Impact of the Euro on Financial Markets

Introduction

This article provides a brief overview of the financial market implications of EMU. In particular, the discussion focuses on specific key issues in three broad areas: 1) the implications of the euro for public debt management and the government securities markets; 2) the implications of the euro for corporate securities markets; and 3) the implications of the euro for institutional competition and structural change in the financial sector. The introduction of the euro takes European capital markets a historic step closer toward full integration. Many of the explicit obstacles to cross-border trade in financial services in the European sphere have been removed through regulatory reforms introduced over the past two decades or so. The adoption of the single currency addresses one of the factors that has contributed to the segmentation of capital markets in Europe – the need to hedge exchange rate risk. With the elimination of currency risk, the valuation of financial assets is expected to be based on credit risk and industry-specific influences. Taken together, these changes are expected to facilitate the development of a pan-European credit market, including growth in the relative proportion of corporate securities, both bonds and equities. But while there are fewer outright restrictions than in the past, important legal, regulatory, tax, and other impediments to full integration of securities markets in the EMU area remain. Consequently, the time required before a broad and deep capital market develops is the subject of some debate among market participants. By contrast, there is almost unanimous agreement that the euro will result in a large market in government debt denominated in euros, and that this will occur much sooner.

It is important to note that EMU is not the only impetus behind change in the financial services area in Europe. Factors such as improvements in information technology, the increased institutionalisation of savings, changes in corporate governance, as well as globalisation and deregulation have influenced the ongoing consolidation and restructuring of banks, managed funds, and other financial services institutions. While EMU is not the only catalyst for change, it is perhaps the main driver behind the move to cross-border consolidation, especially among the larger participants.
Financial Market Trends, No. 72, February 1999

I. The euro and European government bond markets

With the launch of the single currency on 1 January 1999, all public debt denominated in the national currencies of the eleven participating countries in EMU was converted to euros. The result was the creation of a government bond market that in size is roughly equivalent to the US market. In terms of aggregate size, the market for euro-denominated government securities is sufficient to attract a strong demand, and sizeable inflows have already been recorded. Still, before a fully integrated market in government securities emerges a few issues must be addressed.

After the co-ordinated moves by EMU central banks to trim official rates, the gap between short-term rates narrowed substantially in early-December, and had converged fully around the official January 1 start date. Investors also appeared to be pricing longer-term securities similarly, as measured by the convergence of interest rates on longer term government securities of participant states toward the lower levels of those rates prevailing in core countries. Thus, at the outset, measured credit differences among EMU members were small, an important consideration for the full integration of the government bond market in euro.

Prior to the start date, however, there were lingering questions as to whether yield spreads would hold at the prevailing levels. Government fiscal positions (and the long-term sustainability of given fiscal competitiveness) vary across member states, and other structural factors such as finance mechanisms for pension liabilities differ as well. Inasmuch as a devaluation would no longer be possible and governments would be unable to inflate their way out of difficulty or turn to the ECB for help, many analysts expected that these factors, in time, would likely result in a modest widening in spreads between sovereign issues, as nominal differences in government bond yields began to reflect perceived differences in country-specific credit risk. Thus far, spreads on some EMU sovereign issues have widened out, but interest rates in general have not fully stabilised from the heightened volatility in the wake of the Brazilian crisis and it remains to be seen whether bond spreads will be wider or narrower in the future.

A. Establishing a benchmark curve

In a related development, the market seems to have settled for now on German bunds as the benchmark securities for pricing euro government debt. Ahead of the start date, market analysts had given considerable attention to the question as to which government’s securities would attain benchmark status. From a market perspective, establishment of a pricing benchmark is thought to be a pre-condition for full integration of the market. In particular, a “single” reference yield curve based on
bonds with similar credit risk is said to be a necessary condition for the establishment of a futures contract in euro government bonds, especially if delivery of bonds of more than one issuer is to occur. France and Germany are by far the dominant issuers of traditional fixed-rate coupon instruments in the EMU area and much of the debate focused on bonds of one or the other government becoming the benchmark for pricing in the EMU.

