The euro area one year after the introduction of the euro: key characteristics and changes in the financial structure

The euro was launched successfully one year ago. The single monetary policy for the euro area conducted by the Governing Council of the ECB since the beginning of 1999 is based on area-wide economic developments. To put into perspective the environment in which the single currency was adopted, some key structural features of the euro area, such as the scale and openness of the economy and the financial structure, were reviewed in an article in the January 1999 issue of the ECB Monthly Bulletin. It was noted that these features are quite distinct from those prevailing in individual Member States before participating in the euro area, and it is therefore important to bear these differences in mind when undertaking an economic analysis of the euro area. Many structural characteristics of the euro area economy as a whole have changed little during the past year, but the introduction of the single currency has already had a significant impact on the structure and development of the euro area financial markets. This article describes key structural features of the euro area economy and the main changes which have occurred in financial markets. These changes include, most notably, the rapid integration of the national money markets into one euro area market and the rapid growth of the euro-dominated private bond market, the latter providing various options for corporate financing in the euro area.

1 Key macroeconomic features of the euro area

The euro area has considerable weight in the global economy

A number of key macroeconomic features of the euro area are highlighted in Table 1, using the latest information available from various sources. Where necessary, comparisons between the euro area, the United States and Japan are generally based on converting national data into a common currency using the exchange rates prevailing in the corresponding period, unless otherwise indicated. As noted in the January 1999 issue of the ECB Monthly Bulletin, the euro area, in a global comparison, is a "large economy" which has significant purchasing power, exceeded only by that of the United States. According to the latest available data, the Member States of the euro area together have a share of world GDP of around 15½%. This is less than that of the United States (at 20¾%), but around twice that of Japan (at around 7½%). By comparison, the largest single euro area country is estimated to have a share of world GDP of only 4½%.

Considering the sectoral breakdown of activity in the euro area as a whole, the latest available data suggest that patterns of production are broadly similar to those of the United States and Japan. The services sector is the largest, accounting for about 67% of total production; it is thus smaller than that of the United States (at 72%) but higher than that of Japan (at 60%). The industrial sector (including construction) accounts for just below a third of the total activity in the euro area. This is higher than in the United States but somewhat lower than in Japan. Finally, primary production, such as agriculture, fishing and forestry, is similar in all three economies, and limited to around 2% of the total output.

The euro area comprises a significant share of world trade

With regard to its role in world trade, the euro area has the highest share of world trade, with a ratio of exports to total world exports above that of either the United States or Japan (at around 19½% compared with 15% and 8½% for the United States and Japan respectively). The degree of openness, as measured by the average of exports and imports of goods and services as a percentage of GDP, is higher than in the United States or Japan, at 16% compared with 12% and 10½% respectively. At the same time, it remains true that most trade for individual euro area countries takes place with other euro area countries. From an area-wide perspective this is internal trade and hence is unaffected by exchange rate movements of the euro vis-à-vis other currencies. This constitutes an important distinction, as prior to Monetary Union individual Member States were considered "small or medium-sized open economies", with significantly higher ratios for the average of exports and imports of goods to GDP. For the euro area as a whole, exports of goods as a percentage of GDP was just over 13% in 1998, while imports of goods were slightly above 11%. External trade in services is significant, but less than that for goods, with exports and imports of services as a percentage of GDP at around 4%.

A further important feature of trade from the perspective of the euro area as a whole is its geographical distribution (see Chart 1). The United Kingdom, the United States, Switzerland and Japan (ranked in order of their trade shares) together account for approximately 43% of overall external trade for the euro area. Other non-euro area EU countries account for a further 8%. In addition, Russia and China are both significant trading partners, while trade with four other Asian economies, namely Taiwan, South Korea, Hong Kong SAR and Singapore, together comprise a further 5½% of the total. The central and eastern European countries account for around 7% of the total. If this trade is examined in terms of its composition, machinery and transport equipment, other

Table 1

Key characteristics of the euro area

	Reporting period	Unit	Euro area	United States	Japan
Population [1]	1998	mn	291	271	126
GDP (share of world GDP) [2]	1998	%	15.5	20.8	7.4
Sectors of production [3]					
Agriculture, fishing, forestry	1995	% of GDP	2.2	1.8	1.9
Industry (including construction)	1995	% of GDP	30.8	26.3	38.0
Services	1995	% of GDP	66.8	71.9	60.0
General government					
Receipts	1999	% of GDP	47.1	36.1	30.5
Expenditure	1999	% of GDP	48.6	33.9	38.7
Exports of goods [4]	1998	% of GDP	13.2	7.9	9.9
Exports of goods and services [4]	1998	% of GDP	17.1	11.0	11.5
Imports of goods [4]	1998	% of GDP	11.1	10.8	6.7
Imports of goods and services [4]	1998	% of GDP	15.1	12.9	9.6
Exports (share of world exports) [4]	1998	%	19.6	15.0	8.5
Labour force participation rate	1998	%	66.4	77.4	72.6
Employment rate [5]	1998	%	59.4	73.8	69.5
Unemployment rate (share of labour force) [6]	Oct. 1999	%	9.9	4.1	4.6
General government					
Surplus (+) or deficit (-)	1999	% of GDP	-1.6	2.2	-8.2
Gross debt	1999	% of GDP	72.9	57.7	127.8
Current account balance	1998	% of GDP	1.0	-2.6	3.2

