

The Impact of the Euro's Introduction on Financial Restructuring and Capital Markets in the Euro Area

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1. Introduction

Two and a half years have elapsed since the introduction of Europe's single currency in January 1999. With Greece joining in 2001, the number of euro area members now stands at twelve.

Countries participating in the euro must relinquish their authority to conduct independent monetary and foreign exchange policies. In return, they hope to attain the political goals of peace and stability, as well as economic benefits.

The economic benefits of introducing the euro include the enhancement of cross-border competition by reducing foreign exchange costs and enabling direct price comparisons in different countries. In addition, the creation of large euro-based financial markets is expected to significantly contribute to economic efficiency and productivity.

In this paper, we examine progress toward integration in the financial industry, a key element for success in currency unification. We first discuss the transformation of capital markets in the euro area, and then examine how financial institutions are meeting the challenge.

Immediately prior to the euro's introduction, capital markets were expanding amid lower interest rates, increased M&A activity, and the hi-tech boom, while financial restructuring was also accelerating. However, after the euro's introduction, the financial markets have remained segregated due to unresolved differences in regulation, taxation, and accounting systems. As a result, the full benefits of financial integration have yet to be enjoyed. Toward this end, sustained efforts are needed by all members to coordinate macroeconomic policies and harmonize conflicting systems.

2. Transformation of Capital Markets

(1) Characteristics of the Financial Structure in the Euro Area

Among continental members of the euro area such as Germany and France, the main form of financing is indirect financing centered around banks.

Under the universal bank system, companies have depended heavily on banks for both long-term and short-term financing. Bond financing has been minor due to its higher cost and the underdeveloped condition of the bond rating system. Stock markets have been hindered by the practice of bank stock-holding, reluctance of companies to relinquish control to stockholders, and investment regulations on institutional investors.

Due to these background factors, both the bond and stock markets are smaller than the bank lending market, and smaller than their counterparts in the U.S. and Japan (Figure 1).

Figure 1 Comparison of Market Size

| | Date | Unit | Euro area | U.S. | Japan |
|-----------------------|-------|------------------|-----------|----------|---------|
| Population | 12/99 | Million | 304 | 273 | 127 |
| Nominal GDP | 2000 | Bil. euros | 6,530.2 | 10,621.2 | 5,148.5 |
| Bank deposits | 12/00 | Bil. euros | 5,270.2 | 6,171.8 | 5,858.1 |
| | 12/00 | <i>GDP ratio</i> | 81% | 56% | 115% |
| Bank loans | 12/00 | Bil. euros | 6,926.8 | 5,591.0 | 5,021.8 |
| | 12/00 | <i>GDP ratio</i> | 106% | 50% | 99% |
| Domestic bonds | 9/00 | Bil. euros | 5,782.7 | 16,440.1 | 7,258.0 |
| Outstanding issues | 9/00 | <i>GDP ratio</i> | 89% | 155% | 141% |
| Corporate | 9/00 | Bil. euros | 277.9 | 2,757.7 | 840.4 |
| Financial | 9/00 | Bil. euros | 1,937.5 | 4,553.3 | 919.0 |
| Public | 9/00 | Bil. euros | 3,567.3 | 9,129.1 | 5,498.6 |
| Stocks | 12/00 | Bil. euros | 5,660.7 | 16,142.9 | 5,866.1 |
| Market capitalization | 12/00 | <i>GDP ratio</i> | 87% | 152% | 114% |

Sources: BIS, IMF, ECB

The bond and stock markets are also immature from a quality perspective. In the U.S., where direct financing is well developed, companies have a variety of financing options depending on their growth stage, creditworthiness, and needs: bank lending, venture capital, stock market, bond market, and commercial paper. Venture companies, who have played a leading role in the hi-tech industry, rely heavily on sources that supply risk capital.

Corporate restructuring and the growth of new venture businesses are critical to industrial competitive-

ness and productivity growth in Europe. To provide the necessary financing, it is critical to improve the functioning of capital markets and enhance risk capital.