Among the factors cited in favour of France’s debt assuming such a role were the liquidity and size of individual issues, as well as its pre-announced calendar of issuance. Also mentioned was the notion that the French ECU Btan/Oat curve was perhaps the only successful benchmark curve in the ECU market. In addition, France had taken a number of steps with a view toward establishing large, liquid bond issues that provide for transparent pricing. These efforts included repurchases of existing issues, exchanges of new securities for old, and consolidation of issues.

Advantages cited in favour of German bunds as benchmarks was the absolute size of the market. Although German issues had not been consolidated to the same extent as had French securities, analysts believed that sufficient depth and liquidity existed across the German yield curve to sustain continuous two-way pricing of Germany’s bonds. Bid-offer spreads also had remained fairly tight. The greater size and turnover in the Bund futures contract, which, other things equal, significantly enhances the liquidity of the underlying cash market, was considered to be another advantage of Germany’s debt. Perhaps most important, Germany’s issues were said by some observers to benefit from a slight edge in perceived credit quality, acquired through tight monetary and exchange rate management sustained over a longer period of time.

Until the actual start of the single currency, this debate was largely an academic exercise. As always, investors ultimately drive the process of defining a consensus benchmark. Thus far at least, yields on longer-term securities of other EMU sovereigns, including France, are priced at positive spreads to German bunds, suggesting that the latter are the benchmarks of the euro zone. Similarly, bund futures appear to be the current hedging instruments of choice in the euro zone.

The volume of trading in bund futures has at times been sufficiently large that long positions in futures have exceeded the deliverable supply of bonds in the cash market, causing squeezes and other liquidity problems in that market. One recent development that may have some bearing on the situation is the decision in early January by Matif, the French derivatives exchange, to allow delivery of both bunds and French OATs against its notional 10-year bond contract.
B. Liquidity and government debt management

As a consequence of the adoption of the euro, certain regulatory restrictions on the portfolio holdings of institutional investors (e.g., insurance companies and pension funds) have been eased for many institutions. These restrictions have had the effect of providing a captive audience of investors for EMU sovereigns. Their removal enables domestic institutional investors to diversify out of the home country throughout the EMU zone. This, in effect, subjects EMU sovereigns to direct competition from other issuers, and intensifies the need for more active marketing on the part of debt managers. At present, an average of about 85 per cent of sovereign debt in the EMU area is held by domestic investors, but for some sovereigns, this share seems likely to decline going forward.

The need to step up marketing efforts has been apparent for some time and EMU governments have been striving to maintain the competitiveness of their respective bond markets by modernising the market structures used to sell debt to the public, by developing new products such as STRIPS and inflation-indexed instruments, and by granting regulatory approval for derivatives markets, repos, etc. Preparation for EMU also entailed efforts to bring outstanding debt in line with current interest rates. To achieve that goal, some EMU member governments “re-conventioned” existing bonds, while leaving the coupons on the outstanding bonds unchanged. Others have already established, and some plan to implement, exchange programmes whereby “new” bonds are offered for outstanding bonds. All of these steps have been taken to enhance liquidity. This is especially important for “smaller” euro countries, whose securities are unlikely to achieve benchmark status. Concerns about creditworthiness aside, if investors are not satisfied with the liquidity of smaller euro issues, they will either opt for the major bond markets or require sufficient inducement in the form of higher liquidity premia to hold the bonds in question. Either way, borrowing costs will clearly rise for those governments subject to these concerns.

