



Chapter 18: The financial markets and the euro

The big payoff on the Euro is, of course, in the capital markets. [. . .] It will move from the dull bank-based financing structure to big-time debt markets and markets for corporate equities that offer transparency for the mismanaged or sleepy European companies. Capital markets are good at kicking butt.

Rudi Dornbusch (2000), p. 242

The Economics
of European
Integration

Richard Baldwin
Charles Wyplosz

fourth edition



What are financial institutions and markets?

Capital markets collect savings and provide producers with the financial means to invest in productive equipment. They perform three main functions:

1. they transform maturity;
2. they perform intermediation;
3. they deal with inherent risk.

Best-known financial institutions are banks. Bond and stock markets represent the other component of the financial system.

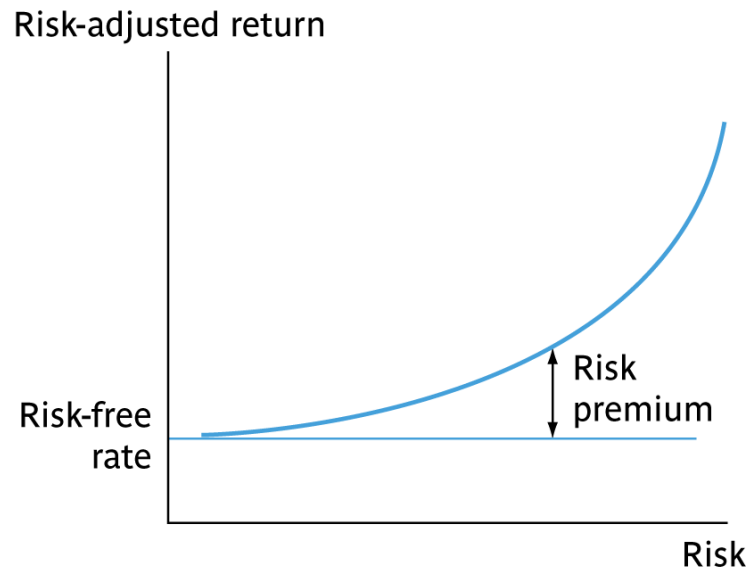
What do financial markets do?

Matching lending and borrowing needs: maturity

- current accounts versus term deposits, with interest differentials since time has a value and the market set its price.

Matching lending and borrowing needs: risk

- investors want high returns and no risk;
- basic trade-off between risk and return: rate of return is adjusted by incorporating a risk premium.



What do financial markets do?

Diversification:

- pooling together assets with negative risk correlation reduce overall risk;
- financial markets can offer almost unbounded possibilities for diversification, the more so the bigger they are.

Characteristics of financial markets

Scale economies:

- matching and risk easier with many players and networks.

Networks:

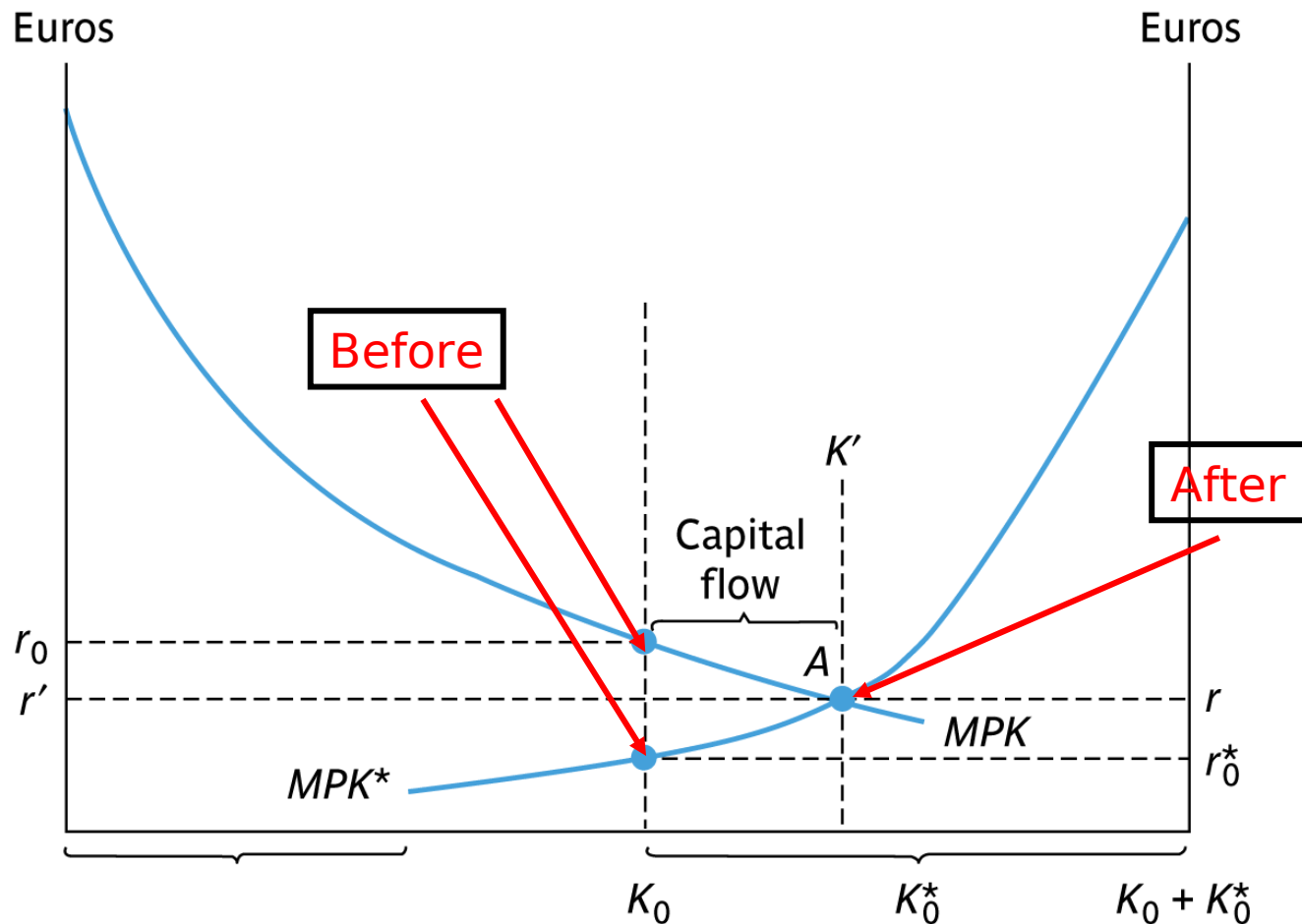
- networks of borrowers and lenders exploiting network externalities (the larger the network, the better it works).

