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COMMUNICATIONS

SOME REFLECTIONS ON THE EURO AND COMPETITION IN EUROPEAN FINANCIAL MARKETS

1 INTRODUCTION

Only a short period of time away from the date at which the decision will be taken to start the Economic and Monetary Union (EMU), the debate in the financial press and in academic circles is still very much focused on the issue of the desirability of starting EMU in 1999. Much of the discussion is concerned with the question whether a sufficient degree of convergence has been achieved among the candidate member states and whether monetary union should not be preceded by political union. The debate is overshadowed by the concern that the euro might not be sufficiently strong, if from its start the EMU is going to include a large number of countries.

With eyes and minds focused on the decisions to be taken in 1998 and on practical aspects of the introduction of new currency, it is not surprising to see little research addressing the question of the role of the euro as an international currency and its implications for European financial markets. Fortunately, the situation is changing. Recently, the Royal Netherlands Economic Association commissioned a study on the euro in a broader perspective (see Jager (1997a)). The recent paper by Alogoskoufis, Portes, and Rey (1997) deals with the position of the euro as an international currency. McCauley and White (1997) from the Bank of International Settlements in Basle investigate the possible implications of the euro for European bond markets and for the European banking system. The paper by Pagano (1997) studies recent changes in the microstructure of European equity markets. The papers by Alogoskoufis et al. and by Pagano were presented at the European Summer Institute 1997 (ESI) organized by K. Koedijk and S. Eijffinger at the Humboldt University in Berlin. The topics are of sufficient interest for academic researchers and policymakers to devote some discussion to them.

In this communication I shall review the contributions in the papers by Alogoskoufis et al. (1997), McCauley and White (1997) and Pagano (1997) on the position of the euro in relationship with likely developments in European financial markets. As the issues studied are closely interrelated, it is appropriate to discuss them in an integrated framework. I shall start with reviewing the theo-

retical framework underlying most research in this area and some important findings in the three papers mentioned above. I shall establish links between the topics addressed in these papers and give some reflections on the current state of the research and on issues that in my view are of importance and request further research.

2 THEORETICAL FRAMEWORK

McCauley and White (1997) argue that the introduction of the euro will eliminate exchange rate risk and create a transparent single bond market, whereas Pagan (1997) states that the monetary union will encourage investors to hold more diversified equity portfolios leading to increased cross-border trading.

As euro financial markets develop and become deeper and more liquid, the transactions volume will rise and transactions costs will fall under the pressure of increased competition. Euro assets become more attractive and the role of the euro as a vehicle currency is strengthened. In Alogoskoufis et al. (1997), the development of euro financial markets and market thickness externalities are the main determinants of the position of the euro as an international currency. To illustrate the potential of the euro as an international currency, notice that the share in the world trade of the largest EU countries with non-EU trade partners is approximately 15%. The role of these countries' currencies as transaction currencies is commensurate with this figure. For the US dollar a similar figure holds for the share of world trade, but its share as a transaction currency is 50% of world trade (see e.g. Duisenberg (1996)). Synergy between the increased role of the euro as a vehicle currency and the increased attractiveness of European financial markets will further strengthen the international position of the euro.

In short, lower entry barriers and costs result in increased depth, transparency and liquidity of European financial markets. Complemented with technological changes in the mode of execution of transactions, these developments will exert competitive pressure on margins and transactions costs and through this foster the attractiveness of the euro and European financial markets.

