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The process of financial integration of EU economies

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Abstract: The aim of this document is to complement the analysis of 'variegated financialisation' provided (in an associated paper) by Passarella Veronese (2013) with a preliminary examination of the process of financial integration of EU countries, and especially of Euro Area's member-States. In this regard, figures show that a process of increasing financial interconnectedness between different country-based economic units has been actually operating since the early 1990s within the Euro Area. As pointed out by ECB's staff and other economics studies, convergences in lending rates and sovereign bond yields have been recorded, coupled with growing cross-border flows of capitals and cross-border interbank market integration (until the outbreak of the recent European crisis at least). However, especially after the launch of the single currency in 2002, this dynamics has gone along with growing current account imbalances (and, symmetrically, financial imbalances) within the Euro Area, due to differences in national growth rates, 'inefficiencies' in economies of peripheral countries, and the successful deflationary policies adopted by core countries. As a result, the permanent current account deficits of Euro Area's peripheral economies have reflected in an increasing amount of financial liabilities placed by their government sectors in international markets (until the outbreak of the crisis at least). Thus, 'real-world' financial integration has not led to the development of a net of *horizontal* links between economic units operating within a uniform supranational economic space. What figures show, is rather a process of concentration and centralisation of capitals within the Euro Area, reinforcing structural imbalances between the core and the periphery. In the absence of radical changes in

European institutions, this *asymmetric* integration is further endangering, instead of improving, the financial soundness of EU.

Keywords: Financial Crises; Govern Policy and Regulation of Financial Markets; Financial Institutions; Varieties of Financialisation.

JEL-Classification Codes: G01; G18; G21; N20.

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1. Introduction

In an associated paper (Passarella Veronese, 2013b) an analysis of some quantitative aspects of the nature, processes and stages of *financialisation* of economies of European Union (EU hereafter) over the last three decades is provided. The main purpose of that paper is to establish whether the economies considered have gone through the process of change in creation and appropriation of economic value that has been defined as the financialisation process. In this regard, the definition of Fine (2011) is adopted, who identifies eight features which mark the process of financialisation of developed countries in the last thirty years: i. the phenomenal expansion of financial assets and financial activities relative to the rest of the economy; ii. the proliferation of different types of financial assets and derivative products; iii. the rise of speculative investment in place to real investment, coupled with the maximization of shareholder value as main corporate target; iv. the increasing dominance of finance over industry; v. the increasing weight of credit- and asset-inflation-led consumption; vi. the penetration of finance into all areas of economic and social life, such as pensions, education and health; vii. the birth and the spread of a 'financial market' anthropology; viii. the re-definition of the role of the States for it to promote the process of financialisation. This specific viewpoint, stressing the cohabitation of different, though interconnected, forms of financialisation across regions and socio-institutional systems, has been labelled the 'varieties of financialisation' approach.¹ It is starting from such theoretical framework that we will provide a general examination of the process of *financial integration* of economies of EU and especially of Euro Area's member-States.² As it will be shown, although the two phenomena (i.e. financialisation and financial integration) are strictly interconnected, they seem not to be completely overlapped.

¹ We refer again to Fine (2011), who talks about 'varieties of financialisation' within a 'variegated capitalism' theoretical framework.

² In this document, the official term 'Euro Area' is preferred to other informal definitions, such as 'Eurozone'. Euro Area is the group of countries which have adopted the euro as their single currency. It currently consists of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

As a first approximation at least, we might define the ‘financial integration’ across national frontiers as the increasing asymmetrical cross-border interconnection of banking systems and financial markets, involving the strengthening of debit/credit relationships among economic units which are located in different geographical areas (see Passarella Veronese, 2013a). This process has historically relied on several interconnected channels: first, the removal of national barriers to capital movements; second, the coordination in the regulation for financial activities, along with the cross-border harmonization of both legal and technological frameworks; third, the practice of States ceding full control over monetary policy to independent and politically-insulated central banks that are mostly focused on inflation targeting; fourth, the change in economic policy, in favour of a rules-based monetary policy as opposed to discretionary fiscal measures. The process of financial integration of EU economies has been the subject of many scientific contributions and institutional reports (see Passarella Veronese, 2013a, for a survey). In the Euro Area, cross-country integration has been monitored by the ECB since before the launch of the single currency. Interestingly enough, the most part of mainstream works found evidence of, and consequently argued in favour of, a process of convergence and *therefore* of increasing integration of Euro Area’s economies. However, as it will be argued, some of the changes which are usually associated with financial integration slowed down (or even reversed) following the US financial crisis erupted in 2008.³ Cross-border capital flows (including intra-Euro-area flows) suddenly collapsed, and five years later they still remain far below their pre-crisis peak (for a survey, see ECB 2013). This occurred because, in spite of the rhetoric on globalization, the most part of ‘transnational capitals’ are still strongly linked to one unique country in terms of ownership (see Duménil and Lévy 2004). In this sense, the process of increasing financial integration of Euro Area’s member-States might be regarded as the other side of the increasing variance in real economy fundamentals, namely, of the rising divergence in the degrees of competitiveness of national industries. Overall, the twofold process of financialisation and financial

³ Notice that we regard the current European economic and financial Great Crisis as a twin balance of payments and banking crisis triggered by the US financial crisis. Among recent works on this topic, we refer to Moro (2013).

integration of economies of EU (and especially of Euro Area) does not account for a brand-new 'mode of production'. Financial sectors are not doomed to totally replace manufacturing and traditional services sectors. Similarly, market-based financial relationships are going along and interacting with, instead of being totally replaced by, more traditional banking (see Sawyer, 2013). In addition, it is probably too early to say if financial integration of European economies is either an irreversible process or not. In any case, the very variety of regional forms in which financialisation is materialising suggests that any 'teleological' or simplistic 'stadial' view of capitalist development should be rejected or, at least, used carefully. For sure, financialisation and financial integration are the historically-determined way in which the re-definition of the international hierarchic chain of value has occurred (and is still occurring) in Europe under the Neoliberal era of capitalism. Such a re-definition is driven by the struggle between different country-based capitals. In fact, it is having enormous consequences, as it is reshaping the economic and political 'borders' between the core and the periphery of Europe. From this take, it is easy to understand why the crisis has seemed to consolidate and even to intensify some aspects of the process of financial integration, if one regards it as an asymmetric dynamics.

Against this background, the rest of the paper is organised as follows. In sections 2 and 3 the analysis of financial integration usually provided by both ECB's staff and mainstream literature is critically introduced and then discussed. Section 4 provides a short analysis of changes in ownership of banks in the Euro Area and in the rest of the EU. It is argued that the retail banking market of the Euro Area has always shown a low degree of integration compared to the US retail market, as it has remained largely fragmented along national lines. In section 4 a different take of the process of financial integration is provided. It will be argued that permanent current account (and financial) imbalances within the Euro Area have not reflected a process of mutually beneficial financial integration of different national economies, as asserted by a part of mainstream economics literature and ECB's early reports. By contrast, these imbalances went along with a process of deepening of the

dualism between the ‘core’ and the ‘periphery’ of the Euro Area. Some further considerations on this controversial issue are provided in the final remarks.

2. Financial integration and financial stability in ECB’s reports⁴

Financial integration is usually regarded as a beneficial phenomenon by supranational institutions and particularly by the ECB. The main reason – as it is explained in the ECB’s website – is that a well-integrated financial system would contribute to a smooth and effective implementation of monetary policy throughout the Euro Area and would increase the efficiency of the economy. In addition, a deeper financial integration is assumed to have a positive impact on the stability of the whole financial system. More precisely, the access to a wide, international, capital market would expand the opportunities for portfolio diversification and therefore would reduce the investors’ risk, while contributing to the efficient allocation of capitals within the Euro Area. Insofar as it provides access to a wider range of assets, financial integration would improve risk-sharing, asset liquidity degree and resilience to shocks of Euro Area’s member-States. This notwithstanding, sometimes it is admitted that, in the real-world economies, financial integration might increase “the risk of volatility and abrupt reversals of capitals flows, contagion and cross-border transmission of financial shocks” (ECB, 2010, p. 69). In particular, the onset of the crisis of 2007 shifted progressively the focus of ECB’s scholars from the advantages to the “potentially destabilizing impact of financial integration” (Forster *et al.*, 2011, p. 11). More precisely, it has been observed that the increasing interdependence of individual Euro Area markets might increase the risk of systemic contagion and bankruptcy chain-reactions in the case of financial turmoil. Notice that the very portfolio diversification may drive investments into countries where crisis occurs, therefore augmenting (and not reducing) investors’ risk. In addition, the available empirical evidence suggests “that there might be a point beyond which a country becomes ‘over-integrated’, in the sense that further integration is associated with movement away from rather than towards optimal

⁴ Sections 2 and 3 of present report are largely drawn from Veronese Passarella (2013b), sections 1 and 4.

diversification” (ECB, 2010, p. 70).⁵ Finally, the misallocation of resources (leading to domestic asset bubbles and debt-based unproductive consumption), the pro-cyclical and volatile nature of cross-border capital flows, as well as the increasing external imbalances of peripheral countries, are cited as costs linked to the process of integration. However, the prevalent opinion (within the European institutions at least) is that the constitution of prudential supervising mechanisms and authorities, along with the adoption of austerity fiscal measures, would be sufficient to reduce the risk to an acceptable level. On the whole, financial integration is still seen as mutually advantageous for EU member-States, in spite of their national specificities and their position in the international chain of value.

In the analysis of the link between financial integration and financial stability provided by ECB’s staff, three factors are usually considered: i. the degree of foreign bank penetration; ii. the degree of interbank market integration; iii. the degree of cross-market integration. Starting from the first factor, in 2010 foreign banks accounted for the ownership of over a quarter of domestic bank sector asset value in the Euro Area. According to ECB’s staff, banking market integration “offers the prospect of important gains in terms of efficiency and diversification, but it also creates potential systemic risks” (ECB, 2010, p. 71). In this regard, it is admitted that the so-called ‘financial accelerator mechanism’⁶ may be higher when foreign-owned banks are involved. The reason is that, during periods of economic weakness and higher uncertainty, foreign banks are prone to repatriate their assets to their own national base, therefore reducing domestic firms’ possibilities to borrow. This may lead to a feedback cycle of falling domestic asset prices, deteriorating balance sheets of domestic firms and banks, tightening conditions on financial and credit markets and real economy’s downturn. Notice that this is what really happened in most part of Euro Area’s member-States since 2007 and even more after

⁵ For “optimal diversification” the ECB’s staff means the convergence of the economy “towards a diversification benchmark based on the idea of allocative efficiency”, so that investors’ risk would not be better diversified by an international portfolio. However, the breaking point (beyond which integration increases investment’s risk) is never clearly identified, either theoretically or empirically.