Asymmetric information:

- borrowers have incentives to conceal risks;
 - lenders are aware and may overprice risk and/or refuse to lend.
- Need of regulation.

Economics of capital mobility: allocation efficiency

Allocation efficiency requires capital to be invested in activities with highest rewards. Capital market barriers inhibit efficiency.

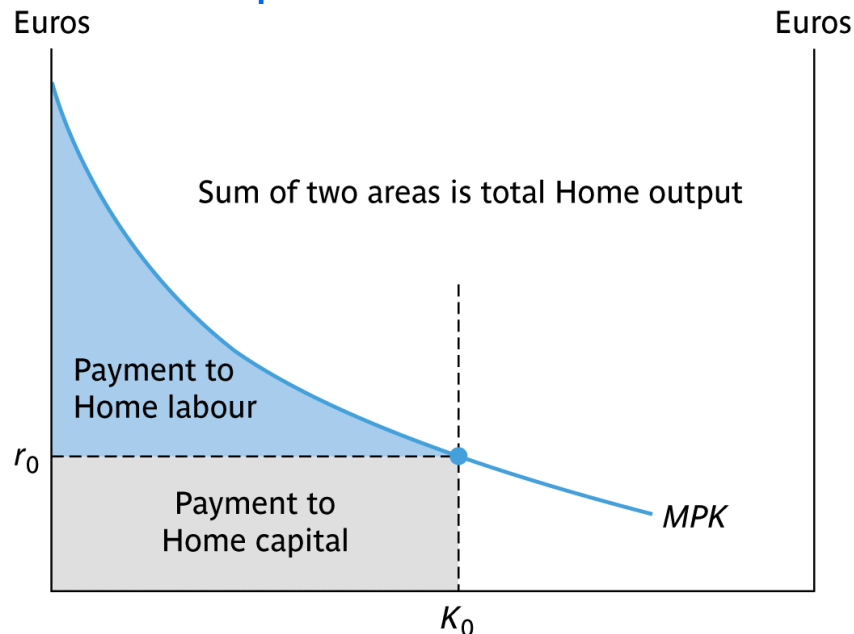


Economics of capital mobility: allocation efficiency

Allocation efficiency leads to:

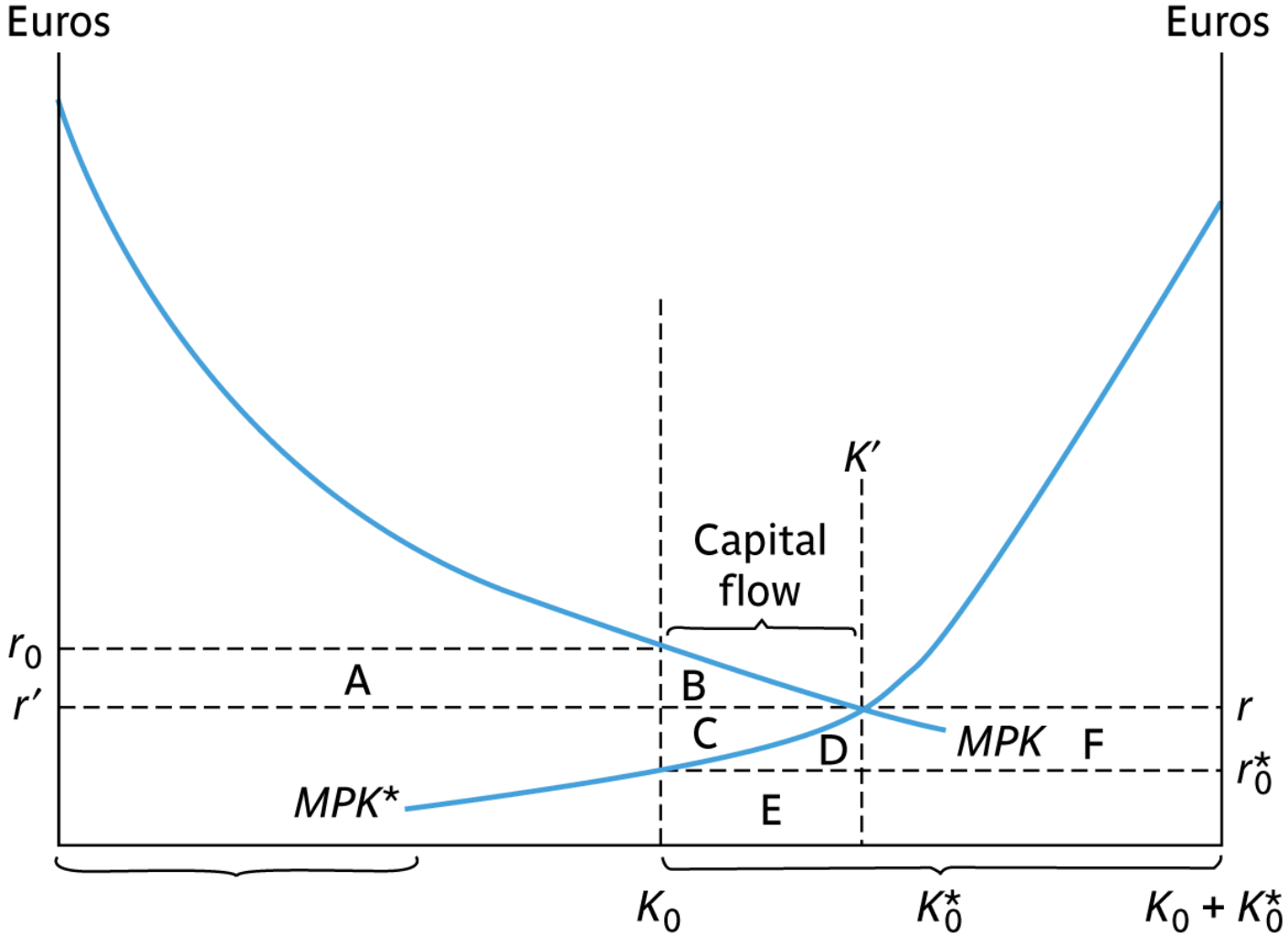
- same returns from saving;
- same borrowing costs;
- capital goes where it is more productive;
- not everyone gains.

Who wins, who loses from capital movement? Notice that:



Economics of capital mobility: allocation efficiency

Welfare effects:



Economics of capital mobility: allocation efficiency

- Home capital was scarce:
 - capital owners lose A;
 - labour gains A + B;
 - home gains B.
- Foreign capital was abundant:
 - capital gains F;
 - labour loses D + F;
 - foreign loses D but receives C + D from Home;
 - foreign gains C.

The result that both countries benefit from capital market integration is the basis for the Single Market and the Commission directive.

Economics of capital mobility: diversification effect

Diversification leads:

- more choice to borrowers and lenders;
- risk is reduced.

Effect of single currency:

- euro eliminates currency risk within Eurozone;
- more competition as national currencies acted as non-tariff barriers;
- better exploitation of scale economies, with the emergence of large financial institutions and markets;
- potential for diversification shrinks;
- potential emergence of euro as another world currency.

Implication for banks

In principle, banks should compete throughout the euro area. In practice, many limits to this scenario:

- good to be known by your banker (information asymmetry);
- large costs of switching banks;
- importance of wide branch networks.

Banks merge, but mostly within countries:

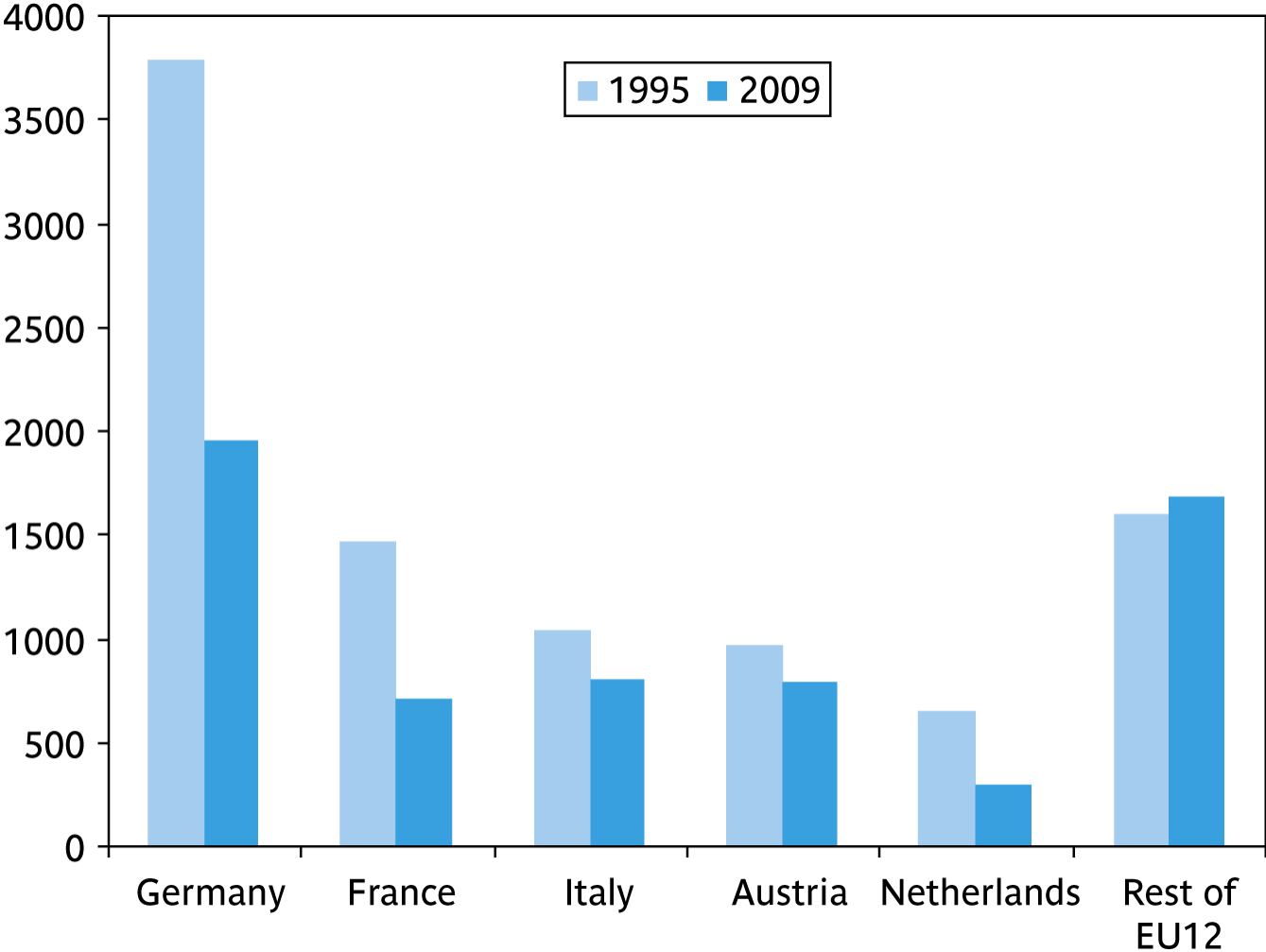
- regulations remain local in spite of harmonisation efforts;
- cultural differences;
- tax considerations.

Early effect:

- more concentration and less competition;
- banks could establish branches abroad (but they don't).