3 THE EURO AS AN INTERNATIONAL CURRENCY

The achievement of the Alogoskoufis et al. (1997) paper is an evaluation of the potential of the euro to become an international currency and an assessment of the welfare effects of different scenarios using a general equilibrium model. The framework used is that of a tripolar world with three main currencies, being the US dollar, the euro, and the Japanese yen. The authors assume that there will be a wide euro, including the UK, and that the euro will be a credible currency. The scenarios vary from the status quo where the start of the EMU does not have an impact on the international monetary order, the quasi-status quo in which the euro replaces the dollar as a dominant currency for transactions between Europe and

Asia, the medium scenario with the euro becoming the main currency for financial asset transactions but trade between the dollar and the Asian bloc remaining denominated in dollars, the big euro scenario corresponding to the previous scenario with in addition the euro becoming the vehicle currency for some transactions between the dollar and yen, and finally the paneuro scenario which goes beyond the big euro scenario in that all transactions between the dollar and the yen are intermediated through the euro.

The transaction costs structure after the start of EMU is derived and used to determine which scenarios are beneficial and therefore likely to arise. Current measures of transactions costs in foreign exchange markets, an elasticity of transactions costs with respect to volume of -0.03 (see Hartmann (1996)) and estimated volumes after the start of the EMU under each of the above scenarios are used to estimate transactions costs for each scenario. Similarly for financial markets the bid-ask spreads on 10 year bonds and an elasticity of transactions costs with respect to volumes of -0.11 (see Tagaki (1987)) are used to obtain the transactions costs structure after the start of EMU.

The analysis by Alogoskoufis et al. (1997) indicates that the most likely scenarios are the status quo or the quasi-status quo although other scenarios cannot a priori be ruled out. The authors conclude that world welfare is maximized in the medium euro case, whereas obviously for Europe the big euro scenario is the preferred one. The estimated welfare gains for the status quo and the big euro case vary from 0.5% to 1.0% of GDP per year for Europe and a loss between 0.4% and 0.8% for the US, and of less than 0.1% for Japan. These changes in welfare result from changes in the efficiency in transactions. Other gains such as due to increased seigniorage for Europe are not taken into account. They were estimated to be of limited size (a flow of less than 0.1% of GDP) by Alogoskoufis and Portes (1991). Alogoskoufis et al. (1997) conclude that the price for the increased international role of the euro is an appreciation of its value relative to the major competitors, the US dollar and the Japanese yen.

4 THE EURO AND EUROPEAN FINANCIAL MARKETS

McCauley and White (1997) start by observing that European-based financial institutions are already under significant competitive pressure to restructure. This pressure will be intensified by existing forces of technological change and deregulation affecting cross-border activity (the First and Second Banking Directives of the European Commission). In their views, the euro is likely to become a catalyst for change that will play a major role in establishing a large liquid security market in Europe, both for private and public securities. The bond market in euros is likely to attract more international investment and more issuance in that currency at the expense of bank loans. As a result the international position of the euro will be enhanced. McCauley (1997) established that a reallocation of private portfolios from the US dollar to the euro such that the euro share

of international assets matches the output and trade shares of the G-10 members of the European Union requires a shift of US \$ 0.7 trillion. The elimination of currency risk within Europe will increase the attractiveness of euro-denominated securities. Portfolios of institutional investors are expected to reduce their bias towards home-country assets. Commercial papers and bonds will become an attractive alternative to bank loans and deposits, thereby gradually shifting the role of commercial banks from acquiring deposits and making loans to underwriting and distributing securities. According to the authors, the direct influence of the euro in stimulating international competition among banks for traditional kinds of business is of less importance. Markets will remain partly segmented due to the existence of different legal, fiscal and regulatory factors, despite the increased pressure for more harmonization. The process of disintermediation is expected to have a more important impact on the banking sector than the loss of net revenues derived from foreign exchange and increased costs resulting from the introduction of the euro during a transition period.

The authors discuss potential issues for public policy in Europe and elsewhere that arise from the competitive challenges faced by European banks. The authors point to the importance of adequate incentive structures and supervisory arrangements to promote sound banking. Given the integration of financial markets, adjustment problems are likely to have spillover effects beyond the European Union. The issue of systemic risk within Europe will have to be addressed in a way that is consistent with that adopted elsewhere. The authors also point out that the development of deep and liquid euro bond markets could weaken the currency concerned. For instance, if new securities were to be issued in euro and the proceeds used to buy in debt in US dollars, investors would have to be induced to hold more euro and fewer dollar assets. This could result in higher euro interest rates and possibly a weaker euro.