(2) Capital Markets After the Euro's Introduction

The largest impact of the euro on capital markets in the euro area has been to reduce foreign exchange risk, a factor which used to segregate national markets. For institutional investors, investment in the euro area is no longer restricted by foreign currency requirements, thereby simplifying cross-border investments.

In addition, with financial institutions competing across national borders, financing and transaction costs are expected to decline. Interest rates declined significantly in some countries in anticipation of the euro's introduction, and outstanding government bonds were reduced under the Stability and Growth Pact aimed at maintaining fiscal soundness. In addition, against the backdrop of the population's aging and pension reform, the shift in assets to institutional investors is also expected to accelerate the flow of funds into bond and stock markets.

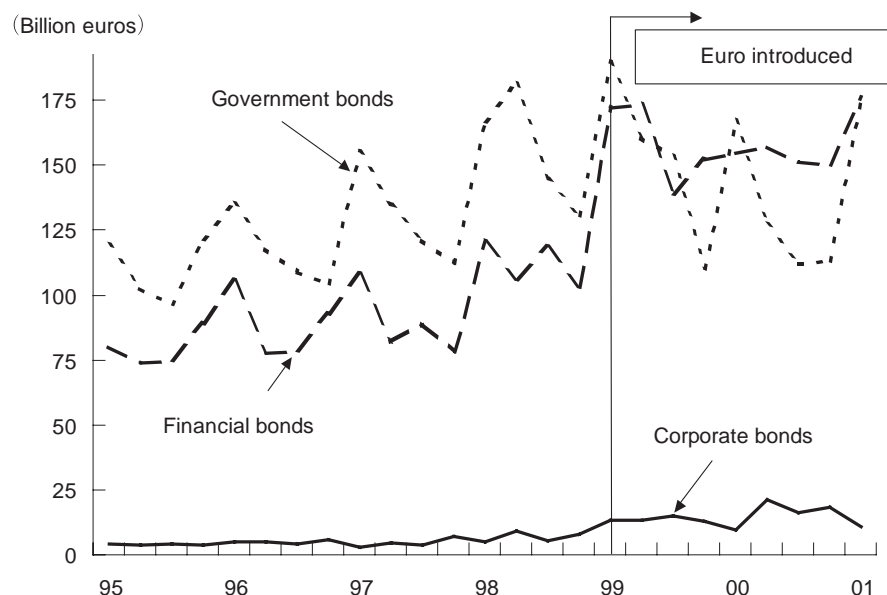
1. Bond market trends

Following the euro's introduction, while the issuance of government bonds was restrained, the financial and corporate bond markets grew sharply due to a rush of euro-denominated initial issues, and a strong demand for funds to finance M&A activity.

However, as these factors faded, and higher interest rates and a weak euro prevailed through the fall of 2000, the market's growth began slowing since mid 2000 (Figure 2).

Despite the corporate bond market's remarkable growth since the euro's introduction, it remains miniscule compared to the government bond and financial bond markets, as well as the U.S. and Japan corporate bond markets.

Figure 2 Euro-Denominated Debt Securities Issued by Euro Area Residents



Note: Shows gross issuance of bonds longer than one year. Prior to the euro's introduction, the aggregate of bonds denominated in separate currencies is shown.

Source: Compiled from ECB statistics.

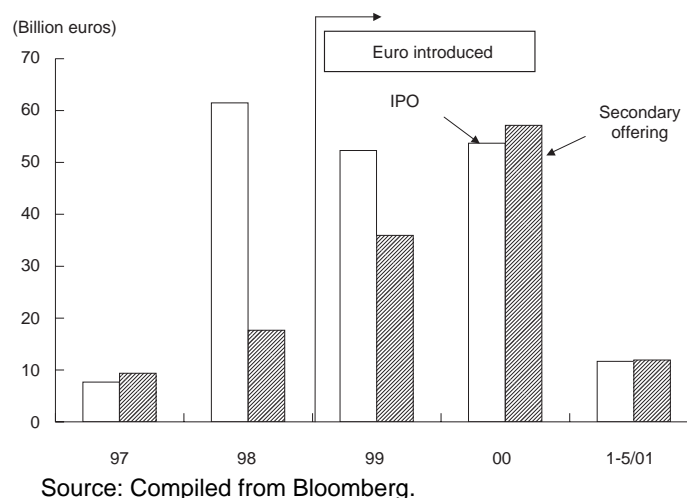
2. Stock market trends

Financing in the stock market has grown sharply since 1998 due to privatization and initial and secondary public offerings of IT and hi-tech companies.