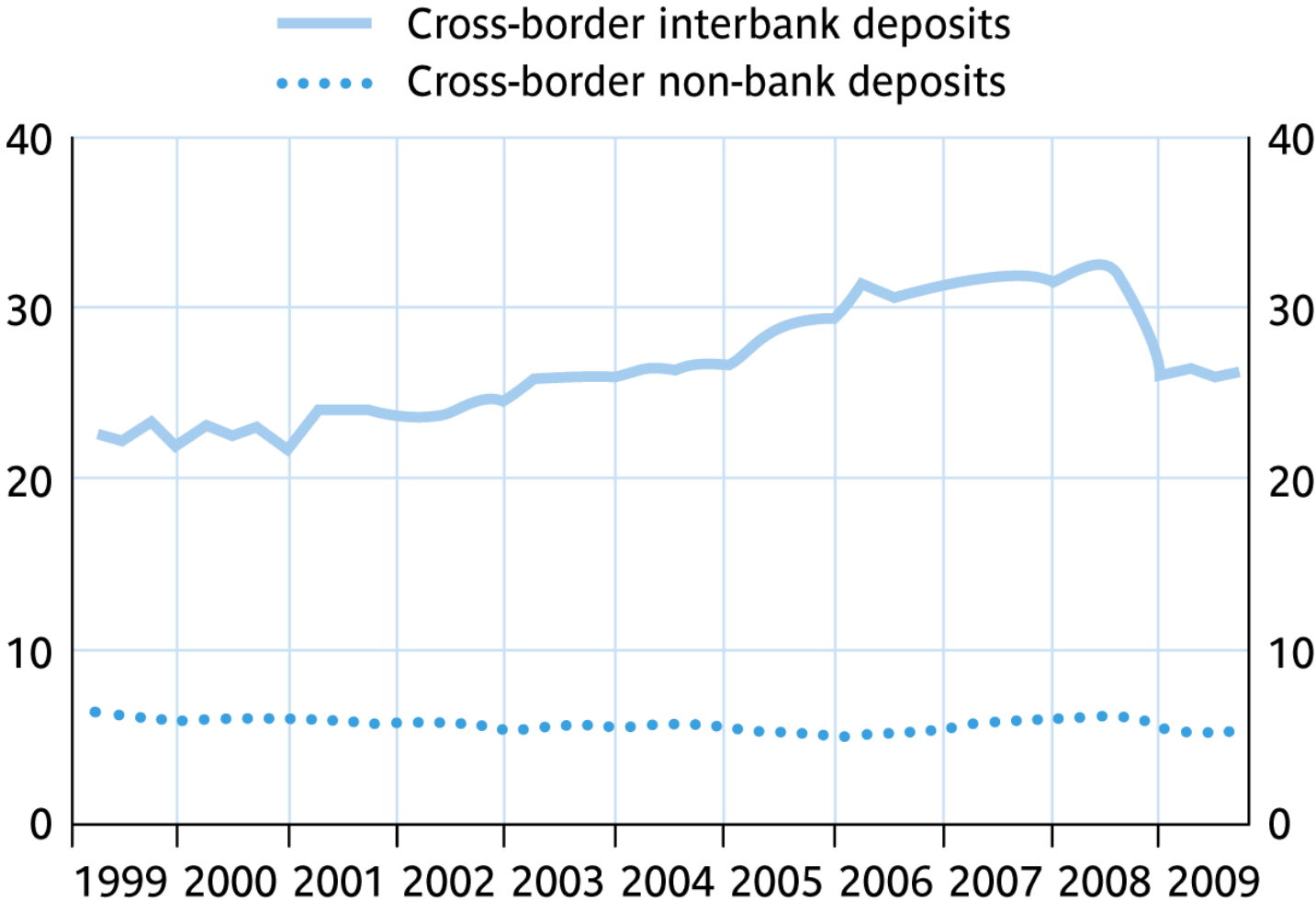
Implication for banks

Number of banks in the Eurozone:



Implication for banks

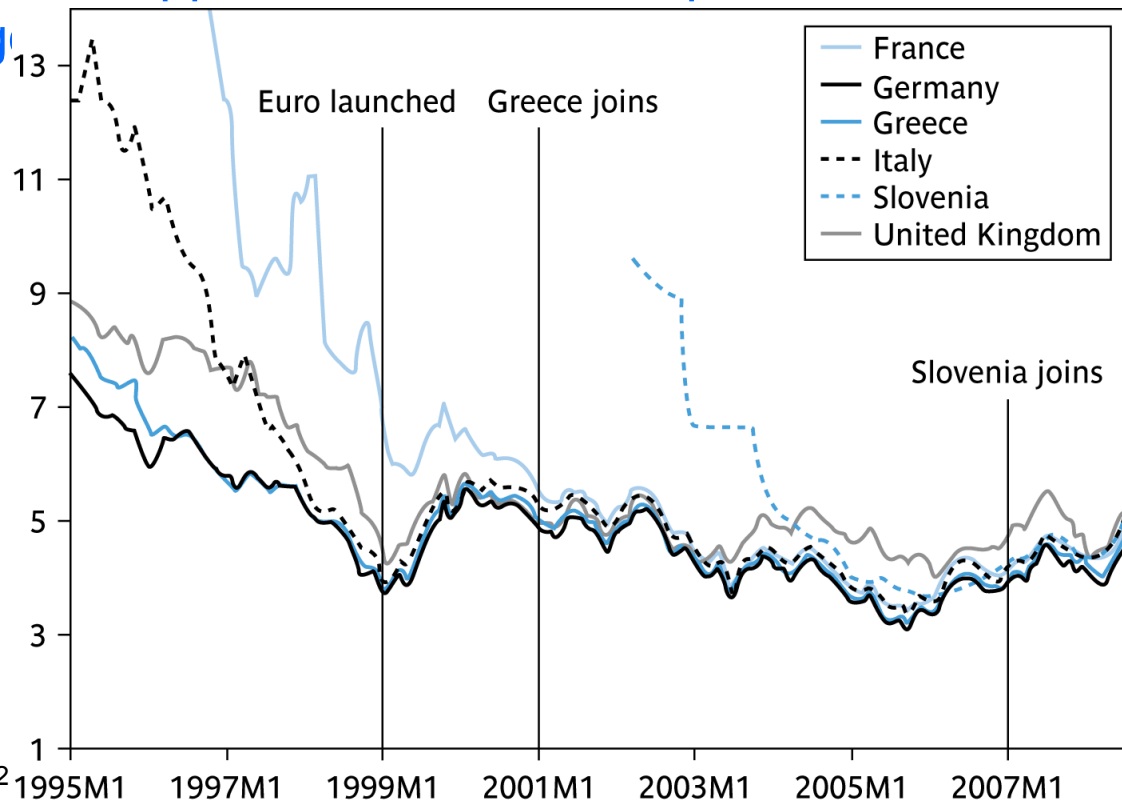
Shares of cross-border banking activity:



Implication for bond markets

Bond markets deal in highly standardised loans. They used to be segmented by currency risk, which implied interest rate differentials.

