

Financial integration and European priorities¹

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Over the last 10 years, there has been a remarkable advance in financial integration in the EU and especially the euro area. As evidenced by European Central Bank research, money markets are now completely integrated within the euro area, and the only significant reason why government bonds are not perfect substitutes to each-other is the persistence of specific issuer risk. A large, liquid and efficient corporate bond market has been created, whose size has more than doubled since the launch of the single currency. Public (let alone private) equity markets are still less integrated and less competitive, but changes are noticeable. Finally, after having remained sheltered for a long time, the banking sector has recently experienced a recent rise in large-scale cross-border mergers.

There are certainly not only bright spots in the landscape. Some markets remain segmented, and the Lamfalussy process for legislation and regulation is a slow and cumbersome one. According to the European Commission (2004, 2005) there is very little evidence of integration, or advance towards it, in retail services such as consumer credit, mortgage credit and insurance. In these sectors, cross-border transactions are virtually nonexistent and price divergence remains important. The picture is therefore not a uniform one.

The question is, how should one assess this situation in the context of the broader European economic agenda? The usual answer is that much has been achieved but that more efforts are needed in order to reap the full benefits of financial integration – until we reach the end-goal, namely, a completely integrated market. This has been, and still is to a large extent, the vision that inspires the European Commission – a simple, forceful proposition that everybody can understand and which can easily be developed into an agenda.

This is also a view that economists find hard to dispute. We all know that financial integration yields significant benefits (this was actually one of the motives for undertaking the creation of a single currency). We also know that as a rule, opposition to it is inspired by the desire to

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perpetuate inefficient arrangements and protect rents. Efficiency arguments thus seem to call for more integration.

But is it a view that helps to best define an agenda for the next few years? I would like to suggest here is that though broadly appropriate, the standard approach to financial integration remains somewhat general and does not take sufficiently into account the economic priorities of the EU and the euro area.

In what follows, I start with some stylised facts on the current state of financial integration in comparison to the degree of integration of products and labour markets. I discuss next the implications of this situation for the integration agenda. I then turn to the current economic priorities of the EU and the role financial integration can play, before concluding.

Throughout this paper, the main focus is on the euro area, though I will also make observations with relevance for the EU as a whole.

1. Capital, product, and labour market integration

A stated goal of the EU is to create a single market for goods, services, persons and capital. Since the very early days, financial integration has been part of this wider agenda. An appropriate starting point is therefore to compare the state of financial integration to the state of integration in other areas.

This is a less easy task than it seems because appropriate indicators for comparing the degree of integration across markets are lacking. But there is little doubt that on the whole, European financial markets today are at more integrated than product markets and by a very wide margin more integrated than labour markets.

Let us start with capital. As indicated, there are many different markets we could look at, but a few general observations can be made. Philip Lane (2005a, 2005b) recently assessed patterns of cross-border bond holdings. He finds that in the euro area, more than 60% of the bonds in the residents' international portfolios are issued by other euro area countries, a disproportionate proportion in view of the weight of the area. The bias is less pronounced for equities, but here also, there is a discernable EMU effect. This bias is robust to the inclusion in econometric equations of natural determinants of financial flows such as trade links, common language and common borders. Lane's central estimate of the euro effect is that it

has raised bilateral holdings between member countries by 97 percent for bonds and 62 percent for equities.

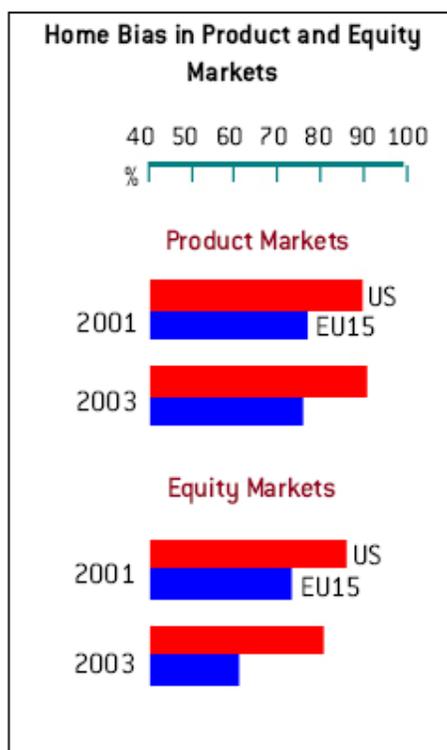
This does not mean that the “home bias” has disappeared. Comparisons to a benchmark world market portfolio in which assets are allocated according to the size of each market indicate that European investors’ portfolios remain tilted towards national assets. But this is much less the case than in the past, and less than in the US or Japan. Furthermore, research on portfolio allocation within the US indicates that even in a market that has been integrated for a very long time, local or regional biases remain: looking at equity holdings, Coval and Moskowitz (1999) find that US fund managers exhibit a strong preference for locally headquartered firms and that a 2000 km distance to between the residence of the portfolio manager and the firm’s headquarter reduces the weight of its stock by roughly 10 percentage points. Against this background, the persistence of financial home bias in Europe is hardly surprising.

