relatively protected group performing highly limited or specialized activities. Consequently, it is critical for current intermediaries to choose their scope of activity and to decide what aspects of the business they intend to focus on. Only a handful (if any) can hope to be profitable providing all services, to all client segments, in each European capital market.

Intermediaries should first assess their own competitive advantages, to determine the "to whom", "what" and "where", before deciding on the "how" of achieving this goal. This results in a complex multi-dimensional matrix.

For instance, players choosing to target the upper-end of the corporate market will need to decide if they wish to focus on a few activities or provide a range of services from corporate finance, to new issuance, to market-making and own-book positioning (or simple broking), to equity market research for institutional investors. Do they wish to be, or need to be, pan European or can they focus on their home market? Then comes the "how": What financial and human resources are needed? Are strategic alliances or mergers or acquisitions necessary? Similarly, this entire group of questions can be raised for intermediaries choosing to focus on small to medium-sized companies.

It is possible that as European equity markets develop in the 1990s, two groups of intermediaries may evolve. One group may focus on the upper-end of the market (typically with a large market share in the home country) and have significant representation in London for issuance, trading, and institutional investor services. The second group may concentrate more on the medium to low end of the market (acting almost entirely in the home market along with many other local intermediaries) and be linked to the first group for servicing those client needs best served via London. Each group may focus on equity research in its respective markets and share such research with the other group.

For most Continental equity brokers or dealers, two handicaps will need to be overcome over the next decade: a) limited capital bases and lack of market making, and b) own-book positioning skills.

The first factor will become critical, especially for those choosing the upper end of the market, in competing with well-capitalized universal banks. Much of the new activity in equity financing is expected to come from privatization programs and corporate restructurings. A player with "deep pockets" will have a definite advantage over one who argues that he can "eventually find buyers for the paper".

The second factor is the chicken-and-egg aspect of the first in many Continental equity markets. Regulation prevented own-book positioning for intermediaries (based on "investor protection" concerns) and hence intermediaries had little incentive to capitalize themselves; thinly capitalized intermediaries confirmed the regulatory authorities fears of disrupted markets if own-book positioning were allowed. Even though proposed EEC regulations will permit positioning activities, Continental intermediaries may still be hampered by a traditional aversion to "Anglo-Saxon style" position-risk analysis even if such skills could be readily acquired.

3. Retail And Institutional Investors: Capturing Diversification Opportunities In An Integrated Equity Market.

Recent studies[10] have revealed that during most of the 1980s, the monthly returns of European equity markets were either independent of each other or slightly positively related (this was found to be the case for both "raw" returns and returns adjusted for changes in exchange rates).[11] This phenomenon implies that diversification across European equity markets would have brought about significant risk-reduction benefits without a commensurate sacrifice in total returns.

Furthermore, these same studies also revealed that standard market indices (both equally-weighted and value-weighted) were not part of the efficient set of European portfolios (that is, the set of portfolios with maximum return and minimum risk). Hence, dynamic asset allocation strategies across European equity markets could have enhanced return without increasing risk.

Can investors still rely on these diversification opportunities in a post-integration economic market? It is quite possible that European integration may result in significantly stronger interdependencies, over the next five to ten years, among major European equity market returns. And stronger interdependencies means less diversification gains. However, one could argue that any decline in diversification opportunities from a risk-reduction standpoint will be more than offset by certain key factors, such as increased operational and informational efficiency, and new opportunities in the form of "focused diversification". Let's examine this further.

Increased operational efficiency should lead to greaer liquidity ("depth") in each major market as well as greater fluidity ("scope") across markets. In other words, as markets integrate, many of the current operational obstacles, such as clearing and settlement differences and inconsistencies, should diminish, encouraging more foreign listings and expanding the choice for investors.

In addition, focused diversification opportunities may arise as markets integrate. For instance, retail and institutional investors could take an "industry sector", "company size", or "economic/geographic pockets" diversification approach on a Europe-wide basis, not unlike that available to investors in the integrated U.S. or Japanese markets.

Diversifying across European equity markets and managing portfolios on a dynamic asset allocation basis demands new skills on the part of most European retail and institutional investors, who for the most part have been pursuing a buy-and-hold strategy of high-grade national paper.

While information is readily available on the upper-end of the corporate market, until the day intermediaries link themselves effectively in providing "small cap research" and liquid trading, investors will need to "piece together" their own portfolios by dealing with multiple intermediaries, of differing quality, in each European capital market.

Dynamic asset allocation is a difficult proposition in one's home market and may turn out to be a nightmare of sorts on a European level for the unsuccessful investors. End-investors will increasingly demand higher returns, consistently, of their institutional fund managers and will be less hesitant than in the past to shift their assets around. In response, fund managers will themselves carefully need to position their range of pan-European investment strategies in those areas where informational and operational efficiencies are optimal and conducive to their stated approaches.