Convergence has happened but is not complete; Interest rates on long-term g

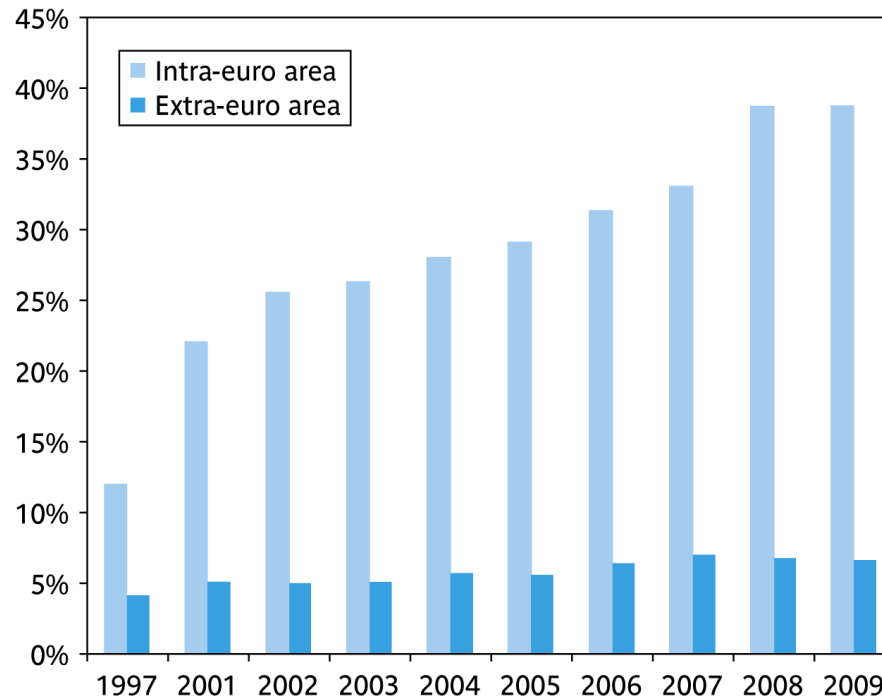


Implication for stock markets

Worldwide stock markets are surprisingly national (home bias), due to:

- information asymmetries;
- currency risk → euro area stock markets should be less subject to home bias.

Cross-border holdings of equity issued by euro area residents:



Regulation and supervision

Because of 'market failures', financial markets are regulated and financial institutions are supervised.

A single financial market would seem to require a single regulator and a single supervisor. Instead:

- regulation largely designed at EU level;
- foster co-operation among national supervisors.

The financial crisis that hit Europe in 2008 showed that this system was not adequate. For example:

- decision by Ireland in 2008 to offer full guarantee to deposits and liabilities of six Irish banks forced other countries, which offered limited guarantees, to offer unlimited guarantees to deposits at their own banks in order not to be at disadvantage.

Regulation and supervision

Crisis led to a task force. The De Larosière Report (2009) showed that:

- national supervisors did not share information with one another;
- ECB, tasked with the function of lender of last resort, was not any better informed of the true situation of stressed banks.

The European System of Financial Supervision (ESFS) has been created which includes 4 new institutions:

1. European Banking Authority (EBA), which is charged with collecting detailed information on all EU banks;
2. European Systemic Risk Board (ESRB), which looks at the overall picture and can issue binding recommendations;
3. European Insurance and Occupational Pensions Authority (EIOPA), focusing on insurance companies and pension funds;
4. Joint Committee of the European Supervisory Authorities (ESAs), which brings national supervisors together to improve transparency.

The international role of the euro

Externally, a currency can be:

- an international unit of account: trade invoicing
- an international medium of exchange: a vehicle currency
- an international store of value: foreign exchange reserves, individual hoarding.