What about trade? Building on John Mc Callum’s seminal 1995 paper, Thierry Mayer and Soledad Zignago (2005a, 2005b) have developed measures of the border effect within the EU. They find that even in the most integrated sectors, large EU member states trade 6 times more with themselves than with neighbours. On average, depending on the estimates, EU member states trade 10 to 20 times more internally than with neighbours. Here again, certainly, there is “home bias at home”: trade within US states is 3 times higher than trade between them (Wolf, 2000). But even discounting this factor, it appears that the EU goods markets are still very far from being integrated.

Even more worryingly, the Single Market does not seem to have had a significant acceleration effect on trade flows – not to speak of services. Mayer and Zignago (2005a) contrast the quick reduction in the border effect between the US and Canada following the signing of the North American Free Trade Agreement with the quasi-stagnation of trade integration within the Single Market. The euro has also had an effect on trade flows, but controlling again for natural determinants, current estimates of the euro effect are between 5 and 15% (Baldwin, 2006). Product markets could not be expected to adjust as fast as financial markets and part of the real effect of EMU is certainly still to come. Nevertheless, the experience so far suggests, first, that early estimates of the trade effects of the single currency *à la* Andrew Rose (2000) were excessive and, second, that even under the best circumstances convergence towards the new steady state will be a long process.

Furthermore, the euro area members paradoxically tend to be less keen on creating a true Single Market than countries not belonging to the euro area. The euro area, and within it the

group of the three largest countries, Germany, France and Italy – scores distinctively worse than the EU25 average or the non-euro EU15 on a series of indicators such as the delay in transposing EU directives into national law, the number of cases of non-communication for transposition in national legislation, the number of infringements for incorrect applications of internal market rules. This has led former Commissioner Mario Monti² to observe that the euro area is at risk of drifting towards becoming a currency without a market.



Source: Bruegel estimates based on OECD & IMF CPIS.

Research by Juan Delgado (2006) of Bruegel has attempted to compare directly the home bias for goods and equity markets through estimating an index that can be used both for goods and stocks. The figure summarises his main finding: controlling for size and distance, the home bias for equities in the average EU 15 country has decreased much faster and is now significantly lower than the home bias for goods. It is also lower than in the US³.

Turning finally to labour markets, it is well-known that labour mobility within the EU remains very low. On average, 98.6% of the EU citizens live in their home country, a strikingly high proportion in comparison to the US, where 67.4% of the citizens live in their birth state. Migration is certainly on the rise, especially following the 2004 enlargement, but

labour immobility remains a fair characterisation of the stylised facts. Furthermore, a host of national regulations keep labour market fragmented.

The picture that emerges is thus of a very uneven state of integration, with financial markets at the forefront of it and labour markets at the other end. A good summary is that the typical citizen of the EU15 holds 35% of his or her equity portfolio in assets issued by non-national OECD issuers but devotes only 14% of his spending to products imported from other OECD

² And Bruegel chairman.

³ What is being compared here is not the home bias across states within the US to the home bias across countries within the EU, but the home bias of the average EU country compared to that of the US as a whole.

countries. She has a meagre 1.6% probability to reside in a country of which she is not a national⁴.

Not only is integration more pronounced, but as apparent in the Figure, the trend towards it has in recent years been much faster for financial markets than for product (and also labour) markets. One or two decades ago, the future euro area was barely a financially integrated area. We do not have long series on bilateral financial flows but a rough indication of the magnitude of the change is for example that Spain's gross external assets (as well as liabilities) increased more than fivefold between 1984 and 1994, and again between 1994 and 2004. This dwarfs by far the growth in exports and imports.