SUMMARY

Despite its current fragmented character, European equity markets are showing clear signs of structural and operational integration. Competitive forces are at work across the various national markets and among all categories of participants.

Traditionally undynamic and protected national exchanges are being jolted by the realization that preparations for 1993 by other exchanges may leave them as stagnant backwaters of finance; they are self-liberalizing and modernizing as never before in their history.

Intermediaries, long used to a cosy existence of monopolistic service provision, are finally realizing that their home governments are opening their markets to foreign participants and that each basis point of even domestic commission income will have to be competed for on the basis of efficient service.

And retail and institutional investors, traditionally confined to passive investment strategies in high-rated paper within their home countries, are increasing in number, becoming more financially sophisticated, and are increasingly ready to cross borders to deal with intermediaries that offer the optimal price-value service on a wide range of pan European investments.

As these structures and dynamics evolve rapidly over the next decade, it is becoming more evident that the key market participants can no longer rely on sharpening their skills on old rules relevant in hitherto stagnant equity markets to tide them over in an integrated and vigorous market. Building a sustainable position in a unified market, where capital and resources flow more freely and where market structures are constantly evolving, requires frequent strategic reassessments of one's situation, and creativity in coming up with defendable strategies.

Successful European equity market participants indeed have many pitfalls to avoid and challenges to tackle, but in return, have numerous opportunities to pursue on an integrated European basis as never before.

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NOTES

1. For instance, approximately 25 percent of the capitalization of the most active French shares are traded in London as opposed to in Paris (Hawawini and Jacquillat, 1989). In addition, this development seems to hold true in the case of large block trading of other Continental shares (Hawawini, 1984; p. 155).

2. See Walter and Smith (1989).

3. Note in this context the dramatic rise in leverage buy-out financing in the U.K. since the early 1980s. This trend has already shown signs of being duplicated in several Continental markets, notably in the Benelux countries and France.

4. Banking institutions, once secure in their comfortable role as financial "intermediaries", increasingly find themselves caught in the middle of a disintermediation process. On the one hand, large corporate and even middle market clients are increasingly looking for the funds more directly on the open capital markets. On the other hand, while there has been no massive shift from bank deposits into the <u>individual</u> purchase of shares and bonds, there is a definite trend towards the purchase of mutual funds which in turn invest in shares and bonds; see OECD (1988, 1987a).

5. The practical ramifications of this requirement should prove to be interesting, especially in the German context. Will the banks simply accept this requirement and off-load substantial quantities of equity paper? Or will they attempt to maintain the concomitant corporate control that came with substantial equity stakes by increasingly offering funds under the grey area of subordinated debt (debt with warrants, mezzanine funds etc.)? If the banks were to push this thinking further, might they also "encourage" the corporations to redeem outstanding shares? Under this scenario, it is possible that corporate leverage may rise and hence our statement on increased secondary equity market liquidity may need to be qualified. The final scenario that holds will most probably depend on the exact wording of "equity ownership by banks" made by the EC legislators.

6. See Hawawini and Jacquillat (1989).

7. Ibid. The reasoning here is that as these funds grow in size, the institutions that "manage" them will increasingly play a greater role in the actual dynamics of securities markets. For instance, typically, institutional market participants transact in vast quantities of securities. Hence, they will have larger effects on price movements in any individual securities market, especially those with

limited "depth" (i.e. liquidity). In turn, this implies that these institutional investors will tend to gravitate their transactions towards those financial centers where they can take an "active" approach to managing their large portfolios than in those where they are forced to take a "buy and hold" attitude. In addition to the importance of liquidity, these institutional investors will naturally favor those financial centers where trading information is readily accessible, where intermediaries are cost effective and where settlement and clearing systems are efficient.

8. For a comprehensive coverage of these legislative issues, see European Economy (1988).

9. The current International Stock Exchange is based on a "quote-driven" system whereby market makers are required to quote firm two-way prices at all times, which, in the absence of a trading floor, is done electronically on the exchange's screens. An alternative approach, the "order-driven" system is used by the New York Stock Exchange. Under this system, brokers bring the trades requested by investors to a central market place, where they take place in the presence of a "specialist" in each stock, who ensures an orderly market. The prices publicly available are those of the most recent trade, rather than competing market makers' offers of prices at which they will transact the next trade. As of this writing, the debate continues as to which system gives investors a more realistic picture of the value of securities. See N. Cohen (1989).

10. See Levy and Sarnat (1970) and B. Jacquillat and B. Solnik (1978).

11. The low correlation between stock returns and exchange rate movements has been documented in various studies. See for example, Adler and Simon (1986) and Solnik (1988).

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1987

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1989

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1990

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