This raises a question about the appropriate issuance strategy for smaller euro countries. While larger EMU governments will likely continue to issue debt in various maturities along the yield curve, this may not be a viable option for smaller governments, which lack sufficient volume to support a sizeable number of liquid issues. The same would be true of governments whose annual gross debt issuance is constrained because of improved fiscal positions due to binding debt/GDP targets according to the Maastricht criteria and the Stability and Growth Pact. Dispersing dwindling bond issuance across the curve would result in thin issues, which could not be easily traded and thus would entail larger liquidity premia.
Since issuance across the entire curve is not feasible for some governments, they will have to choose some other alternative. For example, countries may find it necessary to confine their issuance to specific maturities along the benchmark curve to take advantage of the greater liquidity in those areas of the curve. Alternatively, smaller countries might wish to confine their issuance to the gaps between the issuance nodes on the benchmark curve, in an attempt to achieve a sort of benchmark status of their own in that particular maturity. There might also be scope for coordination between smaller euro countries in their bond issuance. Arguments can be offered in favour of or against any of these options, and it remains unclear which strategy holds the most promise.

A similar question arises as to which approach to marketing the government debt of smaller EMU countries is preferable. Some analysts have argued that a network of committed primary dealers drawn from the ranks of international investment banks would help to market a government's issues to a wider investor base, thereby enhancing liquidity in the bonds. But if auctions are small in size and irregularly spaced, it is not clear that the primary dealer system dominates a strategy of opportunistic issuance through a large syndicate of investment banks. Thus far, syndication has been the arrangement of choice for smaller governments. Austria, Belgium, and Portugal all chose syndication to market their recent euro offerings.

II. The euro and the corporate securities markets

The advent of the euro brings a number of direct benefits for EMU participants, namely the removal of exchange-rate risk within the euro zone and the associated benefits of reduced transactions costs and more transparent pricing. With the reduction of exchange rate risk, the relative importance of other, less volatile types of risk, in particular credit risk, will likely increase. By removing the currency-risk component of cross-border financing costs, EMU is expected eventually to accelerate the development of corporate bond markets, as larger corporations attempt to lower their borrowing costs by improving their credit ratings and tapping the capital markets to take advantage of what is expected to become a large pool of investment capital, as pension funds and other institutional investors seek out the more attractive yields (at least relative to sovereign debt) on corporate offerings. Fund managers are expected to seek out a variety of euro-denominated securities, as they convert their asset allocation to match the re-denomination of their liabilities to the euro. These developments will take some time, as the investor base has not yet mastered all the requisite credit analysis skills, and a few, but important, regulatory and tax impediments remain.
A. Implications of the euro for asset management strategies

In practically all European countries, the vast majority of institutional investors are over-invested in domestic assets. Some analysts estimate that, on average, more than three-quarters of European fund assets are invested in instruments offered by entities in the fund’s domestic markets, and roughly the same proportion of government debt is held by domestic investors. To some extent this may simply reflect a preference for instruments issued by local borrowers with which the fund managers have the most familiarity, but it also reflects the desire of investors to avoid exchange-rate risks, as well as regulatory impediments such as asset-liability and currency matching requirements that have limited the amount of foreign currency-denominated investments held by some types of financial institutions, namely insurance companies and, to a lesser extent, pension funds. With the single currency, investments in assets in other EMU-area countries in most cases automatically have been re-classified as domestic currency assets. This enables insurance companies and other previously constrained investors to shift more of their portfolios outside their domestic borders. However, it is difficult to discern the exact form and size this portfolio re-allocation will take.

Heretofore, asset managers have pursued country-specific investment strategies, with currency positioned at or near the top of the decision ladder, followed by market sector, and then, depending on risk preferences, a yield-curve decision regarding duration/convexity. In an EMU environment, the borders of the “domestic” capital market have been expanded, which allows EMU-based investors to switch their strategies from a focus on segmentation by currency to diversification on a sectoral basis. With currency concerns diminished, the pricing of bonds should become more transparent, so individual company risk can be assessed more accurately. Most market participants expect the increased transparency to induce Europe’s relatively conservative investors (at least in comparison with their US counterparts) to assign more weight to credit risk in the analysis of investment alternatives, especially in light of declining rates on government paper.