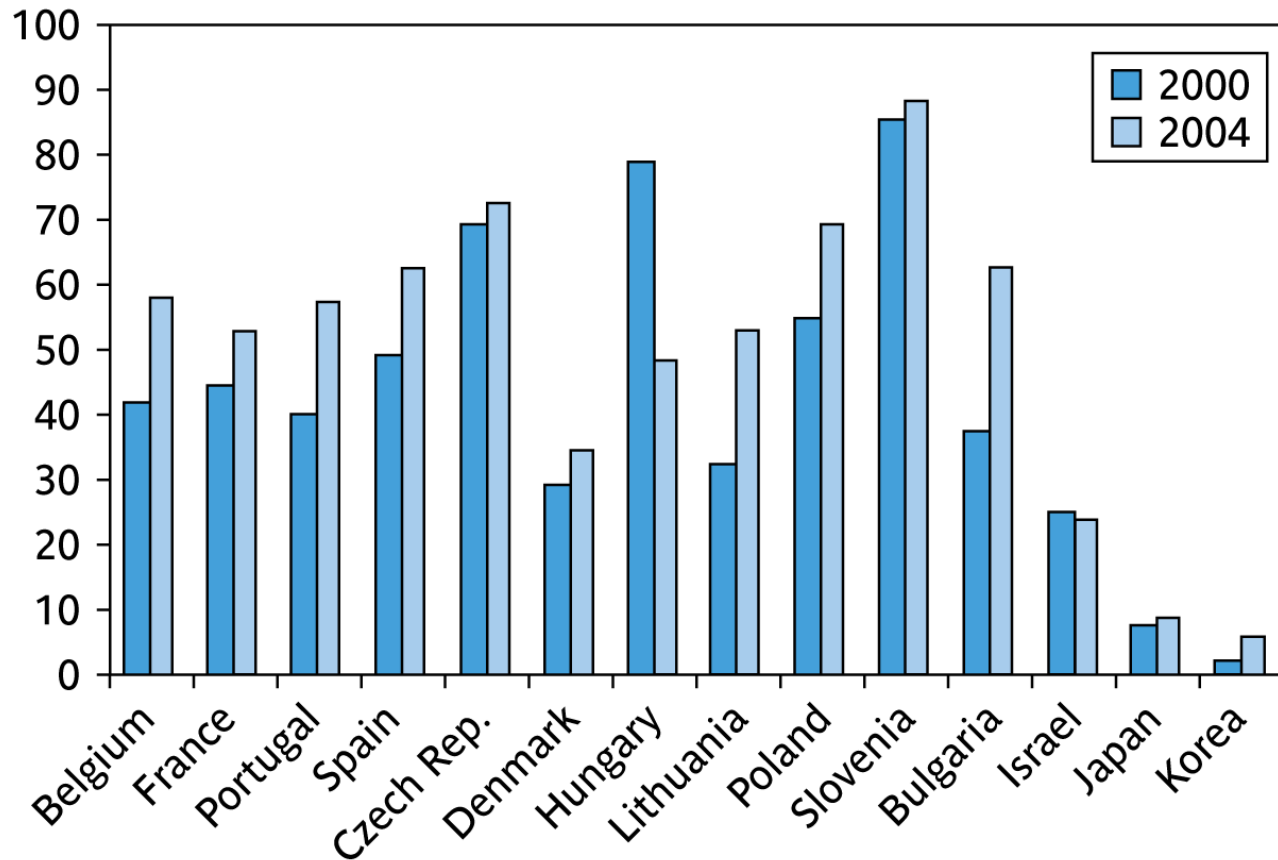
Internally, these functions are established by law.

Externally, they have to be earned.

The international role of the euro

European firms are increasingly able to invoice trade in euros.

Share of exports invoiced in euros (% of total exports):



The international role of the euro

Currencies are used on exchange markets:

- directly for conversion into/from other currencies;
- indirectly as intermediary for other bilateral conversions.

The share of the euro in 2010 is much smaller than the sum of the shares of its constituent currencies.

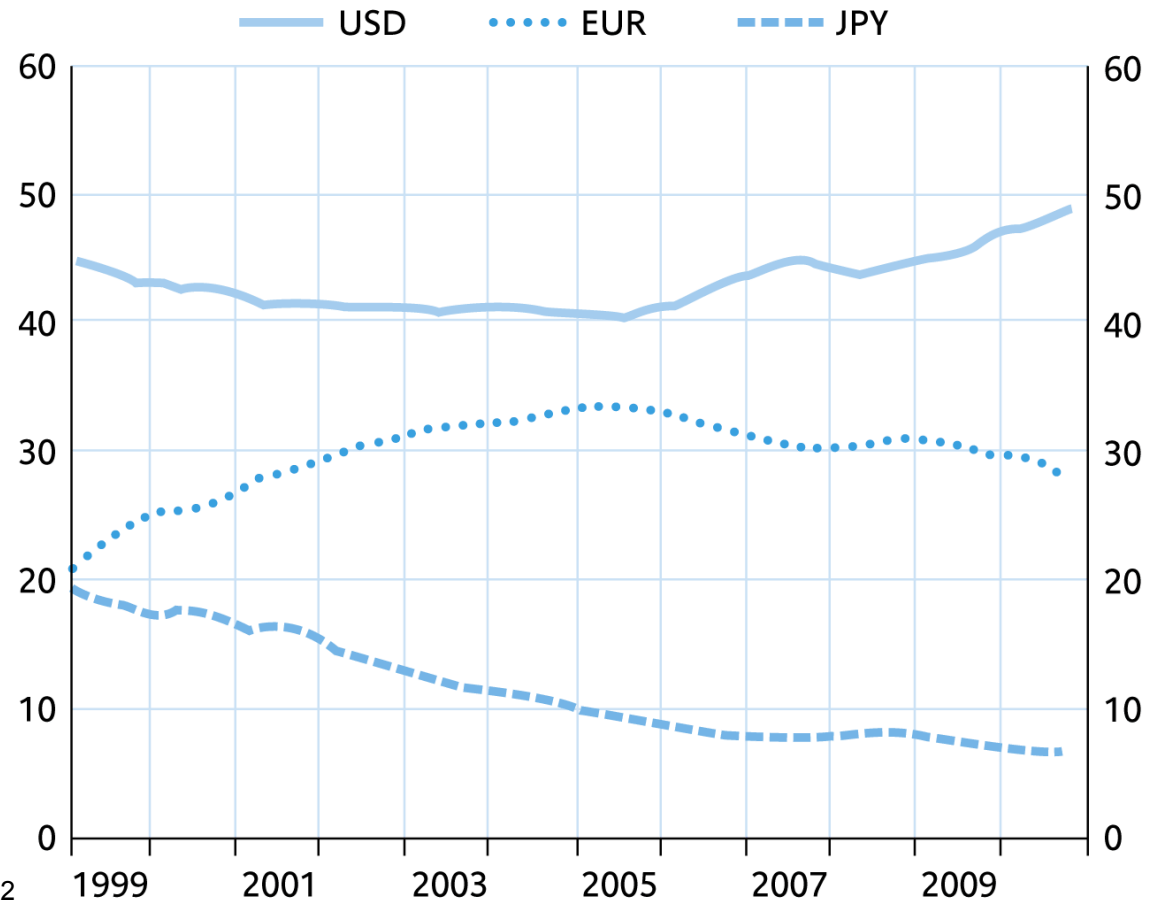
Table 18.3 Currency composition of exchange trading volume (%)

