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Does the introduction of the euro affect the debt-equity choice?

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The elimination of exchange rate risk between the countries in the European Monetary Union (EMU) is a key factor spurring the integration of the twelve national financial markets. A larger pool of euro-denominated funds (increased competition between providers of capital), wider risk sharing and better diversification opportunities for capital allocation became available. Hence, the introduction of euro is likely to decrease the cost of finance for firms. This raises the question whether we can identify the change in firms' financing choices due to the euro introduction.

This paper studies the influence of the introduction of the euro on the firm equity and debt issue choices. The paper combines the capital structure literature with the finance and growth literature. To identify the effect of the introduction of the euro due to the decrease in the cost of financing the authors control for the external finance dependence (EFD) of the firm's industry. The firms from industries with higher EFD are the ones to benefit the most from the decrease in the cost of finance.

The analyses are based on firm-level data from Amadeus database provided by Bureau Van Dijk. The analysis focuses on firms from 14 Western European countries, among which 10 belong to EMU. The time period covered in this study is 1995-2002.

The paper finds that Eurozone firms from higher external finance dependent industries do issue more equity compared to other firms after 1999. Comparison between the firms issuing equity versus firms issuing debt indicates that Euro area firms from industries with higher EFD are more likely to issue equity than debt. Hence, the introduction of the euro (the financial market integration) does reduce costs of financing and in particular make the equity finance more appealing. This result gives an extra motivation for the new EU member countries to adopt the euro. The firms from Eastern Europe rely much less on external finance compared to Western European firms indicating that changes in the cost of finance could change the firms financial structures substantially. The paper makes a contribution to the capital structure literature as well by confirming the mean reverting behavior of leverage --- over-leveraged firms are less likely to issue debt and more likely to not issue any securities or to issue equity.

Keywords: Euro introduction, external finance dependence, firm performance.

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