Many of the points discussed by McCauley and White (1997) are also emphasized by Pagano (1997), who describes how increased competition between European stock exchanges has reduced trading costs and extended the variety of trading mechanisms. He illustrates the convergence among European stock exchanges towards a common dualistic structure, formed by an automated order driven auction system specializing in small and medium-sized trades and a market-making dealer market for large trades. The author discusses likely future developments. Several factors are mentioned, among which the regulatory changes resulting from the EU Investment Services Directive, the increased importance of proprietary trading systems, the pressure of institutional investors to narrow brokers' margins and the start of the monetary union will all increase competition among security exchanges and trading systems. The introduction of a single currency will eliminate exchange rate risk and lead to cross-border diversification of equity portfolios. National stock exchanges will have to compete for European and foreign investors with alternative trading systems (e.g. direct access to institutional investors) and cheap execution of orders. According to Pagano (1997)

lower trading costs will reduce the cost of capital and therefore be beneficial to issuing companies and induce more European companies to go public.

To summarize, the elimination of exchange risk, the increased depth, liquidity and transparency of European bond and stock markets are expected to lead to increased competition and lower transactions costs as a result of the introduction of a single currency. The likely expansion of bond markets will partly result from reduced intermediation by commercial banks. The banking sector and security markets in Europe are expected to face major challenges and big changes triggered by the start of the EMU and important changes in the technology of trading systems.

5 COMMENTS

The thoughtful studies by Alogoskoufis et al., McCauley and White, and Pagano outline likely major developments in the international position of the euro, i.e. in the foreign exchange market for the euro, the European bond market in relationship with changes in the banking sector, and the European equity markets, respectively. Any quantitative assessment of these expected developments should be taken with great care. The uncertainty surrounding estimates of these types of developments is simply very large. There is uncertainty about membership and size of the EMU, about its exchange rate policy, about exchange rate arrangements with EU but non-EMU member states and with EU membership candidate countries, about the (re)action of the US and Japan after the start of EMU. Other required adjustments contribute to the uncertainty in the transition period. After the start of EMU total reserves held by the ESCB (European System of Central Banks) are likely to be reduced. Private holdings of euros might be reduced as well, to the extent that these cash balance holdings result from converting holdings in other ESCB currencies used for intra-union transactions. These adjustments will take place at the beginning of the monetary union. There is also uncertainty about the speed with which increased competition will lead to a reduction of transaction costs, the emergence of deep and liquid bond and equity markets and the shift from bank loans to bond debt, although the fact that the changes in European equity markets described by Pagano (1997) took only a decade to materialize indicates that the events could gain momentum rather quickly.

In line with the study by Alogoskoufis et al. (1997), a theoretical and empirical analysis by Jager (1997b) of the international position of the euro in the post-transition period also concludes that the likely outcome is the status quo scenario. An empirical analysis of the evolution over the period 1980–1995 of the share of European currencies in the distribution of world bank loans, international bonds offerings and foreign currency reserves, respectively, is used as support for the conclusion that for some time the international role of the euro will be at most equivalent to that of the US dollar.

Not only do the studies by Alogoskoufis et al. (1997), McCauley and White (1997), and Pagano (1997) exhibit likely trends that will shape euro money and financial markets, they also point to a number of important policy issues that deserve attention from policymakers and the economics research profession. I shall briefly discuss some of these issues.

