The Euro: Already Here

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Euro banknotes and coins will finally arrive at the beginning of next year, in the triumphant culmination of the half-century-long project of building a financially integrated Europe. The continent's residents and officials are looking forward to this momentous event, it must be acknowledged, with some trepidation. Banks are encouraging their employees to take up weightlifting so that they will be able to heft heavy bags of newly-minted coins. Vending- and automatic-teller-machine operators are gearing up for an unprecedented conversion effort. Patrons of European parking garages where coin-operated payment machines have taken the place of attendants harbor fears of being trapped inside indefinitely.

How should American investors regard this historic event -- as positive, negative, or inconsequential? My answer, perhaps typical for an economist, is "all of the above." The immediate impact will be inconsequential because the main effects of the introduction of the euro have already been felt. They were felt in 1999 when the exchange rates between the participating national currencies were irrevocably locked and responsibility for monetary policy was handed over to the European Central Bank.

The effect of these events was to greatly stimulate the growth of European financial markets. In particular, the replacement of 11 national bond markets with a single Continent-wide market organized around a common benchmark asset, the German *bund*, for the first time gave Europe a market with a depth and liquidity comparable to the U.S. treasury bond market. The result has been the explosive growth of corporate bond issues, investment-grade and "junk" bonds alike. This liquidity has financed a tidal wave of mergers and acquisitions, evident both within Europe and in European companies' acquisition of their American rivals. None of this would have been possible without the locking of currencies and the establishment of the European Central Bank.

Similarly, there will be strong pressure for the creation of a single European stock market (or maybe a couple of competing exchanges along the lines of the New York Stock Exchange and the Nasdaq) as investors, no longer having an incentive to concentrate their transactions where business is denominated in the local currency, take their business to the most efficient exchange. Pressure in this direction is already evident in the negotiation of strategic alliances among the continent's existing exchanges, although which of these alliances will ultimately survive remains to be seen.

There are good reasons to think that the creation of U.S.-style stock and bond markets will ultimately render the European economy more efficient and better able to innovate and compete. U.S. experience suggests that stock markets have advantages over banks in periods when technology is changing rapidly -- that individual investors more than stodgy bankers are prepared to take bets on competing technologies through purchases of initial public offerings and stakes in established companies. There is no reason why the same financial formula that works in the United States, in other words, cannot also work in Europe now that it too has deep and liquid financial markets.

Admittedly, all this financial activity has done little to stimulate European growth to date. This reflects teething difficulties. The growth of securities markets has intensified the competitive pressure on European banks, as long-time corporate customers suddenly able to float bonds take their business elsewhere. Some of Europe's largest and longest-lived financial institutions, the Deutche Banks and Credit Lyonnaises, will therefore have to downsize and restructure. Small companies, unable to issue bonds but finding their banks under pressure and reluctant to lend, are finding it harder to access external funds. There may be painful adjustments and a period of slow growth, in another words, as securities markets gain market share at the expense of the banks.

So what should investors anticipate as a result of the introduction of euro notes and coins at the beginning of next year? On impact, this will be a non-event, because the effects of the euro have been working their way through the European economy since 1999. The slow process of adapting to this new financial environment will if anything make economic life somewhat more difficult for the next few years. But once that adjustment is complete, the single currency, which is allowing the continent to build deep and liquid securities markets for the first time in its history, will mean a more competitive and dynamic Europe.

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