The Effects of the Euro on Financial Markets, Activity and Structure

The introduction of a single currency in Europe has led to both qualitative and quantitative improvements in the functioning of euro-area financial markets. The effects of enhanced competition have often occurred in sectors where they were maybe not so widely expected. For instance, this paper finds that the euro has acted as a catalyst for greater competition between sovereign issuers and markets within the region. Such a form of competition has great benefits if it leads to a convergence of national legal and regulatory environments toward the 'best practice' and the highest standards.

Although the euro was designed as a regional currency to serve an area of 300 million or so inhabitants, it has already become a global currency. This has implications for the management of an increasingly global economy as financial stability and in particular crisis management often require global responses. This paper finds that in one recent crisis – the 11 September terrorist attacks on the United States – the rapid reaction of central banks in Europe and America served the interest of global financial stability well.

Introduction

The adoption of a single currency by 12 sovereign nation states was an unprecedented feat. Its consequences reach well beyond the financial system, and even in the comparatively narrow field of financial markets, they are almost too numerous to list. Much has been said and written about the impact of the euro on financial markets, but there has been far less analysis of the implications it may entail for the management of an increasingly global economy

The globalisation of the world economy is an issue that is as relevant in Europe as it is in Oceania and East Asia as well as in many other parts of the world. It is also an issue for which the analysis of the European experience of regional monetary integration is particularly useful for at least two reasons.

First, European monetary union provides a rare illustration of the developments that occur when a fairly large number of sovereign nation states decide to form a fully integrated economy, unleashing previously restrained competition forces.

Second, even though the euro was born out of a desire for regional integration, its financial market extends beyond the boundaries of the region that it is intended to serve. The global nature of the euro market, which is fundamentally similar to the global nature of the US dollar market, is not without implications for policymakers in general, and central bankers in particular. This is particularly true for crisis management.

The impact of the euro on financial markets: the effects of competition

There is no arguing that the existence of different currencies before 1999 represented one of the most powerful factors segmenting the national markets of the European Union, and in particular its financial markets. There is no arguing either that this segmentation represented a strong impediment to free competition and, therefore, to an efficient allocation of capital toward the most productive investment opportunities.

For that reason it was widely expected that the introduction of the single currency would unleash previously compressed competition forces, and would lead to both qualitative and quantitative improvements in the functioning of the euro-area financial markets.

Evidence gathered to date shows indeed that the effects of enhanced competition have been formidable. They have also occurred in sectors where they were maybe not so widely expected.

Competition in the private sector

First, of course, competition has been strengthened between private market participants. This is a well-researched area and one to which this paper devotes comparatively little time. One among many benefits of greater competition is the reduction in the costs to consumers, such as the fees levied on stock exchange transactions or bid-ask spreads for transactions in major debt securities. More generally, enhanced competition is reflected in the trend toward rationalisation and consolidation in almost all sectors of the financial system. Mergers between stock exchanges, such as the creation of Euronext by the three exchanges of Belgium, France and the Netherlands is one such example. In addition, the recent deal between Euronext and Liffe is an example of the effects the introduction of the euro has had out of the euro area. Of course the introduction of the euro has not been the only source of greater competition in Europe: the development of new technologies has been integral to challenging the concept of national borders and contributing to a more competitive environment, not only in Europe, but worldwide.

Competition between sovereign issuers

A second field where competition has developed strongly as a direct consequence of the introduction of the euro is that of competition between sovereign issuers. Indeed, where sovereign issuers benefited from what was essentially a monopsony position in their national market, they now compete with each other for a broader pool of private savings. To a certain extent, sovereign issuers have to compete for funds in a way similar to private borrowers.

The consequences of this new form of competition between sovereign issuers have been often commented on, and so this paper discusses only a few main facts. In the late 1980s and early 1990s, a few European countries, such as Belgium, France and Spain, underwent a reform of their government bond markets. These reforms aimed – among other goals – at enhancing market liquidity. With the advent of a more competitive environment, governments that had not already initiated their own reforms all did so. The German government announced, at the end of 1995, a reform of its issuance of public bonds to bring it in line with the model adopted, in particular, by the French government. It was clear at the time that the prospect of competition among sovereign issuers in the context of monetary union was an important driving force behind

Table 1 Bond buy-back and exchange operations by euro-area governments, 1998–00 (billion euro)

