



European
Research Area

EUROPEAN POLICY BRIEF

FINESS

Financial Integration in Europe: Strength in Diversity

Policy implications of FINESS, an EU-funded research project involving eight institutions led by the German Institute for Economic Research

May 2010

INTRODUCTION

The global financial crisis calls for urgent regulatory reform of the financial sector. Efforts to determine the proper scope and instruments for this reform are still ongoing, but valuable lessons can already be drawn. This policy brief outlines the key messages of a two-year international research project into crucial aspects of the financial system. Particular focus is given to the banking industry.

One key conclusion of the research is that risk of contagion in financial markets can be reduced if banks hold sufficiently diversified international portfolios. For policymakers, the challenge is to encourage such diversification while preventing increased exposure to systemic risks. This task is certainly difficult, not least because of the limitations of what can be achieved by simply lifting formal economic barriers. There is scope for effective action, however.

Steps can and should be taken, for example, to encourage stronger competition in the European banking sector. Also, even though integration of global financial markets (including those in Europe) is well advanced, the foreign asset portfolios of European banks are less than optimally diversified. Measures should be developed to foster diversification of international banking assets, taking into account the importance of culture and information costs in achieving financial market integration.

KEY FINDINGS

Financial Market Integration

How far has financial integration advanced in the EU?

- The introduction of the euro has accelerated the integration of financial markets in countries that have adopted the single currency. For example, stock market activity in these countries is now influenced more by EU rather than US news.
- European bond and stock markets have become considerably more integrated since the introduction of the Euro, making these markets important alternatives to bank loans. Convergence is observed especially in clusters of bonds with yields above and below the average.
- In some smaller European equity markets, evidence of financial integration is mixed. Here, idiosyncratic factors still play a significant role for stock prices.
- There is no clear trend toward convergence in sectors which are prone to regional shocks and are highly regulated, such as health care.
- Even without the euro, financial integration will still emerge between other European countries as long as the institutional and legal barriers are removed.

Data from 26 European countries over 35 years shows:

How is financial integration affecting GDP?

- Financial market integration and development has had positive and significant effects on real GDP per worker on average. This does not imply, however, that financial innovation is always beneficial for subsequent economic growth. In fact, the recent crisis has raised questions about the role of financial systems in fostering long-term economic growth and welfare.
- Debt inflows attributable to the EU's unique institutional environment have had a significant positive effect on GDP per worker.

Banking Market Competition

Why should bank competition be enhanced?

- Bank competition is beneficial for the performance of the real economy.
- Enhanced bank competition is beneficial for firm entry, especially in industries with more need for external funds.
- A wave of mergers and acquisitions in the European banking sector has resulted in a substantial increase in bank market concentration in most countries.
- More concentrated bank markets lead to increases in the market power of banks and translate into less bank financing of non financial firms.

