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AN ASSESSMENT OF FINANCIAL INTEGRATION IN EUROPEAN UNION

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Abstract. Financial integration is considered to be one of the key factors for making Europe more efficient, and for contributing to sustainable economic growth. Financial integration has been occurring in the European Union for many years and that intensified after adoption of the common currency in 1999. The progress in the financial sector has been achieved in individual segments of financial sector in European Union. Euro area money market and government bond market are the most integrated markets. However, the recent crisis has sharpened the potential impacts of financial integration, and business activity in the European financial services sector shrank. In this regard, this study aims to assess the European financial integration in the context of recent crisis. In order to achieve this, this study analyzes the literature and recent experience, and gives the recent trends about financial development. The study shows that the global financial crisis has had a major impact on the performance of the EU financial integration. Major policy initiatives have been taken in the EU pursuit of crisis control and mitigation. Especially, financial rescue policies have focused on restoring liquidity and capital of banks and the provision of guarantees. The current crisis reveals the need for efficent financial system. Policy measures should promote the recovery of the financial sector, and build a stronger financial system.

Keywords: European Union, financial integration, financial crisis, euro area, financial markets, financial development.

Jel: G0, G1, G3

1. Introduction

Over the past decade, financial crises seem to have become more frequent and more distruptive than in the past. They also seem to propagate more rapidly. This experience has spurred intense interest among academics in the understanding the link between financial integration and crises, and in better assessing the merits of financial integration in Europe.

Financial integration improves macroeconomic stability by allocative efficiency and economic diversification. Cross-border banking tends to improve overall economic performance by ensuring that productive capital is channelled towards the most efficient firms, thereby reducing the risk of crises stemming from mispricing of investment risk (Giannetti, Ongena 2009). The links between the size of the financial system and the level of economic development are well-documented (King, Levine 1993). Integrated financial markets help to realise the full economic potential by increasing competition and expanding markets. This results in lower intermediation costs and a more efficient allocation of capital, which in turn raises the potential for increased economic growth. A study for European commission estimates the potential impact of financial integration to be a 1% increase in EU GDP growth (Giannetti, Guisa, Padula, Pagano 2002). In addition, the transformation of the financial system can have an impact on the stability of the system itself, with possible consequences on the whole economy. The transition between actual and desired capital stocks can be significantly accelerated by capital inflows (Hoxha, Kalemli-Ozcan, Vollrath 2009).

However, many researches, e.g. Edison et al. (2002), Agenor (2003), Baele et al. (2004), Komárek and Komárkova (2008) and ECB (2010) also mention some costs of financial integration: (i) high degree of concentration of capital flows and lack of access to financing for small countries; (ii) inadequate domestic allocation of these flows, which may hamper their growth effects and exacerbate pre-existing domestic distortions; (iii) loss of macroeconomic stability; (iv) pro-cyclical movements in short-term capital flows; (v) high degree of volatility of capital flows, which relates in part to herding and contagion effects; and (vi) risks associated with foreign bank penetration.

Although financial integration carrys some costs, it is considered to be one of the key factors for making Europe more efficient and competitive and, ultimately, for contributing to sustainable economic growth. The EU's financial integration has been an ongoing process during the last decade and has made substantial progress, particularly in the wholesale financial sector (EC, 2009). However, the recent crisis has sharpened potential impacts of financial integration.

The purpose of this paper is to assess financial integration in Europe in the context of crisis. In order to achive this, section 2 provides an overview of European financial integration. Section 3 gives the current situations and basic problems in Europe. Section 4 discusses policy initiatives and lessons from crisis. Last section provides a conclusion.

2. An overview of European financial integration

The most of the literature on the role of financial markets in spurring growth has identified a number of channels through which financial development affects investment and growth. First, by narrowing the wedge between the cost of capital to

firms and the return paid to households, a more efficient financial industry should raise the level of investment. Second, it should improve the allocation of investment across alternative projects, with the funding of higher-return and riskier ventures (Jappelli, Pagano 2008, 3). In addition, integrated financial systems improve the allocation of productive resources, foster entrepreneurship and innovation, enhance market disipline, and help countries to insure against macroeconomics fluctuations. Financial integration can also provide many benefits to economies by rendering them more stable and resilient. Especially, financial integration improves the resilience of the global financial system is risk sharing. Improved risk-sharing opportunities allow economic agents to smooth their consumption and investment patterns better over time. The risk sharing provided by financial integration and increased foreign capital flows have also benefited relatively developed countries, for which the integration of the central and east European countries since 1989 has served as a prime example (Gonzalez-Paramo 2010). Moreover, improved risk-sharing enhances in turn the ability of countries to specialize in their most productive sectors, leading to increased economic efficiency (Kalemli-Özcan et al. 2003).