⁶ As a first approximation, we can define the financial accelerator effect as the degree to which a negative shock to real economic magnitudes is amplified by a worsening in financial market conditions. On this point, we refer, among others, to Bernanke *et al.* (1996). For a critical survey, we refer to Fontana and Passarella Veronese (2013).

2010. Turning to the second factor, the interbank market was regarded as the most successful example of the beneficial effects of European integration before the crisis. However, it also turned to be “one of the first victims of the current crisis, with signs of segmentation and even re-nationalisation” from mid-2007 (ECB, 2010, p. 72). According to ECB’s reports, the main reason of such turn-round was not linked to the fragility of the integration process *per se*, but, on the contrary, to the “absence of sufficient retail market integration” which allowed free-riding on liquidity provision to limit the achievable level of risk sharing (as argued by Fecht *et al.*, 2007). Finally, before the crisis, the idea that cross-dependencies and cross-penetrations between different financial markets were positive, and that both benefited from the activity of institutional investors (such as pension funds, insurance companies, private equity companies, and hedge funds) was unquestionable.⁷ After the outbreak of the crisis, ECB’s reports have begun to explicitly recognize that those actors can threaten the systemic stability and accelerate emerging “liquidity spirals” and market segmentation. A point is made that institutional investors “have altered the channels of funds available to corporations and have changed the set of incentives faced by corporations” (ECB, 2011, p. 40).

3. Financial integration and economic convergence/divergence

If we look at both ECB’s official reports and mainstream literature dealing with the process of financial integration of Euro Area’s countries, an underlying hypothesis is shared that each and every national business cycle is converging into a unique cycle. More precisely, empirical evidences of the convergence would be provided by the converging trend (over the period preceding and following the launch of the Euro) in a number of nominal indicators, and even in inflation and growth rates of Euro Area’s member-States. In figures 2 to 12 some of the indicators employed by the ECB’s staff are shown, including money market price-based indicators (notably, the cross-country standard deviation of lending rates), money market quantity-based indicators (notably, the levels of borrowing activity in the Euro Area’s unsecured and secured money markets), security market price-

⁷ Some have argued, for instance, that “regular hedge fund activities tend to improve liquidity conditions” (ECB, 2010, p. 73).

based indicators (such as the dispersion in the 5-year CDS *premia*, the dispersion in Euro Area's equity returns, and the dispersion of Euro Area 10-year sovereign bond yields), banking market activity-based indicators (such as interest rates and amounts of loans to Euro Area's non-financial corporations, and the standard deviation of banks' CDS *premia*), and banking market price-based indicators (such as the size of capital market, and the amount of debt securities issued by non-financial corporations). The most part of these indicators account for a converging trend from the mid-1990s to 2007. More precisely the cross-country standard deviation of the average overnight lending rates among Euro Area's countries decreased from 270 basis points in January 1996 to less than 2 basis points in February 2000 and remained at the same level until August 2008 (see Figure 2). The same goes for equity returns of Euro Area's countries, whose dispersion decreased from 5.44% in May 1990 to 1.95% in December 2005 (see Figure 6). In addition, the dispersion (measured as the min-max range) of Euro Area's 10-year sovereign bond yields, diminished from 7.59% in April 1991 to 0.22% in March 2002 (see Figure 7). Finally, interest rates on loans to financial corporations of 'distressed' countries were substantially identical to those paid by corporations of 'non-distressed' countries between May 2000 and October 2008 (when the difference was lower than 1%, compared to 5.24% in February 1997) (see Figure 8).⁸

Similarly, the Euro Area's sum of cross-border assets and liabilities increased from 188% of GDP in 1999 to 325% of GDP in 2007, and the rise was even sharper in the case of the UK. Both net purchases by Euro Area's residents of foreign assets (reported in the asset side of Euro Area's financial account) and financial investment by non-residents (liability side of financial account) increased sharply until 2007, with net flows being close to balance for most of the period. Looking at the sum of (market values of) of cross-border assets and liabilities as a percentage to GDP, Kose *et al.* (2006: 17, 63-64) show that: i. the absolute level of integration of different country groups into global financial markets, measured as the sum of gross international financial assets and liabilities, has increased

⁸ Notice that 'non-distressed' countries comprise Germany, Austria, Belgium, Finland, France and the Netherlands. 'Distressed' countries comprise Spain, Italy, Portugal and Ireland (see ECB, 2013, p. 14).

in both advanced economies and emerging market economies since the mid-1980s;⁹ ii. the level of integration into global capital markets is clearly higher for advanced economies (including major EU countries) than other economies.¹⁰ In addition, foreign investment within the Euro Area increased remarkably after the launch of the single currency. Intra-Euro Area portfolio investments expanded significantly from 2001 to 2007 and remained rather high even until 2009 (see Forster *et al.*, 2011; see also Passarella Veronese, 2013b). This contributed to the decline of yield spreads vis-à-vis German bunds, which remained at very low levels until September 2008 (see Figure 15). Finally, in the same period, “intra-euro bank exposure also increased remarkably with Euro Area credit institutions increasingly allocating available savings to Euro Area countries”. Euro Area’s peripheral member-States “attracted sizeable amounts of additional funds in the years prior to the crisis, mostly from German and French banks” (Forster *et al.*, 2011, p. 14). In fact, until 2007 German and French banks expanded their cross-border operations and increased lending (through local subsidiaries and branches) especially within the Euro Area, “with the claims of German and French banks on the aforementioned countries increasing from about 15% to about 20-25% of their total foreign claims” (Forster *et al.*, 2011, p. 15). These figures are the reason why the ECB’s staff remained always quite confident about the process of integration. In addition, the very apparent convergence reinforced the idea that the ‘one size fit all’ policy (i.e. the steering of the short-term interest rate on the unsecured money market) preached by the ECB would have been the best way to pursue the monetary stability and the financial soundness of the Euro Area. This, in turn, should have been enhancing the process of financial integration of all of European economies as well.

⁹ The label ‘advanced economies’ comprises: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States. By contrast, the label ‘emerging market economies’ comprises: Argentina, Brazil, Chile, China, Colombia, Egypt, India, Indonesia, Israel, the Republic of Korea, Malaysia, Mexico, Pakistan, Peru, the Philippines, Singapore, South Africa, Thailand, Turkey, and Venezuela.

¹⁰ By 2004, the sum of gross international financial assets and liabilities amounted to almost 100 trillion USD in advanced economies, compared to less than 8 trillion USD and about 0.5 trillion USD in emerging markets and other developing economies, respectively (source: Kose *et al.*, 2006).

Yet, since the launch of the Euro, the process of financial integration has gone along with increasing external imbalances between core and peripheral countries.¹¹ Actually, a growing number of ECB's reports and documents have been dealing with this issue. However, imbalances are usually considered as either a temporary condition (doomed to disappear as the integration process proceeds) or the result of wrong national policies. The typical argument of the ECB's staff is that inflation, income and output growth differentials between the countries of the Euro Area "are moderate and broadly in line with other large currency areas such as the United States". Those differentials would be none other than the result of "ongoing adjustments leading to a more efficient allocation of resources" (ECB, 2011, p. 52). By contrast, nothing is usually said about: i. the absence not only of something similar to the US Federal Government, but also of a true common European budget; ii. the fact that the Euro has not the particular international status of the USD and hence that, in the European case, cross-country permanent imbalances in national current accounts matter. Looking at the most recent reports, it is sometimes admitted that "the persistence of inflation and growth differentials of individual Euro Area countries over longer period of time [...] may be worrisome and would need to be assessed by national policy adjustments" (ECB, 2011, p. 52-53). In order to measure the dispersion of inflation across the Euro Area, ECB's staff usually looks at the un-weighted standard deviation of the HICP inflation rate. In this regard, the curve for the EU12 shows a broadly stable dispersion since the late 1990s. In 2009 and the early months of 2010, the dispersion of inflation in the Euro Area increased somewhat and the ECB's reports seemed to be concerned about this point. More precisely, they suggested that the rise in the inflation dispersion could highlight "the need for domestic economic policy adjustments to tackle previously accumulated imbalances at a national level" (ECB, 2011, p. 53). Recently, even the President of the ECB, Mario Draghi, has stressed the importance of external imbalances as the 'fuel' of European Sovereign Debt Crisis (see Draghi, 2013, slides 4, 9 and 10). However, the roots of such imbalances are usually generically traced

¹¹ Though with diminution since the European Sovereign Debt Crisis, due mainly to deflation in the deficit countries. By contrast, Euro Area has significantly increased its overall current account surplus. On this point, we refer the reader to footnote 24.

back to some “structural inefficiencies or misaligned national policies” (ECB, 2011, p. 53), rather than to the specific non-cooperative (or ‘beggar-my-neighbour’) model adopted by Euro Area’s core economies.¹² Yet, it is possible to show that the deflationary policies implemented by core countries, aiming to constrain internal demand and to support net export, have been at least as important as ‘inefficiencies’ (i.e. growing unit labour costs) of peripheral countries in generating imbalances (see Moro, 2013). Whatever the cause, the diverging trends in inflation rates, along with the raising differentials in growth rates, have given rise to increasing current account and financial account imbalances between Euro Area’s member-States (see Figures 16 and 17). This real economic divergence is none other than the other side of the process of intensification in financial relationships between Euro Area’s countries.

