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Introduction

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On December 3, 1998, less than a month before the start of the new currency union, the Economic Council of Sweden and the Bank of Sweden Tercentenary Foundation organised a conference on the theme of *Risk allocation and the European Monetary Union.* This volume contains the five conference papers and discussants' comments.

Readers may feel that a sufficient number of conferences were held on EMU and the euro to exhaust the topic. So why another conference? Most of the public debate and academic research has dealt with the new currency union from a macro perspective. But the new currency also creates a new situation in financial markets. With one new currency substituting for 11 old ones, the choice set facing portfolio managers has been fundamentally changed. How can this be expected to affect portfolio allocation? How will changing portfolios alter international capital flows, liquidity, and trading activity in different financial markets? Will the euro challenge the US dollar as the leading vehicle currency of international transactions? The papers in this volume attempt to answer some of these questions.

In "EMU and the changing structure of macro risks", **Hans Genberg** takes a macro perspective. He discusses how the EMU affects macroeconomic fluctuations, particularly in the small European non-member countries (the *outsiders*). He warns of more frequent financial disturbances during the initial period of the monetary union and concludes that the outsiders may be faced with a conflict between stabilising the exchange rate and the domestic monetary stance. In the slightly longer run, he argues that the monetary union will probably lead to more synchronised business cycles within the euro zone. So the demand for outsiders' exports will fluctuate more. Genberg's conclusion is that macroeconomic policy faces new tough challenges. At the same time, policy making is becoming more difficult as old macroeconomic relationships change in response to the creation of the monetary union.

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Three papers deal directly with portfolio choice and the impact of the union on the risk structure.

In "The euro and portfolio choices—a Nordic perspective", **Eva Liljeblom** and **Anders Löflund** start by questioning benefits of international diversification, in general, for Nordic investors. They find that the domestic stock returns are increasingly correlated with international returns. Nevertheless, international diversification is found to offer significant benefits in the sense of allowing investors higher expected returns without having to pay the price of more variable returns. They also find that the correlation tends to be higher when market volatility is higher. In this sense, the benefits of international diversification are smaller when they are most needed. The authors also simulate the impact of the advent of the EMU. Interestingly, this appears to have only a limited impact on optimal portfolios.

Giorgio de Santis, **Bruno Gerard** and **Pierre Hillion** estimate the premium that investors have obtained by bearing currency risk in "Portfolio choice and currency risk inside and outside the EMU". They divide the risk into the components associated with EMU and non-EMU currencies and find that the premium for non-EMU risk has increased over time and now accounts for most of the aggregate currency premium. Their model yields predictions of expected returns and variances and covariances that change over time. The authors use these predictions to simulate dynamic strategies for investing in different assets. They find that including currencies among the assets, alongside equities, significantly improves performance. But most benefits come from non-EMU currencies. This leads them to the conclusion that the euro will probably not have a major impact on portfolio choices of international investors.

In "Economic, financial, and fundamental global risk inside and outside the EMU", **Wayne Ferson** and **Campbell Harvey** note that the euro will simplify the structure of currency markets. They exploit this on historical data by creating a synthetic euro. Estimating a three-currency model with the dollar, yen, and a synthetic euro, they find evidence that euro currency risk affects expected return. Their findings also suggest that aggregating currencies in this way has an impact on other issues in asset-pricing research. It has recently been found that stocks with low price-to-book ratios, (i.e., the ratio of book value of equity to the stock-market value of equity) earn excess returns, and it has been claimed that price-to-book measures exposure to an underlying risk factor. But in their model with euro currency risk, Ferson and Harvey find that a global price-to-book factor has little extra explanatory power.

Apart from affecting the risk structure and portfolio choices, the euro may also be used for transaction purposes. In "The euro and the changing role of currencies as transactions vehicles", **Paul Mizen** discusses whether the euro will challenge the US dollar as the leading currency in international transactions and asset portfolios. Dominant currencies have been historically associated with economic/political power and stable monetary policy. Mizen argues that the euro is likely to fulfil both criteria: (1) The euro-zone economy is at least as large as the US economy. (2) European politics during the 1990s reveal a considerable commitment to create a strong currency. This suggests that the euro will emerge as a very important currency—not just within Europe but also in transactions between third parties. But Mizen argues that it is not likely that the euro will displace the US dollar any time soon, because existing network externalities for currently leading currencies are typically only eroded slowly.

The impact of the euro on the risk structure that faces investors ultimately depends on how the EMU will affect macroeconomic policies. To understand how this may affect investor behaviour, one needs empirical asset-pricing and portfolio-choice analysis. The papers in this volume represent both macro and finance perspectives. We hope to see more research that integrates these lines of research in the future.