	1998	1999	2000
Italy	–	3.7 (b)	14.9 (b)
Germany			
France	1.7 (b)	4.0 (b)	10.0 (b)
Spain	8.9 (e)	1.2 (b)	4.8 (b)
	5.6 (e)	5.9 (e)	
Belgium	10.7 (e)	8.3 (e)	11.7 (e)
Netherlands	–	27.0 (e)	2.8 (e)
	0.2 (b)	5.0 (b)	
Austria	–	–	1.1 (e)
Finland	3.2	2.7	5.6
Portugal	–	–	–
Ireland	–	12.0 (e)	–
Luxembourg	–	–	–

Notes: (e) stands for exchanges and (b) for buy-backs.
Sources: Various sources.

the reform. Clearly an emulating process had been initiated, where all sovereign issuers were attempting to bring their own government debt market in line with the best standards to attract the favour of investors. One indication of the strength of this competitive environment is the multiplication of bond buy-backs and exchange auctions organised by European governments (Table 1).

This new form of competition raises the question of why governments did not initiate such reforms earlier. After all, even in a context of limited competition for private savings, governments may have benefited from a lower cost of funding had they reformed their debt markets earlier. In addition, it may be argued that liquid government bonds generate positive externalities for the rest of the economy in facilitating the valuation and hedging of private assets.

With hindsight, perhaps, governments should have acted earlier. One major contribution the euro has made is that it has revealed shortcomings of government bond markets that were not so clearly visible beforehand. The increase in competition has been very marked in sovereign debt markets, and this is one sector where new competition has delivered some of the most spectacular benefits to investors.

Competition between models of financial structure

Two other forms of competition that have been less widely analysed are worth dwelling on here. The first is the competition that has emerged since the introduction of the euro between two models of financial structure – the intermediated model, based on bank lending, and the disintermediated model, based on securities markets.

Traditionally, the euro-area economy, or most of it at any rate, has been dominated by bank lending. This contrasts with other economies, such as the United States, where securities markets have long played a much more significant role in funding productive investment.

At the time the euro was introduced, there were strong expectations that the broader euro market, relative to the legacy currency markets, would allow a development of non-bank finance, and a gradual convergence toward a disintermediated model.

Two and a half years later, the diagnosis on this specific point is mixed. For instance, at the end of 1997, bank deposits in the (future) euro area represented 84 per cent of GDP, but only 55 per cent in the United States. At the end of 2000, the situation was essentially unchanged. The ratio of bank deposits to GDP had fallen marginally to 82 per cent in the euro area, while it remained unchanged at 55 per cent in the United States (Table 2).

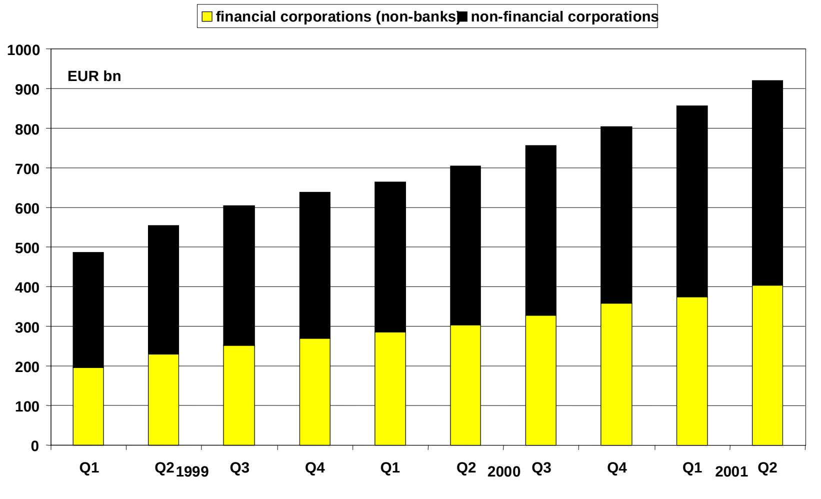
Table 2 Financial structure in the euro area, United States and Japan, June 2000 (per cent of GDP)

	euro area	United States	Japan
Bank deposits	82.5	55.4	111.2
Bank loans	111.0	55.6	93.2
Debt securities (outstanding)	116.5	198.4	131.6
Stock market cap.	99.5	210.7	133.5

Sources: Various sources.

