

THE EURO AT 10: THE NEXT GLOBAL CURRENCY?
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International Trade in Financial Assets

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Background notes

The first decade of the euro has demonstrated the powerful effect of a single currency on financial integration. The euro has led to a fall in transaction costs in cross-border trade in financial assets and weakened, but not eliminated, the financial home bias. On the period 1999-2006 the increase in intra-euro area holdings fully explains the increase in the share of advanced countries in cross-border world financial trade (Lane and Milesi-Ferretti 2008). From this point of view, the euro-effect seems to be much more visible and impressive on trade in financial assets than on trade in goods.

EMU is one of the drivers of financial integration but it is different from the other drivers (financial deregulation, financial innovation and liberalization of international capital flows) in several dimensions in particular because it is asymmetric. An interesting question is to what extent the euro can be considered as a process of unilateral or preferential financial liberalization. The question is important especially for countries outside the euro zone and trade a lot with the euro or are financial centres. If one believes that financial integration and financial flows generate gains in terms of risk diversification and allocation efficiency – a bigger if in the present period - it is important to estimate the different financial gains and (opportunity) costs of the euro for both insiders and outsiders.

Let's first disentangle the different effects that the euro may have on asset holdings for both euro zone countries and countries outside of the euro zone. In theory, the euro may have several effects on the cost of transacting assets: on transactions inside the euro zone, on purchases of euro assets by countries outside the euro zone and on purchases of non euro assets by euro countries. For example, the elimination of currency risk had several effects. It decreased transaction costs of trading across different financial markets in the euro zone. It led to more integration of national equity markets. In particular, due to local currency mandates on many institutional investors, the replacement of national currencies by the euro meant that the feasible universe for such investors was greatly enlarged (Lane 2008). In addition, the single currency and single monetary policy may increase the correlation between returns of euro assets and make them closer substitutes (especially across the bonds issued by different governments and corporations across the euro zone).

These changes should lead to shifts in portfolio weights taking into account the other determinants of cross-border asset holdings. As in trade theory, these changes in transaction costs may also result in diversion.

In Coeurdacier and Martin (2007), we attempt to quantify the impact of the euro on different transaction costs (interpreted very broadly) on cross-border holdings in financial assets (equity, bonds and banking assets). We exploit the Coordinated Portfolio Investment Survey

(CPIS) of the IMF on cross-border holdings of equities and bonds and data from the Bank of International Settlements for banking assets.

Our estimates suggest that the transaction costs to buy assets from the euro zone (relative to other assets outside the euro zone) are lower by around 17% for equity and 14% for bonds. This lower transaction costs benefit both those countries that are in and outside of the euro zone. This can be characterized as a process of unilateral financial liberalization.

Second, the euro works like a preferential financial agreement. On top of the fall of transaction costs which benefits all investors who buy assets in the euro zone, transaction costs are even smaller if both the buyer and the seller of the asset are based in the euro-area. Hence, for a country inside the eurozone, the transaction cost for the cross-border purchase of a stock or a euro bond is lower by around 27% and 31% respectively. Overall, this translates in remarkably large effects on cross-border asset holdings. The euro increases by 150% bilateral bond holdings between two euro countries while equity holdings rise by around 45%. However, the impact on bank assets is not significant. These are very large numbers and one may think that, as for the early effects of the single currency on trade, they are too large to be true. However, these numbers are not driven by the fact that euro countries are more financially developed, have better institutions, are closer to the other main financial markets (or more integrated in product markets). We control for these observable characteristics of euro countries. One could also argue that this result is not due to the euro but to some empirical regularity among European countries: Europe is for some unobservable reasons more attractive for investors than other regions in the world. However, we control for regional dummies.

Note that the euro effect does not hold only for bonds but also for equity although with a smaller impact. The fact that a similar fall in transaction costs translates into a very different shift in demand is not surprising: since bonds of different countries are closer substitutes than equities, any fall in transaction costs (due to the creation of the euro) has a larger effect on bonds than on equities.

These results resemble some in the literature on the euro effect on trade in goods. However, contrary to this literature we find no evidence that the euro decreases the transaction cost for euro countries of purchasing equity outside the euro zone. In fact, for equities we find some evidence that a diversion takes place in the sense that euro countries buy less – less than predicted by the usual variables that determine cross border trade in financial assets - equities from outside the euro zone. This evidence is based on comparing asset trade between euro countries and the nordic countries in (Finland) and out (Sweden, Norway, Denmark) of the euro zone. This diversion effect does not come from an absolute increase in transaction costs for buying assets from the rest of the world but from a relative cost effect.

The estimates also confirm that two euro bonds are more substitutable than other bonds: the elasticity of substitution is around three times as much. No such difference exists for equity though.

For the present conference, I came back to our empirical analysis in order to answer the following questions: Did larger financial markets benefit more from the creation of the euro? Did the UK, the largest financial centre of the EU but outside the euro area, disproportionately benefit from it? The answer to the first question is yes: larger financial markets – in terms of market capitalization – both inside and outside the euro area, benefited from a more

pronounced fall in transaction costs to buy euro based assets. From this point of view, the euro works as any process of financial integration in a world where economies of scale also matter for financial markets. This suggests that the euro certainly reinforces the process of concentration of financial markets. However, contrary to what is often assumed, I find no particular effect of the UK: the UK has not benefited more than other countries from lower transaction costs on euro based assets.

Can we draw some welfare implications from these empirical results? They suggest that the euro has three main effects: 1) a unilateral financial liberalization which makes it cheaper – for all countries - to buy euro zone assets; 2) a diversion effect due to the fact that lower transaction costs inside the euro zone lead investors in the euro area to purchase relatively less non euro assets; 3) an increase in cross-border asset holding inside the euro zone which is the counterpart of the diversion effect and corresponds to a preferential financial liberalization. In any theoretical model where the supply of assets is endogenous, and assets are imperfect substitutes, this surge in the demand for euro-based assets leads to an increase in the supply of euro-based assets, which indeed has also taken place.

The first effect should be beneficial to all countries as it implies that they pay less to diversify risk when purchasing euro assets. The second and third effects are the two faces of the same mechanism. The second is clearly detrimental to non euro countries. If assets are imperfect substitutes, the lower demand for non euro equity (the only asset for which some diversion is suggested by our empirical analysis) implies a lower price of non-euro assets relative to euro assets. This implies an increase in the cost of capital for firms outside the euro zone. Overall, non euro countries should benefit from more and cheaper (in terms of transaction costs) opportunities to diversify financial risk but with a deterioration of their financial terms of trade. Euro area countries benefit from an improvement of their financial terms of trade and from lower transaction costs to diversify risk. In a monetary union where asymmetric shocks cannot be dealt with monetary policy, such diversification may be all the more valuable. Of course, these days, one can have a less positive view on the systemic risk generated by the increased supply of new financial assets that comes as a consequence of euro-driven financial integration.

Coeurdacier, Nicolas and Philippe Martin, 2007, "The Geography of Asset Trade and the Euro: Insiders and Outsiders", CEPR Discussion Paper 6032.

Lane, Philip R, 2008. "EMU and Financial Market Integration", IIS Discussion Paper No. 248.

Lane, Philip R and Gian Maria Milesi-Ferretti, 2008, "The Drivers of Financial Globalization" American Economic Review (Papers and Proceedings), May 2008.