In particular, new stock markets have been established since 1996 to encourage venture businesses, including the Nouveau Marche in France, and Neuermarkt in Germany. The growth of these markets has been phenomenal — the total number of companies listed on the venture stock markets of Germany, France, Italy, Belgium and the Netherlands has grown from 63 in January 1998, to 564 as of the end of 2000.

However, growth has slowed significantly in 2001 due to the sluggish U.S. economy, as well as stock market corrections (Figure 3). With growth expectations for IT industries being revised downward, the stock markets for venture businesses have entered a severe correction phase.

Figure 3 Initial and Secondary Public Offerings in the Euro Area



(3) Toward Further Capital Market Integration

1. Status of market integration

Since the euro's introduction, all transactions and settlements on securities exchanges in the euro area have been conducted in euros, thus eliminating currency barriers that had once caused the segregation of national markets.

However, due to persistent barriers arising from differences in legal, tax and accounting systems, as well as market practices, settlement systems have yet to be integrated.

As a result, while cross-border, short-term interbank transactions have increased, securities transactions have not grown as expected due to complex procedures and high costs.

Thus at the present time, the euro has yet to produce the full benefits of area-wide market integration in the domains of financing and asset management.

2. Integration of exchanges

Competition has intensified among securities exchanges in the euro area to attract new listings and transaction orders. Exchanges must integrate or merge to survive, creating strong pressure for securities settlement institutions to either collaborate or integrate.

In northern Europe, exchanges in Denmark and Sweden merged in January 1998 to form Norex, which has continued to grow in the region. Moreover, in September 2000, the Paris, Amsterdam, and

Brussels exchanges merged to form Euronext.

The planned merger of Europe's top two exchanges in England and Germany was cancelled due to opposition from London Stock Exchange stockholders and an attempted hostile takeover of that exchange by Norex stockholders. Further developments are being watched with anticipation.

3. Standardization of securities exchange rules

The standardization of securities exchange rules is making progress despite a slow start. Under the consensus of national leaders, the Lamfalussy Group of Wise Men compiled a securities reform proposal that calls for initiating a European Securities Commission by the end of this year, and establishing common disclosure and listing standards by the end of 2003.

The establishment of common rules is expected to be a tedious process due to the very complexity of the endeavor as well as to the balancing of national interests.

3. The Accelerating Pace of Financial Restructuring

(1) Changes in the Environment Surrounding Europe's Financial Institutions

1. Institutional arrangements following market integration

Ahead of market integration in the EU, the following practices have been established by law: the single passport rule, in which a certificate or license from authorities in one country enables a company to provide financial products and establish branches in other countries; the universal bank principle, which allows a wide range of operations including banking, securities, and asset management; and home country control, in which the country issuing a license is responsible for supervision.

In addition to securities operations, banks can engage in insurance sales, and also have subsidiaries engage in the insurance business. Insurance companies can engage in banking through subsidiaries.

2. Changes in the business environment due to the euro's introduction

As expected, currency integration is reducing foreign currency fees charged by banks and interest rate spreads by stimulating international competition. In addition, the strengthening of investment banking, asset management, and insurance operations have become critical issues due to the tendency of large companies to seek financing in capital markets, the increase in M&A related funds demand, and the shift of individual financial assets to institutional investors.

Insurance companies are also being challenged by the increased international competition from the elimination of currency-based product differences, and in meeting increased demand due to a wider product selection and the growth of individual annuities.

(2) Characteristics of Financial Restructuring After Currency Integration

Restructuring among financial institutions in Europe began in the mid 1980s. Since 1998, restructuring has been characterized by increases in both frequency and size.