The start of a wide EMU will lead to an international monetary order with three global players. The international role of the euro will challenge the US dollar's dominance. The European Central Bank (ECB) may resist the internationalization of the euro because of the resulting pressures for an appreciation of the euro. Also, the external stability might become of less importance to the EMU as the share in world trade of the union is much lower than the shares of its member states because intra-union trade will become truly domestic trade for the euro-area. Finally, the ECB is expected to pursue its objective of price stability. To achieve this objective, it will have to build a reputation of being tough on inflation. The external position of the euro might thereby get much less attention. The ECB may even follow the example of the Bundesbank and resist to intervene in foreign exchange markets if the measures required to assure external stability threaten the internal stability of the euro. One also has to realize that policy coordination with the non-EMU countries and exchange rate management is at the discretion of the Council of Ministers. According to the Maastricht Treaty (1992), article 109, 2, 'These general orientations [*of the Council of Ministers for exchange rate policy*] shall be without prejudice to the primary objective of the ESCB to maintain price stability.' (Italics added). Notice that the ambiguity in the Treaty about the internal coordination between the ECB and the Council is yet another source of uncertainty (see also Kenen (1995), chapter 5 on this point).

The economic benefits from currency dominance (efficiency gains, seigniorage, balance of payment, deficit financing, and absence of exchange rate risk for currency transactions, etc.) might be sufficiently important to lead to a confrontation with the US about hegemony. Although the introduction of the euro will potentially lead to more symmetry between the US and Europe, it is also likely that exchange rate instability will increase, a prediction made by Kenen (1995, p. 123) as well. This instability might result from the increased uncertainty about the size, impact, and exchange rate policy of the EMU (this policy will be subordinated to the monetary policy of the ECB) and the expected shifts in money and financial asset holdings in the period of transition and, more permanently, from the structure of world foreign exchange markets. In fact, the international monetary system will change from a unipolar regime with a de facto monopoly of the US dollar as a major reserve currency to a multipolar regime in the form of a quasi-oligopoly of several reserve currencies.

In the light of my comments on the uncertainty regarding external policies of the EMU and the strategic issues involved, Jager's (1997b) conclusion that external stability of the euro is likely to occur is rather optimistic. Three arguments are put forward to motivate this conclusion. First, the stability of the external

value of the euro will be promoted if, as expected, non-EU countries peg their currency to the euro. Second, exchange rate policy of the EMU will not be handicapped by the asymmetric effects that often hindered that of the EMS when a movement of the US dollar rate had opposite effects on the D-Mark and other weaker EMS currencies. Third, it is argued that the EMU is more likely to fulfill the conditions for an optimal currency area (similarity of economic structure, flexibility of wages, mobility of production factors, etc.) with the rest of the world than the EU with different currencies. In Jager's view, this should foster the external stability of the euro. These three arguments certainly have some relevance, but as mentioned above there are sufficient reasons to be sceptical about the external stability of the euro.

An analysis of these strategic issues naturally requests a game-theoretic approach. The lessons that can be learned from history, for instance from studying the rivalry about hegemony between the pound sterling and the US dollar in the interwar period as done by Alogoskoufis et al. (1997), are of some but limited relevance for the current situation. History suggests that the international monetary system was more stable when it was dominated by one economic power (see Eichengreen (1989) and Gross and Thygesen (1992)). According to Eichengreen (1989) stability results when the dominant power has an incentive to provide it, e.g. when the position of the dominant power is such that its decisions affect the equilibrium in the global market.

The issues at stake are of significant importance for policymaking. Further theoretical and empirical research is needed to better understand the stability and welfare issues and to quantify the welfare gains and losses involved in various strategies. Simulations by Dellas (1997) using a stochastic general equilibrium model suggest that for a given operating procedure of the central banks monetary union contributes to lower real interest rates and lower exchange rate volatility because the volatility of output in the union is expected to be smaller than that of the individual countries. Operating procedures by central banks appear to matter a great deal for exchange rates. For instance, price rate targeting which counters velocity shocks is found to lead to more stable exchange rates than money targeting. Any welfare calculation should take into account the economic consequences of increased external instability and exchange rate volatility if the euro is going to play an active role as an international currency. The Alogoskoufis et al. (1997) paper is an important contribution in that respect. It needs to be complemented by an analysis of the strategic aspects of the problem.

