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Article

The economic impact of European financial integration: The importance of the banking union

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ABSTRACT

The aim of the paper is to analyze the effect of European financial integration on economic growth. We focus on how the international financial crisis that started in 2007 has affected integration and growth. By combining information at country, sector and firm level, we quantify the effect of financial integration on financial development and therefore on economic growth. Our results illustrate that until the outbreak of the crisis, a significant part of financial development is attributable to progress in integration, with a positive contribution of around 0.04 pp to the EU-15 countries' GDP growth over the period 1999–2007 of advance in integration. However, during the crisis, the decrease in the degree of integration has had a negative impact on financial development and economic growth. Consequently, the European banking union is essential given the economic benefits associated with financial integration.

1. Introduction

Among the issues brought to light by the current crisis is the key role the financial sector plays in developed economies. The international financial crisis that started in the summer of 2007 with the subprime crisis in the U.S. and became more widespread since the summer of 2008 (especially after the collapse of Lehman Brothers) has meant a dramatic decline in their activity. At the same time market values plunged, public debt became refuge markets during the peak of the crisis, at certain moments even presenting zero returns. However, after the improvements observed in 2009 in some segments of the financial markets, in 2010 the worsening fiscal conditions in several Euro area countries affected the bond, and money markets, in a context of a sovereign debt crisis. The subsequent period of instability was so intensive that the possibility of a euro break-up was even considered. It was the action of the ECB supporting the euro in the summer of 2012, and the decisions taken by European leaders to set up a banking union, which has allowed some recovery of the previous degree of financial integration and the normalization, to some extent, of the smooth functioning of the financial markets.

Banking activity also fell significantly owing to various factors. Distrust between institutions caused a decline in the market value of interbank transactions. The first stages of the crisis also saw bank credit plunge in the most developed countries, given that financial institutions were forced to restructure their balance sheets due to either exposure to toxic assets or excessive concentration in real estate markets, or both. During this period, intervention in Europe was needed to recapitalize numerous banks. The high level of indebtedness of some economies (both in the public and private sectors) and the increasing deterioration of bank assets determine the chances of recovery of credit, which is important for some European countries. Moreover, the fragmentation of the financial market has increased the cost of credit in the distressed countries, hindering the investment recovery.

Once the financial turmoil exploded, it spread rapidly to the rest of the economy, having a virulent impact. As a result of all these factors mentioned above, many of the economies around the world have entered one of the worst recessions since the 1929 crash and the Great Depression of the 1930s. Never before have economic agents and the media as a whole been so aware of the importance of the financial sector in the economy. This importance stems from the fact that it is the financial sector which provides investors with the financial surplus of ultimate savers. As a result, either directly in the markets or indirectly through financial intermediaries, this sector helps to finance investment and thus output and employment growth. Furthermore, it makes a direct contribution

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to economic growth, representing 5.2% of GDP and 2.8% of employment (data for 2011) in the Euro area in the most recent years available.

European authorities have also been aware of the importance of development and financial integration for economic performance for one reason: financial integration contributes to the development of the financial system by increasing competition, enhancing stability, expanding markets and increasing the efficiency of financial intermediaries, thereby resulting in lower intermediation costs and a more efficient allocation of capital (Obstfeld, 1994). In addition, financial integration increases the depth and liquidity of financial markets, and consequently enhances the resilience of the European financial system. It also offers greater scope for geographical risk diversification, promoting consumption and income risk sharing. But as Brezigar et al. (2008) point, financial integration can also stimulate growth indirectly by means of improvements in the institutional framework (improved regulation and corporate governance). This will enhance the overall stability and reduce problems of asymmetric information. Another channel of influence of financial integration on growth is by allowing domestic firms to access foreign financial markets (direct lending and listing on foreign stock markets).

It was precisely for these reasons that the integration process of financial markets started in the mid 1980s in the EU, with the objective of achieving a single perfectly integrated internal market. Among the measures implemented were the first and second banking directives, freedom of capital movements, the harmonization of deposit insurance, the introduction of the Euro, the Financial Services Action Plan (FSAP), etc. In general, the studies available illustrate that, at least until the beginning of the financial crisis, the integration process indeed advanced (much more so in the wholesale markets than in retail), and that it had a positive effect on economic growth (see European Central Bank, 2012; CRA International, 2009, among others).

