Essays in financial asset pricing in the European Monetary Union

The impact statement

In this thesis, we discuss the different aspects of joining the common currency union such as reducing default risks of its members, interdependence of government bond markets and increasing competitiveness in the financial markets. The topics are concerns not only to the academic community but also to public policy makers as well as private decision makers.

During the corona recovery package discussion in Summer 2020, the members of the European Monetary Union (EMU) discussed the option of establishing a Eurobond, but it did not come to reality as fiscally strong members object. This Eurobond is a jointly guaranteed debt instrument in which each member has full responsibility for repayment regardless its contribution to the common budget. Due to the no bailout principle, the Eurobonds face higher legal obstacles within the EU Treaty and second they face far less politically acceptance by the member states. The main arguments against jointly guaranteed debt instruments are that they can create moral hazard for the weaker members and discourage fiscal discipline for these members. The arguments that support the Eurobonds are that they promote further market integration, increase liquidity and reduce the risk of crises propagation. We find empirical evidence that supports the last argument. Providing insurance to weaker members would benefit all participating members. A second important impact of this thesis will be pointing out the possible consequences of Brexit on European capital markets, especially on equity markets. Next, I will outline the impact of each chapter.

In Chapter 2, we find that, despite the fact that financial markets have become more integrated, country-specific economic fundamentals do matter for European government bond pricing. Among the country-specific fundamentals, fiscal strength, ability to generate taxes to cover its expenses, is important, but relative real economic growth is the most robust across the different estimations. Fiscal consolidation is preferable to improve governments' credibility. On the other hand, if fiscal consolidation has a strong negative effect on economic growth, rather than bringing the government yield spreads down it can put push them up. The policy makers can continue to prioritize fiscal responsibility while promoting economic growth via structural reforms such as investments in education and infrastructure.

In Chapter 3, we focus on the interdependence of government bond markets in the EMU and how the domestic yield spreads are affected by the spreads of other member countries. The importance of interdependence is detected after extracting the country-specific risks and common factors. We find that bilateral trade connections as well as FDI flows are the main propagation channels. Even if each member country takes care of their fiscal responsibility individually, they are still vulnerable during a financial distress period due to the interdependence. The results of this chapter have profound implications on the discussion whether Eurobonds are essential to prevent the crisis propagation due to interdependence in the bond markets in the EMU. In addition, Eurobond instruments can be another way of strengthening the monetary integration of the union.

In Chapter 4, we investigate the intra-day adjustment of the price discovery of Euronext stocks traded in three markets: the home market in which the firms become public for the first time and in which the highest volume of trade occurs and two Multi Trading Facilities (MTFs) operated by the international financial service providers. For this, we introduce a new estimator that measures the contribution of each market to price adjustments. We find that the integration of European equity markets has had the effect that home market dominance no longer holds in Europe. Second, the influence of the MTFs in the price discovery process has increased. The key implication of our results is to pay attention to the possible consequences of Brexit on financial markets, particularly on equity markets. The, MTFs for European stocks operate in London and are subject to U.K regulations and their legal status is unclear after Brexit. Generally, London as a financial center has been the main channel for European financial markets to access the global financial markets, not just for equity, but also for other financial instruments. European policy makers either need to introduce a European capital market union or boost a new financial capital center to be an alternative to London.

In conclusion, this thesis elaborates on topics that are important to prevent crises propagation in the EMU due to interdependence in the bond markets and to improve integration of financial markets in the union. First of all, regarding the question whether jointly backed debt instruments are essential, we provide empirical evidence for the bond markets and arguments to public policy makers to support the debt instruments, the Eurobonds. Second, concerning the question whether financial integration in European equity markets would be affected after Brexit, we find the evidence for the increasing importance of U.K. regulated MTFs served by international financial service providers in London. This requires actions from European policy makers to boost a new financial capital center in the Continental Europe.