Financial integration has proceeded at a remarkably rapid pace within Europe in the past two decades, especially following the introduction of the euro. The process has affected not only the working of financial markets but also the real economy (Jappelli, Pagano 2008). The EU has moved to increase financial integration within the Union to make the monetary union represented by the Eurozone operate more efficiently and the help the EU members realize the full potential of the EU (Jackson, 2009).

The achievements of European financial integration are truly impressive. Prior to the advent of the euro in 1999, European authorities took deep and successful steps to stabilize cross-country exchange rates and eliminate controls on international capital movements within euro zone. The introduction of the single currency has led to an acceleration of financial integration by eliminating intra-zone exchange rate risk and achieving low and stable inflation. Indeed, the establishment of a common currency backed by a European Central Bank with a clear monetary policy mandate and underpinned by firm fiscal rules has helped to clarify policy responsibilities and make more transparent the structure of this huge multi-country economic region. This has had the expected positive effect on European economies and on global markets. Inflation in the euro area countries has come down substantially, nominal interest rates have fallen, and inflation expectations have become well anchored at low and stable levels. As a result of these achievements, the European Central Bank has rapidly established itself as a key and credible institution in global financial markets (Knight, 2007).

Greater macroeconomic stability has also boosted European financial integration. From the earliest years of the euro, issuance of corporate debt securities surged,

supported by the elimination of exchange rate risk within the currency zone and higher demand from a larger pool of investors. Likewise, a deep euro area-wide interbank money market developed rapidly. This is a key component of the financial infrastructure of the euro zone. Its rapid development owes much to the major efforts of the European Central Bank in elaborating its monetary policy procedures and its liquidity operations (Knight, 2007).

Rajan and Zingales (2003) show that the boom of the corporate bond market after 1999 was stronger in the euro area than outside and suggest that the introduction of the euro was a major causal factor in this development. In addition, Baele et al. (2004) analyze the degree of integration of the corporate bond market under EMU, taking into account that corporate bonds differ in several key respects other than the country of issue. They find that yields are mostly driven by common factors, while the effect of the country of issuance is extremely small. This suggests that the corporate bond market has achieved a remarkable degree of integration.

Quantity-based indicators provide further evidence about the progress of integration in this market. Indeed, the percentage of bond investments originated by other EU countries has recorded a significant increase in 2007 reaching a level of 70%, compared to 67% in 2006. Country level data for 2007 confirms that the EU 'regional' bias is particularly significant for EU-12 countries where, in many cases, EU bond investors account for more than 90% of total bond investments (EC, 2009).

Credit markets have integrated much more slowly than bond markets, presumably because of the heterogeneity of borrowers and the local nature of the information that lenders need (Jappelli, Pagano 2008).

Stavarek et.al. (2011) evaluated the degree of financial integration in the European Union. Accroding to their study, the euro area money markets are nearly fully integrated. The degree of integration in the government bond market has become very high since the introduction of the single currency. Despite a rising degree of integration and a considerable reduction in the home bias in equity portfolios of institutional investors, the euro area equity market remains the least integrated. Integration of the financial infrastructure and harmonization of financial legislation has advanced since 1999. In this field, progress has been especially achieved in evolution and implementation of common payment and settlement systems. By contrast, a securities settlement platform and a system for using central banks marketable and nonmarketable assets still require further integration.

The global financial crisis has had a major impact on the performance of the EU financial sector. For the first time in years, business activity in the European financial services sector shrank. The size of the EU wholesale financial sector fell by 0.3% in 2008, with a further contraction of 6.2% forecast for 2009. Moreover, it was shrinking at a faster pace than the overall economic activity. The real GDP in the EU-27 grew by

0.8% in 2008 while it was forecasted to fall by 4% in 2009. The retail financial services business was hampered by high risk aversion of financial institutions and their clients, worsening financial standing of households and enterprises and a range of other negative consequences of the economic slowdown (EC, 2009).