4. Ownership of banks in the Euro Area and in the rest of the European Union

In Section 2 we pointed out that the interbank market was usually regarded as the most successful example of the beneficial effects of European integration before the crisis. Yet, after the outbreak of the European Sovereign Debt Crisis, the very Euro Area’s interbank market suddenly froze. ECB (2010)’s analysts attributed such a turn-round to a number of still-present market imperfections, including the absence of integration in the retail market. In fact, the retail banking market of the Euro Area has always shown a low degree of integration (compared, for instance, to the US retail market), and has remained largely fragmented along national lines. One of the most evident signs of this scarce integration is the low number of cross-border M&A deals between European banks (see Figures 20 and 21). The most part of M&A take place between institutions located in the same country. Notice that “[i]n the US, the average number of bank mergers and acquisitions per year from 2005-12 was 343, while in Europe the yearly average only amounted to 58” (Sapir & Wolff, 2013, p. 4; see also Daluiso, 2013). The outbreak of the European Sovereign Debt Crisis has further pushed the borders of the banking M&A market behind the national

¹² In fact, the statement that the diseases affecting the Euro Area are wrong and uncoordinated national policies is a constant of the ECB analysis and communication policy.

frontiers (see Figure 22).¹³ Notice that the share of subsidiaries and branches which are foreign-owned has recorded a similar trend. More precisely, the percentage of assets of foreign owned branches and subsidiaries (on total assets) has remained rather marginal, or has even fallen down, in all of major European economies (see Figure 23). Of course, the smallest EU member-States and CAEE countries represent a remarkable exception. The benefits coming from the higher degree of integration of these countries are rather controversial though, as this often signals a financial ‘dependency’ from abroad and, potentially, a high financial accelerator risk. For instance, one of the CAEE economies whose banking sector has undergone the most significant change since the fall of the socialist system is Romania. This change has occurred with a particular strength “after 1999, when a banking crisis and renewed international pressure (from the IMF and the World Bank) saw the Romanian government accelerate the pace of privatization” (Gabor, 2013, p. 90).¹⁴ Such a process has been realised through a massive inflow of foreign capitals. By 2008 the Romanian banking sector had become extensively foreign-owned. The share of domestic banks (including state-owned banks) had felt under 15% of total banking assets (see Table 1). Today, foreign-owned banks (the most part of which follow the universal bank model) dominate the Romanian banking system.¹⁵ However, this seems not to have had any evident beneficial effect on Romanian economic fundamentals. At the same time, foreign currency lending and carry trade activities have exposed Romanian private sector (including households) to increasing debt and have augmented the degree of financial fragility of the whole economic system. It is, therefore, not surprising that the financial crisis led many to question ‘the perceived benefits of transnational banking and the regulatory wisdom of allowing banks to move liquidity through internal capital markets’ (Gabor, 2013, p. 156). In fact, the post-Lehman contagion in CAEE area came through the banking channel, and ended up in the Vienna Initiative (or the European Bank

¹³ By contrast, the same share remained unchanged in the US.

¹⁴ Still in 1998, Romanian state-owned banks controlled 75% of the overall assets of the banking sector. By 2005, this share was fallen dramatically. Only two banks (i.e. CEC Bank and Eximbank) had remained in state-ownership, together holding less than 6% of overall banking assets.

¹⁵ In 2011, foreign owners were based in Austria (whose banks hold 38.85% of market shares of Romanian banking sector), Greece (15.5%), France (14.4%), Netherlands (9%), and Hungary (1.5%) (see Gabor, 2013, p. 91).

Coordination Initiative), involving many other countries besides Romania, such as Hungary and Latvia.¹⁶

Notice that the low share of private domestic capital that could be involved in the processes of privatisation, and therefore the high share of foreign-owned banks, is not just a Romanian feature. On the contrary, it is an important trait of the most part of 'dependent' economies, such as Baltic countries, Hungary¹⁷ and Bulgaria. The impact of foreign ownership on efficiency and soundness of the domestic banking sector is usually regarded as positive, such as in the cases of Estonia (see Juuse & Kattel, 2013), Hungary (see Szabolcs *et al.*, 2013), and Poland (see Janc *et al.*, 2013). Similar considerations hold for some of the early-members of Euro Area, notably Portugal (see Lagroa *et al.*, 2013). However, the over-indebtedness of households and the remarkable loan losses of banking sector in recent years are the other side of the coin. In addition, the higher efficiency of foreign banks had frequently been 'due to the successful performance of green field banks'.¹⁸ Foreign banks that had acquired domestic banks did not appear to have enhanced their efficiency' (Janc *et al.*, 2013, p. 157). This notwithstanding, the favourite investment strategy of foreign institutional investors was often to have a steadily increasing participation in domestic banks' capital, rather than to create their own financial institutions in the country.

Summing up, there have been fewer deals, and especially cross-border deals, in the Euro Area than in the US in the last two decades. Moreover, the financial crisis has further inhibited cross-border deals in the Euro Area compared to the US. In this regard, smallest

¹⁶ The Vienna Initiative is "a framework for safeguarding the financial stability of emerging Europe" (definition from <http://vienna-initiative.com/>). It was launched in January 2009 and it was led by the European Bank for Reconstruction and Development and the International Monetary Fund. The aim was to secure the roll-over of short-term credit to subsidiaries of foreign banks operating in CAEE countries. More precisely, it 'brought together parent banks and regulatory authorities from both home and host markets in an effort to persuade parent banks to maintain commitment to Eastern European subsidiaries' (Gabor, 2013, p. 105). Thanks to this intervention, a disorderly deleveraging by cross-border bank groups in CAEE countries was avoided. A second Vienna initiative followed in March 2012, aiming to strengthen the first initiative.

¹⁷ The share of Hungarian financial assets held by foreign banks to total assets was 81% in 2010. Looking at the nationality of foreign owners, Italy represented 21%, Austria 19%, Belgium 17%, Germany 9%, US 2%, South Korea 2%, and France 1%).

¹⁸ A 'green field investment' is a specific form of FDI in which a parent company starts a new venture in a foreign country by opening new branches, instead of acquiring still-existing companies.

European countries and CAEE economies have represented a remarkable exception. However, the final effects of the increasing presence of foreign actors in their domestic banking sectors is controversial, as it has certainly improved efficiency, but it has turned out to be an element of financial fragility after the burst of the European Sovereign Debt Crisis. In any case, both the absence of cross-country integration between banking institutions of major economies and the 'dependent' nature of CAEE economies' integration could represent an additional factor of economic divergence between core economies of Euro Area and the periphery. The impact of the absence of a true integration of Euro Area has been clearly pointed out by Sapir & Wolff (2013), according to whom the Euro Area financial system is in a problematic state, as:

Banks do not lend to each other across borders without asking for a significant premium. In the larger euro-area countries, cross-border retail banking plays a negligible role and therefore cannot serve as a meaningful source of credit that could compensate for the dysfunctional interbank market. The combination of these two factors leads to significant differences in credit conditions across the euro area and the EU. As a consequence, corporations in some countries are at a competitive disadvantage merely because of their location, and households cannot borrow at reasonable terms. As a result, investment remains subdued and economic growth remains anemic. Alternative financial-intermediation channels, such as capital and equity markets, cannot play a meaningful role in stabilising the different economies and providing sufficient funding for business and households because of their comparatively low degree of development and their limited cross-border integration. (Sapir & Wolff, 2013, p. 2)

This, obviously, would require a number interventions, such as a reduction in fragmentation of financial institutions, the implementation of a true European banking union, the recapitalisation of banks, and, finally, a central bank acting as a lender of last

resort and supporting interbank market through the stabilization of government bond markets.¹⁹

5. A different view on the process of financial integration

As we showed in previous section, European institutions and the most part of economic literature usually regard financial integration as fully reflected in the process of cross-border convergence in a certain number of nominal indicators. The theoretical motive is as follows. Medium-run stability of, and decreasing cross-border variance in, prices (including interest rates and asset returns) are assumed to be the *pre-conditions* for economies to naturally converge to their exogenously-given equilibrium growth paths. Consequently, the convergent trends in lending rates, sovereign bond yields, equity returns, and CDS *premia*, assure that financial integration is actually operating. Yet, this analysis relies on a rather narrow and simplistic definition of financial integration, neglecting the strict link between the increase in current account imbalances *within* the Euro Area and the increase in capital flows from core countries to peripheral ones (leading to a temporary cross-border convergence in return rates and even to a temporary overall financial stability). In other words, the mainstream interpretation usually neglects the ‘imperialistic’ nature of both capital movements and the related process of re-definition of the international hierarchic chain of value. Notice that this process is anything but spontaneous, harmonious and symmetrical. Instead, it is politically-driven, temporally discontinuous and both socially and geographically uneven. Both the form and the impact of financial integration on each single country (or region) depend on the specific place assigned to that specific country (or region) in the emerging Neoliberal European and worldwide capitalist orders. This feature, in turn, is one of the reasons explaining the spread of a variety of different country-specific financialisation processes across the Euro Area in the last two decades.

¹⁹ Notice that financial stability depends crucially on collateral market conditions, because these conditions indirectly affect interbank funding. The point is that the perceived degree of liquidity of collaterals determines the single bank’s chance to access market funding, and government bonds of high income countries are the most important collateral in REPOs (see Passarella Veronese, 2013b, pp. 11-12)

As we mentioned, financial integration can be regarded as the increasing *asymmetrical* interconnection of banking systems and financial markets, going along with the strengthening of debit/credit relationships among economic units located in different geographical areas (see Passarella Veronese, 2013a). This process usually operates through the removal of national barriers to capital movements, the transfer of the control over the monetary policy to independent central banks which are mostly focused on inflation targeting, the coordination in the regulation for financial activities, and the cross-border harmonization of both legal and technological frameworks²⁰. All of these factors, along with the launch of Euro, contributed to the increase in cross-border capital flows between Euro Area's (and other European) countries in the last two decades, leading to a convergence in inflation, interest and return rates. However, the outbreak of the European Sovereign Debt Crisis has seemed to slow down sharply cross-border capital flows in the last few years.²¹ As a consequence, some doubts have arisen upon the actual degree of integration achieved by European (particularly, Euro Area's) countries. In this regard, an interesting empirical analysis on the degree of the financial integration of equity markets of EU's member-States is provided by Higson *et al.* (2013). These authors analyse the convergence pattern of stock market indices since 1985. Their tests 'reject the hypothesis of overall convergence in equity market [...] even when the analysis is restricted to the countries of the Euro Area' (Higson *et al.* 2013: 32). To put it differently, 'even when some convergence is detected, the speed of convergence remains always very low' (Higson *et al.* 2013: 36). Furthermore, a cluster analysis (roughly splitting EU-countries in three different groups: outperforming small countries, highly-volatile small countries and large EU area countries) reveals that large Euro Area countries 'has followed the EU average very closely [...] but it seems to have decoupled around 1998, and settled at slower growth rate' (Higson *et al.* 2013: 37). Finally, 'the Euro Area average is not too different from the EU average' (*ibidem*). Hence, the process of financial integration, if it is to be observed,

²⁰ Historically, the removal of national barriers to financial activities in the EU's member-States was mainly promoted by the Single Market Programme in the 1986, whereas the creation of a single market for financial services was devolved upon the Financial Services Action Plan in the 1999.

²¹ This could be seen as the other side of the reduction in current account deficits as a result of deflation.

‘cannot be solely attributed to the recent adoption to the single currency’ (Higson *et al.* 2013: 39). Rather, as has been pointed out, it seems to reflect a more deep process of convergence/divergence in the underlying economic fundamentals.

