

The Euro, Capital Markets, and Dollarization

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To Sara, my wife
E. B. F.

To Kathryn, my wife
F. A. L.

Acronyms

ADR	American depository receipt
AIM	alternative investment market
APT	automated pit trading
BIS	Bank for International Settlements
CAP	Common Agricultural Policy
CATS	computer-assisted trading systems
CECI	Ettablissement de Credit et des Entreprises d'Investissement
CEE	central and eastern Europe
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
CMF	Conseil des Marches Financiers
COB	Commission des Operations de Bourse
DTB	Deutsche Termin Börse
EC	European Community
ECB	European Central Bank
ECN	electronic communications network
ECS	euro clearing system
ECSC	European Coal and Steel Community
ECU	European currency unit
EEC	European Economic Community
EFTA	European Free Trade Association
EIB	European Investment Bank
EMI	European Monetary Institute
EMU	European Monetary Union
EMS	European monetary system
EONIA	euro overnight index average
EPU	European Payments Union

ERP	Euro Recovery Program
ERM	exchange rate mechanism
ESCB	European system of central banks
ETF	exchange traded fund
EU	European Union
EVCA	European Venture Capital Association
FDI	foreign direct investment
GCC	Gulf Cooperation Council
GDP	gross domestic product
IGC	intergovernmental conference
IMF	International Monetary Fund
IPO	initial public offering
IT	information technology
LBO	leveraged buyout
LIFFE	London International Financial Futures Exchange
LTRO	longer-term refinancing operation
M&A	mergers and acquisitions
MNC	multinational corporation
MPT	modern portfolio theory
MRO	main refinancing option
NCB	national central bank
NYSE	New York Stock Exchange
OECD	Organization for Economic Cooperation and Development
OEEC	Organization for European Economic Cooperation
PYG	pay-as-you-go
RTGS	real-time gross settlement system
SPD	Social Democratic Party (German)
SPDR	Standard & Poor's depository receipt
SWIFT	Society for Worldwide International Financial Telecommunications
TARGET	Trans-European Automated Realtime Gross Settlement Express Transfer System
TMT	technology, media, and telecommunications
TOCA	theory of optimum currency areas
VAT	value-added tax
WEBS	world equity benchmark shares

Preface

Europe is changing more rapidly than most other regions of the world. Part of the stimulus to this dramatic change is the introduction of a single currency. But there are other stimuli, including globalization of business and a growing tendency for regional trade and payments arrangements. Europe is carrying this regionalization further and faster than other parts of the world, creating a political institutional framework of which the European monetary union is the latest and most creative.

When we began to develop this book-writing project, we were uncertain how far Europeans would take their new currency. Early in 1998 we knew only that a great deal of effort and negotiation had been necessary and that in May the EU-15 would meet for another round of discussions.

Thirty-eight months later we can look back at a startling period in European history, in which a new currency is bringing major changes in capital markets, financial and business innovation, and growing shareholder democracy. In 1998 we could not fully comprehend or in any way anticipate the almost revolutionary changes that lay ahead. Since the euro was introduced, Europe's capital markets have demonstrated an amazing ability to reform and reorganize. New stock markets have been created, and older ones are merging or forming alliances.

Corporations in Europe are responding to the new realities of pan-European competition. Companies find themselves in a fishbowl environment, with everything they do more visible and transparent. Unfriendly takeover bids, based on the rising purchasing power held by new sector firms, are becoming accepted as part of the ordinary financial system. Spin-offs have become the newest means of discovering hidden corporate treasure.

Where is Europe headed, and will we discover even more revolutionary changes? Will the new economic sectors, rising shareholder democracy, and expanding financial markets generate even greater change?

Europe appears more prepared to assert itself in business-financial competition, corporate initiatives, defense preparedness, and global political muscle. Will this continue, and will we enter a period of European renaissance accompanied by a shift of economic, financial, and political power and influence that challenges the United States? Will the twenty-first century become the European century, and, if so, in what ways will it lead to a world of better governance?

