European financial integration: before, during and after the crisis

In 1990, the European Commission presented a report,[1] under the suggestive title of «One market, one money», that outlined the path to follow in order to implement the euro. Together with other fronts of action for the European Union, the intention was none other than to further European integration, starting with the monetary aspect, going on to financial markets and finally reaching economic and social dimensions. The euro officially got underway in 1999. The widespread impression during its first decade of existence was one of satisfaction, with notable advances being observed in the integration of financial markets. However, the galloping crisis over the last few years has turned the situation on its head and the spectre of irreversible financial fragmentation has become a cause for great concern, given that it could jeopardise the whole of the European Union project.[2]

The concept of financial integration is quite complex and difficult to measure.[3] The ECB defines it as a situation in which there are no frictions that discriminate, particularly based on location, between economic agents in terms of access to capital and their investment possibilities. More operational approaches identify financial integration with the fulfillment of the single price law (e.g. companies with the same relevant characteristics should be offered the same interest rate for the bonds they issue or their bank loans, irrespective of their country of origin), as well as a considerable or growing presence of cross-border flows or holdings of financial assets (e.g. pension funds that invest in shares from other countries or banks with asset and/or liability transactions abroad).

According to this notion, the effects of financial integration take on a particular tone in the case of the euro area considering two of its distinctive traits: this is a non-optimal monetary area and its financial system is based on banks. Firstly, well-structured financial integration that manages to boost financial development helps to improve the efficiency of the economic system and thereby the standard of living of its citizens. In fact, this is true for most international processes of this nature, as numerous theoretical and empirical studies have shown over the years.[4] In Europe's case, it is believed[5] that financial integration provides national economies with flexibility and, at the same time, market discipline, as well as their mutual convergence and synchronization. But to achieve this it is

(1) «One Market, One Money. An Evaluation of the Potential Benefits and Costs of Forming An Economic and Monetary Union», European Economy, No. 44, 1990.
(2) In Gual, J., «European Integration at the Crossroads», "la Caixa" Economic Papers, No. 8, 2012 there is an extensive discussion of financial and bank integration together with fiscal integration, economic policies and political union.
(3) Every year the ECB publishes the report entitled «Financial Integration in Europe», which provides an exhaustive review of integration in a wide range of markets. In parallel, the European Commission also produces, every year, its «European Financial Stability and Integration Report».
(4) See a brief, up-to-date review in Beck, T., «Finance and Growth: Lessons From the Literature and the Recent Crisis», LSE Growth Commission, 2012.
(5) See, for example, Lane, P.R., «The Macroeconomics of Financial Integration: A European Outlook», IIIS Discussion Paper No. 265, 2008.

necessary for the financial integration process to be harmonious, both internally and in its interaction with the other economic and institutions policies, at an EU level and also that of the Member states. Secondly, there are the effects on stability, its pros and cons. On the one hand, integration provides stabilizing elements such as increasing the possibilities for diversifying portfolios as well as sources of financing. On the other, it is a potential source of tension due to phenomena such as the greater complexity of financial relations, episodes of a sudden reversal in capital flows and cross-border contagion. In addition, proper financial integration is required in order for the transmission of monetary policy to work properly, a basic instrument in stabilization.

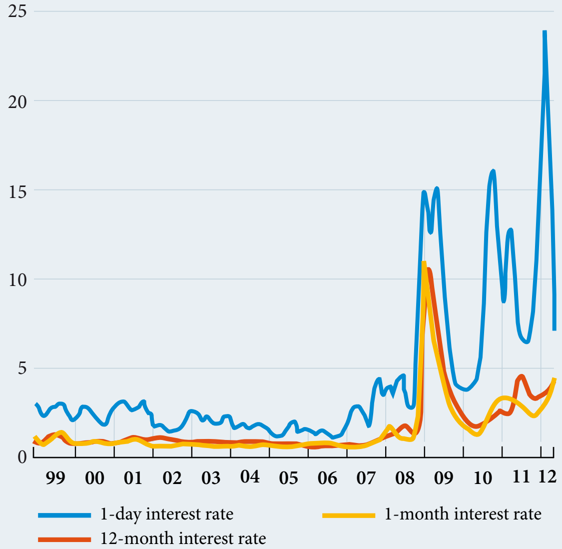
As in many other areas of public policy in Europe and in the rest of the world, over the two decades prior to the outbreak of the crisis, the focus adopted prioritized efficiency over stability, trusting that market mechanisms would function correctly. This helps to explain the strategy adopted by authorities to boost financial integration. The institutional framework's two main elements were the Single Market Programme (freedom of movement and establishment) and the creation of the euro (elimination of exchange risk and simplifying transactions). Some have classified this approach as a «pull strategy» insofar as these two pillars lay the foundations and provide incentives for subsequent actions, both by private agents and the regulators themselves, to gradually establish an integrated financial system. Alternatively, what might be called a «push strategy» would have consisted of introducing, at an EU level and early on, all the system's institutional and legal pieces to support the markets, thereby «forcing» integrating actions on the part of agents. There were certainly some outstanding contributions in this respect, such as the Financial Services Action Plan (coordination of standards and various financial institutions) and the harmonization of microprudential bank regulation (the directives implementing the Basel agreements on banks' capital requirements) but other, very important elements were missing, as would be realised later. In any case, for years the results were satisfactory, with a considerable advance in financial integration in most markets. Of note was the fast integration of the securities and bond markets but this was also remarkable in areas of banking, particularly in wholesale financing markets (interbank, securitization, etc.) and, to a lesser extent, in the retail markets of loans and deposits.