Another usual measure of financial integration is the index provided by Eurostat and labelled the ‘foreign direct investment intensity’. It refers to the average value of inward and outward *flows* of foreign direct investment (FDI hereafter) in percentage of GDP. In all of major EU economies such indicator peaked in 2000, and then in 2007 (at lower levels though), whereas it decreased sharply after the two crises. Among largest EU economies, the UK is the one with the highest value. By contrast, Italy always registered a flat volume of FDIs (see Figure 1). Anyway, the current (average) value of this indicator is returned to that of the early 1990s. This could suggest that FDIs have been driven by economic growth (and inflation) differentials among EU countries, more than vice versa. From this viewpoint, EU market integration has been a temporary (or, at least, discontinuous) process. Negative shocks, and especially asymmetric shocks, end up replacing integration trends with ‘home-bias’ tendencies and ‘flight-to-safety’ behaviours of investors. This happens because large transnational EU corporations and banking groups are still strongly linked to one unique country in terms of ownership and management (see Duménil and Lévy 2004; see also Passarella Veronese 2013b,c). Looking at the *stocks* of foreign capitals, both inward and outward FDI stocks generally recorded upward trends in the last thirty years (see Figures 13 and 14). One of the most notably exceptions is Ireland, whose stock of inward FDI to GDP has recorded a decreasing (but rather volatile) trend since the mid-1980s (it has increased in absolute terms though). On the whole, Euro Area member-States, and especially CAEE and northern European countries, have faced a remarkable increase in inward FDI stocks. By contrast, outward FDI stocks of CAEE countries have remained rather weak. Furthermore, the growth in FDI stocks seems to have been slowed down sharply in major economies after the two crises of the 2000s. Notice, in addition, that FDIs are just a minor component of intra-Euro Area’s total foreign investments, the most part of capital flows being short-term financing (mainly in the form

of cross-border deposits from abroad). However, portfolio and other investments are much more volatile than FDIs (see Figure 18).

On the whole, the Lehman Brothers turmoil and then the European Sovereign Debt Crisis have reflected in a 'sizeable deleveraging of external financial exposures by the private sector and, in particular, the banking sector'. There were also 'significant changes in the composition of Euro Area's cross-border portfolio flows, as investors shifted from equity to debt instruments and from private to public sector securities' (Forster *et al.*, 2011, p. 4). In addition, the advanced European economies 'which have traditionally dominated global capital flows and were considered immune from sudden capital withdrawals, were particularly affected' by the crisis (Forster *et al.*, 2011, p. 5). Not only capital flows reversed, but their volatility sharply increased. Ironically enough, after a decade marked by a progressive retrenchment of government sector, this latter has become the main (and often the only) net borrower from abroad (see Figure 19). Similarly, the *McKinsey Global Institute* (quoted in Cohen-Setton, 2013) argues that for three decades, financial integration "appeared to be an unstoppable trend". However, 'the financial crisis brought that the era of rapid growth to a halt. Cross-border capital flows collapsed, and today they remain 60% below their pre-crisis peak'. More precisely, such capital flows increased from around 0.5 trillion USD (representing 4% of overall GDP) in 1980 to 11.8 trillion USD (equal to 20% of overall GDP) in 2007. In this period 'Europe accounted for 56% of the growth in global capital flows [...], reflecting the increasing integration of European financial markets'. The crisis of 2008 dramatically reversed this trend: global cross-border capital flows fell to 2.2 billion USD in 2008 and to 1.7 billion USD in 2009. Today they amount to 4.6 billion USD (equal to 6% of global GDP).

Finally, as it has been mentioned in Section 4, the trend in M&A within the industry of financial services is another important indicator of financial integration of Euro Area's countries. From this viewpoint, the instability on financial markets and the worsening of the funding conditions, coupled with the need to reduce leverage ratios, have had a significant effect on their number and size since 2008. More precisely, cross-border deals recorded remarkable overall *values* in the period 2004-2008, but dropped markedly after

the peak of 2008. The *number* of M&A deals followed an opposite trend though (see Passarella Veronese 2013b: 58-59; see also Figure 22). According to ECB's scholars, the forced 'participation of governments and resulting shift in the ownership structure of the relevant banks was one of the factors that contributed to the decline in private M&A activity in 2009'. By contrast, the 'low volumes of M&A deals in 2010 and 2011 can to a large extent be attributed to the sovereign debt crisis and the exceptional levels of volatility observed in European financial markets'. The reason is that banks 'focused on repairing their balance sheets and solving short-term problems (e.g. funding) rather than expanding their businesses through M&A' (ECB 2012, p. 64). Notice, however, that, despite the ongoing uncertainty, ECB's scholars expected 'more M&A activity and wider sector restructuring [...] in 2012 and beyond' (ECB 2012, p. 65).

6. Final remarks

The aim of this document was to complement the analysis of financialisation provided in Passarella Veronese (2013) with a preliminary examination of the process of financial integration of EU, and especially of Euro Area's member-States. In this regard, figures show that a process of increasing financial interconnectedness between different country-based economic units has been actually operating since the early 1990s within the Euro Area. As pointed out by ECB's staff and other economics studies, convergences in lending rates and sovereign bond yields have been recorded, coupled with growing cross-border flows of capitals and cross-border interbank market integration (until the outbreak of the recent European crisis at least). However, especially after the launch of the single currency in 2002, this has gone along with growing current account (and, symmetrically, financial) imbalances within the Euro Area, due to both the different national growth rates and the successful deflationary policies adopted by core countries.²² As a result, the

²² The label 'core countries' here refers to those countries which have recorded permanent current account surpluses since 2002, notably, Austria, Belgium, Germany, the Netherlands, Finland and Luxemburg. Strictly speaking, France should not be included in this group, as it has registered recurring current account deficits after 2004 (see Figure 17). In this sense, it could be likened to the Italian case. However, unlike Italy, France is an important net exporter of capitals towards the periphery. This is the rationale of including it in the 'core'. For an analysis of the causes of imbalances between Euro Area's member-States, we refer the reader to Moro (2013).

permanent current account deficits of Euro Area peripheral economies have reflected in an increasing amount of financial liabilities placed by their government sectors in international markets (until the outbreak of the crisis). Ironically enough, in early 2000s these very imbalances were regarded as the proof that the economic and financial integration process of EU's countries (and, particularly, Euro Area's member-States) was working.²³

By contrast, external imbalances were not fuelling a process of mutually beneficial financial integration of European economies. On the contrary, they were contributing to deepen the dualism between the core and the periphery of EU. More precisely, the periphery has progressively turned into an end market for exceeding domestic output (and capitals) of the core, whereas the most industrialised regions of the former have turned into low-cost 'sub-contractors' of the latter. The post *Lehman Brothers* financial turbulence and the outbreak of the European Sovereign Debt Crisis harshly unveiled this asymmetry, as capital flows suddenly reversed and cross-border investment of core countries were replaced by 'flight-to-home' behaviours. This is clearly reflected in figures of FDI and other investment flows, even though the stocks of foreign capitals are still rather high (compared to 1980s and early 1990s). Yet, the crisis did not affect dramatically imbalances in trade (let alone in the overall current account) within the Euro Area: imports of distressed economies have reduced somewhat due to the recession, but structural imbalances (which fuelled the crisis) have not disappeared. In fact, they have even reinforced. Insofar as distressed countries will manage to return to growth, these

²³ For instance, Blanchard and Giavazzi (2002: 148-149) argue that the "fact that both Portugal and Greece are members of both the European Union and the Euro Area [...], and the fact that they are the two poorest members of both groups, suggest a natural explanation for today's current account deficits. They are exactly what theory suggests can and should happen when countries become more closely linked in goods and financial markets. To the extent that they are the countries with higher expected rates of return, poor countries should see an increase in investment. And to the extent that they are the countries with better growth prospects, they should also see a decrease in saving. Thus, on both counts, poorer countries should run larger current account deficits, and, symmetrically, richer countries should run larger current account surpluses. [...] saving rather than investment is the main channel through which integration affects current account balances. [...] Lower private saving – due to both internal and external financial market liberalization but also to better future growth prospects – and, to a lesser extent, higher investment appear to be the main drivers of the larger current account deficits". On this basis, the authors ask "whether countries such as Portugal and Greece should take measures to reduce their deficits [and] conclude that, as a general rule, they should not"!

imbalances are, therefore, likely to outbreak again.²⁴ The point is that financial integration has not materialized in the development of a net of supranational horizontal financial relationships between economic units operating within a uniform economic space (thereby reinforcing the financial soundness of all of involved countries). What figures show, is rather a process of concentration and centralisation of capitals in the hands of the strongest countries of the Euro Area, reinforcing structural imbalances between the core and the periphery. In the absence of a true European banking union, a system of 'financial repression',²⁵ a substantial common budget for Euro Area's countries, and a European central bank acting as a lender of last resort, nothing could ensure the smoothing of such imbalances.

²⁴ As we mentioned, a current account imbalance has arisen between the Euro Area and the rest of the world. The former (considered as a whole integrated area) has been registering a remarkable surpluses in the last two years. More precisely, in September 2013 the seasonally adjusted current account of the Euro Area recorded a surplus of 13.7 billion Euro, mainly due to the surplus of goods (see the press release of ECB, 18 November 2013, entitled 'Euro area balance of payments in September 2013'). Such a surplus is mainly with the USA, Switzerland, and Canada, and also with some BRICS (such as Brazil and India) and other Asiatic economies (see Eurostat, 'newrelease euroindicators', No. 151, 17 October 2013).

²⁵ The concept of the 'financial repression' has been recently rediscovered by a number of mainstream contributions. See, among others, Reinhart & Sbrancia (2011).