There is a broad consensus that financial crises tend to have three phases (Diamond, Dybvig 1983; Calomiris, Gorton 1991; Brunnermeier et al. 2009): i) a solvency shock affecting a relatively small part of the financial system caused by, for example, a decline in house prices; ii) a general run for liquidity resulting from asymmetric information about the size and location of solvency problems that takes advantage of the substantial amount of maturity transformation services performed by financial intermediaries and markets—i.e., financing long-term assets with short-term liabilities, including bank deposits; and iii) widespread insolvencies following the financial and real dislocations triggered by the run for liquidity and the associated decline in the use of the functions of finance (Bernanke 1983; Merton and Bodie 1995).

In the context of crisis, following section assesses the current situations and basic problems in European financial integration.

3. Current situations and basic problems in European financial integration

European financial integration have proceeded at different paces in different financial markets. Integration of the retail banking markets, for instance, has remained limited, reflecting the persistence of legal, institutional and regulatory differences. Even a cursory reading of the financial press shows that financial integration is making visible progress almost day by day (Knight, 2007). Freiedrich, Schnabel and Zettemeyer, (2010) shows that the European transition region benefited much more strongly from financial integration in terms of economic growth than other developing countries in the years preceding the current crisis.

Financial and monetary integration have been reinforcing each other, with financial integration fostering the process of monetary union, and monetary union strengthening efforts to increase financial integration (Winkler, 2010). The available evidence (Hartmann et al. 2001; Gaspar et al. 2001; Perez-Quiros, Mendizabal 2006) suggests that both the unsecured and secured segments of money markets have reached a high degree of integration. There is not only high level of integration within the euro area money markets recorded, but the speed of convergence is very high as well. A very fast convergence of interest rates was found across the Europe (ECB, 2005).

However, the financial turmoil has heavily impacted on the European money market. According to European Commission financial integration report, the country dispersion of the interest rates of both the unsecured and the secured segments, reached their peak in the third quarter of 2008 and over the same period, the cross-country

standard deviation of EURIBOR started to exceed that of the EUREPO rates. While the share of “other euro area” counterparties for the unsecured segment decreased from 50% to 42% over the period 2007-08, it remained almost stable in the repo market. Unsecured money markets of non euro area countries have been heavily affected by the market turbulence as well (EC, 2009).

The size of the financial sector gives an idea about the depth of financial intermediation. The amount of M2 as a percentage of GDP, acts as an indicator of the depth of the financial sector. This monetary aggregate has increased until 2009. However, the improvement in the size of the financial sector remained same between 2009 and 2010 (Fig 1).

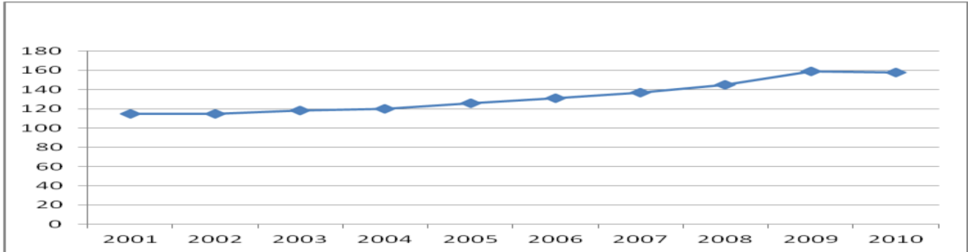

Fig. 1. M2 as a percentage of GDP in EU(Source: Worldbank databank).

The level of bank intermediation, measured by the ratio of domestic credit by banking sector to GDP, has increased since 2001. However, the speed of increase in credits has slowed down after 2009 (Fig. 2).