2. In a second best world

Should this situation be regarded as sub-optimal? The optimistic answer is that Europeans have for long known that they would be more successful in integrating financial markets than product markets, let alone labour markets. European financial integration is also part of a global trend towards financial liberalisation which, unlike the liberalisation of goods and services, has not been confronted with significant resistance so far. The imbalance is however probably more pronounced than anticipated and it has every probability to persist for many years. The question is, what does this imply for the policy agenda? Should financial integration be considered as a goal in itself, that can be pursued irrespective of what is taking place on other markets? As a complement to real integration – which could imply to hold it back in order for other sectors to have time to catch up? As a substitute – which would lead to the opposite conclusion? Or as an accelerator, which implies that it should it be pushed further in the hope that other sectors will follow?

As already mentioned, the standard approach is based on the first answer. Financial integration is regarded as an end in its own right and it is expected to yield benefits irrespective of what happens in other fields. In short: too much of a good thing can only be a good thing.

This assumption was for example explicit in the study on the macroeconomic effects of financial integration prepared by London Economics (2002) for the European Commission. This study essentially quantifies the reduction in the cost of equity, debt and credit that can be expected from the integration of capital markets and the corresponding GDP gain over a

⁴ Figures are from Delgado (2006) and refer to the EU15. Corresponding figures for the euro area are close.

medium-term horizon. The more the cost of capital decreases, the better, independently from any particular assumption about goods and labour market integration and whatever the segment of capital markets responsible for the decrease.

This way of thinking has two interesting consequences. One is that the gains from integration are essentially a growing function of its degree. Nothing implies that the agenda must be held back if other sectors do not catch up, and nothing that it must be entirely implemented. While it is sometimes claimed that no gain can be reaped until 100% of the agenda is implemented, this is only true when it amounts to the building of a network. When advances in integration can be measured in basis points, whatever fraction of it that leads to a decrease in the cost of capital can be implemented, the end-effect will be strictly proportional .

For example, on the basis of the assumptions made⁵, the London economics study envisages a 1.1% medium term increase in EU15 GDP – not an unusual order of magnitude for this type of study. As the equity and corporate bond markets have recently experienced significant progress in integration⁶, part of this effect is presumably behind us already. What can be obtained by further efforts is probably a fraction of the 1.1% GDP increase – barely a strong incentive to overcome strong national or local resistance to the liberalisation of banking and other financial services⁷.

The other consequence is that integration appears to yield modest gains. It is worth recalling that according to the European Commission, GDP per head in the US was in 2005 38% higher than in the EU15. Though very rough, the figure suggests there is considerable scope for policy-led improvements in our economic performance. Admittedly, this gap does not only reflect an efficiency shortfall, but also different social preferences – for example as regards working hours or holidays. How much of the 38% corresponds to genuine preferences and how much to policy failures is a matter for dispute among economists⁸, but what is certain is that the numbers at stake are of a different order of magnitude: there must be policies that have the potential to raise output per head by several times more than 1.1%⁹.

⁵ A reduction in the cost of capital of 50 basis points for equity, 40 basis points for bonds and 20 basis points for credit, together with a partial substitution of bonds to credit.

⁶ This is documented in the indicators of financial integration published twice-yearly by the ECB. See <http://www.ecb.int/stats/finint/html/index.en.html#data>

⁷ The 1.1% increase in GDP of the London economics study should not be confused with a welfare gain.

⁸ Alesina et al. (2005) provide an up-to-date discussion of the issue.

⁹ This 1.1% of GDP is furthermore not a welfare gain as it results from an increase in investment whose counterpart is lesser consumption. The actual welfare gain is bound to be significantly smaller, which in turn implies that the welfare gain from implementing what remains of the financial integration agenda is bound to be minuscule.

The observation that the standard gains from financial integration are dwarfed by those from remedying policy failures is not an unusual one. For example Gourinchas and Jeanne (2006) use a calibrated neoclassical growth model to quantify the welfare gains from financial account liberalisation in a capital-poor country. Even in this rather favourable case they find that those gains are markedly inferior to those arising from the removal of the domestic distortions that prevent productivity from taking off.