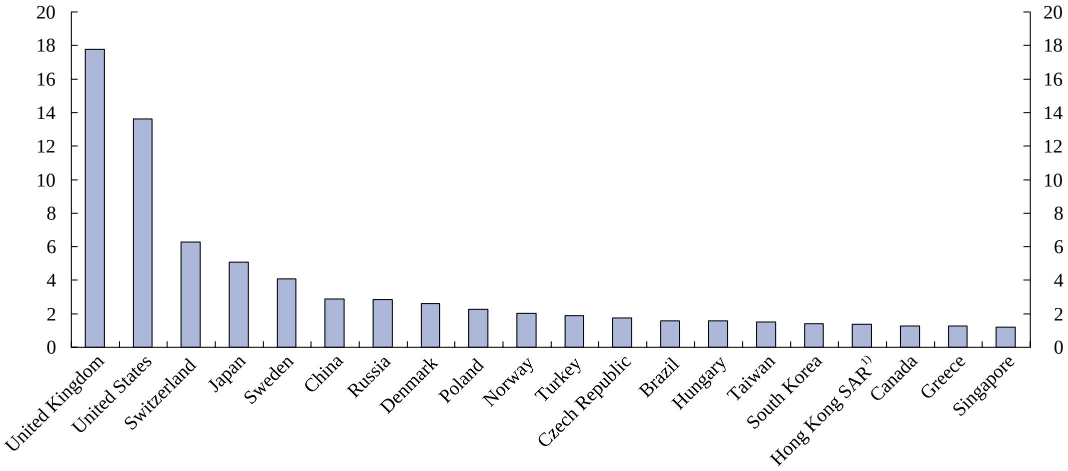
Sources: Eurostat (population and unemployment), autumn 1999 European Commission economic forecasts (general government data (calendar year basis)), OECD (sectors of production, the labour force participation rate and employment ratio; ECB calculations for the euro area), IMF (shares of world GDP, exports, imports, exports as a percentage of world exports, gross debt for the United States and Japan and the current account balance), national data (for the United States and Japan: unemployment) and ECB (for the euro area: exports, imports and the current account balance).

1) *As of 1 January 1999.*
2) *GDP shares are based on purchasing power parity (PPP) valuation of country GDPs.*
3) *For euro area: 1995 or latest available annual data; for the United States: 1994.*
4) *Excluding intra-euro area trade; exports: f.o.b.; imports: c.i.f.*
5) *As a ratio of persons aged between 15 and 64 years who are in employment and of the working age population.*
6) *United States: November 1999.*

Chart 1

Trade weights of the main trading partners of the euro area

(in percentages; average 1995-98)



Source: ECB calculations based on Eurostat trade data.
Note: Sum of exports and imports expressed as a share of total euro area exports and imports.
1) Special administrative region.

manufactured articles and chemicals account for the bulk of trade. The relative importance of other economies for the competitiveness of the euro area depends, however, not only on direct exports and imports, but also on so-called "third market" effects (i.e. taking into account competition faced by European exporters in third markets by other exporters and domestic producers). This is done, for instance, when calculating the ECB effective exchange rate. On this basis, the United States is more important than the United Kingdom, and Asian countries also take on greater significance.

Important differences exist in national labour markets in the euro area

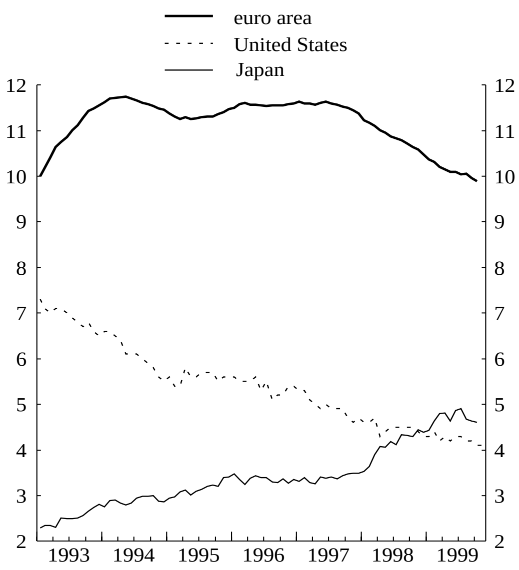
For the euro area as a whole, the average level of unemployment in 1999 was just over 13 million. This represents slightly more than 10% of the labour force, a significantly higher rate of unemployment than in either the United States or Japan. These different labour market performances are a longer-term feature (see Chart 2). Further information on the characteristics of labour markets is given by the participation rate (i.e. the sum of employment and unemployment as a proportion of the population of working age). For the euro area this is estimated to be around 66½% compared with over 72½% in the case of Japan and more than 77% in the United States. Even greater differences exist in terms of the ratio of employment to the population of working age. In the euro area this is below 60%, compared with almost 70% in Japan, and close to 74% in the United States.

There are important differences in national labour markets across the euro area in terms of structural features, including wage and non-wage labour costs, employment protection legislation, part-time employment and the scale and duration of unemployment benefits. The data for the euro area as a whole mask significant differences across participating Member States, with relatively higher rates of growth and job creation in some countries reflecting the structural reforms in labour and product markets undertaken earlier, as well as differences in cyclical positions. The range of unemployment rates is illustrated by the fact that while unemployment was below that in the Unites States in only two Member States in 1999 (Luxembourg and the Netherlands), it was over 10% in four others (Spain, France, Italy and Finland).

Chart 2

Unemployment in the euro area, the United States and Japan

(% of the labour force; monthly data; seasonally adjusted)