During this period, restructuring has accelerated due to many factors including: the euro's introduction, financial liberalization and privatization, increased competition due to the aggressive entry of U.S. investment banks, and pressures to increase IT investment.

In addition, financial restructuring has been facilitated by the expansion of opportunities for large-scale financing in capital markets, and ease of M&A activity due to high stock prices.

Financial restructuring can be categorized into four patterns depending on whether they involve cross-border or cross-sector combinations. The patterns, which are based mainly on M&A activities, have the following objectives and characteristics (Figure 4).

Figure 4 M&As and Financial Restructuring in the EU (Since 1999)

| | | Country | |
|--------|--------------|--|--|
| | | Domestic | International |
| Sector | Same-sector | BNP (Fra., bank) — Paribas Banca Intesa (Ita.) — Banca Commerciale Italiana Banco Bilbao Biscaya (Spa.) — Banco Argentaria Banco Santander (Spa.) — Banco Central Hispano Generali (Ita., insur.) — INA (Ita.) | Hypo-Vereinsbank (Ger.) — Bank Austria (Aus.) AXA (Fra., bank) — Guardian Royal Exchange (U.K., insur.) Aegon (Ned., insur.) — Transamerica (U.S., insur.) |
| | Cross-sector | Allianz (Ger., insur.) — Dresdner Bank Lloyds TSB Bank (U.K.) — Scottish Widows (insur.) | Deutsche Bank (Ger.) — Bankers Trust (U.S., inv. bank) Allianz (Ger., insur.) — PIMCO (U.S., asset mgt.) ING (Ned., conglom.) — BBL (Bel., bank), BHF (Ger., bank) Dresdner Bank (Ger.) — Wasserstein Perella (U.S., inv. bank) Dexia (Fra./Bel., bank) — BIL (Lux., bank), Kempen (Ned., inv. bank) |

Source: Compiled from news reports, Bloomberg.

1. Domestic same-sector M&A

The objectives of M&As in the same sector and country include streamlining operations and reducing capacity, expanding market dominance and strengthening the capital base, diversifying financial products and services, and reducing IT investment costs necessary for risk management.

The restructuring wave that began in the mid 1980s among small and medium-sized financial institutions spread to the major institutions: the 1999 merger of BNP and Paribas in France, as well as large mergers in Italy and Spain.

2. Domestic cross-sector M&A

The objectives of entering other sectors and diversifying operations include risk dispersion, efficient use of management resources, and achieving synergy.

In the cross-entry of banks and insurance companies, Europe is ahead of the U.S. and Japan. In addition to establishing subsidiaries, business collaboration is widespread because it provides benefits to both sides: banks can expand into insurance, annuity, and investment trust products, while insurance companies can expand their sales channels.

Of the cross-sector M&As in the euro area, the acquisition by Allianz, Germany's largest insurance company, of the country's third largest bank, Dresdner, has been focused on for its impact on the strategy of other major financial institutions.

3. International same-sector M&A

Among banks, the most prominent cross-border M&A activities are those involving U.S. banks, and banks in emerging markets, where there is still room for growth for traditional banking operations.

In Europe, such activity is limited outside of the northern countries and three Benelux countries. The lack of widespread M&A activity among the main European countries can be attributed to institutional differences that impede financial integration, and to differences in forms of corporate culture and governance. In insurance, advances are occurring in acquisitions by U.S. and U.K. insurance companies, as well as cross-border restructuring in the euro area.

4. International cross-sector M&A

Cross-border, cross-sector M&A activity is primarily aimed at strengthening investment banking and asset management functions by acquiring U.S. companies. A typical case is Deutsche Bank's acquisi-

tion of Banker's Trust in 1999.

Such activity is often designed to reconstruct business portfolios by expanding into strategic sectors and selling off subsidiaries in non-strategic sectors.

(3) Financial Restructuring: Results and Challenges

Due to the accelerating pace of major restructurings since 1998, the ranking of financial institutions in Europe has altered significantly.

Overall, the financial system has been altered by the following trends: decrease in number of financial institutions, growth in net assets and employees per institution, concentration of business, and decline in government ownership ratio.