Interest rates in the EMU-area generally have remained at historically low levels; thus, to enhance the returns of their bond investments, investors will probably have to turn to higher-risk, credit-driven performance strategies. This shift in focus would tend to be reflected in both issuers and investors paying increased attention to credit ratings. Furthermore, the European market of the future will consist of bonds across the credit ratings matrix. In the past, the ratings assigned to the bond offerings of European companies were clustered in the triple-A and double-A categories. Lower-rated companies generally have been unable to access the capital markets. In the past couple of years, however, the share of ratings in the highest two categories has declined, as more and more companies with lower ratings have
successfully brought issues to market. In fact, in 1997, over half of the new corporate issues rated by Standard & Poor's carried ratings at double-B or below, as the market in high-yield corporates took off.

Much of the funds controlled by institutional investors is actually managed by professional asset managers. These fund managers compete actively for mandates to manage funds from, for example, pension plans, foundations and life insurance companies that are often based on the managers' investment performance. Increasingly, emphasis is being placed on a portfolio’s performance against a broad benchmark index. Faced with nominal yields on government bonds that remain at or near historical lows, and flat term structures associated with declining inflation expectations, which offer little scope for yield pick-up by increasing duration, EMU-based fund managers have an incentive to increase their holdings of corporate debt. Some movement in this direction has already begun, but the euro is expected to facilitate this shift.

B The euro and growth of the corporate bond sector

Historically, European bond markets have been dominated by sovereign issues, followed by offerings by supra-national agencies, and other government-guaranteed entities. On the supply side, issuance of corporate debt has been low as European corporations generally have relied on close banking relationships for their working capital and strategic funding needs. In contrast to the norm in the US, European corporations have not tapped the capital markets on a regular basis. Many European corporations raise nearly all of their funds from their relationship banks, while US banks supply only about a third of the capital raised by the corporate sector.

Many analysts expect the single currency to result in a significant increase in the supply of euro-denominated corporate bonds, as the more liquid and deeper EMU capital market will lower borrowing costs both for EMU-based companies and for non-EMU borrowers raising funds through euro-denominated instruments. To the extent that borrowing costs for euro-denominated assets are relatively low, foreign issuers, including emerging market borrowers, would have incentives to capture some of the surplus savings being generated in the EMU-area. In the wake of the euro’s launch, a large number of euro-denominated issues came to market and euro-denominated issues accounted to over half of all international bond issues in January. Hungary became the first emerging market borrower to fund in euro, raising € 500 million in a Baa2/BBB-rated issue priced at 87 basis points over the yield on the 10-year bund. The volume of euro-denominated issues offered in January included a large number of Pfandbriefe bonds, and it seems unlikely that the January
pace will be sustained in coming months. Even so, the aggregate volume of euro issues may hold above the historical one-third share of the combined constituent currencies, as non-EMU borrowers come in to tap the growing liquidity of the market.

C. Implications of the euro for portfolio diversification

Other demand-side factors expected to support the growth and development of a strong euro-denominated corporate bond sector include the upward trend in the use of private pension schemes, as well as other means of encouraging savings on the part of European countries’ ageing populations. Budgetary restrictions embodied in the EMU accords limit the ability of member governments to solve the problems of state pension systems through traditional fiscal measures. Thus, the need to generate sufficient returns for the future is likely to entail an increase in the demand for safe, but higher yielding, fixed-income securities, and a greater role for equities as well. In addition to maximising returns, investors are likely as well to perceive the benefits of offsetting the higher risks of individual issues by holding diversified portfolios of bonds, which eventually could lead to an increase in diversification across borders. Demand for euro-denominated corporate debt is also likely to come from investors outside the euro area, as a means of diversifying their own portfolios. Recent data indicate, for example, that some Japanese investors have begun to re-weight their portfolios from dollar-denominated to euro-area bonds, although most of the institutions making the switch, thus far, have opted for sovereigns rather than corporates.