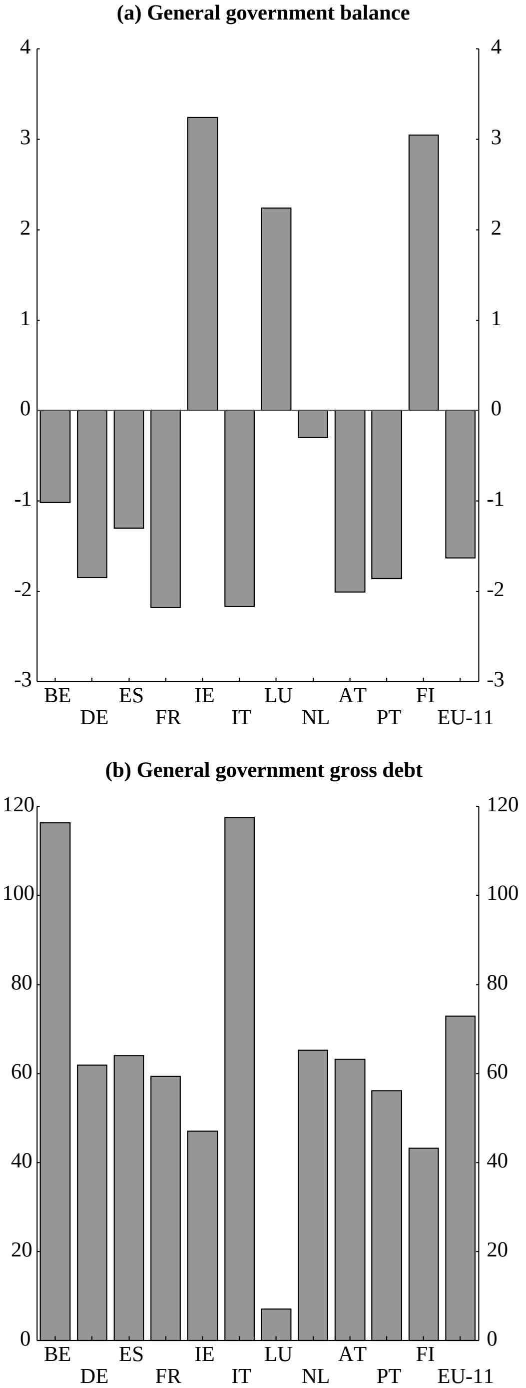


Sources: Eurostat and national data.

Chart 3

Fiscal positions in the euro area in 1999

(as a percentage of GDP)



Source: European Commission (autumn 1999 forecasts).
Note: Data are estimates.

Further consolidation needed in government budgetary positions

In the euro area as a whole, the debt-to-GDP ratio is still well above the reference level set by the Treaty establishing the European Community. The average ratio of debt to GDP is estimated by the European Commission to have declined slightly, to 72.9% in 1999. At the same time, there was only a small improvement in the ratio of general government deficits to GDP for the euro area as a whole. The average general government deficit-to-GDP ratio in the euro area is estimated to have been 1.6% in 1999. As Chart 3 shows, there is significant variation across euro area countries in both deficit and debt levels, with only a few countries reporting budget surpluses and debt-to-GDP ratios of below 60% in 1999.

Overall, budgetary imbalances and government debt levels in the euro area as a whole are higher than those of the United States but lower than those of Japan. However, comparisons with the United States and Japan are affected by their very different cyclical positions. It should also be recalled that, in the longer term, the ageing of populations represents a serious challenge to the sustainability of the pay-as-you-go financed public pension schemes (which exist in all three economies).

The size and structure of the government sector in the euro area differs significantly from that of the United States and Japan. The share of government expenditure in GDP is significantly larger in the euro area than in either Japan or the United States (at 49% compared with 39% and 34% respectively). Government current transfers to households are relatively high in euro area countries, largely owing to the characteristics of the social security systems. The proportion of GDP devoted to the provision of collective services by governments is also higher in the euro area than in either the United States or Japan. Turning to the structure of government receipts, social security contributions in euro area countries and in Japan are higher than in the United States, amounting to around one-third of governments' current revenue. While the euro area relies more on indirect taxes, direct taxation plays a greater role in the United States and Japan.

2 Euro area financial structure

Predominance of indirect finance in the euro area

Although some changes are taking place in the euro area's financial structure, it can still at present be considered as being close to a bank-oriented financial structure. This is because domestic bank loans represented a larger percentage of GDP in 1999 than financing through domestic debt securities issues, i.e. 100% versus 89% at end-June. The latter are mostly issued by the public sector (see Table 2). Furthermore, stock market capitalisation in the euro area as a percentage of GDP was 71% in October 1999. By contrast, the financial structure in the United States could be considered as exhibiting more of the features of a securitised structure, with financing through the issuance of domestic debt securities (as a percentage of GDP)

Table 2

Financial structure in the euro area, the United States and Japan

	Reporting period	Unit	Euro area	United States	Japan
Bank deposits 1)	June 1999	EUR billions	4,752.2	4,742.8	4,467.5
	June 1999	% of GDP	77.8	55.2	111.7
Bank loans 2)	June 1999	EUR billions	6,136.1	4,154.8	4,280.8
	June 1999	% of GDP	100.4	48.4	107.0
Outstanding domestic debt securities	June 1999	EUR billions	5,422.7	14,140.8	5,061.1
	June 1999	% of GDP	88.8	164.6	126.5
– issued by corporates	June 1999	EUR billions	202.3	2,493.8	583.4
– issued by financial institutions	June 1999	EUR billions	1,891.5	3,900.1	753.7
– issued by the public sector	June 1999	EUR billions	3,329.0	7,746.8	3,723.9
Stock market capitalisation 3)	Oct. 1999	EUR billions	4,346.0	13,861.1	6,275.8
	Oct. 1999	% of GDP	71.1	163.3	137.7

Sources: BIS (domestic debt securities), ECB (bank deposits and MFIs loans for the euro area), IMF (bank deposits and GDP forecasts in Japan and the United States), Eurostat (GDP forecast for the euro area, stock market capitalisation), Federal Reserve (bank loans for the United States), Bank of Japan (bank loans for Japan).

1) For the euro area, data cover demand deposits, deposits with an agreed maturity and deposits redeemable at notice of MFIs other than NCBs and the ECB. For the United States, data include demand, time and savings deposits from all banking institutions, while for Japan, data include demand and time deposits from deposit money banks. For Japan, other banking institutions which offer close substitutes to deposits are not included.

2) For the euro area, data cover loans to euro area residents from the consolidated balance sheet of euro area MFIs. For the United States, data cover total loans at commercial banks, saving institutions and credit unions (from the Flow of Funds accounts of the United States from the Federal Reserve), while for Japan data cover total lending at deposit money banks from the monetary survey from the Bank of Japan.

