

The Euro Impact on European Financial Markets

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The coming of the Euro marks one of the final phases of European monetary and economic integration. A single currency will be in effect throughout the eleven-nation European Monetary Union (EMU). The European Central Bank will be responsible for the supply of the Euro and maintaining price stability. The ECB will define EMU monetary policy, which the national central banks of the eleven EMU countries will implement.

What implications do these actions have for financial intermediaries and instruments? What changes will occur in securities and derivatives markets? Will convergence be a blessing or a bane?

This article examines the impact of convergence upon several aspects of European financial markets and institutions. It first considers the effect upon interest rates and yield spreads throughout the EMU. It then looks at the changing competitive scene for financial intermediaries as well as the emerging EMU-wide government bond, equity and derivatives markets. Finally, it discusses the significance for funds managers and for equity benchmarking.

1. Convergence of Interest Rate Differentials

Before January, largely domestic inflationary prospects and the external value of the currency had determined domestic interest rates for each EMU member. With the adoption of a single monetary policy, these influences are disappearing. Interest rates across the Continent are converging. The general direction appears to be downwards, towards the German level (Lowe, 1998).

Furthermore, the Maastricht Treaty stipulates that the primary objective for the ECB is to ensure that price stability is a priority in the EMU. That policy is more firmly in line with current German and American practice. The short-term result will be increased activity on the bond markets.

Monetary and economic integration will eliminate the last barriers to capital flows within the Euro-currency community. The creation of a large international financial market will foster greater liquidity through increased trading. Foreign exchange risk among the member nations will no longer be a material factor. Even now, when the Euro is still only a unit of account, member nations have pledged to tie their national currencies to it and thereby to maintain parity with each other's exchange rates.

The ECB has already set only one Euro-denominated repo rate. Yet, some yield differentials will remain among money and capital market rates. The credit rating of the issuer, whether public or private, will continue to be important. The re-

sulting market for these issues will resemble the municipal bond market in the United States with its credit-spread differentials. Loss of confidence in the finances of one EMU member will be reflected in the yield spread on its bonds and the deposit premium paid by its banking system. This situation is not unlike the premium currently being paid by Japanese banks for Eurodollar accounts (Shirreff, 1998).

Against what interest rate index will the new Euro money market yields be measured? Since the United Kingdom is not participating in the current phase of the EMU, a movement is afoot to replace LIBOR with the EURIBOR. In an effort to be inclusive, a 50-member panel drawn from the largest banks in Europe, including foreign ones has designed the latter index. In contrast, only 16 bank rates make up LIBOR. Bank size makes a difference in determining basic yield levels. Thus, the Euribor may trade several basis points over LIBOR. If that is so, the market may continue to prefer the LIBOR (Burns, 1998).

However, the London derivatives exchange, LIFFE, has instituted a voluntary conversion programme enabling holders of positions in the existing Euro-LIBOR, Euromark, and Eurolira futures contracts to convert into Euribor positions. This conversion is rapidly establishing the Euribor's dominance.

II. Competitive Impacts on Financial Institutions

Competition among financial institutions has increased as financial barriers have fallen. Banks are seeking more business outside of their home country. Income from foreign exchange transactions is declining. Banks must look to money market trading, treasury advisory activities, and asset management as possible sources of revenue regeneration. The increased competition in these areas can result in lower fees and margins. Increased risk-taking may also result as banks strive to increase margins (McCauley and White, 1997). Competitive responses may also take the form of specialisation, strategic alliances, or concentration through mergers and acquisitions (Duisenberg, 1998).

Another likely outcome from the introduction of the Euro is fewer financial centres or exchanges in the EMU. Currently Europe has 32 stock and 23 futures exchanges. In contrast, the United States, until recently the largest financial market in the world, has only eight stock and seven futures exchanges. (Benos and Crouhy, 1996). Frankfurt, Paris, and London are presently in fierce competition to be the exchange where Euro-based currency, Eurobonds, European stock index futures and options contracts are traded (Maguire, 1998).

In like manner, investment-banking firms, looking for cost reductions in operations, are choosing to transact in fewer financial centres. Some of the larger American and British banking houses are already consolidating their positions. Technology, such as order routing and other electronic trading systems as well as economies of scale, can make this possible. Once the EMU is in full force, a Smith Barney can offer securities for sale not just to a dozen pension funds in one country.

That firm will be able to issue to hundreds of life insurance and pension plans throughout Europe.