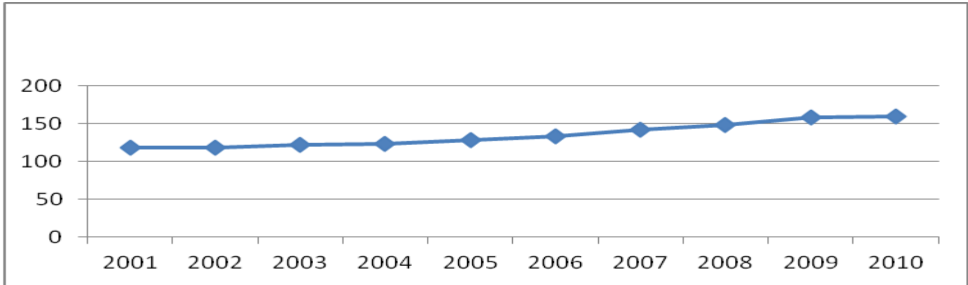

Fig. 2. Domestic credit provided by the banking sector (% of GDP) in EU (Source: Worldbank databank).

Credit depth of information index indicates the availability of more credit information to facilitate lending decisions. Credit depth of information index gives same results for EU. Credit depth of information index had lower values the last three years (Table 1).

Table 1. Credit depth of information index (Source: Worldbank databank).

2004	2005	2006	2007	2008	2009	2010
4	5	5	5	4	4	4

Cross-border banking integration has been associated with the transmission of financial distress from banks'balance sheets to the corporate sector of countries which were not the origins of the shock (Popov, Udell 2010) However, this effect has mostly worked through banks which relied predominantly on wholesale funding, rather than on a strong deposit base (Puri, Rochol, Steffen 2009)

Likewise, in the euro zone, the money and public debt markets integrated almost immediately with the adoption of the single currency. In the equity, repo, corporate bond and especially credit markets integration has instead proceeded more slowly and is currently still incomplete (Jappelli, Pagano 2008). Since the beginning of the financial crisis, a considerable decline in financial integration has been observed in the euro area. Especially, cross-border provision of financial services in the euro area has declined rapidly since the second half of 2008, in a particular in wholesale and securities-related activities. By contrast, retail banking integration, which had originally remained at a lower level, seems to have been less affected (ECB, 2011).

According to ECB (2010) quantity-based indicators show that the degree of integration in equity markets is rising. The holdings of equity issued in other euro area countries are growing. However, the financial crisis slowed down the increasing trend in the area.

In terms of market capitilization, EU experienced the lowest market value in 2008. EU stock markets had a fluctuation process between 2001 and 2010. Both global financial crisis and debt crisis affected the stock markets, negatively (Fig.3).

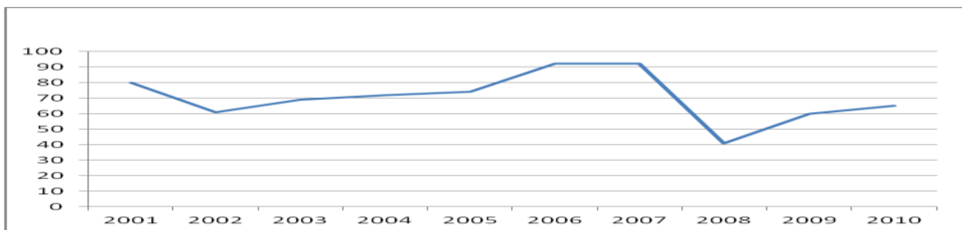

Fig 3. Market capitilization of listed companies (% of GDP) (Source: Worldbank).

Euro area equity markets have also been affected significantly by the market turbulence. Since October 2007, the cross-country dispersion has started to rise, reversing the previous trend, and has begun to exceed the cross-sector dispersion with

increasing differentials. The impact of the turmoil on the euro area equity market integration is confirmed by the increasing relevance of global shocks in explaining equity volatility in comparison to euro area events (EC, 2009).

The government bond yields reveals increasing spread divergences between the German benchmark and other euro area sovereign bonds since the beginning of market turbulence. This trend partly reflects the increase of country-specific risks and related credit risk premiums linked to rising concerns about fiscal soundness of certain euro area countries in the midst of the market crisis. Also non euro area government bond markets have been heavily influenced by the crisis and an increasing divergence among non euro area bond yields has been recorded since 2007. Both indicators show an inversion of the trend in 2009. They suggest that to a certain extent the experienced disintegration might have been a short-term phenomenon linked to the dynamics of the financial crisis (EC, 2009).