Whether bank finance has lost importance or not is, however, a relatively minor point. What is more important is that securities markets have developed to the point where they offer a real alternative for potential borrowers. Even though the stock of outstanding debt securities or the stock market capitalisation of the euro area remain well below that of the United States (relative to GDP), both the equity market and the private bond market have experienced unprecedented development over the past few years.

Figure 1 Outstanding amount of euro-denominated bonds issued by corporations



Source: *ECB*.

As an illustration of this development, Figure 1 shows that the outstanding amount of euro-denominated bonds issued by non-financial corporations increased by 67 per cent between January 1999 and mid-2001 (although there are a number of caveats that apply to this impressive figure, such as the very small size of the market at the start of the period, and the large share of the net issuance accounted for by non-euro-area companies).

The main lesson to be drawn from this development is the following. Prior to the introduction of the euro, borrowers in the legacy currency markets were considerably constrained in terms of the capital they could raise in domestic securities markets. Following the introduction of the euro, issuers have access to a broader and more diversified base of potential investors, which makes it possible to raise capital in much more favourable conditions than previously. An example of this point is the widespread comments, heard throughout 1999 and 2000, that many of the large mergers and acquisitions in the euro area would not have been possible if the purchasers had not been able to raise capital through the bond market.

However, as mentioned above, the development of non-bank finance is not necessarily a panacea that should replace bank-based finance. On the contrary, it is the coexistence of the two, and the competition between the two, that is most positive, precisely because borrowers are provided with a broader range of options. This is likely to allow more entrepreneurs to access capital in the form most appropriate to their needs. In addition, the two modes of financing can be mutually reinforcing. For instance, the closing of the window of opportunity for issuance of equity in the new technology sector in early 2001 certainly made clear the benefits of being able to raise funds through more traditional bank finance.

It is also noteworthy that in the United States, the 'traditional' European model of universal banking seems now to be attracting much more interest than it did only a few years ago, as testified by the reform of the Glass-Steagall Act. Recent mergers of investment and commercial banks convey the same message.

Competition between regulators and legislators

The second form of competition that is less widely commented on is the one that has developed between legal and regulatory environments. The free circulation of capital across Europe, and beyond, was a reality well before the introduction of the euro. However, it seems that it was only after the single currency was established that pressure really mounted on legislators and regulators alike to provide their national financial centre with a truly competitive environment. To illustrate, here is a very practical example.

Prior to the introduction of the euro, the main – albeit not the only – mortgage bond market in Europe was the German Pfandbrief market. The German legal framework allowed for the issuance of asset-backed securities by German banks in conditions that were not available to many banks in other countries. It can be argued that this represented a competitive advantage for German banks, insofar as they benefited from a particularly appropriate instrument for refinancing the assets on their balance sheets.

The effect of competition has been felt here too in the sense that other European countries, such as France, have been encouraged to pass legislation aiming at providing their own domestic institutions with a similar legal framework for the issuance of asset-backed securities. The case of Spain is slightly peculiar but not fundamentally different, insofar as the framework for issuance of bonds in the Cedulas Hipotecarias market was revived in 1999 rather than created altogether. Austria represents an interesting case of a relatively small market possibly being turned into a dynamic reality through the increased competition introduced by the euro. Austrian authorities, in fact, are currently revising the law that regulates Pfandbrief-style markets; in particular, Austrian banks are now allowed to use loans and mortgages sourced from other EU countries and from Switzerland as Pfandbrief collateral. The broadening of the investor base beyond the traditional boundaries of the Austrian and Swiss markets is underway and issuers may decide to pool their borrowings in order to compensate for their relatively small size. All these developments find a clear trigger point in the introduction of the common currency. A once local market is likely to soon become an integrated component of the lively European-asset-backed securities market.

What is very telling in this example is that, in almost every case, the new legislation was obviously designed with the German Pfandbrief legislation as a benchmark, and with a view to providing an environment that could compete with it. Clear evidence to that effect is in the wording of the press release issued by the Irish government on 26 February 2001, announcing the approval of a draft legislation 'which will provide for the introduction of new financial instruments in the Irish market – mortgage and public credit bonds similar in nature to the German Pfandbrief' (see Annex 1 for the full text). Reference is also made to the asset-backed structures prevailing, inter alia, in the French and Luxembourg markets. The rationale for this new legislation is even more explicit in the following excerpt: the legislation 'is designed to bring Ireland in line with best practice in other European financial centres'. Finally, the Irish government draws attention to the fact that 'the introduction of the euro and the new monetary policy framework has led to the development of an integrated and competitive money market in the euro area'.