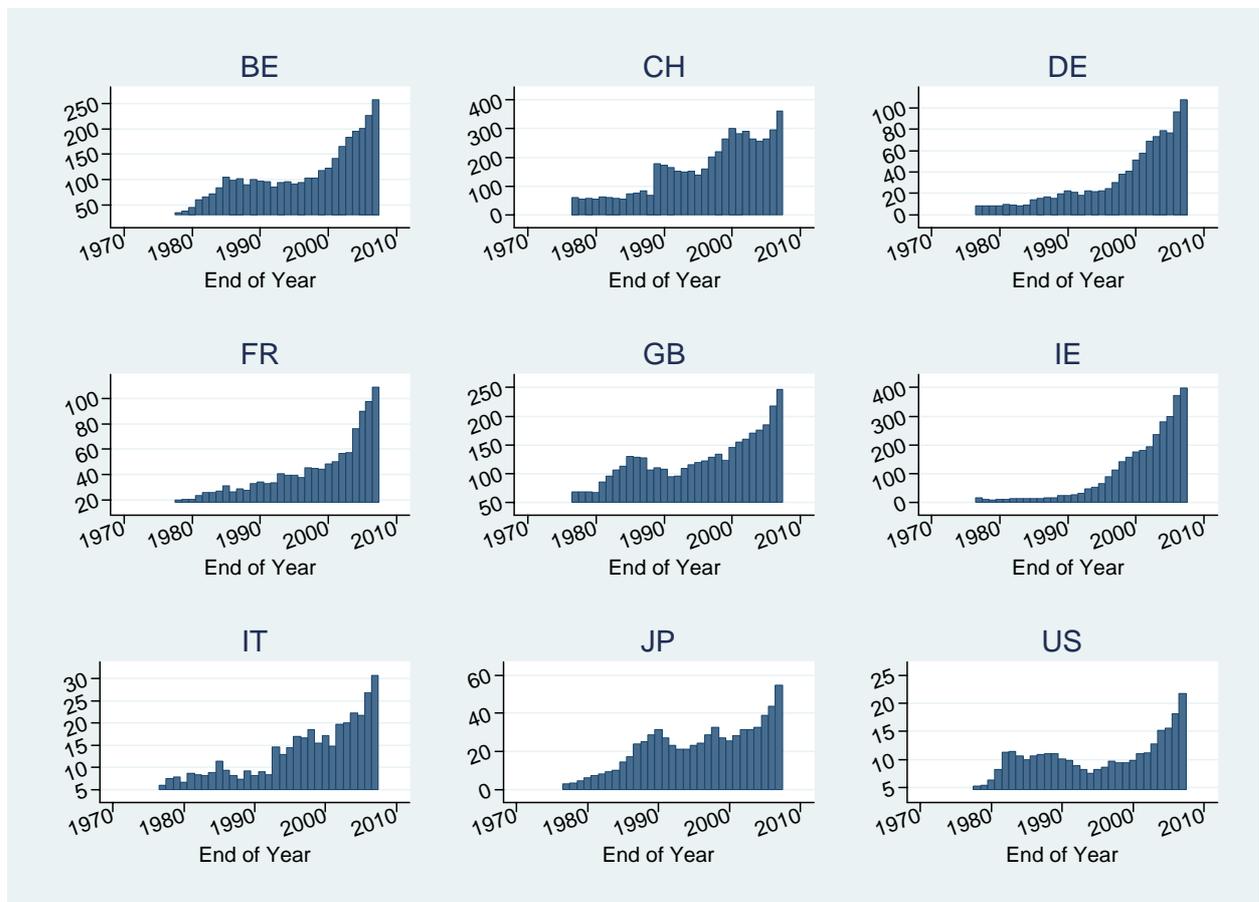
What are the risks of banking market concentration?

- Ongoing (domestic) consolidation in the banking sector has the potential to hamper access of firms to bank financing
- In the new member states, as financial convergence speeded up, the competition among banks led to an under-pricing of credit risk.
- For the new members states, sounder legal systems and property rights can enhance bank competition and boost the growth potential of these countries.
- Foreign banks in the new member states can exert negative effects on the creation of new firms in industries with high informational asymmetries.

International Diversification of Banking Assets

- Despite a substantial increase in cross-border assets and liabilities of commercial banks in recent years (Figure 1), the degree of diversification of banks' foreign assets has not changed much.
- Regulation plays a crucial role as a policy tool to encourage diversification in banks' international portfolios and, in turn, to reduce the risk of financial contagion.

Figure 1 - Cross-Border Assets of Banks Relative to GDP (in %)



Source: Own calculations based on BIS Locational Statistics

Banking Sector Shocks

Do banking sector shocks affect GDP growth?

- Analysis of data for large banks from 18 Western European and 17 Eastern European countries for the years 1996-2006 shows that shocks to the operating income of banks do not effect GDP growth. However, a consistent impact of lending shocks on GDP growth can be detected.
- This effect is mostly driven by episodes of negative loan growth rates and by the Eastern European countries in the sample.