	US dollar	Euro	Yen	Deutsch-mark	French franc	ECU and other ERM currencies	Pound sterling	Swiss franc
1992	82.0		23.4	39.6	3.8	11.8	13.6	8.4
1998	87.3		20.2	30.1	5.1	17.3	11.0	7.1
2010	84.9	39.1	19.0				12.9	6.4

The international role of the euro

Share of bonds issued in euros has taken off.

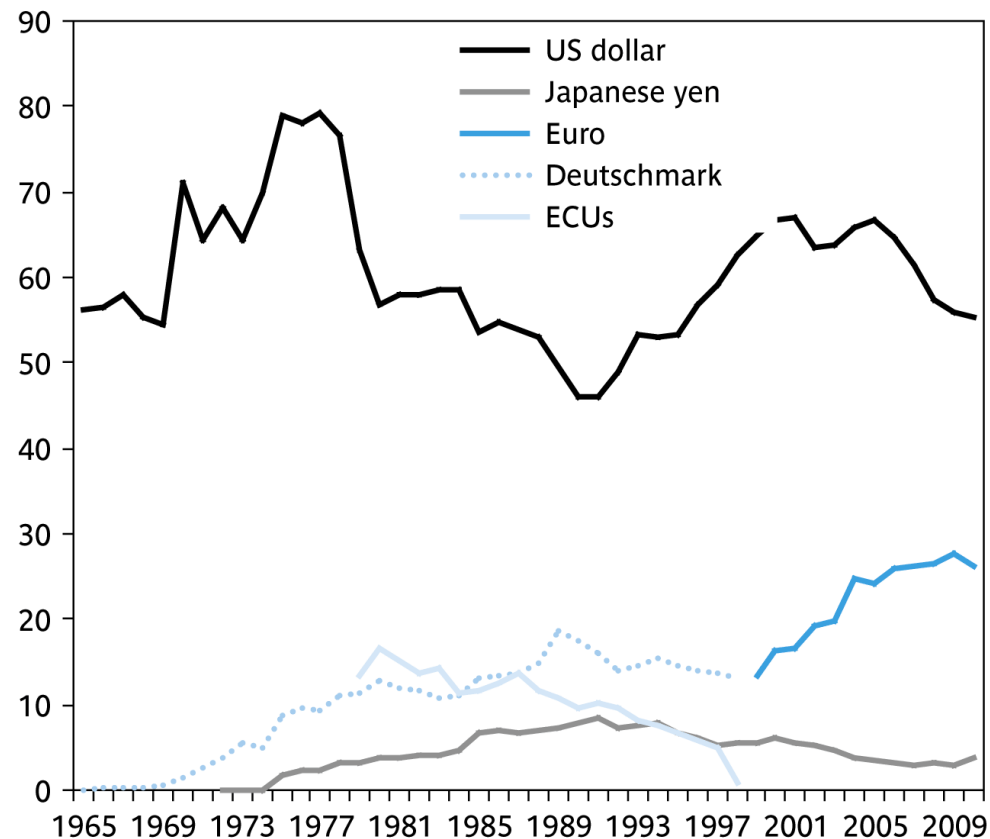
Currency shares of international bonds, 1994–2010:



The international role of the euro

Dollar seems firmly entrenched as the leading currency for international reserves.

Foreign exchange reserves: shares of main currencies, 1965–2010:



The international role of the euro

Foreign currencies are also sometimes used alongside the domestic currency: parallel currencies.

Table 18.4 Countries using the euro as an anchor (as of May 2011)

ERM 2	Peg to euro	Peg to basket including the euro	Managed floating with euro as reference currency	Euro-based currency boards	Unilateral euroization
Denmark	CFA Franc Zone	Algeria	Croatia	Bulgaria	Kosovo
Latvia	Cape Verde	Belarus	Czech Rep.	Bosnia-Herzegovina	Montenegro
Lithuania	Comoros	Botswana	Macedonia		Micro states
	São Tomé e Príncipe	Fiji	Romania		
		Iran			
		Kuwait			
		Lybia			
		Morocco			
		Russia			
		Samao			
		Singapore			
		Syria			
		Tunisia			
		Vanuatu			

Does it matter?

For some Europeans, the euro is challenging the supremacy of the dollar. Indeed, the dollar reigns supreme!

The wish to displace the dollar is not driven by political sentiment, but what about the economic advantages?

Economic benefits of having a world currency are quite modest → ECB considers that a possible international role for the euro is something that it should neither encourage nor discourage. Beyond some legitimate pride, it does not really care!