The main causes behind this unexpected upsurge in liquidity risk and credit risk are two key factors: information failures in credit markets; and weaknesses in the "originate-and-distribute" business model adopted in recent years by large internationally active banks.

First, the opacity of certain parts of the global financial marketplace, particularly the markets for structured financial products and the off-balance sheet vehicles designed to hold them has led to a sudden collapse of confidence in asset valuations and a generalised distrust of counterparties. As a result, market participants wonder about the size and character of banks' exposures because of the existence of explicit or implicit backup credit lines to a wide variety of market players. Beginning last summer, this crisis of confidence triggered an evaporation of market liquidity for the instruments concerned and a funding liquidity squeeze for those institutions that were suspected of being vulnerable to them (Knight, 2007).

Second, weaknesses in the "originate-and-distribute" business model of the large banks, primarily in the United States and Europe. The operation of this model in recent years has been associated with an excessive relaxation in standards of credit origination and credit monitoring in the financial system as a whole. As a result of the current turmoil, the originators and securitisers of complex financial instruments have become the "holders of last resort" of the more exotic credit products. This development has also underlined weaknesses in the risk management practices of investors, who underpriced the risks concerned and relied excessively on external ratings for monitoring risk. And it has demonstrated that the wider distribution of risk across the financial system, if not supported by transparency and market discipline, makes it difficult to gauge the risk exposures of market participants (Kinght, 2007).

4. Major policy initiatives and lessons from the crisis

Since the spring 2009, there has been a stabilisation of the European financial sector. To a large extent this recovery has been policy induced, and has been based on large scale coordination involving a combination of monetary, fiscal and financial services policy instruments. This unprecedented policy action has been necessary to re-establish confidence and get markets back to normal, in view of the increasing financial globalisation and deepening financial integration within the European Union (EC, 2009).

Major policy initiatives have been taken in the EU pursuit of crisis control and mitigation. Financial rescue policies have focused on restoring liquidity and capital of banks and the provision of guarantees so as to get the financial system functioning again. Deposit guarantees were raised. Central banks cut policy interest rates to unprecedented lows and gave financial institutions access to virtually unlimited lender-of-last-resort facilities. Governments provided liquidity facilities to financial institutions in distress as well, along with state guarantees on their liabilities, soon followed by capital injections and impaired asset relief (EC, 2009). The EU policy framework for crisis management builds on existing institutions and procedures. This EU framework could be summarized following Table 2.

Table 2. Crisis policy frameworks (Source: European Commission)

	Crisis prevention	*Crisis control and mitigation*	*Crisis resolution*	*EU coordination frameworks*
Financial policy	Regulation, supervision (micro- and macroprudentional	Liquidity provision, capital injections, credit guarantees, asset relief	State-contingent exit from public support; audits, stress tests, recapitalisation, restructuring	EU supervisory committees, Single Market, Competition policy, joint representation in international fora (G20)
Monetary policy	Leaning against asset Cycles	Conventional and unconventional expansions	State-contingent exit from expansion, safeguarding inflation anchor	Single monetary policy, European System of Central Banks
Fiscal policy	Automatic stabilisers within medium-term frameworks, leaning against asset cycles	Expansions plus automatic stabilisers, while respecting fiscal space considerations	State-contingent exit from expansion, safeguarding sustainability of public finances	Stability and Growth Pact, European Investment Bank
Structural policy	Market flexibility, entrepeneurship and innovation	Sectoral aid, part-time unemployment compensation	State-contingent exit from temporary support	Single Market, Competition policy, Lisbon Strategy

EU coordinated tools	Micro- and macro-prudential surveillance, fiscal surveillance, peer pressure,	Liquidity provision, balance of payment lending facilities, eurobonds	Definition of coordinated exit strategies, structural funds