The increased use of securitisation, which in some variants segments assets from the institution that originated them and enables risk to be split into different tranches, provides evidence that the corporate bond markets in Europe have begun to expand. This financing technique has contributed to the start of a broader European market in non-sovereign debt, as classic fund managers such as pension funds, mutual funds, and life insurance companies have begun to develop the credit assessment skills necessary to evaluate the various asset-backed securities (ABS) alternatives. As their understanding of the complex interest rate/credit risk interactions have grown, a few dedicated portfolio managers at some of the larger European funds have even moved down the credit spectrum toward higher yielding ABS structures and high-yield bonds. However, these particular funds tend to be very specialised entities and most European institutional investors have continued to pursue relatively conservative investment strategies. Indeed, investments in ABS by most mainstream European investors have been concentrated in the deals’ senior, triple-A rated tranches. The more subordinated tranches of European ABS have been allocated to a relatively small number of specialist investors, but even these investors have avoided the first-loss positions, which typically have been sold primarily to US investors.
Despite the continued preference for relatively safe investments by most European fund managers, analysts believe that institutional investors in Europe have begun to develop the necessary credit analysis skills, as reflected in the growth in markets for both high-yield bonds and ABS early last year. However, activity in both sectors subsequently slowed in the wake of financial market turbulence and has yet to recover fully. Nonetheless, history suggests that periodic bouts of volatility do not do any permanent damage to markets for ABS and high-yield bonds, and eventually both markets will recover and again find favour with institutional investors.

III. The euro: increased competition and faster structural changes in the financial landscape

EMU is expected to intensify competition among providers of investment services in all segments of asset management (pension funds, life insurance companies, investment funds and private banking) and this competition is expected to become increasingly cross-border. Many financial institutions, which heretofore were relatively large players in their domestic market, will become small or medium-sized participants in an EMU context. This increases the incentives for institutions to expand the scale of their European operations and, thus far, has encouraged a number of local and pan-European mergers and acquisitions (M&A) and joint ventures. A few of these combinations have involved non-European institutions. More M&A activity seems also likely to occur, both between European counterparts and with entities based outside Europe. It is far from clear, however, whether these new combined entities will prove successful in all or most parts of their business activities, especially in an environment characterised by more intense competition and an increased focus on profitability.

As indicated before, the introduction of the euro laid the groundwork for a vastly enlarged capital market in the euro area. By removing a number of hurdles to cross-border linkages, EMU, in theory, creates opportunities for a wider distribution of financial services, including wholesale underwriting, and pan-European asset management, operating services, and consumer/private banking. As more efficient global providers enter the market, regional competitive advantages should diminish. Institutions that can offer services across the EMU area in a cost-effective manner are expected to be the big winners, but there is room for niche players as well, who retain a local market expertise and can assist lead investment banks in placing securities with retail investors.

To date, EMU has been the driver of considerable restructuring and consolidation in the European financial sector, as institutions have sought to capture as much EMU-wide market share as possible. At the forefront of this change are the investment
banks, which have invested heavily to position themselves to take advantage of perceived opportunities in the EMU capital markets. Both European and US bankers have expended considerable effort and resources in expanding their London and Frankfurt-based operations, expecting Europe’s capital markets to develop greatly over the next few years. Although investment banks have received a lot of attention, commercial banks have been quite active as well. European banks traditionally have allocated most of their capital to serve their corporate and sovereign clients through relationship-based lending. Some analysts contend that many European banks have maintained these relationships at the expense of profitability. A considerable amount of restructuring was underway well before the launch of the euro, and managers of banks and other financial institutions in the eurozone had begun to implement revised operations strategies and to pay much more attention to shareholder value. What EMU has done is to reinforce the existing trends in the banking sector.

A. The euro and increased competition for the commercial banking sector

For commercial banks, the euro poses a serious threat to profitability. Compared with the more efficient providers of banking services, many European banks are relatively overstaffed and over-branched. Thus, the boost to competition expected to follow the euro’s launch should expedite the pace of consolidation in this sector. For the typical large commercial bank, foreign-exchange trading, corporate banking and government bond trading together account for over half of profits. One consulting firm, McKinsey & Company, predicts that European bank revenues in these three businesses will fall by a fifth over the next decade or so. Profits derived from trading euro-area currencies against one another vanished on 1 January 1999.