What I am saying here is not that we should downplay financial integration, rather that it should not be considered in isolation when assessing its potential contribution to growth and welfare in the EU and the euro area. Europe has first order problems – unemployment, low labour utilisation, slow productivity growth; and difficulties with the functioning of the euro area – and a high cost of capital for the large corporations which have access to equity and bond markets is not one of them. Therefore, what really matters, and what European policymakers should focus on, is to what extent financial integration and financial sector reform can contribute to solving those first order problems.

The approach advocated here dwells on a recent literature on economic reforms that advocates the choice of explicit priorities. In a development context, Ricardo Hausmann, Dani Rodrik and Andrés Velasco (2005) criticise what they call the “laundry-list approach to reform that implicitly relies on the notions that (i) any reform is good; (ii) the more areas reformed, the better; and (iii) the deeper the reform in any area, the better”. They claim that such a strategy can be a waste of political capital and that in the presence of significant distortions, it is not guaranteed that it will improve welfare. They propose instead to focus on the most binding constraints on growth. In a similar vein, the OECD (2005) has undertaken a systematic assessment of the main constraints on growth and employment in its member countries and has come up with a method to select country-by-country policy priorities¹⁰.

The EU, however, has precisely tended to follow the laundry list strategy through pushing for integration – including financial integration - wherever feasible. The belief behind it was precisely that integration was a goal in itself and that it could be aimed at in all sectors, leading to a piling up of the corresponding benefits.

Disappointing results with this strategy have not yet led to the emergence of a better one. The strategic approach advocated by Hausmann and his colleagues has not been translated into a policy agenda for the EU. The national reform programmes which form part of the Lisbon

¹⁰ Braga de Macedo and Oliveira-Martins (2006) also criticise the lack of explicit strategies and discuss reform complementarities. They advocate instead a “radial” approach that reduces all distortions proportionally.

agenda could be an instrument to this end, but neither their preparation nor their assessment by the Commission are based on a systematic approach (Pisani-Ferry and Sapir, 2006).

3. EU priorities and the financial integration agenda

To develop a systematic blueprint for a more strategic approach to European financial integration is beyond the scope of this paper. What I wish to do here is to start from the policy priorities of the EU and to outline in a sketchy manner what kind of reasoning and proposals such an approach would give rise to.

Two pressing issues today in the EU are (i) employment and growth and (ii) divergence within the euro area. The first one mostly relates to efficiency and the second to stability – both cardinal European objectives. The first one has been around for a very long time, while the second has only recently come to the forefront of the policymakers' concerns. They are therefore good test cases for the approach suggested here and for discussing what the contribution of financial integration can be.

Efficiency

Let us start with growth. The by now well-known stylised fact emerging from micro data is that the growth rate of newly created firms is markedly lower in the EU than in the US. This does not only contribute to reducing the pressure on the incumbents and to slowing down their replacement by newcomers, but also to lowering overall productivity growth (Bartelsman, Haltiwanger and Scarpetta, 2005). The reason is that in the US, a significant part of the productivity gains come from a churning effect – that is, the replacement of less productive firms par new entrants – while in Europe, productivity gains tend to take place inside existing companies – through capital deepening and incremental innovation. All in all, the EU loses on three fronts: competition is less intense, productivity growth is lower, and there is a more acute trade-off between productivity and employment creation – a trade-off that the US seems to ignore.

There is not yet a compelling account of the reasons behind the slow development of Europe's young companies. It is however known that besides obstacles on product and labour markets, the emergence and growth of such firms depend on the quality and quantity of external finance (Rajan and Zingales, 1998). Aghion (2006) reports that in sectors which intrinsically depend on external finance, financial development plays a stronger role than labour market flexibility in fostering post-entry growth. Evidence confirms that potentially fast-growing

new European companies do face limitations in their access to finance and that this constrains their ability to grow (Inderst and Müller, 2006)¹¹.

The main channel here is not the overall cost of capital, rather the supply of funds to growing companies and their adequacy to the need of this particular type of demand. In other words, fast-growing small firms do not benefit, directly at least, from an efficient and liquid corporate bonds market (which does benefit to the incumbents). Whether bid-ask spreads on that market are higher or lower than in the US is of little concern to them. What matters for those firms is the supply of credit and venture capital and the liquidity of the market for equity at the time of IPOs. It could even be argued that by lowering the cost of capital for corporate bond issuers, financial integration may have strengthened the competitive advantage of the large incumbents and further discouraged entry.

