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The real effects of financial (dis)integration: A multi-country equilibrium analysis of Europe

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ABSTRACT

Using data from 15 European Union economies, we quantify the real effects of supply-side frictions due to the financial disintegration of European countries since the 2008 financial crisis. We develop a multi-country general equilibrium model with heterogeneous countries and destination-specific financial frictions. Financial institutions allocate capital endogenously across countries, determining the cost of capital to firms and the wealth of nations. The cost of financial disintegration has reduced access to capital for firms which results in lower output. Financial disintegration leads to a 0.54% fall in output in Europe since the crisis. We also estimate benefits of further financial integration.

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1. Introduction

Global financial integration and in particular a more integrated Europe have been important policy goals, until the 2008 financial crisis. During the crisis, policymakers attempted to reduce financial contagion by “ringfencing” risks within national regulatory boundaries. While this helped limit financial contagion, it also created a segmentation of credit markets. After the financial crisis and the sovereign debt crisis, the general policy consensus has been that “financial interconnections can be too destabilizing” (European Commission, 2015). Recent academic literature has also addressed the costs of financial integration (see Bolton and Jeanne, 2011; Farhi and Tirole, 2014; Uhlig, 2014, among others). In sum, financial integration in Europe seems to have unraveled since the financial crisis and the sovereign debt crisis.

This paper seeks to quantify the costs of financial disintegration to the European economy. Such analysis allows a better understanding of the trade-off involved between systemic risk reduction and costs on the economy due to reduced bank

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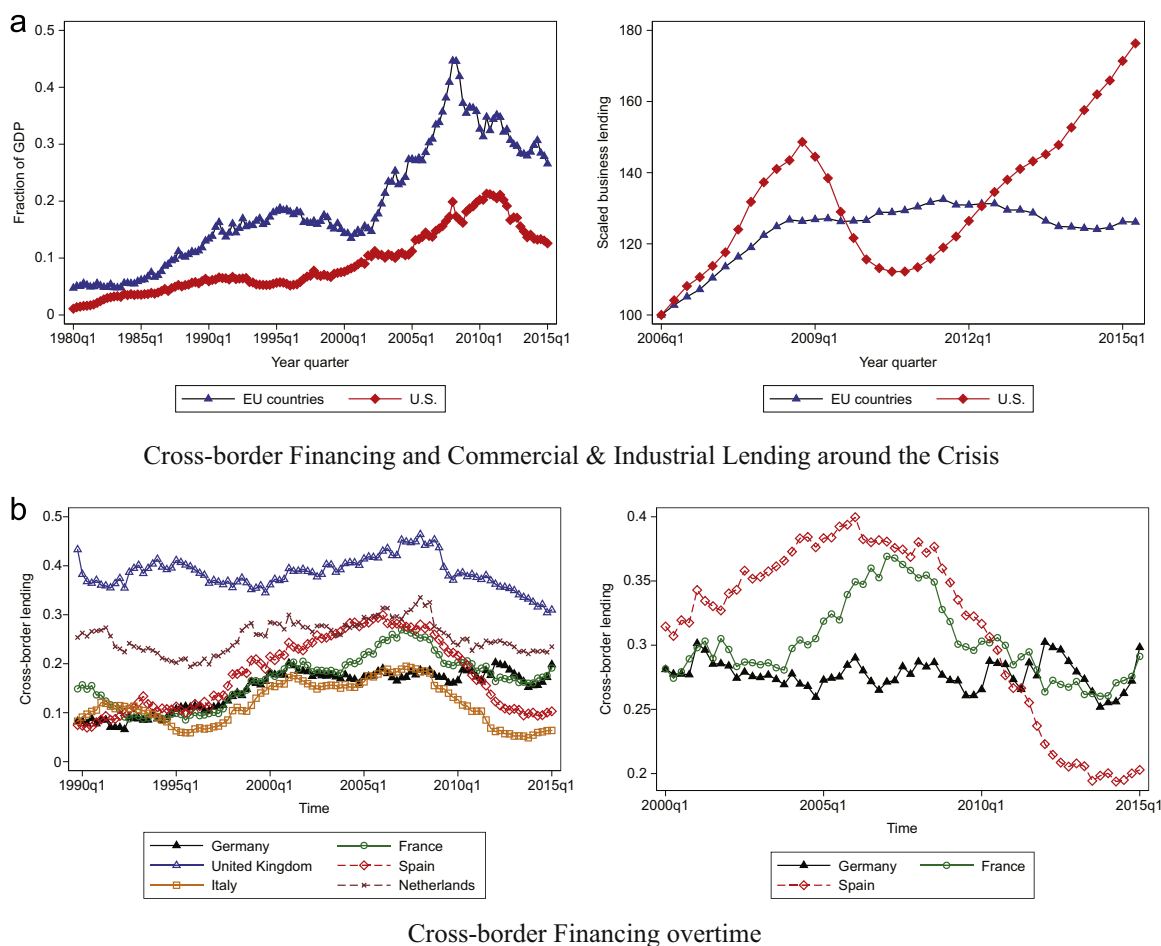


Fig. 1. Cross-border financing in Europe around the crisis. (a) Cross-border Financing and Commercial and Industrial Lending around the Crisis. (b) Cross-border Financing over time. *Note:* The left figure of Panel (a) reports the cross-border claims outstanding as a fraction of GDP against the respective economies. Data are obtained from BIS Statistics Explorer Table C3 (See <http://stats.bis.org/statx/srs/table/c3>, details in Section 2). GDP data are obtained from PWT 8.1. The right figure of Panel (a) reports business loans in EU countries and in the U.S. normalized to 100 in the year 2006. Data are obtained from ECB Statistical Data Warehouse (see <https://sdw.ecb.europa.eu/browse.do?node=8549726>) and the Federal Reserve Bank of St. Louis (FRED Economic Data, see <https://fred.stlouisfed.org/series/BUSLOANS/>). Panel (b) of the figure reports the incoming cross-border claims outstanding against each country as a fraction of total claims outstanding by all financial institutions who have claims outstanding (domestic and foreign) against the respective country in the respective years. Data from BIS is used to calculate cross-border financing (BIS Statistics Explorer Table C3, details in Section 2).

lending. We focus on the change in barriers to capital flows in the European Union since the Great Recession. These international capital flows could be through equity or debt and could be done by financial institutions such as banks or mutual funds, or by individuals.

To infer the changes in the barriers to capital flows we develop a multi-country, general equilibrium model of international capital allocation among heterogeneous countries. In our model, heterogeneous countries solve an optimal portfolio diversification problem with the objective of maximizing risk-adjusted returns. We estimate destination-specific haircuts (financial frictions) that can justify the observed post-crisis capital flows by targeting moments on the share of foreign investments before and after the financial crisis.¹ We find that the estimated GDP-weighted financial frictions in Continental Europe increased by 54.3% between the two time periods 2000–2007 and 2008–2011. We then quantify the impact of these changes on the level and distribution of economic activity and welfare. We find that the increase in financial disintegration leads to a 0.54% drop in GDP. The welfare loss is 0.20 percentage point in terms of consumption equivalence.

Trade in the EU has grown significantly for decades. However, the European economy is divided across political boundaries, with each nation deciding policies for its own benefit. The right panel of Fig. 1(a) shows that business lending in the EU countries, as measured by the stock of loans reported, has not risen much after the crisis. The left panel of Fig. 1(a) shows that gross incoming cross-border financing, as measured by the stock of loans as a fraction of output, has been

¹ Data on foreign claims outstanding are used for the identification.

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