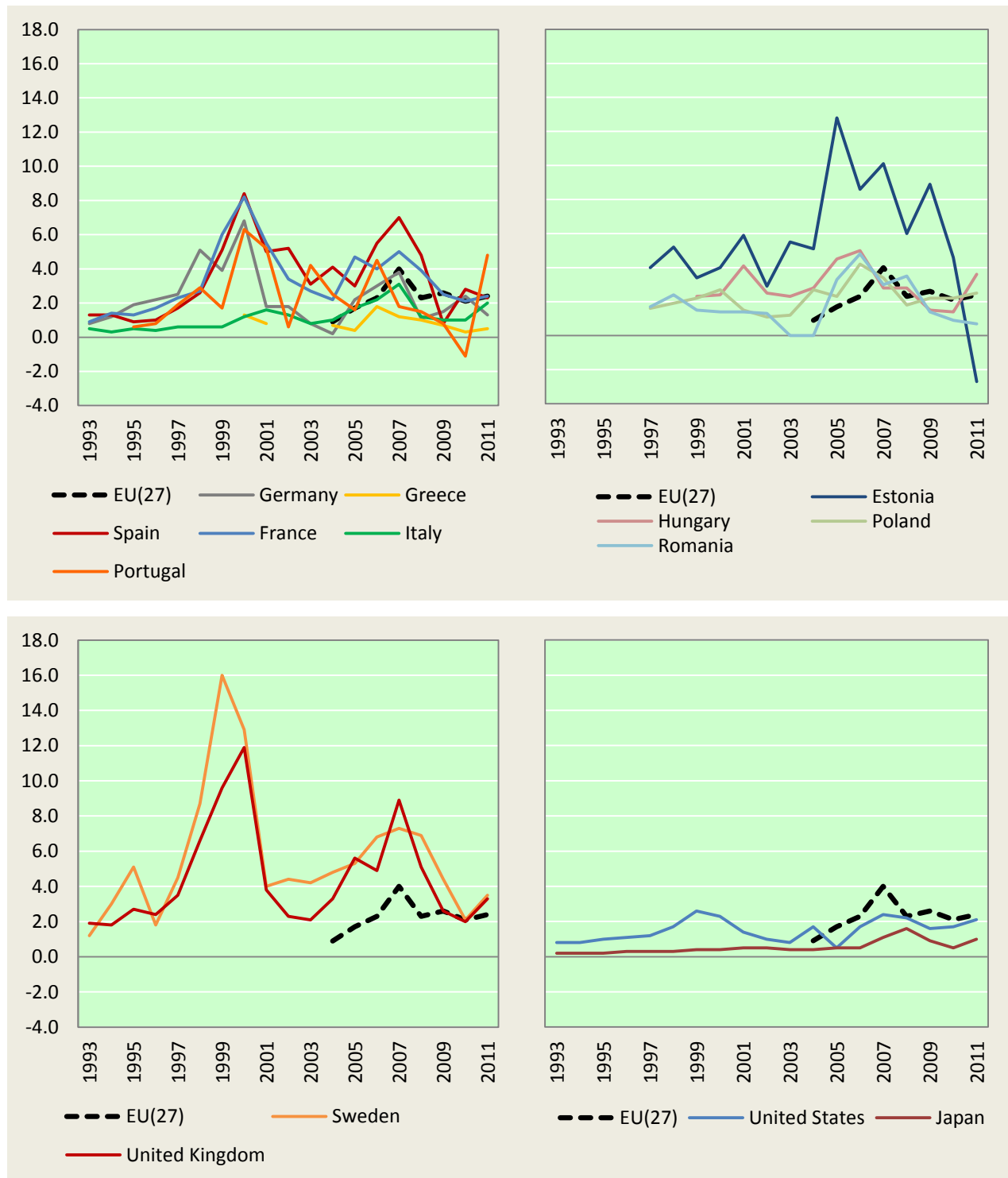
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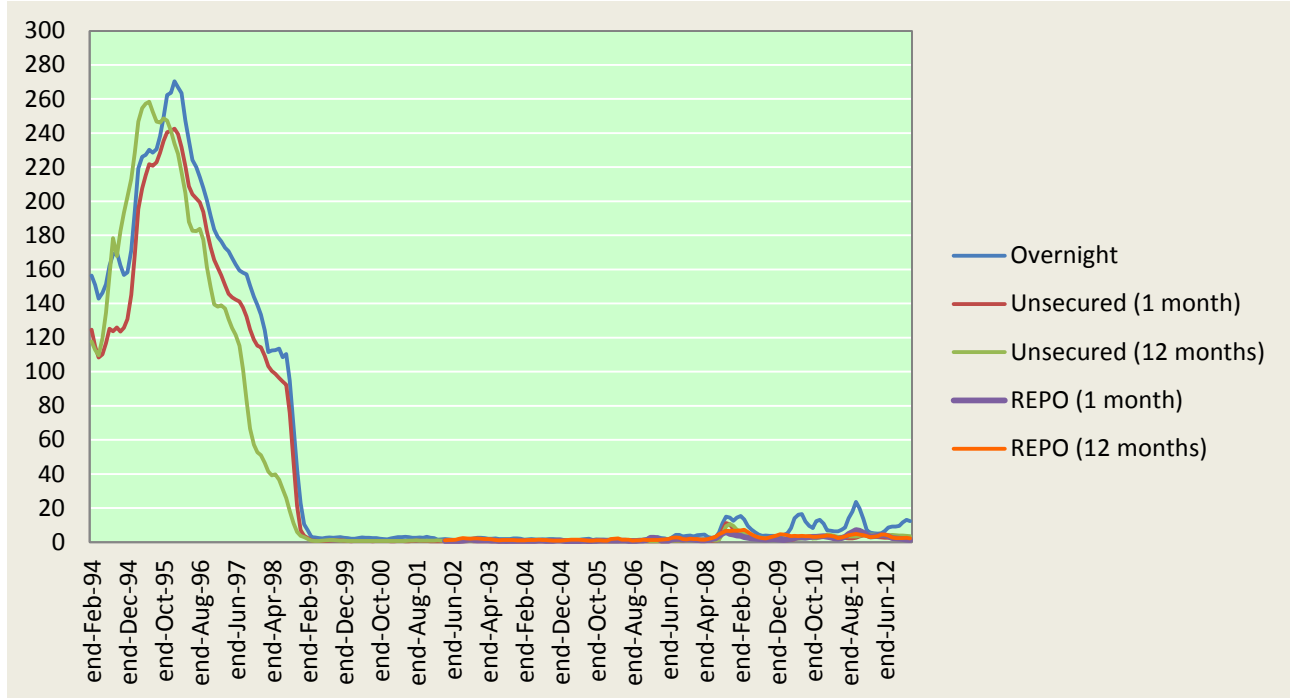
Tables and figures

Figure 1. Foreign direct investment intensity (average value of inward and outward FDI flows divided by GDP and multiplied by 100).



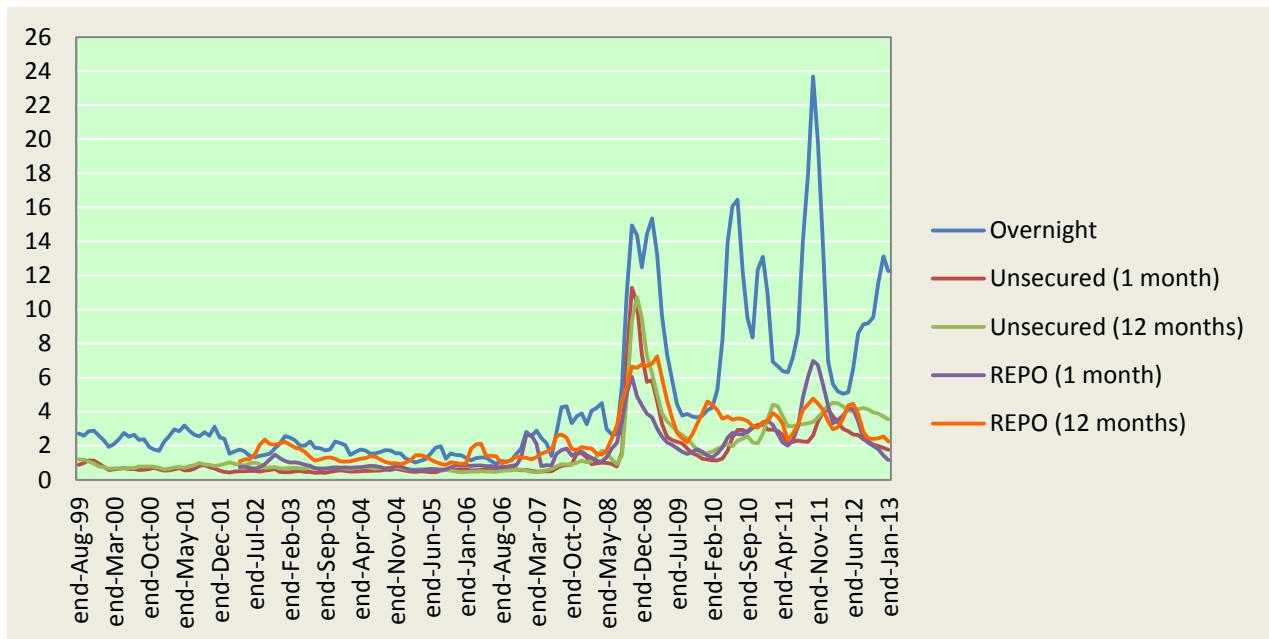
Source: elaboration on Eurostat statistics (October 2013).

Figure 2. Cross-country standard deviation of lending rates among Euro Area countries (basis points, from February 1994 to January 2013).



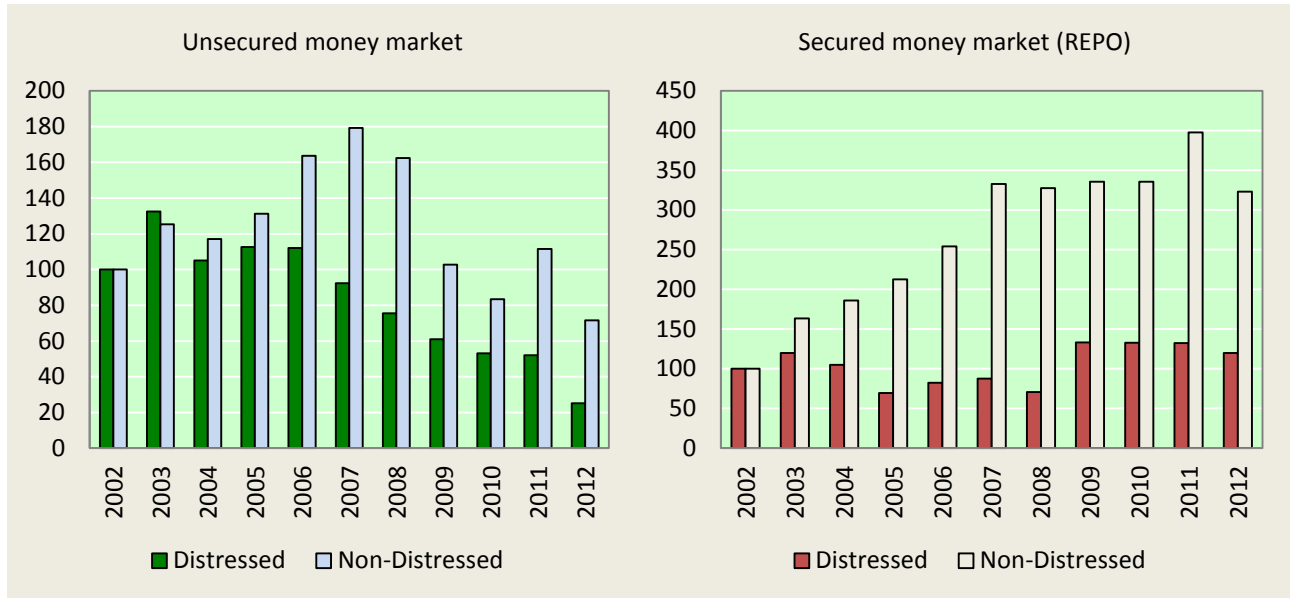
Source: elaboration on ECB statistics (November 2013).

