The euro is good after all

The euro has increased valuations for large firms in Eurozone countries.

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Economic and Monetary Union (EMU) and the creation of a new common currency for Europe is arguably the most significant institutional change in international financial markets during the past quarter-century. The introduction of the euro as a common currency has already changed the functioning of European financial markets significantly, especially by fostering the creation of a corporate bond market comparable to that of the United States.

Even though most observers agree on the historic significance of the new currency, there has been a lot of skepticism about the wisdom of the endeavor. It is not clear whether monetary union has had a positive or negative effect on European corporations. This paper aims to address this issue by looking at corporate valuations, investments, and financing choices of European corporations.

We use corporate level data from 10 countries that adopted the euro, the three European Union countries (Denmark, Sweden, and the U.K.) that did not join EMU, as well as Norway and Switzerland. Using yearly data we study how the introduction of the euro has affected Tobin's Q (the ratio of a company's total market capitalization to the replacement value of that company's total assets), investments and financing choices in panel regressions that span the years 1995 to 2000. The year 1998 was used as the benchmark for adoption of the euro, instead of the official beginning of EMU in January 1, 1999, for two reasons: in May 1998 the European Council decided on which countries where allowed to join EMU, and; in January 1998 there already was a consensus on which countries would adopt the euro as their currency.

In the period 1998-2000, Tobin's Q for large firms in the eurozone has increased by 7.9% per year compared to firms in non-EMU countries, after controlling for firm, country, and time-specific effects. The increase in valuation is higher for large firms in euro countries with a history of recent currency crises compared to the euro countries that managed to stay within the European Monetary System during the turmoil of the early 1990s (13.8% compared to 6.1%). The previous results suggest that the adoption of the euro has lowered the cost of capital for large European firms through the elimination of intra-European currency risks, especially for large firms coming from countries that were expected to have significant currency risk premia. Furthermore, among small firms we only document a significant increase in valuation for firms coming from countries that have experienced recent currency crises (an increase of 13.2%). Again, this result supports the view that the cost of capital has declined because of the euro. In sum, the euro has increased the value of these firms that we expect *ex ante* to benefit the most from the elimination of currency risks: large firms, firms in countries with weak currencies, and firms exposed to currency risks.

THE RESEARCH INDEED FOUND THAT THE INTRODUCTION OF THE EURO HAS HAD A POSITIVE EFFECT ON INVESTMENTS FOR FIRMS IN THE EUROZONE.

If the cost of capital were lower, then firms would also invest more, so long as investment opportunities had not worsened. The research indeed found that the introduction of the euro has had a positive effect on investments for firms in the eurozone. This effect is stronger for firms that come from EMU countries that used to suffer from currency crises, and for large firms. The next logical question is "How have the investments been financed?" It is not obvious how the lower cost of capital should affect debt and equity choices. The paper found that the increase in investments has been financed mainly with debt, but firms that would have benefited from currency depreciations have also issued more equity. ■