ECB research (Hartmann et al., 2006) confirms that whereas the size of European capital markets (measured by the sum of stock market capitalisation, private bond outstanding and bank credit to the private sector as a proportion of GDP) is about one-half the size of US capital markets for the euro area and three-fourths for the UK, the same ratios are respectively one-fifth and one-third for venture capital. This suggests that early-stage financing is the financial Achilles' heel of European growth.

Furthermore, financial sector reform can complement other reforms of products and labour markets that aim at favouring a more dynamic market and they can facilitate them. Since Coe and Snower (1997) and Blanchard and Giavazzi (2003), it has become commonplace to observe that product market reforms may foster labour market reforms. There is increasing interest among researchers for interactions between, on the one hand, capital markets and, on the other hand, labour or product markets (Wasmer and Weil, 2004, Rendon 2005).

There are several ways in which financial reforms can have a role in triggering changes in labour and product market¹². An efficient capital market first puts pressure on reallocating capital from the ailing sectors and companies to the growing ones, thereby adding incentives to reform. Second, it facilitates this reallocation and therefore reduces the economic and social cost of restructuring. Third, it may increase the intertemporal pay-off from labour and product

¹¹ See also Betbèze and Saint-Etienne (2006) on the French case. On the German case, Posen (2006) also criticises the allocation of capital to incumbents rather than newcomers and the role of capital markets in the perpetuation of the industrial structure.

¹² There have been several instances in which this has happened, notably in France where the banking reforms of the mid-1980s set in motion a process of non-financial exit and entry (Bertrand et al. 2006).

market reforms through alleviating liquidity constraints and accelerating their medium-term job creation effects.

Summing up, the overall degree of financial integration as summarised by aggregate price convergence indicators may matter less than the efficiency of the financial system, its ability to channel funds to young companies and its contribution to economic transformation. Policymakers in the EU are certainly aware of these effects and in recent years, emphasis has increasingly been put on the financing of innovation through targeted instruments (EIB loans) and the promotion of venture capital markets. But the integrationist logic tends to prevail over the efficiency logic and complementarities between capital markets, product markets and labour market reforms have yet to be addressed in an integrated fashion.

Stability

As regards stability, it has been known for long that financial integration helps coping with asymmetric shocks. There are two different channels for that: first, the holding of foreign assets is a way to diversify risk and to avoid correlation between fluctuations in labour and capital income. Asdrubali, Sorensen and Yosha (1996) have shown on US states that this is a significant channel of risk-sharing and it is increasingly at work in Europe as cross-border holdings of assets has developed. Second, cross-border lending or borrowing smoothes fluctuations in consumption when a country is confronted with shocks to income. Financial integration can therefore to some degree substitute other channels of adjustment such as labour mobility (and it can actually be superior from a welfare point of view as long as shocks remain temporary).

This suggests that financial integration is even more desirable in a monetary union when incomplete real integration results in both asymmetric shocks and weak adjustment mechanisms. It is, from this angle, a substitute to real integration and seems to be just what EMU needs.

Turning to data, there is evidence of a relaxation of current account constraints since the launch of the euro. From 1990 to 1997, current account balances within the euro-11 (Luxembourg excluded) were on average comprised between -4.3% and +5% of GDP. From 1998 to 2005, i.e. after the selection of the participants in the euro, this range has widened to [-8.1, 6.9]. What was expected has in fact happened. The vanishing of constraints on the current account within a unified financial and monetary area was explicitly identified early on

as one of the benefits of the euro, and their actual relaxation should not be regarded as a surprise.

The question however is whether increased cross-border capital flows actually contributed to stability or, on the contrary, to destabilising the euro area. Recent difficulties in Portugal and Italy and increasing worries about Spain have highlighted the problem of macroeconomic divergence (Blanchard 2006; Ahearne and Pisani-Ferry, 2006). Seven years into the euro, persistent differences in inflation have translated into real exchange rate changes that are often not consistent with underlying fundamentals – especially in Portugal and Italy. Interestingly, Portugal and Spain are among the countries with the highest current account deficits: in Portugal, the deficit reached 10% of GDP in 2000; in Spain, it is expected to exceed 8% in 2006.

There are two reasons why financial integration may have contributed to building up problems. The first has to do with the origin of the shock that initially led to the widening of current account deficits and the second with the uneven integration of products and capital markets.