The serious and persistent crisis erupted within a complacent climate in terms of this strategy, the problems starting in 2008 in the United States and worsening as from 2009 with Greece and then other peripheral countries. The process of building up financial integration came to an abrupt halt and has subsequently gone backwards. First of all, the insufficiencies and dysfunctions of the existing institutional system came to light. Moreover, the decisions made by the authorities as they went along often merely accentuated fragmentation. The epicentre of these problems lies at the core of Europe's financial system: banks. The fact that the safety net for banks is national in scope rather than European has been a determining factor in the withdrawal of banks to within their own borders. Deposit guarantee schemes are different and separate for each country. Similarly, bank bail-outs have operated on a national scale barring exceptional cases (such as Dexia and Fortis), which have required bilateral agreements between the governments affected, although they are still far from being a collective solution. The ECB's function as a lender of last resort has also stumbled against the fatal problem of the absence of any central fiscal authority with sufficient power to withstand its risks. Consequently, part of the liquidity has been provided under the ELA regime (Emergency Liquidity Assistance), through which the central bank of the country in question assumes the risk involved. These kinds of developments have given risen to a severe process of disintegration or segmentation of markets, especially noticeable in banks' wholesale financing markets (money and bond markets) and, by extension, in the sovereign debt market, creating a perverse feedback loop.

THE INDICATORS FOR PRICES AND QUANTITIES SHOW CLEAR SEGMENTATION IN THE INTERBANK MARKET

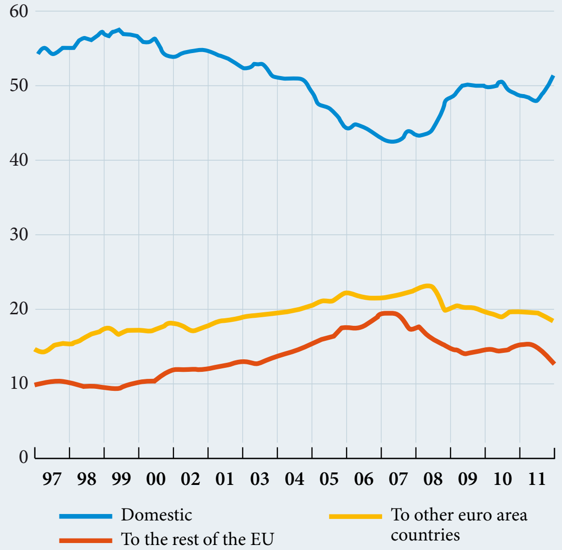
Dispersion of interbank interest rates between euro area countries

(Standard deviation of the average Euribor rates in each country; moving average of 61 days, in b.p.)



Distribution of interbank loans by counterparty's country of residence

(Loans between monetary financial institutions excluding the Eurosystem; in % of total)



SOURCE: European Central Bank.

Many observers believe that this regression is evidence of the failure of the integration strategy adopted for the last twenty years, classifying it as naive or simply wrong in its technical design.(6) A more benevolent view believes that it was a pragmatic, subtle option given the political reticence to accepting the fiscal implications of implementing a bank safety net at a European level. In this respect, it can be said that the strategy has worked, resulting in an emergency situation that would be the only way to make the powers that be take politically compromising decisions. Both interpretations might possible be valid. Whatever the case, there is now the urgent need to act. In fact, the authorities have already reacted by formulating new proposals: the so-called «banking union», whose main elements(7) are analysed in the rest of the boxes in this issue. The hope is that these reforms will act as a catalyst to once again move towards integration, correcting the errors or dysfunctions of the past and reinforcing the positive lessons learned. Political determination and technical skill will be crucial to overcome the trap we have slipped into of «one money, several markets».

(6) In fact, there were several prior warnings of the weaknesses of the model adopted, for example in Dermine, J., «European Banking Integration: Don't Put the Cart Before the Horse», Journal of Financial Markets, Institutions and Instruments, Vol. 15 (2), 2006.
(7) These elements are, on the one hand, those that make up the safety net (in particular deposit guarantee schemes and the mechanisms to recover from and resolve bank crises) and, on the other, those that help to control bank behaviour (regulation and supervision).

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