Figure 3. Cross-country standard deviation of lending rates among Euro Area countries (basis points, from August 1999 to January 2013).



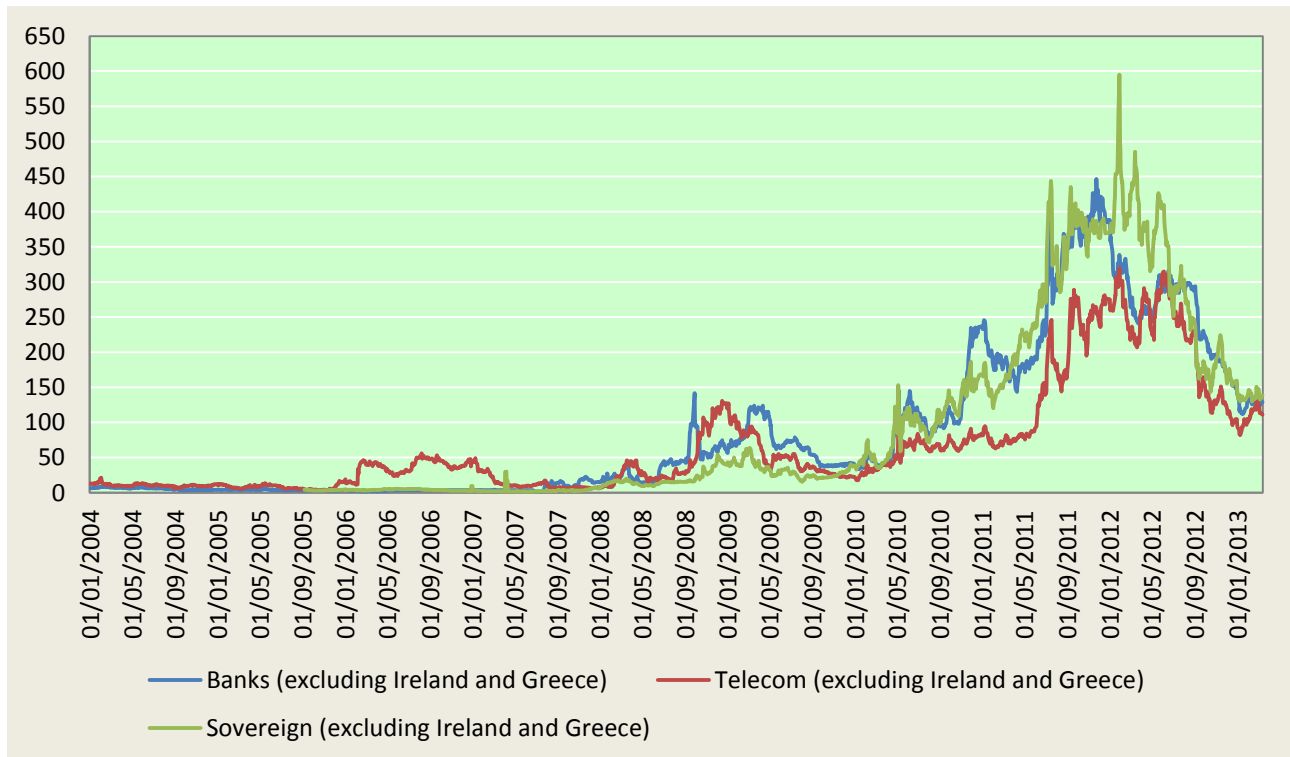
Source: elaboration on ECB statistics (November 2013).

Figure 4. Borrowing activity in the Euro Area unsecured and secured money markets. Distressed countries vs. non-distressed countries (average daily turnover, indexed on 2002=100).



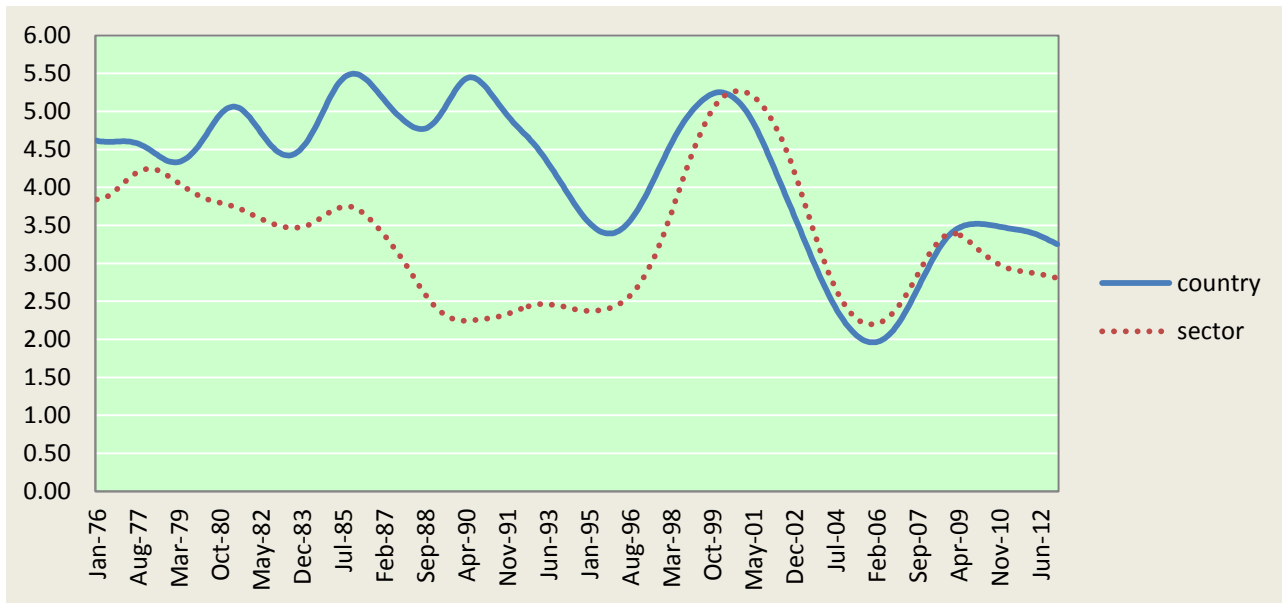
Source: elaboration on ECB statistics (November 2013).

Figure 5. Dispersion in the 5-year CDS premia across the Euro Area (basis points).



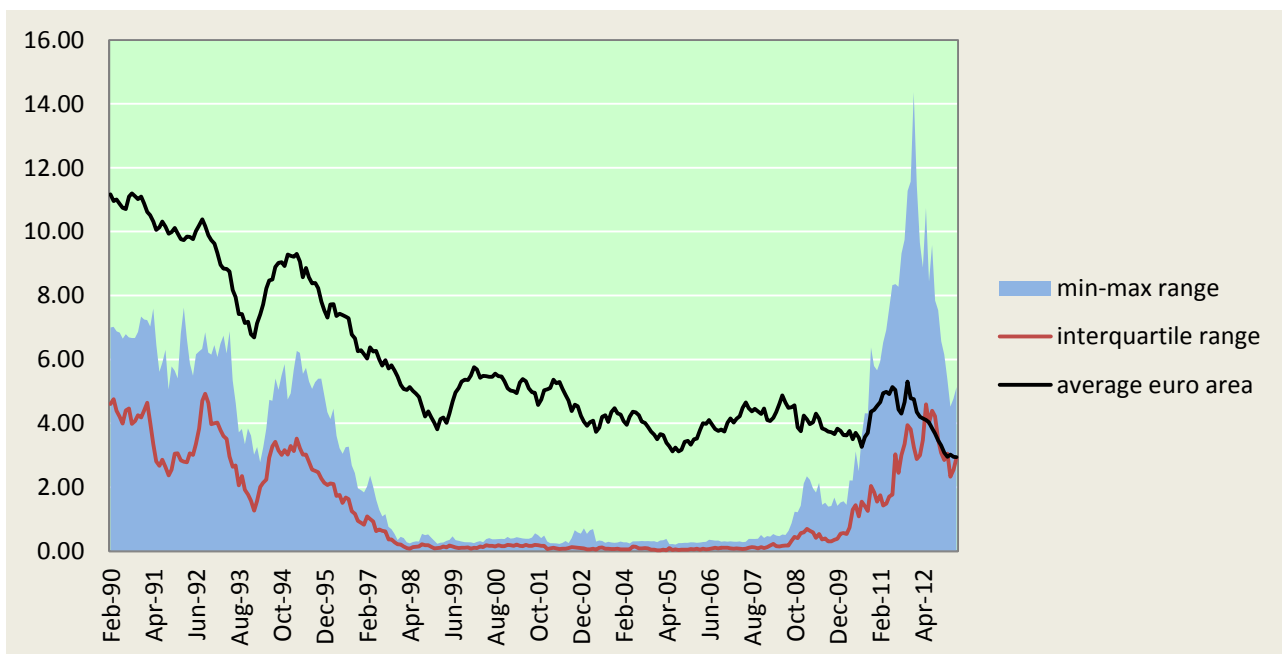
Source: elaboration on ECB statistics (November 2013).

Figure 6. Country and sector dispersions in Euro Area equity returns (percentage).