III. Bond Markets

Since January all new government bonds of EMU countries have been issued in Euro denominations. The German, French, and Italian governments have been the largest issuers. The capital markets have accommodated by also converting to the Euro. Foreign currency risk is effectively no longer an issue. Yet, credit risk remains. Yield differentials will reflect the financial conditions of the issuers.

This market is bound to grow as EMU members consolidate their borrowings and refinance their debts into longer maturities. It will probably be double the size of the US Treasury market in five to ten years. In short, Euro government bonds will comprise the world's largest bond market. Issuers will be both central and local governments, whose bonds will then enjoy greater liquidity by being sold beyond national boundaries. Since all these public authorities will be competing for funds, there may well be a move to standardise the contracts and offerings.

These securities are finding ready buyers. Just as issuers in the past have often been "placebound" in their offerings, so too have investors in their purchases. In many countries, large financial institutions, especially life insurance companies, have been obliged to have currency matching of their assets and liabilities. For example, Belgian insurance companies have been required to maintain 80% of their investments in their home currency (Fleming, 1999). Such rules have locked most long-term savings in the local market. With all contracts now in Euros, these intermediaries are now free to invest elsewhere in the EMU.

Prior to the EMU, the corporate bond market was underdeveloped compared with that of the United States. Many companies tended to rely upon banks for their borrowing needs. Bank of England figures show that 58% of the EMU bond market consists of government issues, compared with 25% for the US market. Corporate bonds in the EMU market have only accounted for 3% of the total, compared with 20% in the United States. The former figure is sure to rise. The shift from small fragmented markets to a single large market should have appeal to investors and corporate bond issuers alike.

Which exchanges will survive in the bond market? It is apparent that the race will go to the largest and best technologically equipped ones. The current leading candidates appear to be the Frankfurt and Paris exchanges. However, automatic electronic trading may eventually reduce their roles as well.

IV. Equity Markets

The Equity market structure in EMU countries has been highly fragmented. With the coming of monetary and economic integration, these markets too must consolidate. An agreement is already under way between the Frankfurt and London Stock

exchanges for electronic trading. This system is comparable with the NASDAQ in the United States.

The single currency will also engender a large volume of securities denominated in Euros. The EMU has a gross domestic product of over \$6 trillion, compared with \$8 trillion for the United States. So far, however, only 2800 firms are listed on the EMU equity exchanges, compared with 8600 in the United States. There is certainly room to grow in Europe. More institutions and individuals will participate in the new financial markets, since they will no longer be tied to local conditions and currency risks.

The upshot is more competitive, active, and thus liquid markets characterised by greater “depth, breadth, and resiliency.” The increasing quantity of trades will generate economies of scale and induce operating efficiencies. Borrowers from small countries will find it easier to raise capital. In the longer perspective, as the introduction of the Euro spurs economic growth more persons will be turning to equity markets to invest their increasing savings.

If the United Kingdom does not join the EMU soon it may miss the opportunity to be a major player in this expansion. The City of London may lose its pre-eminent position among capital markets to, say Frankfurt (Wasserman & Klinck, 1998).

The coming of the Euro has also been an impetus to facilitate cross-border securities trading and settlement. TARGET, the pan-European interbank funds transfer system, will link domestic payments systems. The European Bankers Association has developed a multilateral clearing system in Euros. These developments will make it easier for the cross-border payments associated with cross-border transactions in securities to be completed.

Increased direct access to foreign exchanges and the settlement of foreign securities transactions via remote membership of foreign systems or through domestic systems’ links abroad may reduce investor dependence on intermediaries for cross-border business. Custodians and clearing agents will compete with new methods of clearing and settling transactions cross-border based on the quality and range of services that they offer. It will be difficult for national systems currently oriented towards domestic business to match the services provided by the large custodians. They may be able to compete, however, based on efficient low-cost execution services in foreign securities. Euroclear and Cedel Bank, the established systems specialising in cross-border settlements, are mounting strong challenges to prevent their business from being eroded.

Increased competition will probably be a precursor to consolidations of systems in the medium term. Cooperation already exists in the form of links between systems. A European Central Securities Depositories Association (ECSDA) proposal provides that an investor may hold securities issued with any ECSDA member, using any member as a point of access. Some systems have amended their rules

to permit remote access. The Deutsche Bourse Clearing now admits members located abroad. Even the US settlement system, the Deposit Transfer Corporation, has set up an office in London to facilitate remote settlements of US instruments (Hills, 1998).