The financial turmoil that started in mid 2007 in the USA and rapidly spread to the rest of the world was a shock of such magnitude that it has affected not only the level of financial flows but also the progress of financial integration in Europe. In fact, the reports of the European Central Bank noted a slowdown and even a reversal of the financial integration process, although the effect is uneven across different market segments. Thus, as Fig. 1 shows, the new synthetic indicator of financial integration of the ECB[1] shows the damage caused by the financial crisis, as it triggered fragmentation to reach levels similar to those seen before the euro was introduced.

One of the reasons for this decline in financial integration is the protectionist measures implemented by some countries as a reaction to the turmoil, along with a preference for national institutions (with the increase in the home bias), given the lack of trust in international markets. Fortunately, the initial isolated responses gave way to coordinated measures as the creation of a new architecture of financial supervision in Europe (with three new European Supervisory Authorities), a new Basel agreement on bank regulation (Basel III) and the establishment of the European Financial Stabilization Mechanism (EFSM) and the European Financial Stability Facility (EFSF) with the aim of reducing tensions in the Euro area sovereign markets. More recently, the measures adopted by the ECB in September 2012 (OMT program) and the banking union announcement have reduced the financial instability and improved the degree of integration.

[1] This indicator tracks the overall level of financial integration over time and reflects the developments in four main market segments: money, bonds, equities and banking.

In this context, it is therefore fundamental to examine how the crisis has affected financial integration, and by this means to quantify its impact on economic growth. Furthermore, it will be useful to compare the impact of the crisis over an extensive time period and assess the financial integration process as a whole rather than merely over the last years. The aim of our paper is to analyze the impact of financial integration on the economic growth of Euro area countries since the introduction of the Euro and the implementation of the FSAP in 1999, quantifying the differential impact of the financial crisis and disintegration over the period 2008–2012. In order to achieve this, our work evaluates the part of financial development growth which is attributable to financial integration over the period analyzed, so as to isolate its contribution to growth. Thus, we decompose the total financial development observed in each EU country into a component related to financial integration and into another component which could be considered "pure" financial development. By doing this, it is also possible to quantify the impact of the crisis on integration and economic growth.

The results illustrate that both financial development and integration have been important driving forces behind the growth of European economies. In fact, from 1999 to 2007 estimations show that financial development contributed with 0.23 percentage points (pp) per year to the GDP growth of the EU-15, thus explaining 9.5% of annual GDP growth. The contribution was found to be highest in those countries which had increased more their level of financial development. However, following the international crisis, there has been a fall in the growth of financial flows, and the contribution of financial development to GDP growth is negative in some countries. In the case of the contribution of the process of financial integration, progress made until 2007 accounts for an important part of financial development growth (around 45%), with a contribution to GDP growth of around 0.04 pp per year. However, due to the crisis, there has been a decrease in the level of financial integration and in its contribution to financial development. In fact, the decrease in the degree of integration has had a negative impact on GDP growth in the period 2008–2012.

Our paper is structured as follows. Section 2 reviews the literature analyzing the impact of financial integration on economic growth. Sections 3 and 4 outline the methodology used to measure the impact of development and financial integration on economic growth (the finance–growth nexus), and also to decompose the part of observed financial development which is due to integration. The effect of financial development and integration on growth is evaluated in Section 5, while summary and conclusion are presented in the last section.

2. Financial integration and economic growth: background

Several survey papers and collections of articles analyze the different channels through which financial integration affects economic growth. Financial integration: (a) facilitates the functions carried out by the financial systems (to intermediate funds from ultimate borrowers and lenders of the economy), leading a better risk sharing and diversification; (b) allows economic agents to access more sources of funding, increasing the supply of funds for investment opportunities; and (c) fosters competition and the efficiency in the task of financial intermediation, reducing intermediation costs and bank margins. Thus, financial integration translates into a reduction in the cost of intermediation, a more efficient allocation of capital, a better access to the markets, and an increase in portfolio diversification. Through all these channels, a higher degree of financial integration implies more financial development and, therefore, economic growth.

There are only a few papers that estimate the impact of financial integration on economic growth. Two studies supported by the