Chapter 1 summarizes the historic antecedents of the EMU from the Marshall Plan through Maastricht, and concludes with a comparative analysis of Euroland and the United States. Chapter 2 examines the dual issues of resource mobility in the Eurozone and the theoretical requirements of an optimal currency area. Both capital mobility and labor mobility are discussed. Chapter 3 analyzes macroeconomic conditions and issues in a single currency area. These issues include fiscal balance, the Growth and Stability Pact, pensions systems, and euro currency weaknesses in the foreign exchange markets. Chapter 4 considers the impact of the euro on the profitability of the European banking sector, prospects for bank merger and consolidation, and focuses its analysis on banking and financial activities in the Eurozone. Chapter 5 examines the legal and operative framework for the European Central Bank.

Chapter 6 compares capital markets on the eve of the introduction of the single currency, and the impact of the euro on capital market development. Proposed stock market consolidation and competitiveness is analyzed. Three merger cases are discussed in detail. Chapter 7 examines bond market development in the Eurozone, noting the increase in issuance and changes in practices. Chapter 8 examines equity market development, the evolving structure and operation of the stock exchanges, and the expansion of venture capital markets.

Chapter 9 compares the single currency with proposals for dollarization. The theory of optimal currency areas is reviewed, and its applicability to NAFTA and Mercosur. Chapter 10 considers EU enlargement and Eurozone expansion. Considerable attention is given to prospects for the UK entering the single currency system, as well as access to the EU for central and eastern European nations.

Acknowledgments

When we began to research this volume in 1998, we wondered if a single currency and a European-wide financial system could succeed. Although the experts hailed the single currency as the most important, revolutionary monetary event of the century, they were divided on the likely outcome.

We cast our net across the Atlantic searching for materials and information for this study. We sought to obtain viewpoints, insights, and perspectives from those based in Europe, those working in the Eurozone, and those most directly exposed to the political, economic, and financial discussions and debate. We are particularly indebted to the following people who evoked an early interest focused on these subjects. Of these people, we would like to thank particularly Dr. Nicholas Bruck, formerly with the World Bank, Economic Development Institute.

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Naturally, we accept full responsibility for all errors of commission and omission.

Contents

List of Tables	ix
List of Acronyms	xiii
Preface	xv
Acknowledgments	xvii
1 The Road to Euro	1
2 Resource Mobility in a Suboptimal Currency Area	19
3 Macroeconomic Environment	45
4 European Banking and the Euro	75
5 The European Central Bank and Role of the Euro	107
6 Capital Markets in the Eurozone	157
7 Bond Market Development	189
8 European Equity Markets	207
9 Dollarization: Extending the Single Currency Concept	239
10 The European Union and Eurozone Expansion	263
Index	291
About the Authors	315

Tables

1.1	Nontariff Barriers Covered by Single European Act	4
1.2	Summary of the Maastricht Treaty for European Monetary Union	5
1.3	Euroland Compared with the United States and Japan	11
1.4	Central Government Financial Balances, Surplus (+) or Deficit (–) as a Percentage of Nominal GDP	13
1.5	Planned Timetable for the Introduction of the Euro in First-Wave Member States	14
2.1	Development of Conceptual Foundation for European Currency Union	20
2.2	Movement in Unemployment Rates, Selected European Countries, May 1997–May 1998	23
2.3	Labor Costs and Productivity in the Eurozone, 1997	25
2.4	Projections of In-Migration to the EU-12, 1990–2020	29
2.5	Methods and Determination for Achieving Citizenship	33
2.6	Six Mechanisms Promoting European Capital Mobility	36
2.7	Top Ten Cross-Border M&A Deals	38
2.8	Cross-Border Mergers and Acquisitions by Region (U.S.\$ millions)	39
2.9	Foreign Direct Investment by European Companies and Entering European Countries, 1997 (U.S.\$ millions)	40
2.10	Total FDI Outflows and Inflows, Selected European Countries, 1990–1996 (U.S.\$ millions)	41
3.1	The Convergence Criteria	46
3.2	Maastricht Definition of General Government Gross Public Debt as a Percentage of Nominal GDP	48
3.3	Euro Interest Rate Convergence, October 19, 1998	49