3) Owing to the use of different reporting rules and calculation methods, data are not entirely comparable.

being considerably larger than via banks (165% versus 48% in June 1999). Compared with the euro area and relative to GDP, the outstanding amount of domestic debt securities and stock market capitalisation in the United States are substantially larger. The financial structure of Japan appears to be less securitised than in the United States, but more than in the euro area. The latter partly reflects the relatively high proportion of outstanding debt securities issued by the public sector in total outstanding debt securities in Japan.

The following section discusses the ongoing trend of consolidation in the financial industry in the euro area. Thereafter, the main changes regarding both euro area money markets, in which short-term debt instruments (i.e. those with a maturity of less than one year) are traded, and capital markets, which concentrate on long-term finance (bonds and equities), are set out, based on indicators such as size, breadth and depth. The emergence of new euro-denominated financial instruments is also described. Finally, the structure of the euro foreign exchange market is outlined. The findings draw, in part, on analysis carried out by the ESCB.

Consolidation of financial services industry continues

During 1999 there has been significant further consolidation of the financial services industry in the euro area. Over the period from December 1998 to November 1999, the number of Monetary Financial Institutions (MFIs) in the euro area decreased by about 4% from 9,856 to 9,443. The number of the largest group of MFIs – credit institutions – declined by almost 5% from 8,320 at the end of 1998 to 7,906 in November 1999. This decline in the number of credit institutions has been an ongoing trend for more than a decade.

The consolidation trend in the banking sector reflects the response of banks to changing market conditions in Europe, which, in turn, are driven by a number of factors. Of these factors, most frequently mentioned are technological developments, deregulation, liberalisation and globalisation. The introduction of the euro is seen as strengthening these driving forces. It is important to emphasise that changes in market conditions vary considerably between different areas of banking activities. The most notable changes have taken place in wholesale banking, with the creation of a large and integrated interbank market in the euro area. Changes in retail banking activities are seen to be more gradual. The emergence of large domestic players was one of the main developments in this area in the course of 1999.

Developments in the money market

Responding to the introduction of the euro and the new monetary policy framework, the money market has undergone a process of deep integration and standardisation throughout the euro area. Nevertheless, the degree of integration achieved to date differs among the various market segments. Those which are more integrated are the unsecured deposit market, in which banks exchange short-term liquidity without the guarantee of collateral, and the derivatives markets. Relatively less integrated segments of the market include the repo market, in which participants exchange short-term liquidity against collateral, and the short-term securities markets (Treasury bills, commercial paper and certificates of deposit).

The need to redistribute liquidity among the 11 euro area countries, including the liquidity provided by the Eurosystem in its refinancing operations, has enhanced the development of cross-border transactions in the money market. Such transactions currently represent more than 50% of the overall activity in all segments of the money market. This development has been fostered by the smooth functioning of the TARGET system for the transfer of large-value funds throughout the euro area and the other EU countries. TARGET has played a key role in facilitating the redistribution of liquidity across the euro area and in arbitrage activity, which helps to level out prices prevailing in the various segments of the money markets throughout the area. Increased cross-border activity is particularly notable in the unsecured and swap segments and helps to explain their clear homogeneity and high level of liquidity. Such homogeneity is evident from the overnight maturity, as shown by the very limited differences between the overnight rates prevailing in the individual euro area countries. This is reflected in the rates contributed by the most active banks of the various countries of the euro area, which form the panel used to calculate the key price reference for the overnight market, the EONIA (euro overnight index average).

Beside the increased cross-border activity, there are a number of other, related, structural changes in the euro area money market. These include the increased concentration, by market participants, of their euro cash management activities compared with the situation which prevailed in the formerly fragmented money markets, the increased competitiveness, the larger number of counterparties actually available to individual banks and the surge in the liquidity of secondary markets.

The unsecured deposit market exhibits a high degree of integration

Of the various segments of the euro money market, the unsecured deposit market is the most highly integrated. It is worth noting that in this market segment liquidity is mostly concentrated on shorter maturities, with the bulk on overnight transactions. This concentration has increased significantly since the beginning of 1999, with a jump of 40% in the volume of the overnight maturity between the end of 1998 and the first half of 1999. The immediate and full acceptance by all market participants of EONIA and EURIBOR (euro interbank offered rate, a benchmark rate for the euro money market up to one year) has played a key role in providing the market with a uniform price reference thereby contributing to its full integration. This is reflected in almost identical risk-adjusted short-term interest rates across participants from various euro area countries.

As regards money market participants, it should be noted that some major players, which previously focused on their domestic market or on the most active European markets, have naturally extended the scope of their activities to the whole euro area. At the same time, the quickening pace of the process of consolidation has fostered the concentration of cash management and money market activities. Large players seem to have reinforced their market share, benefiting from a larger and more liquid market and from internal reorganisation efforts which have improved their competitive positions. A certain pattern of size-related specialisation seems to be developing, according to which large banks are usually active on the area-wide money market in cross-border deals, thereby enhancing market integration and ensuring homogeneous conditions for the funding of smaller banks. This kind of segmentation already existed to some extent prior to the introduction of the euro and does not appear to have given rise to a deterioration in funding conditions for smaller banks.

The repo market is not yet fully integrated

Compared with the unsecured market, the repo markets are not yet fully integrated within the euro area, as indicated by the variety of prices prevailing in the "general collateral" market (i.e. that part of the market in which the securities exchanged for cash are broadly accepted throughout the whole market owing to their relatively homogeneous characteristics). The main reasons for this situation include:

- the diverging prices of underlying bonds and their differing degrees of liquidity;

- the lack of harmonisation of the legal documentation used for repo agreements;
- practical difficulties in the cross-border management and settlement of collateral;
- different tax treatment of bonds; and
- an uneven availability of collateral across the euro area.

Repo transactions with longer maturities seem to be more attractive as they offer greater security. The expansion of the repo market seems to be related not only to the introduction of the euro but also to the need to limit credit exposures and to reduce capital needs. The size of standard deals has also increased, with contracts for between €50 million and €100 million becoming normal.

