

# The Euro Area One Year After the Introduction of Euro

## Key Characteristics and Changes in the Financial Structure

### 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 I, 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 15 1/2%. This is less than that of the United States (at 20 3/4%), but around twice that of Japan (at around 7 1/2%). By comparison, the largest single Euro area country is estimated to have a share of world GDP of only 4 1/2%.

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 ag-

*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. 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.*

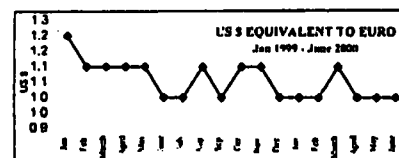
riculture, fishing and forestry, is similar in all three economies, and limited to around 2% of the total output.

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 19 1/2% compared with 15% and 8 1/2% 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 10 1/2% 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. 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 5 1/2% 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 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.

### 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 1). 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 66 1/2% compared with over 72 1/2% 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.

### Government Fiscal 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. 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.

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 government's current revenue. While the Euro area relies more on indirect taxes, direct taxation plays a greater role in the United States and Japan.

### 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 capitalization 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) 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 capitalization in the United States are substantially larger. The financial structure of Japan appears to be less securitised than in the

Table 1

#### Key Characteristics of the Euro area

	Reporting Period	Unit	Euro area	United States	Japan
Population	1998	mn	291	271	126
GDP (share of world GDP)	1998	%	15.5	20.8	7.4
Sectors of production					
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					
Expenditure	1999	% of GDP	48.6	33.9	38.7
Exports of goods	1998	% of GDP	13.2	7.9	9.9
Exports of goods & services	1998	% of GDP	17.1	11.0	11.5
Imports of goods	1998	% of GDP	11.1	10.8	6.7
Imports of goods and services	1998	% of GDP	15.1	12.9	9.6
Exports (share of world exports)	1998	%	19.6	15.0	8.5
Labour force participation rate	1998	%	66.4	77.4	72.6
Employment rate	1998	%	59.4	73.8	69.5
Unemployment rate (share of labour force)	Oct. 1999	%	9.9	4.1	4.6
General government					
Surplus (+) or deficit (-)	1999	% of GDP	-1.6	2.2	-5.2
Gross debt	1999	% of GDP	72.9	57.7	127.8
Current account balance	1998	% of GDP	1.0	-2.6	3.2

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.

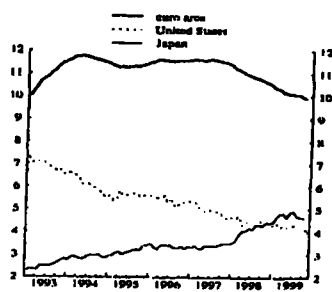
The following section discusses the ongoing trend of consolidation in the financial industry in the Euro area. Thereafter, the main changes regarding both Euro area money markets, in which short-term debt instruments (i.e. those with a maturity of less than one year) are traded, and capital markets, 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.

**Consolidation of financial services industry**

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.

**Chart 1**  
Unemployment in the Euro Area, the United States & Japan

(% of the Labour Force: monthly data; recently adjusted)



Sources: Eurostat and national data

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 deposits).

The need to redistribute liquidity among the 11 Euro area countries, including the liquidity provided by the Euro system 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.

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.

**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.

**Table 2**  
Financial structure in the Euro area, the United States and Japan

	Reporting Period	Unit	Euro area	United States	Japan
Bank deposits	June 1999	EUR Billions	4,752.2	4,742.8	4,487.5
	June 1999	% of GDP	77.8	55.2	111.7
Bank loans	June 1999	EUR Billions	6,138.1	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	683.4
- 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	Oct. 1999	EUR Billions	4,346.0	13,861.1	6,275.8
	Oct. 1999	% of GDP	71.1	163.3	137.7

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).

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.

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 3).

*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.*

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.

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.

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 cooperation 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

**Developments in the structure of the Euro foreign exchange markets**

The infrastructure for trading the Euro in the foreign exchange market

**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

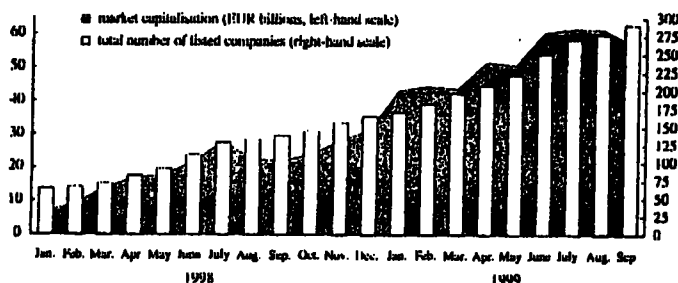
**Table 3 Euro-denominated private gross bond issuance by issuer type in 1999 (1) (annual percentage increases)**

	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

Chart 3

Market capitalisation and number of listed companies in the EURO.NM 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:

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 an 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.

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 have 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.

*Excerpts of an article of ECB Monthly Bulletin - January 2000 by W.G.S. Waidyanatha.*

The Value of the Euro		
Country	Currency	€Rate
US	\$	1.1789
Japan	¥	133.73

Rates quoted on 04th January 1999, the first day the Euro began official trading on foreign exchange markets - Source: ECB