

# The European Bond Markets under EMU

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## Abstract

In this paper, we document how, in the wake of monetary unification, the markets for euro-area sovereign and private-sector bonds have become increasingly integrated. Issuers and investors alike have come to regard the euro-area bond market as a single one. Primary and secondary bond markets have become increasingly integrated on a pan-European scale. Issuance of corporate bonds has taken off on an unprecedented scale in continental Europe. In the process, both investors and issuers have reaped the considerable benefits afforded by greater competition in the underwriting of private bonds and auctioning of public ones, and by the greater liquidity of secondary markets. Bond yields have converged dramatically in the transition to EMU. The persistence of small and variable yield differentials for sovereign debt under EMU indicates that euro-area bonds are still not perfect substitutes. However, to a large extent, this does not reflect persistent market segmentation but rather small differentials in fundamental risk. Liquidity differences play at most a minor role, and this role appears to arise partly from their interaction with fundamental risk. The challenges still lying ahead are numerous. They include: the imbalance between the German-dominated futures and the underlying cash market; the vulnerability of the cash markets' prices to free-riding and manipulation by large financial institutions; the possibility of joint bond issuance by euro-area countries; the integration of clearing and settlement systems in the euro-area bond market; and the participation of new accession countries' issuers in this market.

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