Some changes are perceived in the markets for short-term securities

Compared with the second half of 1998, the markets for short-term securities in euro area countries experienced an increase in gross new issuances during the first half of 1999, with the exception of Treasury bills (short-term, fixed income securities issued by national Treasuries), which declined by around 7%. However, Treasury bills remain the most important segment as regards turnover and outstanding amounts. The decrease in the short-term securities issued by the various national Treasuries within the euro area in relation to the gross issuance of certificates of deposit and commercial paper, i.e. short-term fixed income securities issued by banks and corporations respectively, has its origin in the improvement in the fiscal position of the national governments as well as in the consolidation of public debt in favour of longer maturities. Moreover, the strengthening of economic activity and the trend towards financial disintermediation have also fostered the increased issuance of private short-term securities.

Although the available data are imperfect, there is evidence that, unlike the unsecured deposit market and, to a lesser extent, the bond market, the markets for short-term securities within the euro area remain rather fragmented. However, the starting point of these markets in January 1999 was very different from that prevailing in the unsecured market, which, from the start of Stage Three of Economic and Monetary Union (EMU), was highly liquid and standardised and could rely on the infrastructural support of the TARGET system. By contrast, primary and secondary markets for short-term securities markets were underdeveloped or even non-existent in most euro area countries and cross-border transactions played a very limited role.

The most broadly accepted explanation given for the current limited integration of the short-term securities markets, which is also of relevance to the repo market, is the lack of adequate settlement procedures for cross-border transactions coupled with insufficient harmonisation of the settlement procedures used for domestic transactions and of the relevant legal frameworks (see the box below).

This notwithstanding, some signs of increased activity and some integration in the private paper segment of the market have been observed since the start of Stage Three of EMU. These signs included a trend towards increased cross-border diversification of the investment in the Treasury bills markets and the surge during the first half of 1999 of the gross new issuances of certificates of deposit (by 52%) and commercial paper (by 20%) compared with the second half of 1998. Moreover, discussions on possible solutions for a fast move towards consolidation of the existing securities infrastructure are under way. These facts suggest that a higher degree of integration and increased development of the short-term securities markets can be expected as the aforementioned obstacles are gradually overcome.

Significant developments in the short-term derivatives market

Since the start of Stage Three, the integration, standardisation and depth of the short-

Table 3

Euro-denominated private gross bond issuance by issuer type in 1999 1)

(annual percentage increases)

	Private bank	Private corporate	Private finance	Private utility	Total
Q1	49.4	231.7	22.8	116.4	62.9
Q2	49.4	248.2	24.5	2,541.7	76.4
Q3	52.3	476.5	168.2	7.0	99.2
Jan.-Sep.	50.2	294.4	47.1	187.6	77.2

Source: Capital Data Bondware.
Note: ECB data on sectoral securities issues will become available in early 2000.
1) Issues are calculated using the nominal amount.

term derivatives market has increased considerably. The euro interest rate swap market (in which fixed interest rate payments are exchanged for floating interest rate payments) showed an important increase in average daily transactions. Its depth and liquidity increased notably as it became fully unified, as did the prices – as attested by the existence of a single yield curve for the whole euro area. The bulk of transactions became cross-border ones. The increased liquidity is reflected in the usual indicators, namely the evolution of bid-ask spreads, which narrowed with regard to those prevailing in the relevant markets before Stage Three of EMU and are now between 1 and 2 basis points, and the standard deal size, which increased to an average of €50 million, with some very large amounts (such as €5 billion) not uncommon.

The most active segment of the swap market is formed by the "overnight index swaps" in which the fixed rate component of the transaction is exchanged for an overnight variable rate component (the EONIA rate).

Concerning other derivatives, activity and liquidity on futures money market contracts has increased. As EURIBOR has become the single reference rate, EURIBOR futures contracts have replaced all former contracts.

Developments in bond markets

With regard to the euro-denominated bond market, the most spectacular development in 1999 has undoubtedly been the rapid growth of the private bond market, which has surpassed the expectations of many private market observers (see Table 3). The market gained momentum with the launch of large debt securities issues that were related to a number of sizeable mergers and acquisitions in the first half of 1999. The rather smooth and fast way in which the euro-denominated private bond market proved able to absorb these issues was widely regarded as an important sign of the increased depth of this market. However, there is still scope for further integration of bond markets within the euro area (see the box below).

Although still relatively small in terms of volume – in particular when compared with either domestic credit in euro in the euro area and/or with the size of the private bond market (comprising both non-financial corporations and financial institutions) in the United States (which is approximately three times larger than the euro-denominated private bond market) – the year-on-year growth rates of euro-denominated private issuance of bonds have been significant, particularly in the case of private non-financial corporations and private utility companies. As seen in Table 3, during the first nine months of 1999 private non-financial corporate bond issues increased by 294% as compared with the same period in 1998, while issuance by private utilities increased by 188% over the same period. The largest private issuers in 1999 were banks, which accounted for more than half of the total issuance volume, followed by non-financial corporations, other financing companies and utility companies. The increased recourse of private enterprises to the bond market was

Box

The integration of bond markets in the euro area

The introduction of the euro has brought about significant changes in the European bond markets. The former national markets, especially the government bond markets, have become more integrated and there is increased activity in both the primary and the secondary markets. At the same time, various market segments still remain underdeveloped as far as depth, efficiency and completeness are concerned. Although important steps have been taken, the deep changes that are under way will take time to take effect and full integration of bond markets must be viewed as a medium-term process rather than an instant development.

The disappearance within the euro area of foreign exchange risk, which is one of the key factors that typically constrains cross-border investments, has allowed investors, in the course of 1999, to substantially increase the diversification across the euro area of their bond portfolios which formerly had a significant domestic orientation. However, although many European investors changed their benchmarks (i.e. the indices composed of a variety of assets on which they base their portfolio diversification) to area-wide indices, differences in the pace of diversification can be observed depending on the residence and types of investors concerned. In particular, investors in smaller countries seem to have diversified more quickly than those in larger ones.