In all countries which previously suffered from high risk premia, the sudden and large drop in the bonds rate that followed the introduction of the single currency represented a significant shock to wealth and demand. In Portugal at least, the choice was made to pass on to consumers the corresponding reduction in the public debt burden. This contributed to a sizeable appreciation of the real exchange rate and a widening of the current account deficit.

It would obviously be wrong to say that in the case of Portugal and other deficit countries, financial integration and liberalisation were intrinsically destabilising. However, financial relaxation in the context of a fiscal discipline framework aiming at controlling the budget deficit, rather than the primary deficit, favoured an imprudent macroeconomic policy which in the end resulted in a lasting deterioration of the external position of the country. What was a problem was the combination of financial integration with a multilateral surveillance framework which failed to address the risk of contributing to excess demand and the building up of real exchange rate misalignments.

The shock at the time of the introduction of the euro was a once-and-for-all event. The second reason why financial integration may play a destabilising role has a more permanent character. It comes from real interest rate differentials. According to the so-called Walters critique, a monetary union runs the risk of vicious circles in which the rise in inflation in a

particular country reduces the real interest rate and thereby contributes to further stimulating excess demand – especially in the non-traded goods sector and in real estate. This can be counterbalanced by the competitiveness channel, i.e. the effect of a real appreciation on trade flows and investment, but the strength and speed of this channel depend on the degree of products markets integration. If this integration is low, the competitiveness channel is not powerful enough to counterbalance the effect of domestic demand and divergence may build up for an extended period of time, giving rise to boom and bust cycles involving foreign borrowing. There is evidence that such mechanisms are at work in the case of the euro area.

The problem here is clearly one of complementarity of policies across markets. The first-order response is certainly not to slow down financial integration, but to strengthen the competitiveness channels through making product and labour markets more reactive. But in the absence of such reforms, there can be a case for fiscal or supervisory measures that help avoiding excessive demand growth.

Such problems can be compounded by differences in the effectiveness of the transmission of monetary policy. The proper functioning of an integrated monetary area requires a high degree of uniformity in the transmission of monetary policy impulses to private agents and for this to happen, borrowing patterns need to converge, especially as regards the components of final demand which are the most sensitive to credit. However, although the existence of asymmetries in borrowing patterns has for long been documented, including in ECB research (Angeloni, Kashyap and Mojon, 2003), the issue has not been given major priority by policymakers.

Summing up, from the stability standpoint financial integration appears to be at the same time a potentially powerful ingredient to the functioning of a monetary union whose product and labour markets are less-than-perfectly integrated, and a potential source of asymmetries and divergence. Hence, there is a case, first, for fostering complementary measures in fields such as products and labour markets reforms and, second, for enhancing macroeconomic surveillance and financial supervision in order to avoid financial integration to become a source of severe instability.

4. Conclusions

This paper started from the observation that although not yet complete, Europe's financial integration is significantly more advanced than products markets integration and, obviously, labour markets integration. The question raised was, what should be concluded from this fact?

My main point is that the traditional answer – ignore whatever happens on other fronts and go ahead with financial integration – misses some important dimensions of the discussion. Certainly, financial integration has by itself a significant contribution to economic efficiency and growth. But this way of looking at the issue does not help focusing the discussion on its interaction with other dimensions of the European agenda and the ways through which it could contribute to fostering growth and promoting macroeconomic stability.

This lead to advocate emphasising, rather than integration *per se*, the leverage of financial reforms and their direct or indirect contribution to the solution of the first-order problems of the EU and the euro area. Such an attitude requires a more strategic approach to financial sector reforms and an explicit identification of the way in which they can help to alleviate the main constraints on growth or contribute to improving the stability of the euro area.

This is admittedly not an easy task. The attraction of a pure integration agenda is that it can be pursued by the EU as a medium-term goal, independently from the policies conducted by the member states in their fields of competence. Such an agenda does not require coordinating policies between the EU and the national level or between member states. It does not even require developing an integrated approach to EU-led policies and avoids European Commissioners to need to talk to each other.

On the contrary, it must be recognised that the more strategic approach advocated here may involve non-negligible coordination costs. At the euro-area level at least, there would nevertheless be merit in pursuing it. This would imply, first, to define a core set of reform priorities to which financial integration and reforms could contribute; and second, to enhance surveillance and supervision to address more directly potential threats to macroeconomic stability in an integrated capital market.

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