The corporate banking book is considered to be a potential source of weakness. For some time, banks have found it difficult to lend profitably to big companies. Prior to the early-1990s, big companies used to rely primarily on a series of one-offs (bilateral loans) arranged with several banks. Around that time, however, corporate borrowers found it more cost effective to pay agent banks to arrange, syndicate and administer loans. By mid-decade, pricing on these investment-grade and near-investment grade loans had become much more aggressive, with both upfront fees and utilisation fees declining toward their late-1980s lows in the midst of intense competition (see Chart 1).

Loan fees began to turn up late last year in the wake of the global financial market turmoil, as banks came to realise that many deals had been priced with razor-thin margins that were difficult to rationalise in the absence of sufficient ancillary business from the borrowers (see Chart 2). While pricing has become less
Chart 1. Undrawn fees on investment grade loans, since 1987

Source: Loan Pricing Corp./Gold Sheets.

Chart 2. Drawn spreads for syndicated loans, since 1987

Source: Loan Pricing Corp./Gold Sheets.
aggressive of late, loans to large corporate borrowers are perhaps still not a major source of profitability for most banks. The euro is expected to put even further pressure on this market segment, through the development of a single, liquid market in euro-denominated corporate bonds, which will compete directly with bank loans. A few large banks will be largely unaffected, having already wound down their corporate-loan books. Niche providers are likely to survive, as well, especially those catering to smaller clients, who often tend to exhibit inertia in establishing banking relationships. The greater pressure will likely befall banks with a sizeable volume of large corporate loans on their books. To compete effectively, many of these banks will likely opt for some form of securitisation of their loan books. A number of eurozone banks have already begun to pursue such a strategy.

EMU also seems likely to bring about a drop in the number of deposit and money market accounts held for treasury purposes, as companies both within the euro-area and outside will no longer have to maintain accounts in several currencies. Companies eventually may require only one master account for making euro payments and, thus, may reduce the number of their banking relationships in the euro area. Large, multinational companies, in particular, are expected ultimately to switch banks in order to streamline their cash-management operations across Europe. The use of electronic payments is already putting pressure on prices for banks’ payments services. Although banks may be able to price in some differential for processing cross-border payments, the euro is expected to add further impetus to the general downward trend in prices for payments services. Across the EMU area, the payments business is likely to become concentrated among a small number of relatively large providers, those with the technical skills and economies of scale to remain competitive. Many of these firms will be EMU-based entities, but the possibility exists that global providers will step in to provide the service.

This process toward Europe-wide banking will not be immediate, as some parts of national regulation still protect domestic banks. Eventually though, as corporations consolidate their banking relationships, lending margins will be compressed further and profitability from banking operations will decline. This development is expected to result in a further consolidation of banking services in Europe, as smaller institutions will be forced to either form larger, more efficient entities or face disintermediation and possible extinction at the hands of competitors with scale economies. Already, the pace of consolidation has increased, first at the national level and then Europe-wide as institutions have sought to attain the right mix of scale and scope.

Banks have not been passive as the financial services industry has consolidated. Many have invested heavily in trying to become leaders in euro-denominated bonds. There have also been a number of mergers between banks and insurance companies.
Also, cross-ownership between banks and the corporate sector in Europe gives relationship banking an edge in Europe, and regulations in some jurisdictions restrict competition from banks based outside Europe. Clearly, trading revenues from foreign exchange transactions between constituent currencies will vanish, but banks can, and some have, begun to move into other products and lines of business. The next few years will likely see further strategic alliances, as banks remake themselves to compete in the EMU environment.