With regard to the pricing of bonds, a change in the relative relevance of the factors explaining differentials among the various sovereign issuers has materialised. Before Stage Three of EMU, credit, inflation and related exchange rate risk differentials were the main factors explaining the prevailing yield differentials, whereas in the Monetary Union, apart from credit risk considerations, liquidity has currently become a major factor in defining investors' preferences for the various euro-denominated government bonds. However, in spite of the overall tendency by investors to diversify their portfolios on a cross-border basis throughout the whole euro area, some segments of the bond markets – especially those that are less liquid – have remained largely national and have not undergone many changes. This notwithstanding, the improved national budgetary consolidation observed over the past few years, together with the Stability and Growth Pact and further market integration has contributed to markedly narrower yield spreads between the various sovereign bonds, only rarely exceeding 30 basis points during 1999. Looking forward, the only way to ensure a sustained reduction in credit risk premia differentials will be by means of full convergence towards sound national public finances.

Further to the integration of national markets, the competition among official sector issuers has increased significantly. As a consequence, sovereign (and supranational) issuers have reconsidered their issuance policies as well as organisational aspects affecting the functioning of their secondary markets. Increasing convergence of the issuing techniques towards the most efficient possible practices has been observed. The reforms implemented have generally aimed at improving the liquidity of the bonds issued by means of increasing the size of individual issues and have often provided improved conditions for market access by non-domestic investors.

There are nonetheless still some barriers to further integration of EU bond markets. Sufficiently harmonised regulation of property rights (of particular relevance for the lower-rated bonds segment), harmonisation of accounting rules and corporate governance systems, appropriate regulation of deposit and settlement issues, and appropriate harmonisation of the regulations and of the legal documentation affecting the repo market, are all needed. Furthermore, unlike banking regulation where there is a fairly standardised set of rules, securities regulation is far from providing a common competitive framework. The need for further integration of the euro area capital markets was highlighted in the European Commission's Action Plan on implementing the framework for financial markets which was published last year. This plan promoted the creation of a single wholesale financial market, the opening of cross-border retail financial services and the strengthening of prudential regulation. Within its field of competencies, the Eurosystem is also conducting studies aimed at identifying areas in which action to enhance integration could be taken. Some follow-up work aiming at harmonising domestic settlement procedures and improving the cross-border exchange and settlement of collateral has also been envisaged by the Eurosystem.

also visible in a decline in the share of MFI loans to non-financial enterprises in total MFI loans to the private sector during the first three quarters of 1999 (see Table 2.5 in the "Euro area statistics" section).

Importance of corporate restructuring for growth in the corporate bond market

In addition to the catalysing influence of the introduction of the euro, the strong growth of the euro-denominated private bond market has been driven by a number of factors that have produced a larger and more liquid private bond market which appeals to a larger pool of investors. One of the most important factors has been the ongoing process of corporate restructuring in Europe, which has resulted in strong demand for funds by the private corporate sector. As the introduction of the euro has stimulated the integration of the euro area capital markets, euro area companies involved in merger and acquisition activities and operations such as leveraged buy-outs – in which a take-over of a company is financed through the issuance of high-yield bonds – have financed these deals to a large extent with large euro-denominated debt securities issues. These issues often served to repay bridge facilities (mainly syndicated loans). This led to some very large issues, unprecedented in the history of European capital markets. In general, merger and acquisition activity by euro area companies grew strongly in 1999, both for the banking and non-banking industry (see Table 4).

According to private data providers, in the case of the non-banking industry merger and acquisition transactions involving companies located in the euro area as parent or target increased in terms of value by 153% in 1999 (as of 23 November) compared with 1998 as a whole. For the banking industry, the corresponding figure was 35%. Following the introduction of the euro, the boom in merger and acquisition business involving euro area banks led to a situation in which the euro area surpassed the United States in the course of 1999 in terms of the nominal value of deals. This was in strong contrast with 1998 where the value of completed deals among banks was less than half that of the United States. Similarly, while in the non-bank sector, the value of deals in the euro area in 1998 was around one-quarter of the US figure, in 1999 this proportion rose to around one-half.

Table 4

Merger and acquisition activity in the euro area, the United States and Japan [1)]

(EUR billions, number of deals and percentage growth over the previous year)

		Euro area		United States		Japan [3)]	
		Bank [2)]	Non-bank	Bank [2)]	Non-bank	Bank [2)]	Non-bank
Value of transactions	1997	41.1	174.3	86.0	857.9	1.9	15.2
in EUR billions	1998	110.2	335.3	271.7	1,309.5	1.5	17.1
	1999 [4)]	148.7	847.6	88.1	1,645.7	7.9	40.4
Annual % change	1998	168.0	92.3	215.9	52.7	-22.0	12.1
in the value of transactions	1999 [4)]	34.9	152.8	-67.6	25.7	445.9	136.6
		Bank [2)]	Non-bank	Bank [2)]	Non-bank	Bank [2)]	Non-bank
Number of deals	1997	199	4,323	596	12,325	26	497
	1998	245	5,167	651	13,757	19	564
	1999 [4)]	245	6,138	481	10,778	71	1,171
Annual % change in the	1998	23.1	19.5	9.2	11.6	-26.9	13.5
number of deals	1999 [4)]	0	18.8	-26.1	-21.7	273.7	107.6

Source: Securities Data Company.
1) *Classified according to the location of the target company.*
2) *The ECB's definition of MFIs and the Securities Data Company's definition of banks are not equivalent.*
3) *The announced deal between Dai-Ichi Kangyo, Fuji and the Industrial Bank of Japan is not included in the 1999 figures for Japan.*
4) *As at 23 November 1999.*

In Japan the slowdown in the pace of economic activity over the past few years seems to have resulted in a surge in corporate restructuring in 1999 (an increase of 446% for banks and 137% for non-banks in 1999 compared with 1998). However, in terms of their value, Japanese mergers and acquisitions are still relatively small compared with those taking place in the United States and in the euro area.

