The Euro, Capital Markets, and Dollarization

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ROWMAN & LITTLEFIELD PUBLISHERS, INC.
Lanham • Boulder • New York • Oxford

ROWMAN & LITTLEFIELD PUBLISHERS, INC.

Published in the United States of America
by Rowman & Littlefield Publishers, Inc.
4720 Boston Way, Lanham, Maryland 20706
www.rowmanlittlefield.com

12 Hid's Copse Road, Cumnor Hill, Oxford OX2 9JJ, England

British Library Cataloguing-in-Publication Information Available

Library of Congress Cataloging-in-Publication Data

Flowers, Edward B., 1939–
The euro, capital markets, and dollarization / Edward B. Flowers and Francis A. Lees.
p. cm.
Includes bibliographical references and index.
ISBN 0-7425-0207-4 (alk. paper)—ISBN 0-7425-1305-X (pbk. : alk. paper)
1. Euro. 2. Money—European Union countries. 3. Monetary policy—European Union countries. 4. Capital market—European Union countries. 5. Dollar, American. I. Lees, Francis A. II. Title.

HG925 .F574 2002
332.4'94—dc21

2001041689

Printed in the United States of America

∞™ The paper used in this publication meets the minimum requirements of American National Standard for Information Sciences—Permanence of Paper for Printed Library Materials, ANSI/NISO Z39.48-1992.

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	Establissement de Credit et des Enterprises 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.

Many individuals in the private sector also provided necessary information and ideas. These include Hugh Baxter at Standard & Poor's (London office); Catherine Claydon at Goldman Sachs (London office); Keith Mullin at IFR-Thomson (London office); Dan Adler at 3i; Robert Darwent at Hicks Muse Tate & Furst (London office); Oliver Haarmann at KKR (London office); Jonathan Meggs and Philip Rattle at Chase Capital Partners (London office); William Northfield at Deutsche Bank Capital Markets (London office); Charles Brealey at William M. Mercer (London); Eric de Bodard at Moody's (London office); Ian Davis and Jonathan Day at McKinsey & Co. (London office); Clifford Dammers at International Primary Market Association (London); Kelly Streatley at Deutsche Morgan Grenfell; Peter Churchill-Coleman at Dresdner Kleinwort Benson (London office); Loretta Murphy at Commerzbank (London); Susan Falks and A. Wilkins at Cable & Wireless; and Elaine Cole at J.P. Morgan (London office).

A number of individuals in the governmental sector and regulatory agencies assisted by providing information. These individuals include John Barrass and Lieselotte Burdorf-Cook at Financial Services Authority (FSA) in London; Elaine Trimble, Eric Meyer, and Nicola Nathan at the European Bank for Reconstruction and Development in London; Ekkehart Boehmer at the Securities Exchange Commission (Washington, D.C.); Ida Reeve and Lynne Fordrad at the Bank of England; and Andrew Jackson at the Department of Trade and Industry of the British government.

The following organizations were helpful in providing information and data: British Venture Capital Association (London); the U.S. embassy in London; Schroders Investment Bank; OECD; the Bank for International Settlements (Basel); and the Federal Reserve Bank of New York.

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

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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