Banks as Shareholders

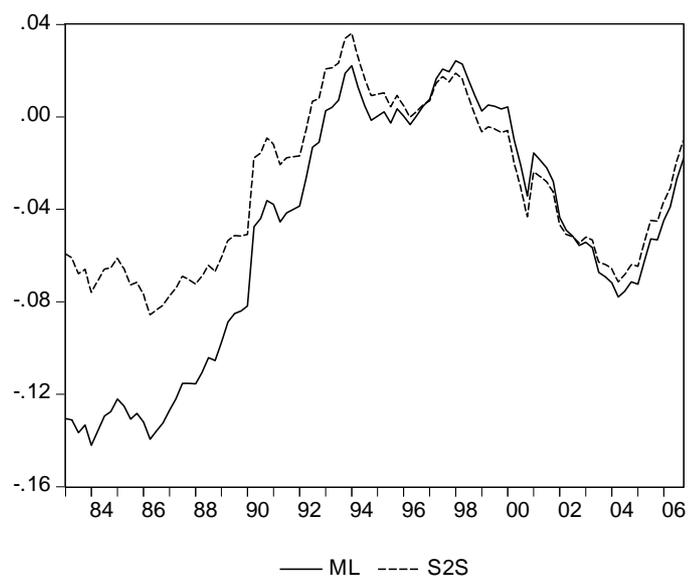
Should banks hold shares in non-financial firms?

- A negative relationship has been found between financial institution ownership and the market value of firms.
- Banks do not appear to effectively monitor corporate management. The fact that banks (in Germany, for example) have reduced their equity holdings in non-financial firms seems to reflect an awareness of this limitation.
- Policies that restrict banks' holdings of equity of non-financial firms are beneficial to the economy.

Monetary Policy

The monetary overhang indicates that there has been no problem with excess liquidity in the euro area. According to different estimates ('maximum likelihood', 'simple two-step'), the real money gap was virtually 0 at the end of the sample period (Figure 2).

Figure 2 - Real Money Gap



ML = Maximum Likelihood, S2S = Simple Two-Step estimator
Source: Own calculations

- The acceleration of stock and housing prices in recent years has raised money demand because of a positive impact on wealth.
- Heterogeneity of the institutional framework of housing and mortgage market across EU countries lead to differences in the transmission of monetary policy. These discrepancies are sizable.

International Consumption Risk Sharing

How do goods and asset market frictions affect international risk sharing?

- Simulations in a two-country DSGE model show that frictions in goods and asset markets lead to substantial deviations from optimal risk sharing.
- However, the impact is non-linear suggesting that both types of frictions provide different but interrelated channels through which they disturb risk sharing. Lowering both, costs for trade in goods and assets is followed by a growing increase in risk sharing, indicating that the benefits of goods and financial market integration reinforce each other.
- Policy makers and central banks should coordinate their actions as the effect of market liberalization on risk sharing also depends on the monetary stance. Looser monetary policy leads to larger violations of optimal risk sharing if frictions in both, goods and asset markets are large. Yet, as both markets are becoming more and more integrated, this picture reverses and a tight monetary policy increasingly impedes the optimal sharing of risk across countries.

Private Equity

What affect do private equity shareholders have on firms?

- Examination of firms with private equity shareholders in 26 European countries shows these investors seem to be quite normal: they intend to avoid an observably high risk and shy away from vulnerable and possibly opaque firms.
- Though adding value to the firms does not appear to be the main aim of private equity shareholders, they do not generally act as asset strippers.
- The presence of a Private Equity firm among the shareholders does not have a significant effect on firm's performance.

How important are tax incentives for private equity activity?

- Bank lending volume and equity market capitalization are among the main determinants of private equity. Their impact is particularly strong in the new member states. Business confidence and tax incentives play less important roles.
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Gender

Do men and women make investment and lending decisions differently?

Analysis of activity on a large peer-to-peer lending platform in Germany suggests:

- Women are less likely to hold risky financial assets than their male counterparts. The gender wealth gap is probably the main reason for this.
- The hypothesis that females take more conservative investment decisions than males because they are *inherently* more risk-averse was not confirmed by the data.

RECOMMENDATIONS FOR POLICYMAKERS

Banking Sector Regulation

What should be done with “toxic assets”?