This illustration provides ample evidence of the new competition between legislators and regulators. The wording of Irish government's press release points to the potential benefits of such a form of competition, if it effectively leads to a convergence across the euro area of the national legal and regulatory environments toward the 'best practice' and the highest standards.

Of course, such a form of competition will develop slowly because time is required to assess the need for new legislation, draft it and pass it. However, this is a development that deserves more attention than it has received up to now.

This form of competition is extremely interesting when analysing the consequences of regional or global economic integration. Even though the euro has acted as a catalyst for these developments, it is likely that the existence of a single currency is not a necessary condition for competition between legislative and regulatory environments to develop. It is probably sufficient that a large degree of freedom of capital movement exists. In fact, this form of competition has been present for many years. But in the context of an increasingly global economy, competition between legislators may increase. It may be fundamentally good if it leads to the best practice. On the other hand, it may become eminently dangerous if it leads to a form of regulatory dumping. This is another topic altogether, but not an insignificant one.

Global currencies, the global market and the maintenance of financial stability

There is a second way in which the regional integration of the European continent provides a useful insight into the issues raised by the globalisation of the world economy.

The euro market: a financial market without a centre

The euro is sometimes referred to as a 'currency without a state'. This means, inter alia, that its financial market is 'decentralised', or more exactly spread over several jurisdictions. In addition, even though the euro was designed as a regional currency, it has de facto become a global currency. This means that not only do its financial markets extend across many jurisdictions within the euro area, but they also extend across many jurisdictions outside the euro area. This has called for specific responses by market participants and public authorities alike.

The euro area, unlike most other currency areas, does not have a dominant financial centre. Prior to the introduction of the euro, much had been said about the expected competition between financial marketplaces, and about which would emerge as the financial centre of the euro area. Almost three years later, no clear conclusion has emerged. Activity on the government bond futures market is largely concentrated in the Eurex, in Frankfurt. Meanwhile, trading on government bonds themselves occurs to a large extent on the MTS platform, an originally Italian system developed in various marketplaces, such as Amsterdam, Brussels, Lisbon, Paris and – outside the euro area – London. Luxembourg emerged as the favourite location for the issuance of corporate bonds, while Paris has achieved a similar role as regards commercial paper. Finally, the City of London holds the dominant position in foreign exchange trading, as confirmed by the recent Triennial Survey of Foreign Exchange and Derivatives Market Activity, published by the Bank for International Settlements (BIS). The City hosts almost one-third of the global foreign exchange turnover, around twice as much as the entire euro area or, for that matter, the United States.

A global currency

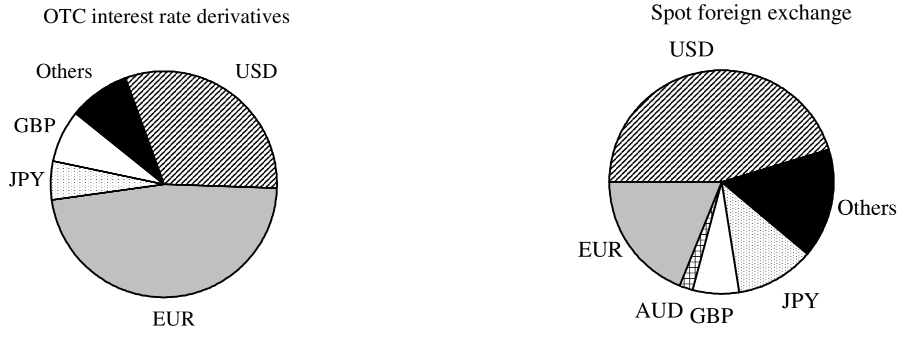
The fact that activity in the euro financial markets extends well beyond the borders of the euro area is not unprecedented. The City of London has long dominated trading activity in many currencies. The traditional international role of the US dollar also means that its financial markets have been global, rather than national or even regional, for many decades. To an increasing extent, the same situation arises in the case of the euro.

Although the euro was designed as a regional currency to serve an area of 300 million or so inhabitants, it has already become a global currency. This has implications for the management of an increasingly global economy.

