International Trade in Financial Assets and the Euro

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THE EURO AT 10: THE NEXT GLOBAL CURRENCY?
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The euro as an engine of financial integration

- The euro-effect on trade in goods has been much discussed and most recent estimates find positive but modest impact
- The euro effect on trade in financial assets seems more visible and impressive
- Possible implications for geography of financial markets

How can the euro affect cross-border trade in assets?

- Elimination of currency risk, local currency mandates on institutional investors relaxed, liquidity related costs fall, economies of scale due to larger market…
- Lead to lower transaction costs (broad interpretation):

  For all investors (insiders and outsiders) to buy euro area assets: the euro as **unilateral financial liberalization**

  Additional fall of transaction costs if investor who buys euro assets is in the euro area: the euro as **preferential financial liberalization**

Some numbers on unilateral effect

- Based on empirical work with Nicolas Coeurdacier using IMF and BIS data on cross-border holdings of equity, bonds and banking assets
- <u>Large portfolio bias for euro assets:</u> investors (insiders and outsiders) hold 60% more euro equity (100% for bonds) than predicted by usual determinants of cross-border asset holding
- Our estimate : consistent with lower transaction cost of 15% to buy euro assets

The euro as preferential liberalization

- In addition to the fall in transaction costs which benefit all investors, extra effect that benefits only investors in euro area
- The euro increases bilateral holdings between two euro countries by 150% (bonds) and 45% (equity)
- Consistent with 13% lower transaction costs on euro assets (equity and bonds)

The euro as a diversion effect

if lower transaction costs in euro financial markets relative to other financial markets => portfolio rebalancing:

⇒ Lower (relative to scenario with no euro) demand for non euro assets by euro area countries

evidence of this diversion effect comparing Nordic countries in euro area (Finland) and out (Sweden, Norway, Denmark): only for equity (not bonds)

Does the euro benefit larger financial markets?

- Yes: larger financial markets (inside and outside the euro area) have benefited more from low transaction costs to buy euro based assets (no UK effect)
- Implications for geography of financial markets:

in a world with economies of scale: lower transaction costs reinforce

- concentration (towards larger financial markets in and out of euro area)
- specialization (in the euro area)

Costs and benefits of the (large) euro effect on cross border asset holdings

- Insiders: higher demand for euro equity → lower cost of capital (if assets imperfect substitutes)
- Ousiders: diversion effect deteriorates financial terms of trade
- For all: lower cost to diversify risk (may be important in monetary union with asymmetric shocks), increased supply of risky assets
- A few weeks ago, we might have interpreted this as a welfare gain