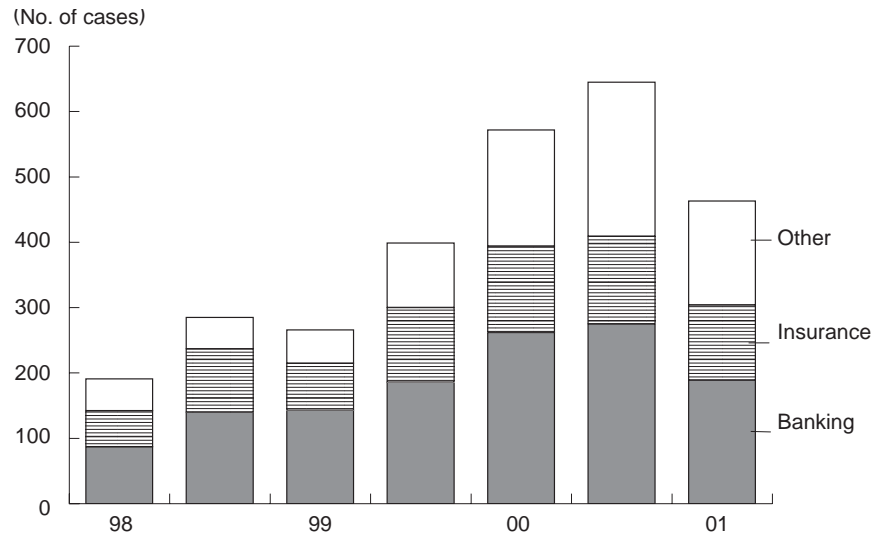
However, the pace of change is not uniform throughout the euro area. For example, countries differ in the concentration of market share among top financial institutions and government ownership ratio depending on the traditional structure of financial systems and political conditions. Disparities also need to be corrected to ensure fair competition, such as the government guarantees extended to Germany's savings banks.

Moreover, some deeply rooted factors are depriving the euro area of important benefits of restructuring. For instance, labor market rigidity and political friction are obstructing labor cuts and other rationalization measures. In addition, in the absence of a European company law, the restrictions impede the optimal execution of business strategies — for example, mergers cannot be carried out if acquired companies are dissolved and absorbed, and the integration of subsidiaries is difficult.

While M&A activity has lost some momentum due to stock market corrections and the poor environment for bond issuance, the latent demand for financial restructuring in Europe remains strong amid the increasing global competition and vertical and horizontal integration (Figure 5).

Along with achieving a genuine integration of financial markets through institutional harmonization, it is critical that a supervisory scheme be established to promote the growth of financial institutions across sectors and national borders.

Figure 5 M&A Activity of Financial Institutions in Europe



Note: Includes results up to May for first half of 2001.
Source: Compiled from Bloomberg.

4. Future Prospects

The circulation of euro paper and coin currency begins at the start of next year. After circulation of national currencies is phased out in one to two months, the final stage of the euro's introduction will be complete. However, at the present stage, the integration of the financial sector and capital markets in the euro area remains partial due to delays in harmonizing institutional arrangements.

After its introduction, the euro's exchange rate declined quite consistently, and has subsequently been unable to rebound. The euro's weakness is caused by a net capital outflow to the U.S. and elsewhere, against the backdrop of disparities in economic conditions, interest rates, and size and depth of capital markets, as well as low confidence in the European Central Bank's unproven policy management.

There also remains the problem that coordination among members would prove difficult if some exogenous shock causes disequilibrium in the euro area. Of the methods to restore equilibrium, currency adjustment no longer exists as an option, while fiscal policy is constrained. Meanwhile, income redistribution through the EU budget is limited in both scope and scale. With regard to the movement of factors of production within the area, labor mobility is limited, and smooth capital movement is also severely impeded as discussed earlier.

At the present stage, many challenges remain to be met before the full benefits of the euro's introduction are realized. Toward this end, the sustained efforts of member states to coordinate macroeconomic policies and harmonize institutional arrangements are critical.