One of the reasons why the euro corporate bond market developed so rapidly within months of the introduction of the single currency was the sizeable issuance of euro by corporations located outside the euro area. In fact, non-resident issuers held 40 per cent of outstanding euro-denominated corporate bonds in mid-2001. The share of non-resident issuers in the money market denominated in euro was less significant, but here again a corporation located outside the euro area, General Electric, signalled itself when it became the largest single issuer of euro-denominated commercial paper.

Of course the interest of issuance in the euro market relates, at least in part, to the funding of commercial activity in the euro area. But it is clear nonetheless that the sheer size of the euro market, compared with that of each legacy currency, also makes it a much more attractive market

Figure 2 Breakdown of turnover in the foreign exchange and OTC derivative markets, by currency



Note: The pie relating to foreign exchange indicates the share of each currency in total foreign exchange flows. However, each foreign exchange transaction involves *two* equal flows in opposite directions, one for each of the two currencies involved. This translates into the following interpretation: the 45 per cent share of flows for the US dollar means that it appears on one side or the other of 90 per cent (twice 45 per cent) of transactions. The euro appears in 38 per cent of all transactions, the Japanese yen in 23 per cent. The total of the share of all currencies in transactions is therefore 200 per cent (twice 100 per cent).

Source: BIS.

for funding even for issuers, which do not have a strong commercial presence in Europe. The decision by a US government-sponsored enterprise (GSE), Federal Home Loan Mortgage Corporation (Freddie Mac), to launch a so-called Euro Reference Note program is a good example. This program, launched in August 2000, was not the first case of issuance outside the US market. However, it was the first time that a US-based GSE had committed itself to large and regular issuance in a currency other than the US dollar.

On another front, some 56 countries around the world have adopted an exchange rate regime entirely or partly anchored on the euro; most of these countries are very small, however, and altogether they account for only 4 per cent of world GDP. The euro enters into one side of 38 per cent of all foreign exchange transactions (Figure 2). It also accounts for just under 40 per cent of global activity in Forward Rate Agreements (FRAs) and interest rate options and more than half of the activity in the interest rate swap market, making it the most traded currency in over-the-counter derivatives.

The euro is certainly not 'competing' with the US dollar for the role of the dominant international currency. The US dollar remains by far the largest currency for international funding, investment, official reserves and a multitude of other purposes. If one illustration was necessary, it would be sufficient to recall that the US dollar enters into 90 per cent of all spot foreign exchange transactions and 80 per cent of all currency options transactions worldwide.

What these facts illustrate, however, is that the financial markets of the euro, just like those of the US dollar, exceed by far the boundaries of the euro area.

Maintaining financial stability in a global market: the example of the Fed-ECB swap agreement

The currency swap between the US Federal Reserve and the European Central Bank in the aftermath of the 11 September 2001 terrorist attacks in the United States has implications for financial stability that are directly relevant not only for European policymakers but for all policymakers in the context of an increasingly global economy. To put it in the most simple terms, the increasingly global nature of financial markets means that financial stability and in particular crisis management have increasingly become global issues. Only through cooperation can public authorities ensure that domestic mandates in this field are effectively fulfilled.

In the dramatic situation of the 11 September terrorist attacks, major central banks had to take immediate and decisive action to support the normal functioning of financial markets. One of these actions was the establishment of a swap agreement between the Federal Reserve and the ECB. The rationale for this decision and its general principles were as follows.

In the immediate aftermath of the terrorist attacks, a large upward shift in the demand for liquidity occurred in the United States, as banks were understandably reluctant to enter into money market transactions in a climate of strong uncertainty and difficulties in the settlement of some cash and securities transactions. Typically, such a shortage of liquidity can be relieved by central bank intervention, in the form of fine-tuning liquidity-providing operations, or by making use of standing facilities such as the discount window in the United States, and indeed the Federal Reserve took timely and forceful action in this respect. Monetary policy operations, however, are essentially domestic in nature and not always sufficient to alleviate a market failure that takes global proportions. The case of the US currency can be used to illustrate this point.

Being a global currency, the US dollar is traded internationally across many time zones. Many European banks in particular conduct a very sizeable activity in the US dollar market.

The same applies to banks from other parts of the world of course. Not all banks active in the US dollar market, however, have a presence in the United States, and certainly not all of those banks have access to the discount window of the Federal Reserve. This implies that, should a disruption of the market take global proportions, as it did in mid-September, the national framework of monetary policy does not necessarily allow the channelling of liquidity to all places where it is needed. Disruptions may still remain, and with them the risk of systemic instability.