3.4	Covement between Budget Net Recipient Position and Public Support for EU	59
3.5	Schröder's Structural Reform Agenda: Need and Reality	61
3.6	Population Aging in Eurozone Countries, U.S., and UK: Percentage of Population over 20 Who Will Be 60 and over in 2015 and 2035	65
3.7	Real GNP Growth Rate, 1998–2001	70
3.8	Chronology of the Euro in Foreign Exchange Markets	72
4.1	Comparison of Europe (E-15) and United States, 1997	76
4.2	Projected Impact of Single Currency on European Wholesale Banking Revenues (U.S.\$ billions)	77
4.3	European Stock Markets, Market Capitalization, Relative to GDP (percentage)	79
4.4	Changes in Equity Business Revenues, 1998–2006	80
4.5	Equities Trading Cost Elements as Percentage of Total Cost, Mid-1990s	81
4.6	Number of Equity Researchers, 1995	81
4.7	Selected Banking Mergers in Europe, 1992–2000	83
4.8	Top European Banks by Stock Market Capitalization, May 2000	85
4.9	European Acquisitions of Merchant and Investment Banks	92
4.10	Top Advisers on Deals Involving European Companies' M&A Deals Announced and Not Withdrawn, January 1, 1999 to February 15, 2000	94
4.11	International Equity Bookrunners, January–June 2000	97
4.12	Country Composition of the Pfandbrief Market, 2000	100
4.13	Main Stakes in Commerzbank, Mid-2000	103
4.14	Initiatives by Commerzbank to Build Global Asset Management	104
5.1	Operating Procedures of the European System of Central Banks	110
5.2	Eligible Collateral	112
5.3	Width of Overnight Corridor (Basis Points) in 1999	115
5.4	Foreign Reserve Assets of the Eurosystem (including gold)	119
5.5	Euro Valuation on Forex Markets, April 28, 2000	120
5.6	The Eurozone as a Potential Monetary Giant	128
5.7	Comparative Inflation Rates, 1973–1997	131
5.8	Shares of Selected Currencies in Global Gross Foreign Exchange Market Turnover	133
5.9	U.S. and EU Relative Economic Size and Use of Currencies	134
5.10	Currencies in Use as Official Reserve Holdings (percentage)	136
5.11	Alternative Scenarios under the Euro	138

5.12	Currency Composition of Latin American External Debt, Year-End 1997	140
5.13	Currency Composition of Asian External Debt, Year-End 1997	142
5.14	TARGET Price System Compared with Alternatives	144
5.15	Chronology of Intervention on Forex Market by the European Central Bank	148
5.16	Eurozone Inflation and Unemployment in June 2001 (%)	150
6.1	International Comparison of Bond and Share Market Capitalization	159
6.2	Definitions of Financial Market Efficiency	162
6.3	Volume of Corporate Bonds Outstanding on Eve of Euro	163
6.4	Securities Indices in Euroland	164
6.5	Investors in EASDAQ IPOs	168
6.6	German Company Share Listings on NYSE, Early 1999	175
6.7	Key Events in Olivetti-Telecom Italia	180
6.8	Chronology of Events in the Three-Way French Banking Merger	181
6.9	Comparison of BNP, Société Generale, and Paribas	183
6.10	Europe's Top Banks by Assets (year-end 1998)	183
6.11	Largest Agreed Merger Deals	185
7.1	Financial Structure in the Euro Area, the United States, and Japan	190
7.2	Long-Term Euro-Denominated Securities Issued by Nonfinancial Corporations, 1999	194
7.3	Projected Net Government Bond Issuance (in billions)	196
7.4	Comparison of Pfandbrief and Mortgage-Backed Securitization	200
7.5	European High Yield Issuance (U.S.\$ billions)	203
8.1	Percentage Share of European Market Capitalization In and Out	209
8.2	Sources of Increased Wealth Effect from Euro (U.S.\$ billions)	210
8.3	Present Value of \$1,000 Receivable in Five Years	210
8.4	Financial Systems, Capital Structure, and Share Issuance	212
8.5	Trading Screens Used in North America by Equity Traders	214
8.6	Alternative Stock Markets in Europe	220
8.7	How to Misprice New Tech Stocks	225
8.8	New Funds Raised by European Venture Capital and Private Equity Fund Managers	230
8.9	Neuer Markt Capitalization, by Country of Listed Corporation	233
8.10	Continental Europe Buyouts, 1997	234
8.11	Value of Public-to-Private Buyouts (U.S.\$ billions)	235
9.1	Conditions Required for Optimal Currency Area	242