- Enhance bank competition, as this is beneficial to the economy. It helps firms gain financing and supports firm entry.
- To help assure availability of bank financing for firms, increase the contestability and integration of bank lending markets in Europe. This also involves a higher potential for foreign bank entry and cross-border lending.
- Consider restricting banks' holdings of equity of nonfinancial firms. (Look at tax measures enacted in Germany allowing banks to dispose of their equity stakes.)
- Encourage banks to focus on intermediation and to not combine lending and equity stakes, as this creates conflicts of interest.
- Relieve ailing banks from toxic assets by transferring these assets into a publicly sponsored work-out unit (bad bank). Have government bear responsibility for management and future resale of toxic assets at its own cost and recapitalize the good bank by taking an equity stake in it.
- Prior to the crisis, shocks to the operating income of banks had no significant affect on the real economy. Therefore, policymakers should exercise some caution with regard to measures targeted at large financial institutions.
- Create reporting systems that facilitate systematic analysis of exposures of large and small financial institutions to macroeconomic risk factors.
- In industries characterized by high informational asymmetries, the presence of foreign banks might constitute an impediment for new firm financing. Policymakers should therefore consider different ways to support entrepreneurship, such as venture-capital funds.

Monetary Policy

Should monetary policy respond to asset price fluctuations?

- As housing and mortgage markets are heterogeneous, the European Central Bank should be concerned about the influence of house prices when setting interest rates.
- Monetary policy should respond to asset prices insofar as they affect inflation and output expectations. This is in particular relevant for house prices due to their significant impact on demand.
- The impact of liquidity shocks on asset prices is not robust. Therefore, to avoid negative side effects, monetary policy should not try to directly target asset prices.
- Because the effect of market liberalization on risk sharing also depends on the monetary stance, central banks should coordinate their actions with other relevant policymakers.

Financial System Reform

DIW Berlin's Nine-Item Agenda for Building a New Financial Architecture (abbreviated version)

- 1) **Minimize coordination failures by creating**
 - (i.) a central agency for the establishment of international regulatory standards;
 - (ii.) an international institution that can coordinate intervention in times of crisis; and
 - (iii.) a European financial market oversight agency
- 2) **Force subsidiarity**
with a two-tiered European system for financial supervision in which small banks are supervised by national agencies and large system-relevant banks are supervised by the European financial market oversight agency (see 1.) which also monitors the national supervision agencies
- 3) **Put the right incentives in place**
by enforcing the participation of originators in the default risk of loans. That is, at each stage of the securitization process, the originator has to keep a share of the loan or the security in its own books.
- 4) **Use the credibility of governments to rate debt**
with non-commercial public rating agencies at the European level
- 5) **Avoid excessive demands on the government**
by discouraging governments from taking on operative responsibility for banks beyond crisis management.
- 6) **Prevent misuse of government responsibility**
in the financial sector by not granting private financial service providers long-term guarantees beyond crisis management.

- 7) **Account for non-renegotiation-proof contracts** by giving supervisors the power to authorize establishment of off-balance sheet vehicles.
- 8) **Avoid one-size-fits-all regulation**
- 9) **Place greater emphasis on equity financing.**

RESEARCH PARAMETERS

FINESS (Financial Systems, Efficiency and Stimulation of sustainable Growth) was an EU-funded research project aimed at advancing our understanding of how financial market integration in Europe affects economic growth, employment and competitiveness.

Objectives

The main objectives of the project were to:

- measure the degree of financial integration in Europe;
- identify likely future paths of financial market integration;
- investigate how financial systems affect growth and the transmission of monetary policy;
- uncover catalysts and bottlenecks in the architecture of financial systems from the perspective of heterogeneous agents;
- examine the capacity of financial structures (i.e. banking, private equity and venture capital) to improve efficiency of start ups and established firms;
- draw policy-relevant conclusions.

Methodology

The project used a range of research methods:

- FINESS utilized innovative and tailor-made econometric techniques which take dynamic interactions between financial, product and labour markets into account.
- The project used a comparative approach which is especially useful for uncovering catalysts and bottlenecks.
- Empirical analysis was conducted using elaborated econometric methods.
- A range of indicators was constructed to measure the degree of financial integration.

PROJECT IDENTITY

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Funding scheme	Collaborative Research Project , funded under the 7th Framework Programme of the European Community within Socio-economic Sciences and Humanities.
Duration	February 2008 – May 2010 (27 months)

Budget

EC Contribution: 998.170 €

Website

<http://www.finess-web.eu>

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Further reading

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