The major changes in the European financial markets and banking sector discussed by McCauley and White (1997) and Pagano (1997) are of concern to public policy as well. Systemic stability of the financial system could be threatened seriously. Gains to the society from a more efficient allocation of funds to investment projects could in the short run be partly erased by the costs of fast restructuring and possible downsizing of the banking sector.

Among the issues discussed in McCauley and White (1997) are the interference of the practice of state bailouts of banks with sound banking practice, the difficulties of organizing a bailout of large EU-wide operating banks, increased deposit competition on the basis of different deposit insurance regimes, sufficient diversification of sovereign debt risk (currently held by national banks and pension funds), the problem of information-sharing in a system with national supervisory authorities, and the design of an effective supervisory system for a largely integrated market of banking activities requiring a system-wide response.

The principles of home country control and mutual recognition laid down in the second banking directive and implying that only a single banking license is required for banks operating in the European Union will have to be complemented by some form of host country supervision or joint control by home and host country authorities as long as national authorities bear the responsibility for national and foreign banks operating domestically (see e.g. Dermine (1990) on this point).

Another problem is the course to be taken by the process of disintermediation mentioned by McCauley and White (1997). For instance Masera (1994, p. 23) states '... the description of the US model as market-oriented, with a declining role for intermediaries, and more advanced and efficient than the European model is simplistic.' (See also the comparison of intermediaries and financial markets in Germany and the US by Allen and Gale). In his view the process of disintermediation in the US should be better called a process of diversification of the forms of intermediation with a growing role for non-bank intermediaries. Europe could take a different course with the banking sector taking up the challenge caused by the increased tendency of direct dealings between savers and final investors through markets. Competitive complementarity results on the one hand from the decreased costs of market transactions on financial markets and, on the other hand, from the specific role of financial intermediaries in resolving the informational asymmetry between savers and borrowers. This complementarity justifies the simultaneous existence of markets and financial intermediaries in providing financial products. As in Europe banks are also allowed to act as investment banks (universal banks) primarily linking institutional investors and issuers of securities, banks have the opportunity to address the challenge of the expected shift in the form of intermediation in the wake of the introduction of the single currency. The recent wave of mergers and take-overs in the European financial sector indicates that European banks are willing to face this challenge.

As documented by Pagano (1997), European equity markets have already taken up the challenge and are engaged in a process of competition, converging into a dualistic structure of an automated auction system which runs parallel to a dealership market for large trades. The question whether there is a prospect for local financial markets in this dualistic structure has recently been addressed by Boot (1997), in particular for the Amsterdam Exchanges. The answer to this question is moderately positive. Boot emphasizes that the local financial markets can be

successful if they use the advantage they have in efficiently collecting and processing information on companies and markets in their vicinity.

6 CONCLUDING REMARKS

In this note I reviewed and commented upon recent studies on the role of the euro as an international currency and its role as a catalyst of significant changes in the European financial sector. The process of deregulation and technological developments in trading systems will be amplified by the introduction of the euro which adds transparency and depth and therefore exerts competitive pressure on margins and transactions costs and fosters the attractiveness of the euro and of European financial markets. Because of the increased attractiveness of European financial markets, the status quo scenario is rather unlikely in the longer run. Also, it is similarly unlikely that the increased attractiveness of the euro and European financial markets will not challenge the US, Japan and other parts of the world to respond. The result will be ongoing competition in a multipolar financial world that could have major implications for economic growth and welfare in the different parts of the world.

Quantifying the likely developments and making reliable projections for the future are difficult. Uncertainty surrounding future developments is still high. Straightforward extrapolation of trends in financial data is deemed to be defective. One has to rely on a careful analysis and deep understanding of the strategic issues involved and the interests at stake. The authors of the papers discussed have made important contributions. The issues are of sufficient significance to justify further research efforts in these directions.

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