In fact, there was one additional complication in this case. Even though some banks, notably European, were counterparties of the Federal Reserve System for discount window operations, and even though they were in possession of sufficient collateral to cover their liquidity needs in this context, some of their custodians in New York were unable to deliver this collateral to the central bank.

In practice, the situation was the following. To alleviate potentially systemic risks in the US dollar market caused by difficulties in the circulation of liquidity, in a context where the normal functioning of the interbank money market was seriously disrupted, it was desirable to channel US dollar liquidity outside the normal perimeter of intervention by the central bank.

To do so, the ECB entered into an swap agreement with the Federal Reserve. Without entering into the specific details of the operation, its mechanics were essentially as follows: the European Central was provided with US dollar liquidity by the Federal Reserve, which in return received euro liquidity on its account at the ECB. The European Central Bank, in turn, with the assistance of national central banks of the euro area, arranged identical swap agreements with the euro-area banks that needed liquidity, providing them with the US dollar liquidity in return for euro liquidity. So in practice, the ECB acted as a 'broker' for the Federal Reserve System, allowing it to extend its perimeter of action.

There can be no doubt in anybody's mind that the rapid reaction of central banks in this context, as well as the strong spirit of cooperation in which they have worked, has served the interest of global financial stability well.

Conclusion

The situation that emerged in mid-September in the money market was unique in many ways, but there are some lessons that can be drawn from this particular event, and from the comments above.

First, as markets become increasingly global, domestic financial stability and global financial stability become increasingly interdependent. This is probably true for most currencies, but certainly all the more so for global currencies such as the US dollar and the euro.

Second, as a consequence of this interdependence, the pursuance of domestic financial stability must increasingly be thought of, and achieved, within a global framework.

Third, global action requires a strong spirit of cooperation between public authorities in different jurisdictions, in particular in times of crisis, when rapid action is crucial. This point is as applicable to other public authorities as to the central banks.

Annex 1: full text of the Irish government press release of 26 February 2001[1]

The Government has approved proposals for draft legislation from the Minister for Finance, Mr. Charlie McCreevy, T.D., which will provide for the introduction of new financial instruments in the Irish market – mortgage and public credit bonds similar in nature to the German *Pfandbrief*.

The Bill is designed to bring Ireland in line with best practice in other European financial centres, to enable Irish lenders to finance their activities as efficiently as their European counterparts, and to further develop Irish capital markets. Other European countries, notably Germany, France, Luxembourg and Denmark either have or are in the process of introducing similar measures, in recognition of the efficiency of this type of funding and the creation of the euro single currency. According to figures compiled by the EU Commission, these types of bonds now account for nearly 20 per cent of all euro-denominated bond issuance, including sovereigns.

The bonds are a loan instrument which will, in practice, mainly be issued by banks. The bonds are secured on a pool of underlying assets held by the same banking entity. These assets remain on the bank's balance sheet and are kept in a secure register which is monitored by independent trustees. Certain unique features of the instruments – the high quality of the assets underlying them, the reciprocal recognition, by other issuing centres, of their high credit standing and the preferential creditor status afforded to investors in the bonds mean that they are designed to achieve a triple A rating.

The introduction of the euro and the new monetary policy framework has led to the development of an integrated and competitive money market in the euro area. In this regards, mortgage bonds are becoming a standard feature of European markets. They are a recognised asset class in their own right and, accordingly, will be attractive to long-term institutional investors. For certain credit institutions, they offer the prospect of raising finance in a cost-effective manner and, as a consequence, they can have a substantial and beneficial impact on competitiveness.

Annex 2: full text of the ECB press release regarding the swap agreement with the Federal Reserve[2]

13 September 2001

In order to facilitate the functioning of financial markets and provide liquidity in dollars, the Federal Reserve and the European Central Bank (ECB) have agreed on a swap arrangement. Under the agreement, the ECB would be eligible to draw up to $50 billion, receiving dollar deposits at the Federal Reserve Bank of New York; in exchange, the Federal Reserve Bank of New York will receive euro deposits of an equivalent amount at the ECB. The ECB will make these dollar deposits available to national central banks of the Eurosystem, which will use them to help meet dollar liquidity needs of European banks, whose operations have been affected by the recent disturbances in the United States. This swap line will expire in 30 days.

Notes

1 Text also available at <www.irlgov.ie/finance>.
2 Text also available at <www.ecb.int>.

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