9.2	Currency Boards in Operation	246
9.3	Three Crises: Similarities and Differences	250
9.4	Relative Size of Capital Inflows to Emerging Market Countries, 1973–1982, 1991–1996	251
9.5	Exchange Rate Movements during Crises	252
9.6	Basic Data for the Argentine Economy	254
9.7	Gains and Losses from Argentine Dollarization	256
10.1	EU Attitudes toward Eastern European Worker Mobility in an Expanded Single Market (percentage of total)	264
10.2	Macroeconomic Indicators for Greece (annual percentage change)	275
10.3	Comparative Data on Five Possible Accession Countries	279
10.4	Shifting of Trade Focus of CEE 6 (percentage of total)	280
10.5	FDI by Source Country for Poland and the Czech Republic	281
10.6	Basic Parameters of Budget Compromise to Year 2000	286

Chapter One

The Road to Euro

In 1991 the member states of the European Union (EU) confirmed the goal of achieving a single European market. Further, they agreed to work toward European monetary union. This is the first time that a group of countries moved toward a common currency on such a scale without also forming a political union. Never before had political leaders worked for so long to overcome historical, language, and cultural differences.¹

The lowering of the iron curtain and breakup of the centrally planned economic system in eastern Europe had removed a fundamental political assumption on which the architects of the European Economic Community had based their economic strategy. Reunification of Germany expanded the European Union (EU) eastward, in defiance of the cold war political assumptions that provided incentive for European economic cooperation.

Indeed, the disappearance of the monolithic Soviet Union fostered a new political philosophy—liberty is necessary because it serves the interests of Western power and capital.² This is different from the idea that liberty, as an abstract philosophical principle, is fundamental to the West. This idea also seems peculiarly suited to explain the advent of the EU, which is occurring in the economic arena (because it is necessary to capital) rather than in the political arena, where union may be less important.

This chapter examines the role of the euro as it comes into operation and analyzes the historical and political basis for postwar European economic cooperation.

HISTORICAL BACKGROUND

Postwar Economic Cooperation

In September 1947 Secretary of State George C. Marshall presented to the U.S. government a report urging that the European countries be assisted in undertaking concerted action, marking the advent of “a new stage of European economic cooperation.” This was the basis for the European Recovery Program (ERP). European nations were expected to undertake cooperative efforts among themselves and organize a joint recovery program. Economic integration would be a means as well as an end.³

The Marshall Plan that evolved from this report was an “economic recovery program” based on the “supremacy of political aims.” As stated by Howard S. Ellis:

Europe is a continent of half a billion people, seat of the world's dominant powers for more than two thousand years. Even today, and even if we assume that we can save only that part of Europe which is not now controlled by Russia, Europe is important.⁴

Political aims become implemented by economic objectives. The ERP transferred close to \$14 billion in aid and credits to European recipients over the six-year period from 1947 to 1952. The Organization for European Economic Cooperation (OEEC) was organized to monitor progress on European economic recovery, while the European Payments Union was established to further multilateral trade and payments and ultimately currency convertibility.

By 1953 European production had regained prewar levels, and investment expenditures were providing a base for renewed competitiveness. In 1951 the European Coal and Steel Community (ECSC) was established, a forerunner of the Common Market, but was restricted to the coal and steel sectors. Soon after, western European nations were discussing closer economic cooperation in the form of a free trading zone in industrial product.

The European “Exception”

According to Abba Eban, the European Community (EC) and the EU are the optimistic exceptions in the recent history of global diplomacy.⁵ The conventional wisdom was satisfied with the fatalistic expectation that the cold war would continue for a few more decades and that it would end in a bloodbath. There was a fatalistic acceptance of the “balance of terror.”

Thus it was a great surprise when global economic growth brought an end to the Soviet Union, unified world capital markets, and set the stage for both the Asian crisis and the EU. Yet international law never celebrated a golden age