Other factors also underlie developments in the corporate bond market

In addition to the surge in merger and acquisition activity in the euro area after the introduction of the euro, investor behaviour contributed to the growth of the euro-denominated private bond market as well. Institutional investors increasingly started to invest in higher yield bonds, as the possibilities to diversify risk across the sovereign euro area bond markets decreased further, while currency diversification-related opportunities to achieve higher rates of return for a given level of portfolio risk ceased to exist. Furthermore, the demand of pension funds for private bonds has been supported by strong growth of the European pension market and mutual funds as well as the high savings rate in Europe. Moreover, demand for investment opportunities in corporate bonds by insurance companies, which traditionally invested a significant part of their funds in corporate loans and unquoted debt securities (partly reflecting the underdevelopment of a pan-European corporate bond market) may have given additional support to the development of this market.

In fact, it has been argued that liquidity considerations have increasingly led retail investors to purchase corporate bonds via investment funds, which has further institutionalised the structure of finance and facilitated the absorption of large issues by capital markets. This is attributable not only to Monetary Union, but also to technological developments which allow for a deeper and more efficient corporate bond market. In the past, this market has been more difficult to develop from a technical point of view owing to the heterogeneity of issuers and markets.

Finally, as regards the choice between direct and indirect finance, the issuance of private euro-denominated bonds may be related to the financial structure of the euro area itself. In particular, financial markets may have perceived that risks to the soundness of financial intermediaries have increased as a result of greater competition and deregulation in the financial services sector and a growing exposure of banks to emerging markets during the past decade. In this environment, many corporate borrowers in the euro area have recently seen their ratings rise above those of financial intermediaries.

The growth of the euro-denominated private bond market is an indication of the increased importance of direct finance and an orientation of the euro area's financial structure towards more securitisation. The surge in mergers and acquisitions, leveraged buy-outs and management buy-outs in European markets coupled with a more benign economic outlook seems to have resulted in an increase in financing needs in the course of 1999, as is shown by the high year-on-year growth rates of euro-denominated private bond issues.

Developments in equity markets

The total stock market capitalisation of euro area equity markets stood at €4,346 billion at end-October 1999 or 71% of GDP (see Table 2). This compared with a market capitalisation of €3,624 billion at the end of 1998. Apart from reflecting an increase in stock prices over this period, this also reflected a steady increase in the total number of firms listed on stock exchanges in euro area countries in the course of 1999. This is a further indication of the growing importance of direct finance in the euro area and provides additional evidence that the financial system in the euro area may be becoming more securitised.

The introduction of the euro appears to have acted as a catalyst for the emergence of stock markets for so-called growth companies and cross-border co-operation between these stock markets. This assists those companies which may have found it difficult to raise bank finance in the past to raise equity finance which may be more appropriate for the risk profiles of their earnings. There was significant growth during 1999 in the EURO.NM market, a pan-European group of regulated exchanges which aims at attracting listings by growth companies. As of November 1999 this alliance, which was established at the end of 1997, included five European equity markets for growth companies – Le Nouveau Marché (Paris), Neuer Markt (Frankfurt), NMAX (Amsterdam), EURO.NM Belgium (Brussels) and Nuovo Mercato (Milan); several other European exchanges have shown interest in joining. Compared with end-December 1998, the total number of companies listed at EURO.NM increased by 76% up to end-September 1999 (from 165 to 291); during the same period, total market capitalisation grew from €31.5 billion to €57.4 billion, an increase of 80% (see Chart 4).

Other initiatives in the equity markets include Nasdaq-Europe, which is scheduled to begin operating in 2000 as a pan-European platform for initial public offerings of European high-growth companies, and EASDAQ, an international exchange based in Brussels which focuses on attracting listings by intermediate high-growth companies with a European or international orientation. This exchange had a total market capitalisation of €30.3 billion as of 26 November 1999. All in all, the emergence of these new initiatives in recent years is a sign that the movement towards and the subsequent start of Stage Three of EMU has provided incentives for private enterprise in Europe and that more companies are positioning themselves to reap the benefits of Economic and Monetary Union.

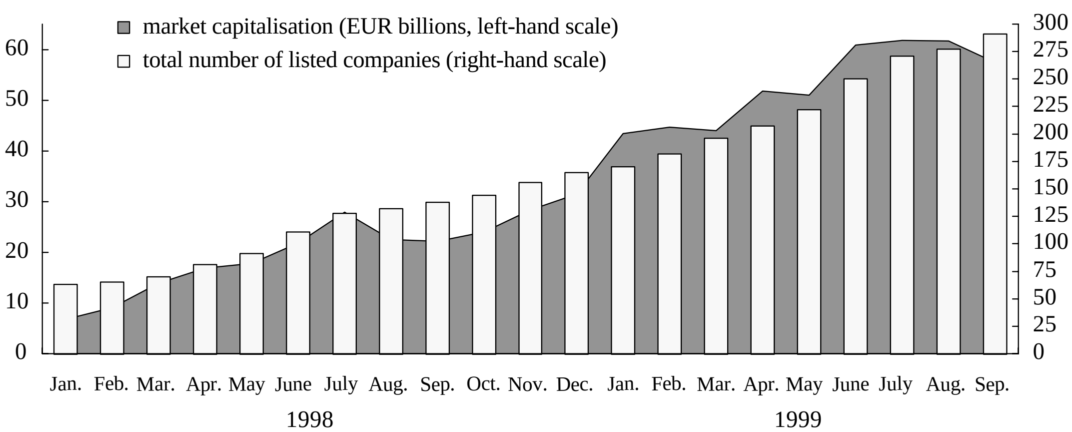
Emergence of new financial instruments in euro-denominated capital markets

In parallel with the growth of the euro-denominated private bond market, the structure of corporate finance broadened in 1999 as various segments of the euro area capital markets developed further. In this respect, the growth of a market for high-yield bonds should be mentioned (i.e. bonds