As the institutions underpinning the common currency have clearly been inadequate during the crisis, highlighting the need to delegate more country sovereignty to the center. The first lesson from the crisis is that effective functioning of the economic and monetary union requires some kind of fiscal risk-sharing mechanism at the euro area level, to provide assistance to countries facing sovereign funding pressures and to back up European Central Bank emergency operations (Allard, 2011). Experience suggests that prior to the current turbulence investors underestimated the tail risks to which they were exposed, including the interdependencies between credit, market and liquidity risks. The European Central Bank has shown great success in maintaining an appropriate monetary stance while at the same time fine-tuning its liquidity operations in the interbank market so as to ensure that its overnight rate remains broadly on target, and that monetary conditions continue to be set effectively given prevailing macroeconomic conditions. And the ECB has also been a leading central bank in taking action to address dislocations in the longer-term interbank money markets, even though this has proven difficult to realise given that the term premium comes from banks' own uncertainties about liquidity and counterparty risks. In this regard, euro zone monetary policy will continue to play a key role in fostering further European financial integration (Kinght, 2007).

A second lesson is that the euro area institutions' oversight of fiscal and macroeconomic policies at the national level needs to be seriously strengthened. Governance is indeed being enhanced at the supranational level to reinforce budgetary discipline and better monitor the build up in imbalances (Allard, 2011).

Third lesson, the need for an integrated, pan-European approach to financial supervision, regulation, and crisis resolution has become increasingly evident as the crisis has unfolded. European institutions have recently been set up; they will bring much-needed coordination in supervision and systemic risk assessment. But it will be equally important to complete the region's financial stability framework with the establishment of a European resolution authority that would provide a common backstop for banks irrespective of nationality. Only then will the fate of banking sectors be fully delinked from that of their respective sovereign (Allard, 2011). Greater financial stability calls for closer communication and cooperation among players in the financial system, not just within the official sector, but also between the official and private sectors (Knight, 2007).

5. Conclusion

The financial integration process has accelerated in European Union since the advent of the euro in 1999 has contributed importantly to a remarkable rise in greater financial stability. The studies show that financial integration is increasing in Eurpean Union. Especially, Euro area money markets are fully integrated. Additionally, the degree of integration in the government bond market and equit market is rising. However, the recent crisis has affected the the degree of financial integration and sharpened the potential impacts of financial integration. The crisis demonstrated that there is a need to strengthen the financial system to make it more able to with stand future financial shocks. In particular, the reform of the system needs take into account the increasing pace of financial globalisation as well as the deepening of financial integration within the European Union. One aim should promote the recovery of the financial sector. Another aim should build a stronger financial system, which is more able to resist future financial shocks.

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FINANSŲ INTEGRACIJOS VERTINIMAS EUROPOS SĄJUNGOJE

N. Terzi

Santrauka

Finansinė integracija yra laikoma vienu iš svarbiausių veiksnių siekiant, kad Europos ekonomika veiktų efektyviau, ir prisidėti prie tvaraus ekonomikos augimo. Finansinė integracija Europos Sąjungoje vyksta jau daugelį metų ir ypač suintensyvėjo po 1999 m. priėmus bendrą valiutą. Viso Europos Sąjungos finansų sektoriaus progresas buvo pasiektas atskiruose segmentuose ir tokiu būdu pažanga buvo pasiekta. Tačiau neseniai įvykusi krizė išryškino galimai neigiamą finansų rinkų integracijos poveikį, ir Europos finansinių paslaugų sektoriaus veikla sumažėjo. Atsižvelgiant į tai, šio tyrimo tikslas - įvertinti Europos finansinės integracijos ypatumus neseniai įvykusios krizės kontekste. Siekiant pasiekti šį tikslą, analizuojami literatūros šaltiniai ir naujausi įvykiai, kuriais remiantis galima numatyti tam tikras finansinės plėtros tendencijas. Tyrimas rodo, kad pasaulio finansų krizė turėjo didelį poveikį ES finansinei integracijai, tačiau įvairių politinių iniciatyvų pagalba buvo siekiama valdyti krizę ir ją sumažinti. Tokia finansų sektoriaus gelbėjimo politika buvo siekiama atkurti bankų kapitalo likvidumą ir suteikti garantijų. Taigi dabartinė krizė atskleidžia efektyvios finansų sistemos poreikį, o taikomomis politinėmis priemonėmis turėtų būti skatinamas finansų sektoriaus atsigavimas siekiant sukurti stipresnę finansų sistemą.

Reikšminiai žodžiai: Europos Sąjunga, finansinė integracija, finansų krizė, euro zona, finansų rinka, finasų vystymasis.

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