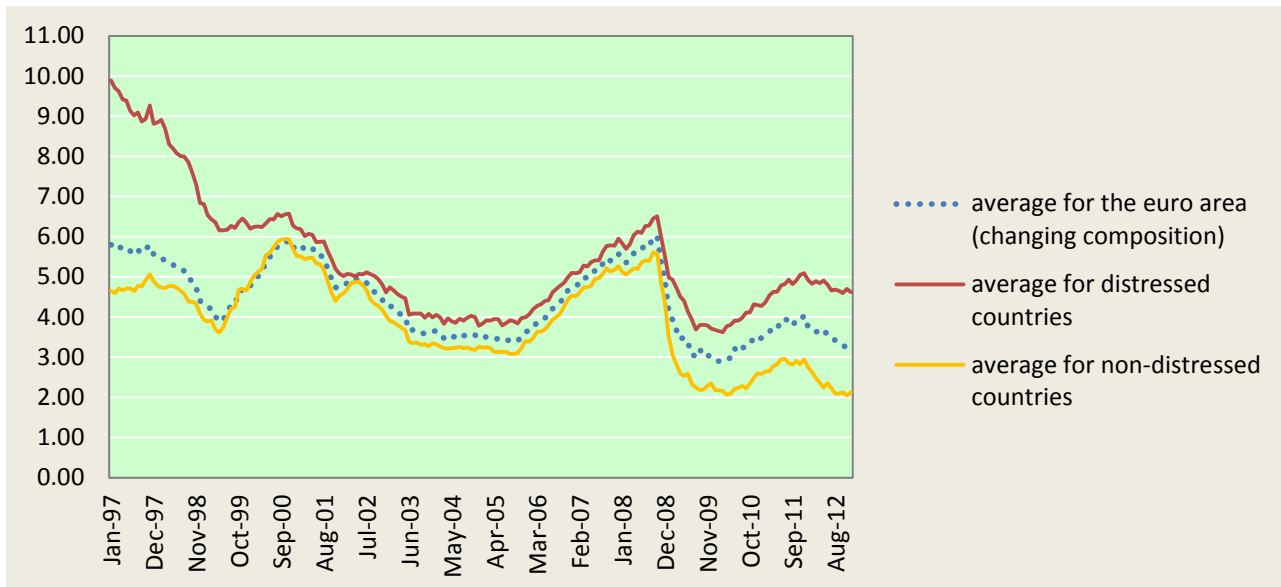
Source: elaboration on ECB statistics (November 2013).

Figure 7. Dispersion of Euro Area 10-year sovereign bond yields (percentage).



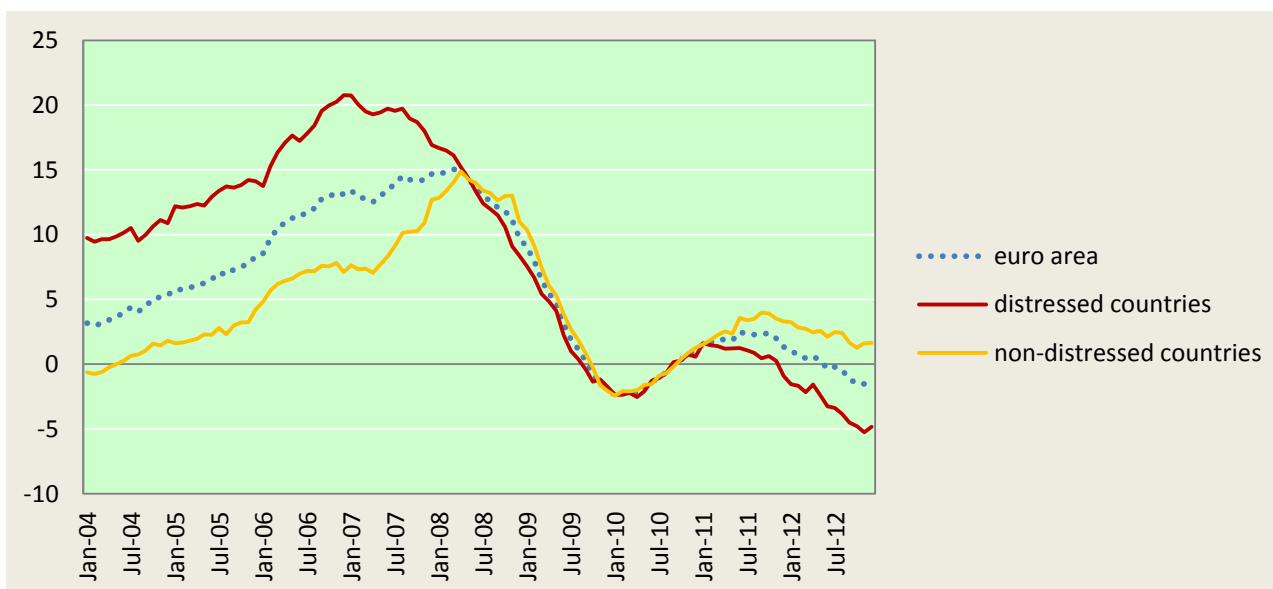
Source: elaboration on ECB statistics (November 2013).

Figure 8. Interest rates on new loans to Euro Area non-financial corporations (percentage).



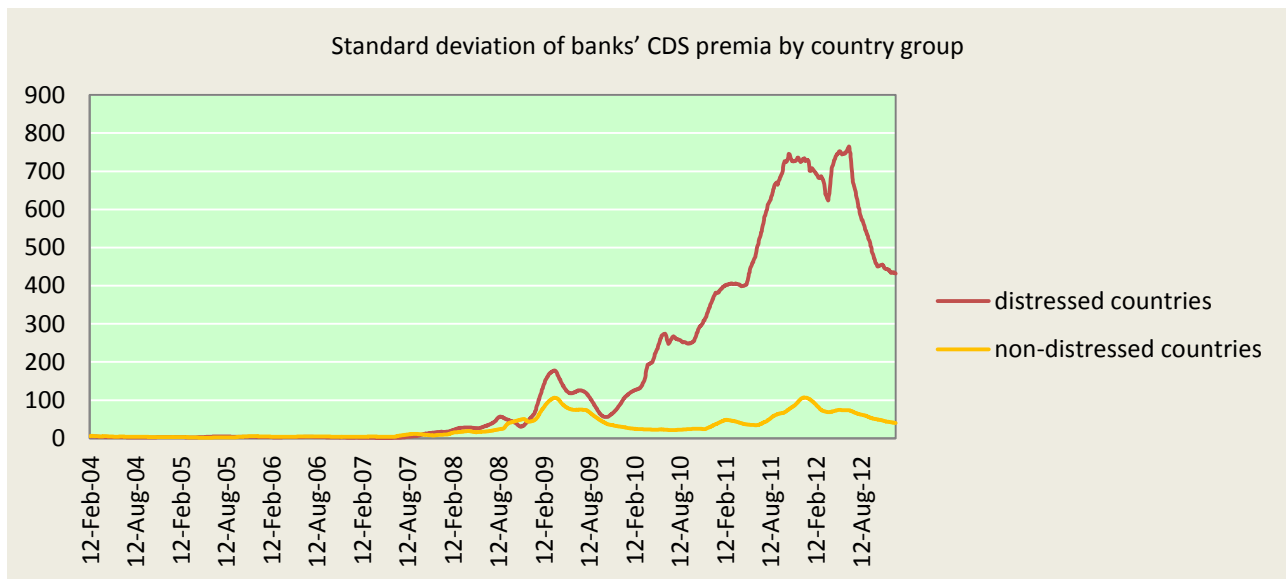
Source: elaboration on ECB statistics (November 2013).

Figure 9. MFI loans to non-financial corporations (annual loan growth, percentage).



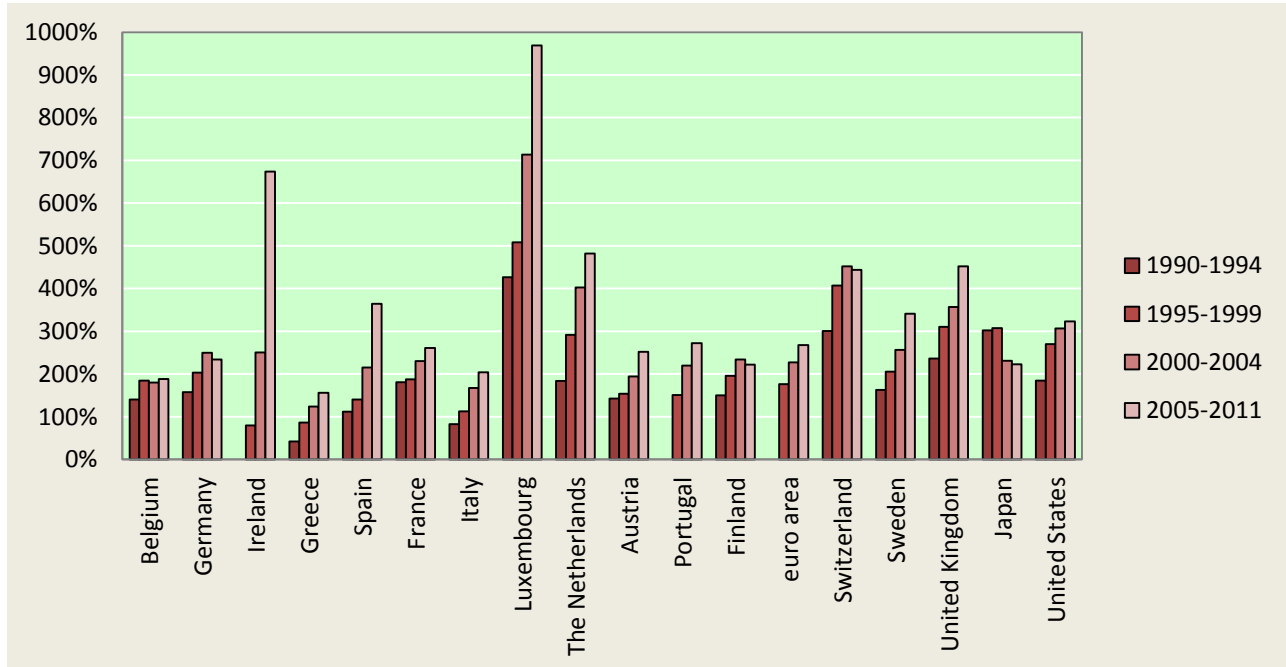
Source: elaboration on ECB statistics (November 2013).

Figure 10. Standard deviation of banks' CDS premia by country group (basis points).