Chart 4

Market capitalisation and number of listed companies in the EURO.NM market [1)]

(end of period)



Source: EURO.NM

1) *EURO.NM is the European Alliance of Stock Markets for growth companies. The members of EURO.NM and their respective growth markets currently include the Paris Bourse (Le Nouveau Marché), the Deutsche Börse (Neuer Markt), the Amsterdam Exchanges (NMAX), the Brussels Exchanges (EURO.NM Belgium) and the Italian Exchange (Nuovo Mercato).*

issued by lower rated institutions). The high-yield market has been promoted by the rise in private issuance related to merger and acquisition and leveraged buy-out activities and strong demand by institutional investors for higher-yielding bonds. In this regard, the fact that the preparation for, and subsequent introduction of, the euro has resulted in a significant convergence of government bond yields should be mentioned since it has reduced diversification opportunities.

Overall, an increasing number of relatively small and low-rated companies have taken the step of joining the private euro-denominated bond market and have issued bonds that offer relatively high yields. The growth of the high-yield market has been strong (see Table 5). Private bond issues rated BAA and below by Moody's increased by 171% during the first nine months of 1999. However, the relative importance of issuance by companies with such low ratings is still far below that of the US markets.

The surge of merger and acquisition activity in the euro area in 1999 has revitalised the syndicated loan market, in which loans are made by a group or syndicate of banks if a loan is considered too large to be made by one bank alone. The advantages of syndicated loans are that they can be arranged more swiftly than debt securities issues and that they provide for loan commitments that can be cancelled if a merger or acquisition does not materialise.

Bond derivatives markets, which are used for both hedging and position-taking, have been concentrating on one contract (the Bund contract traded at Eurex) mainly because of liquidity considerations. In addition, interest rate swaps have been used increasingly for hedging and relative value purposes. Furthermore, equity futures based on pan-European stock indices have been introduced, of which the turnover in the contract based on the Dow Jones EURO STOXX index has been the largest.

New electronic trading systems have been developed as part of the financial innovations related to the euro area capital markets. These new systems might improve market efficiency and transparency. Settlement systems are still fragmented across the euro area, and this is regarded as impeding cross-border repos, as discussed above with regard to the money market.

Developments in the structure of the euro foreign exchange markets

The infrastructure for trading the euro in the foreign exchange market developed rapidly in 1999. The introduction of the new currency also coincided with significant changes in the overall structure of the foreign exchange market in respect of liquidity, volumes and participation. Although these developments have been driven mainly by global factors – such as bank mergers, a general reduction in risk appetites, and the increased use of electronic broking systems – the transition to EMU has also been one of the prime catalysts triggering this rationalisation process. The main changes observed so far include the following:

Table 5

Euro-denominated private gross bond issuance by issuer rating in 1999 [1)]

(annual percentage increases)

	AAA	AA	A	BBA and below
Q1	194.5	48.8	79.4	413.7
Q2	156.1	59.5	71.8	247.5
Q3	60.1	44.6	114.0	42.1
Jan.-Sep.	120.5	50.9	85.1	171.2

Source: Capital Data Bondware.

1) Rating according to Moody's.

The recommended quoting convention for the euro – "certain for uncertain" against all other currencies (i.e. €1 = X units of currency "Y") – has been widely adopted. Quotation of legacy currencies has largely ceased in the interbank market and for large corporate customers. However, banks are still encountering demand for legacy currency quotes from retail and smaller corporate customers, and this is expected to continue until accounting systems have fully adjusted to the euro.

The number of market participants has fallen as a result of bank mergers and the centralisation of euro dealing by banks and treasury activities. The commercial pressures for rationalisation of the banking sector in Europe have been substantially heightened by the creation of the euro, and seem likely to remain a feature for the foreseeable future.

There has also been a decline in the traditional foreign exchange market-making function and the readiness of banks to quote reciprocal prices. In other words, the number of dealers committed to quoting two-way prices to their counterparties at any time (i.e. ready to buy or sell a currency at any time at the request of their counterparty) has decreased. Rather, the major source of spot liquidity in the major currencies, including the euro, is now to be found on the electronic trading systems, in which dealers can enter deals without having to provide their counterparties with two-way prices.

Foreign exchange turnover has fallen globally for some of the reasons noted above. However, the declines have been more marked in some euro financial centres – in some cases turnover has fallen by rather more than 30%. A significant part of this sizeable contraction can be attributed to the mechanical effect of the introduction of the euro, whereby cross-currency trading between euro area legacy currencies disappeared. It may also reflect the fact that many cross trades were conducted via the US dollar.

For the most part, dealing spreads on trades involving the euro narrowed quickly as the market became used to dealing with and accounting for the new currency. The spreads (i.e. the usual differentials between the bid and ask prices) for standard size deals in euro against the US dollar, the pound sterling and the other non-participating currencies were soon roughly the same in percentage terms as for similar deals against the Deutsche Mark. The main exception has been in trading between the euro and the Japanese yen, where spreads have continued to be wider and more variable than was the case in trading between the Deutsche Mark and the Japanese yen.

3 Concluding remarks

The introduction of the euro at the start of January 1999 brought about a significant change in the economic and financial environment. The most remarkable changes which took place in the course of 1999 occurred in the financial structure of the euro area, with some signs that the euro area is becoming a more market-oriented structure. The integration of the national money markets into one euro area market for short-term liquidity progressed smoothly. Furthermore, a rapid growth of the euro-denominated private bond market and the related advance of financial instruments such as high-yield bonds has increased the various options available for corporate financing in the euro area. These developments could change the financial structure of the euro area in a more fundamental manner in the years to come. Further integration would enhance the efficiency of euro area financial markets, which would be beneficial to both borrowers and investors. Both the single monetary policy for the 11 euro area countries, and economic policies which remain the responsibility of national authorities, need to take these changes into account.