B. Investment banks

Investment banks also have prepared for the increased competition expected to come with the development of a single corporated market. Given that these institutions generally are characterised by different corporate cultures (e.g., some have big retail networks, others are largely wholesale shops), their preparations also took different forms. Nonetheless, there are a few common themes: firms invested heavily to upgrade back-office and front-office systems; to realign government and eurobond trading groups; and, for those with EMU-based operations, to develop and implement a more intense focus on corporate credit, both for bonds and equity. Large US investment banks have been competing fairly aggressively to increase their share of the pan-European market, and are perceived by most observers to be further ahead in the process of establishing active euro funds and euro benchmark indices. They also are believed to have the superior credit analysis skills. In contrast, European bankers have a greater knowledge of European markets and have direct access to a more extensive European client base. This has clearly worked to their advantage in the early stages of the single currency. European service providers were dominant as lead managers for most of January’s heavy volume of euro offerings. However, this, too, may reflect the large share of pfandbriefe, which tend to be managed by domestic, hence, EMU-based, institutions. Going forward, competition for new credit underwriting business is expected to be fierce.

EMU is but part of a number of structural forces that are influencing the development of the financial services sector in the EMU area. These factors include ongoing economic and financial deregulation, increased saving on the part of ageing populations in OECD countries, continued technological and financial innovation, and until the Asian crisis hit, strong economic growth in emerging economies. Increasingly, the provision of financial services is developing into a sector dominated by a relatively small number of firms with global capacity, with the remaining firms operating on a regional or more local basis. Over the next several years, the number of cross-border linkages is likely to increase. The asset management business in Europe is likely to experience some consolidation as well.
C. Mutual fund sponsors

Last year’s global financial market turmoil occurred at a time when competition for market share among European firms had been intensifying in the run-up to EMU. The unsettled market conditions may have placed temporarily on hold efforts of investment managers to adapt to the euro. At that time, a number of US investment banks with mutual fund affiliates were actively exploring whether to establish funds targeted to European investors. Also in the works were high-yield products and Europe-only high-yield funds. The Brazilian crisis, though not as severe, may have forestalled a resumption of these particular activities, but eventually the number of euro-zone funds is expected to increase sharply.

Mutual fund sponsors in the US have for the past several years offered over 100 funds that give US investors exposure to European markets. According to Chicago-based Morningstar Inc., more than thirty of these funds were started in the past couple of years, as mutual fund companies geared up for the start of EMU. A few fund complexes also started funds in Europe, either by setting up stand-alone operations (e.g., Fidelity and Vanguard Group) or by purchasing existing European franchises (e.g., Merrill Lynch’s acquisition of Mercury Asset Management). Other US-based providers are reported to be in the initial stages of amassing assets. Thus, far, however, US-based funds account for a very small share of total assets of mutual funds distributed in Europe. As in other financial service areas, however, competition is said to be intensifying in the wake of the euro’s launch.

At stake is a share of what is expected to be a rapidly growing market as the single currency leads to an acceleration of the pension reform process that is currently underway. The Bank of England has estimated, for example, that pension assets in Europe will total $1 800 billion by the year 2001, roughly three times the volume in 1996. A similar increase is expected for growth in insurance company assets, from around $2 600 billion in 1996 to about $6 300 billion in 2001. The combined expansion in assets is expected to contribute to the growth and development of the pan-European financial market, especially in equities.

In comparison with their US counterparts, who have been active investors in equity mutual funds for the past decade, European investors have less experience with this particular investment option. Thus, European-based funds have not developed to the same extent. However, going forward, fund sponsors expect interest in the mutual fund concept to increase among European investors and the number of retail mutual funds is expected to increase sharply. A number of new funds have already been introduced that target the retirement income market. In addition to actively managed funds, index funds are starting to appear as well. These are being positioned to track one or another of the new benchmark indices that have
been offered. Some of these indices incorporate only large, blue chip issues to capture liquidity; others are broader, encompassing as many securities as is practical. There are three main groups of indices currently in existence for pan-European portfolios: i) the Morgan Stanley Capital International indexes for Europe and the EMU area, which are used by many US investors; ii) the Financial Times/S&P Europe and Eurobloc and the narrower Eurotop 300 and 100 indices, which are generally preferred in the UK; and iii) the various Dow Jones/Stoxx indices. In addition to these groups are indices that have been launched by Salomon Smith Barney, J.P. Morgan, Lehman Brothers, and Merrill Lynch, which are all US-based operations, and one by Barclays Capital, which thus far is the only European bank to offer an index for the pan-European market. Judging from the US experience, not all of these indices will prove successful, but there is scope for two, possibly, three across the pan-European market.

