

# Monetary integration and the cost of borrowing

Marta Gómez-Puig\*

*Universitat de Barcelona, Spain*

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## Abstract

With European Monetary Union (EMU), there was an increase in the adjusted spreads of euro-area sovereign securities over Germany (corrected from the foreign exchange risk), causing a lower than expected fall in borrowing costs. The objective of this paper is to study the reasons for this increase, and in particular, whether the change in the price assigned by markets was due to domestic factors (credit risk and/or market liquidity) or to international risk factors. The empirical evidence suggests that it may have been a change in the market assessment of domestic (both liquidity and default risk) rather than international factors that caused the observed increase in adjusted spreads with Monetary Integration, even though, since market size scale economies have increased since EMU, their effect differs according to the size of the market.

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## 1. Introduction

European Monetary Union (EMU) caused large-scale changes in euro-area sovereign securities markets (see [Danthine et al., 2001](#); [BIS Study group on fixed income markets, 2001](#)). Before the introduction of the euro, yield differentials between European sovereign borrowers were mostly determined by four factors: expectations of exchange rate fluctuations,

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\* Departament de Teoria Econòmica, Universitat de Barcelona, Diagonal 690, Barcelona 08034, Spain. Tel.: +34 934 020 113; fax: +34 934 039 082.

*E-mail address:* [marta.gomezpuig@ub.edu](mailto:marta.gomezpuig@ub.edu)

differences in domestic tax-regimes, differences in credit risk, and differences in market liquidity. The removal of foreign exchange risk in January 1999 and the elimination (or reduction to insignificant levels) of differences in tax treatment during the 1990s eliminated two of these factors, and paved the way for a much more integrated and competitive public debt market.

As a result, euro-area government bond markets began to be considered as a single market, comparable in terms of size to the US or Japanese markets. Nevertheless, segmentation did not disappear completely. In 2006, public debt management is still decentralised under the responsibility of 12 sovereign issuers with differences in rating and a variety of issuing techniques (see Favero et al., 1999). These are features that distinguish the euro-area debt market from its US and Japanese counterparts. One example of this segmentation is the persistence of yield differentials.

This paper sets out to examine this persistence and to explore what happened to euro-area countries' yield spreads on government bonds after the introduction of the euro. The pre-EMU literature speculated that with the elimination of currency risk, yield spreads would narrow and would primarily reflect default risk. Conversely, market participants and member state debt managers appeared to believe that EMU yield differentials would be due mostly to liquidity factors. Therefore, in order to reduce borrowing costs, debt managers introduced substantial innovations that were expected to enhance the liquidity of their bonds.

Actually, the main effects of the introduction of the euro in government bond markets were on the one hand, an increase in the degree of substitutability among securities issued by different treasuries and higher levels of competition between issuers to attract investors, which led to a certain reorganisation of the market structure, and on the other, a gain in the importance of credit risk and market liquidity in yield differentials. Before Monetary Union differences in these factors were perhaps not completely priced due to market segmentation.<sup>1</sup>

Therefore, a first point that will be assessed in this paper is whether EMU has increased credit risk by denying governments the emergency exit of money creation and by forbidding both the ECB and the EU to bail-out troubled governments; or whether, conversely, the maximum threshold that countries have for both their budget deficit and their level of public indebtedness (resulting in broad improvements in budgetary balances) and the possibility that markets do not regard the “no-bail-out” clause as credible, especially in the case of large markets (i.e. that the theory “too big to fail” holds), have actually resulted in a decrease in perceived credit risk.

Secondly, the introduction of the euro reduced segmentation among euro-area government bond markets. The removal of the exchange rate risk brought down an important barrier that had fostered captive domestic markets and had gone some way to explaining the home bias that existed in cross-border investments in the European Union. Adjaouté et al. (2000) traced the extent of the home bias, in both the bond and equities markets, for the major European countries – the UK, France, Germany, Spain, the Netherlands, and Italy – during the period

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<sup>1</sup> Blanco (2001) reports that on the side of the issuers, some significant changes were observed such as the harmonisation of market conventions in the computation of yields, the introduction of a single trading calendar and pre-announced auction calendars, or the increase in issue sizes. In some countries, the creation of large issues was facilitated by the introduction of programmes of exchange of old illiquid bonds for new bonds and by the concentration of issuance activity in a smaller number of benchmark securities. With the aim of attracting more investors, some of the smaller issuers such as Austria, Belgium, the Netherlands and Portugal resorted to syndication procedures. Others such as the French Treasury introduced new instruments such as constant maturity and inflation-indexed bonds.

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