

The impact of a five year old euro on financial markets

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In 'The Emergence of the Euro as an International Currency', Richard Portes and I argued back in 1998 that the creation of the euro '[would] have substantial implications for the international monetary system; for the currency composition of portfolios; for exchange rates, and hence monetary policies; and for economic efficiency and welfare. The key determinant of the extent and speed of internationalisation of the euro [would] be transaction costs in foreign exchange and securities markets.' When Central Banks are equally credible, market size and liquidity become very important factors to determine whether a currency is widely used by market participants around the world or not. We developed the idea that, due to the sheer size of the euro area, a common European currency would have profound effects on international and European financial markets (see also Bergsten 1997). First it would lead to more des-intermediated finance in Europe. It would also increase the liquidity of different financial markets via well-known synergies between the different roles played by a global currency. Efficient capital markets attract more capital inflows, which raises the liquidity of the foreign exchange market. In turn, more liquid foreign exchange markets reduce the costs of portfolio substitution, which raises the turnover on home financial assets and cuts transaction costs even further etc...

Having well-developed financial markets and a widely used currency matters for investment and hence for growth beyond the traditional benefits of international seigniorage, lower exchange rate risks for one's exporters and importers, easier current

account deficit financing with issuance of liabilities denominated in one's currency and political influence.

It is now time, after five years of existence of the European currency, to give some preliminary assessment regarding both the role of the euro on the international scene and its contribution to the deep structural changes undergone by European financial markets in recent times. I will briefly review the main recent developments in euro area government bond, corporate bond, derivative and equity markets. I will argue that the creation of the euro has led to spectacular developments in European financial markets, with the emergence of new markets and in most cases a significant increase in liquidity and integration of existing markets. I will then report on the role of the euro in the international arena and will argue that the increase in the use of the euro has been very unequally distributed across markets and has been in general quite slow. I will finally suggest as a possibility that the international use of the euro may be accelerated in the future by a shift of market participants out of dollar assets due to the unprecedented external deficits of the United States.

European financial markets and the euro

1. Government bond markets

The spreads of euro area 10-year government bonds versus the German Bund have fallen since the birth of the euro and are now at very low levels. In February 2004, the Austrian bond was trading at 3 basis points above the Bund, the French bond 2 bp; the Finnish bond -2 bp; the Dutch bond 0 bp; the Italian bond at +14 bp. Since currency risk is now

absent and since there are few reasons to believe that default risks have changed much over the past five years (if anything they should have increased following the recent break up of the Stability and Growth Pact!), this suggests that the liquidity risk on those markets has been falling.

There is now as well some evidence that market participants have been coordinating on some key securities, which have become benchmark securities for the government bond market. These are the German Bund at 10 years, the French bond at 5 years and the Italian bond at 2 years. The existence of such benchmark securities facilitates the process of price discovery and the well-functioning of markets (see Dunne, Moore and Portes (2003)).

2. Corporate bond markets

Corporate bond markets were almost inexistent for non-financial and non-monetary institutions in 1998. So were markets for 'junk' bonds. But corporate bond markets as a whole underwent a substantial development after the birth of the euro. Total corporate sector issuances amounted to less than €150 bn in 1998. It increased to €60 bn in 1999; €250 bn in 2000; €300 bn in 2001; €250 bn in 2002. It increased again in 2003.

3. Derivatives market

The euro swap market was at the beginning of 2003 the largest financial market in the world with more than 25 trillion euros outstanding. Just as a matter of comparison, the total amount of dollar denominated money market instruments and bonds issued by governments and non-governments in domestic and international markets was just around 20 trillion euros at the same time.

4. Equity markets

European equity markets have been traditionally quite segmented. The advent of the euro seems to have fostered a greater degree of financial integration. The degree of correlation between equity price indices in the major markets has kept on increasing (but it has been doing so ever since the beginning of the 1990s. More strikingly, the share of equities invested in Europe-wide funds has gone up substantially in euro area countries to become close to 50%. A similar increase has not been observed for the countries, which have chosen to remain outside the euro area (Denmark, UK, Switzerland).