Summary

By eliminating currency risk for EMU participants and reducing transactions costs, the advent of the euro is expected to contribute to the development of an integrated government bond market denominated in euro. But EMU sovereign issuers, which heretofore have been positioned at the top of their national credit market, might potentially lose a once-captive investor base going forward. Sovereign borrowers will have to compete against other sovereign borrowers in the EMU-zone, as well as against private-sector borrowers. Some sovereigns might also lose their benchmark status, as the market comes to price against a single reference yield curve in euro. A given sovereign’s yield spread to the curve will depend in part on the liquidity of its issues. With that in mind, most EU sovereigns were active in attempting to increase the liquidity of their issues ahead of EMU.

With a reference benchmark yield curve in place, represented at the short end by rates on overnight repo transactions, the single currency will eventually result in a strong focus on credit risk analysis, with EU-wide corporate securities being priced against the single benchmark curve. Credit ratings should take on increased importance in the new environment. The increased focus on credit risk is expected to result in the development of broader and deeper corporate bond and commercial paper markets, characterised by liquid investment pools for multi-tiered credits. The market for corporate equities is expected to expand as well, with an acceleration of the existing move towards sectoral allocation rather than the prevailing country-specific focus. At a minimum, the single currency seems certain to help lower hedging and other associated costs, but a fully integrated market will not develop overnight. Investment strategies that have been established over the course of many years are unlikely to change immediately. For one, the global financial crisis likely
has damped some enthusiasm for strategies entailing increased credit risk, and the de-leveraging process that was precipitated by the crisis may not have fully run its course. In addition, many investors have not yet fully developed the necessary credit analysis tools. But efforts in this regard are certainly underway, and many of the fundamentals for the development of an integrated pan-European capital market are now in place.

Residual concerns still exist, however. Generally, these revolve around remaining structural, regulatory, fiscal and other impediments that hinder the potential for the supply of efficient EMU-wide financial services. For example, the International Swaps and Derivatives Association has indicated that “the procedure for perfecting collateral in some member states is too cumbersome and the position on cross-border use of collateral is murky“. In addition, legal uncertainties arise from a lack of specificity over which member states’ rules should apply in cross-border dealing. Other participants have noted that national laws in some jurisdictions still protect domestic banks, inhibiting the development of cross-border banking services. There are also concerns about the inconsistent withholding tax treatment across borders. Despite these concerns, however, most market participants believe that the integrated market will become a reality. The relevant question for many is when, rather than if.
Notes

1. This article was contributed by Stephen L. Lumpkin, Senior Economist and Principal Administrator, Division of Financial Affairs, Directorate for Financial, Fiscal and Enterprise Affairs, OECD.

2. An example are currency matching requirements, which were intended to minimise the exchange rate risk associated with obligations to policyholders and fund claimants being denominated in one currency while the assets used to fund them are denominated in another.


4. A number of US investment banks and European-based Barclays Capital have sought to develop an index that will become the benchmark for the future euro-denominated bond market.


6. For example, Japanese participant in government bond auctions in France and Germany in early January was sufficiently heavy that the auctions were over-subscribed by a factor of two to three.

7. In Europe, on-balance sheet securitisations have been by far the dominant form of issuance. However, increased competition has led some banks to begin structuring off-balance sheet transactions to reduce regulatory capital charges and improve returns. Issuance of collateralised loan obligations, for example, was quite strong before the onset of unstable financial market condition.