V. Derivative Markets

Competition among the derivative exchanges has become particularly intense. For example, five different exchanges have launched short-term interest rate products based on the Euribor rate. Only a few years ago the London International Financial Futures and Options Exchange (LIFFE), an open outcry exchange, was the dominant futures exchange in Europe. Then the all-electronic exchange, Eurex (formerly the DTB), captured the Bund (German Government futures) market from LIFFE and became the largest futures exchange in Europe. In an attempt to recapture market share, LIFFE has since changed ownership structure and drastically reduced staff. Since the start of the year, it has instituted electronic trading in all contracts.

Consolidation and cooperation is also at work. EUREX and MATIF have created trading and clearing links (the Euro Alliance). Since last October all EUREX and MATIF bond and short-term interest rate derivatives have been listed and traded on a single order book. At present members of these exchanges have to use agents to clear contracts at the other clearinghouse. By January 2002, however, there will be a single clearinghouse for all derivative products traded on the joint order book.

In addition, electronic trading systems are currently threatening the open outcry floor trading system. The latter form requires a local presence, with local agents performing cross-border trade execution and clearing. Growth in remote screen-based trading, however, will fuel demand for remote access to clearing systems. US-based derivative exchanges have already placed screen-based trading systems in Europe. The Chicago Board of Trade placed its first electronic trading screen in France in March of this year. The Chicago Mercantile Exchange has collaborated with MATIF via the GLOBEX2 system.

The coming of the EMU in its final phase will reduce the range of available currency and interest rate derivatives. Only one short-term interest rate contract will probably be offered. On the other hand, Eurobond and European Stock Index Options and futures should flourish. Already there is keen competition among the German, French and London markets for these derivatives.

VI. Index Driven Portfolio Rebalancing

The introduction of the Euro has prompted many pension plan and investment fund managers to reconsider their asset allocations. Sector-based approaches are taking over from country-based ones. This expansion will change the efficient frontier for

investors. It will also result in efficient investment sets that extend beyond national boundaries (Ratray and Boomgaardt, 1998).

For example, Italy's Fiat, Germany's Siemens, and France's Alcatel are now based in the same currency for investment purposes. The advent of the Euro has effectively removed the currency risk of all three companies for EMU fund managers. Therefore, further diversification into equities in other EMU countries is desirable, because the diversification will decrease a portfolio's stock-specific risk without introducing the added risk of currency fluctuation.

The new asset allocation policies extending throughout the EMU call for a new benchmark against which fund managers can measure their investment success. Constructing such an index is not easy in a multinational/multi-industry environment. Country and sector weights need to be changed. Additional features must include exchange-traded derivatives on that index, real-time calculation and back data. It is hardly surprising that no clear leader has yet emerged. However, the competition to be the European benchmark is fierce. Dow Jones, the Financial Times, Standard & Poors, Morgan Stanley, among others, have created new indexes designed to measure the performance of the EMU market.

These new Euro indexes can be compared across two dimensions: capitalisation and Europe-wide versus EMU. Some indexes are large "cap" (Dow Jones STOXX 50, Euro STOXX 50, and the FTSE Eurotop 100). Other indexes are more broadly based. They include the Dow Jones STOXX, Dow Jones Euro STOXX, FTSE Eurotop 300, FTSE Eurotop Eurobloc, and MSCI EMU. Derivatives based upon these indexes have created additional competition among the major European exchanges as each one attempts to establish a market in index futures.

Some countries are witnessing a net outflow of money from their local stock exchanges, as pension and mutual funds invest larger proportions of their portfolios in other EMU nations. Once a new Euro index gains wide acceptance, additional equity flows are likely to occur as fund managers re-examine their portfolios in comparison with that index.

The sector weightings in each of the EMU countries have varied in comparison with the new Euro indexes. These differences in sector weights will result in funds shifting from some EMU countries to others as fund managers adjust their portfolio weights. So far, "Net winners" appear to be Germany, France, and Italy. The "losers" appear to be the Netherlands and Ireland (Wasserman and Klinck, 1998).

Conclusion

In the final analysis, there can be no doubt that the advent of the Euro is having an impact upon European financial markets. New products and new institutions are emerging. Domestic securities and derivatives exchanges must consolidate or cooperate if they are to survive in this competitive multinational setting. Trading, clearing, and settlements systems will probably go "high-tech," as investors

throughout the EMU clamour for remote access. Meanwhile, fund managers face challenges in portfolio asset allocation and in the development of new benchmarks. As in any period of major changes, there will be some difficult adjustments. In the end, however, the European economies will benefit. British and American securities markets will face formidable competition.

Endnote

The views expressed herein are those of the author and do not reflect the opinions or policies of the Chicago Board of Trade, its employees, or owners.

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