Euro area financial markets have therefore become more liquid, more diverse and more integrated since the birth of the euro. On the international side however, the dollar has remained the key international currency, by most measures.

International role of the euro

Foreign exchange trading in euros as a percent of global trade has not increased compared to the share of EMS currencies. In 1998, the dollar was present 87.3% of the time at one end of a transaction on the foreign exchange market while the EMS currencies were present 52.5% of the time (note that the percentages sum up to 200% since transactions involved pair of currencies). In 2001, the share of the dollar was 90.4% and the share of the euro was a mere 37.6%. All the intra-european trades have been netted out with the arrival of the euro so in fact that there is no dramatic fall in the share of the euro compared to EMS currency, but there is no increase either.

Similarly although the share of the euro in reserves has been gradually increasing over time it only amounted to 18.7% in 2002 compared to 64.5% for the dollar.

The role of the euro for international trade in goods (invoicing currency) has also markedly increased but is still below the dollar level. For example in 2002 55.3% of French export of goods were invoiced in euros. The comparable number was only 48% in 2000. Similarly only 35% of French imports were invoiced in euro in 2000. In 2002 46.8% were. As regional integration has been proceeding further in Europe, the share of exports and imports invoiced and settled in euro has increased to approximately 60% to 80% for countries which will accede to the European Union (such as Bulgaria, Cyprus, Czech Republic, Hungary, Latvia, Poland, Romania, etc...)

But it is in the realm of international debt issuance that the euro has taken on more clearly its international role. The stock of international debt denominated in euros (excluding home country issuance) has risen from below 20% at the end of 1998 to just above 30% at the beginning of 2003.

The euro has successfully completed its first five years of existence. It has triggered important changes in European financial markets. It has also established itself immediately as the second most important currency in the world and as a potential competitor to the US dollar. It has however not displaced in any significant way the dollar as the currency of choice for most international transactions and as a reserve currency. The main reason for this is the inherent inertia of the international monetary system (see Krugman 1980, Rey 2001). Once a currency is at the center of the system it is very difficult for other currencies to compete with the incumbent since no economic agents find it desirable to use a currency different from the one that everybody else is using. It has taken a long time before pound sterling lost ground as an international

currency and was replaced by the dollar, which had become a credible alternative over the years as the US grew to become the biggest economy in the world (and its biggest exporter and importer). The dramatic change between the sterling and the dollar occurred only after two world wars, after the stability of the sterling was significantly undermined, after the shrinkage of the importance of the UK in the world economy and after the establishment of Bretton Woods.

Scenario for the future

The euro has become a credible alternative to the US dollar, given the size of the euro area economy in the world, and its active trade links with other areas. The European Central Bank has also established the reputation of the euro as a stable currency. But the US is still the largest economic power in the world (unlike the UK after World War 2). Hence there are reasons to believe that the future of the dollar as the main international currency is not threatened. There are however also some elements pointing towards a potential shift in the relative importance of the euro and the dollar in the world economy. The United States has been running very substantial current account deficits in the last two decades. It has gone from a net creditor to a net debtor position, crossing the zero line around 1986. With current account deficits now attaining 4 to 5% of GDP, a process of adjustment towards external solvency will have to come about. This adjustment will occur in particular through a substantial depreciation of the dollar (see Gourinchas Rey 2004), which will both stimulate US exports in the long run but also impose sizable capital losses on foreign holders of US assets in the short to medium run. This very instability of the dollar, necessary to restore the long run external solvency of the US

economy may trigger portfolio shifts out of the dollar into the euro and other currencies, further undermining the stability of the dollar. The key question is therefore whether international investors will go on accepting to take capital losses on their dollar holdings and keep financing the US current account deficits at a low cost, as they currently do or whether they will shift their wealth towards more stable nominal assets. In 2003 and 2004, most of the capital flows financing the deficits have come from Asian Central Banks accumulating liquid dollar assets as reserves to limit the appreciation of their currency vis-a-vis the dollar. Private flows have become scarcer. But international investor decisions have proved difficult to predict and it would be at this stage quite hazardous to make a definite prediction.