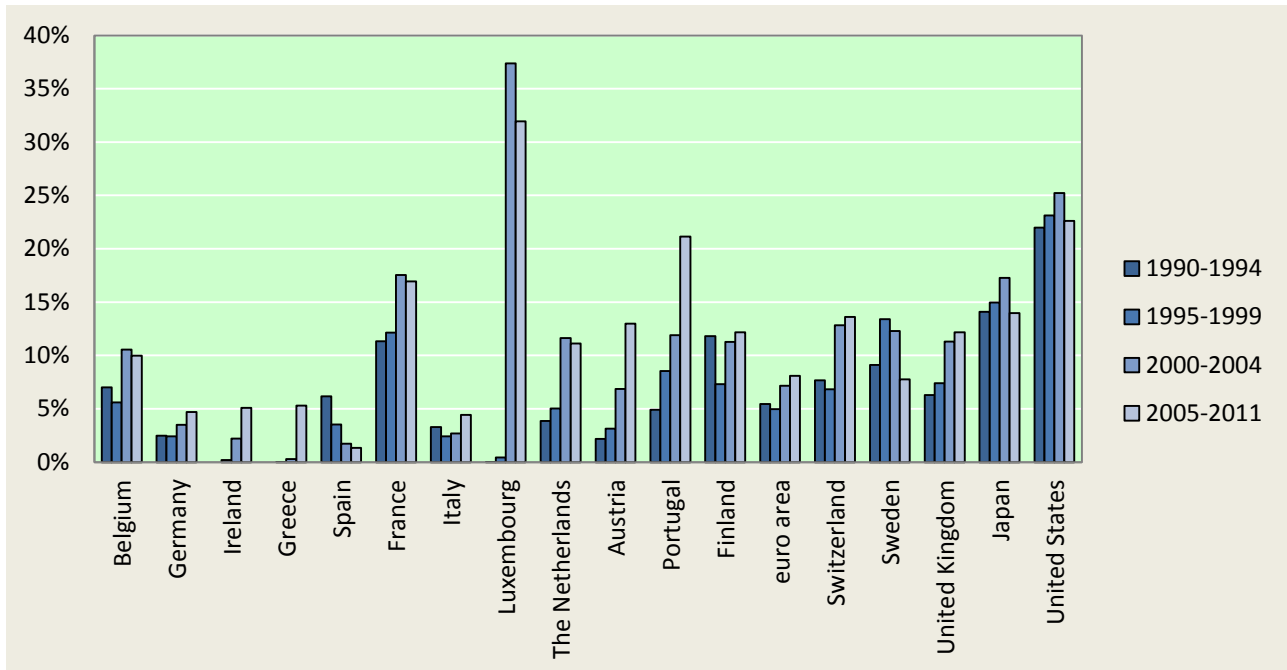
Source: elaboration on ECB statistics (November 2013).

Figure 11. Size of capital markets* in a number of selected countries (percentage of GDP).



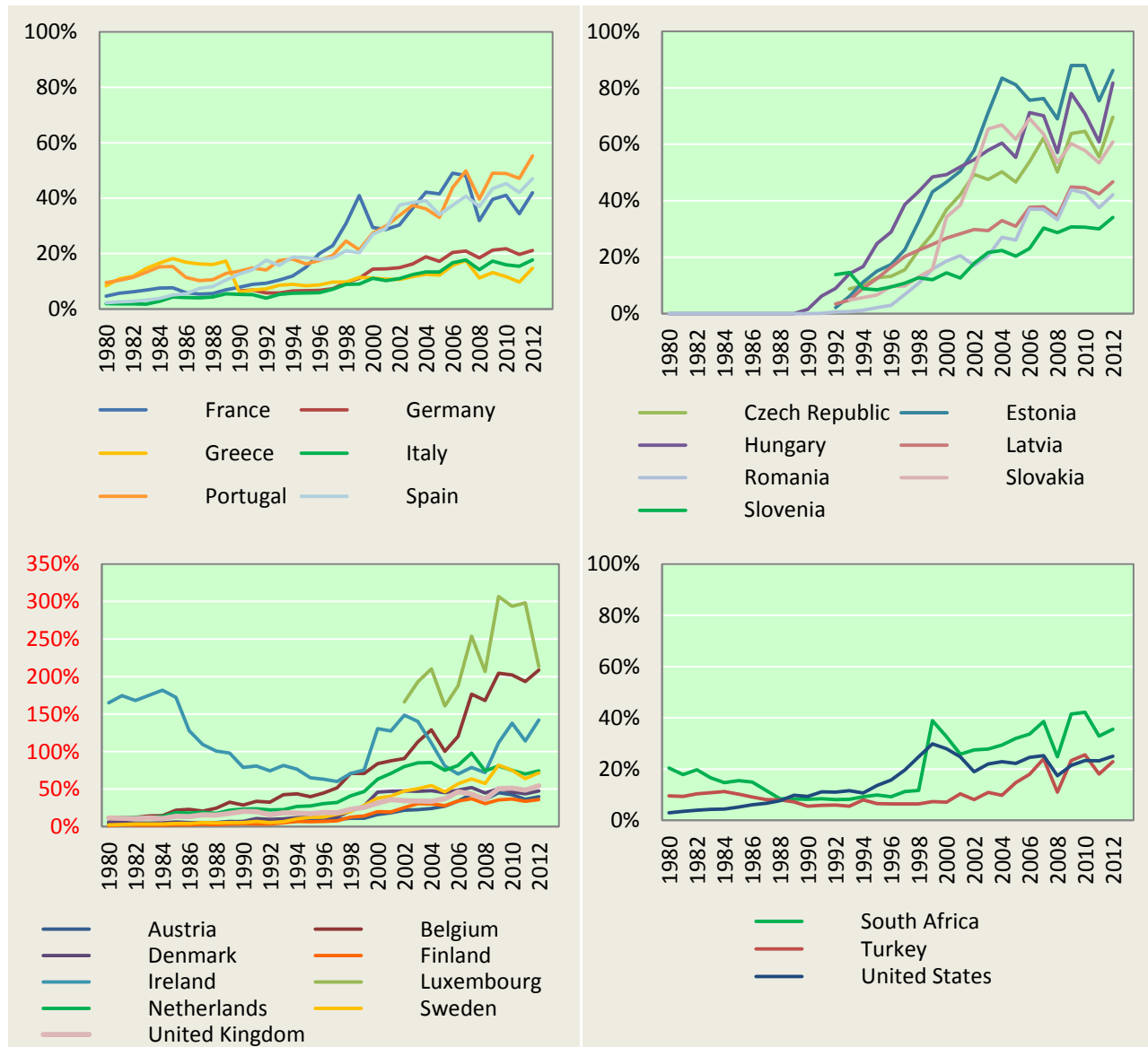
Source: elaboration on ECB statistics (November 2013). Note: * sum of stock market capitalisation, bank credit to the private sector, and debt securities issued by the private sector.

Figure 12. Debt securities issued by non-financial corporations (percentage of GDP).



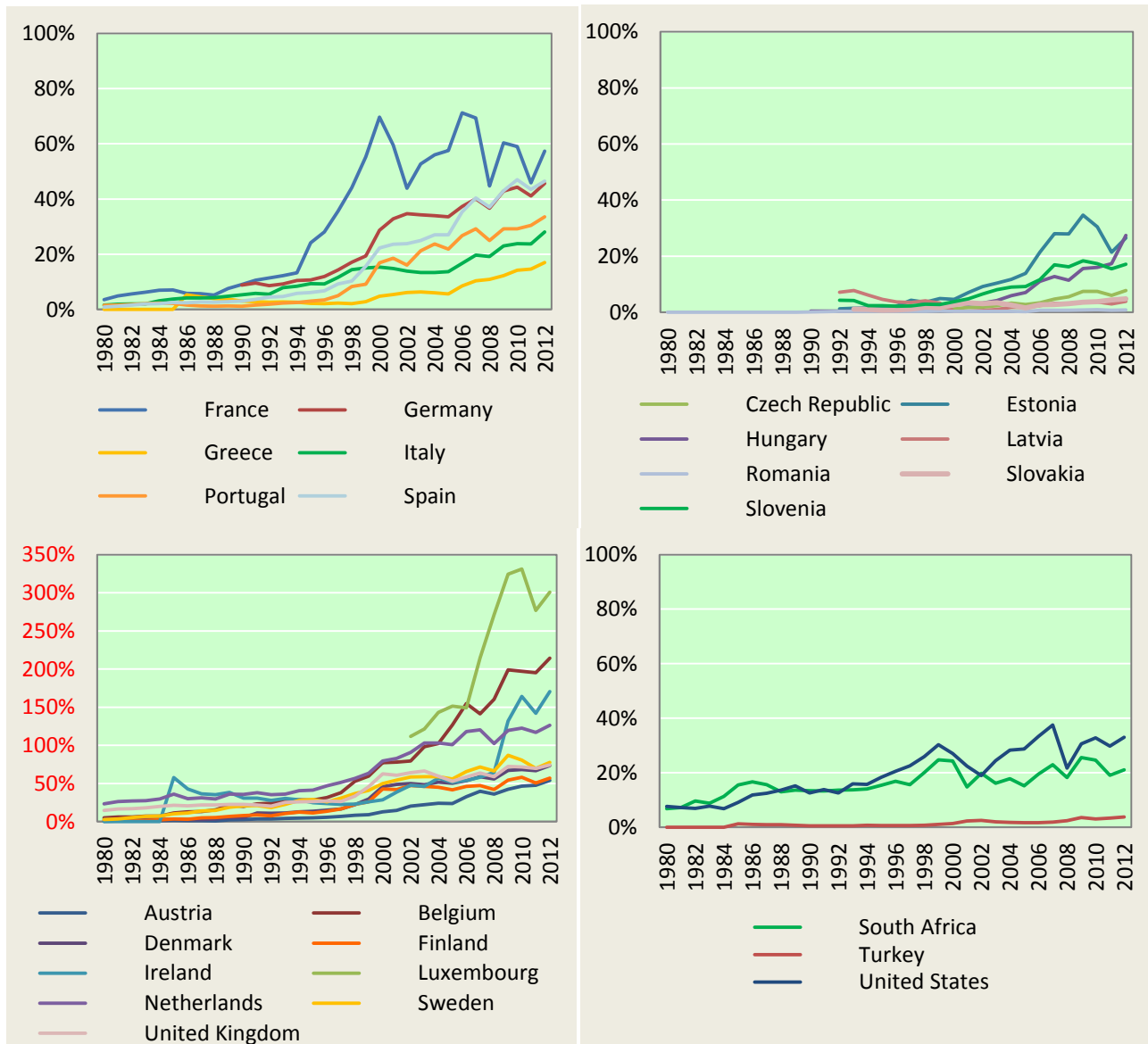
Source: elaboration on ECB statistics (November 2013).

Figure 13. Inward FDI stock (percentage of GDP) in a number of selected countries.



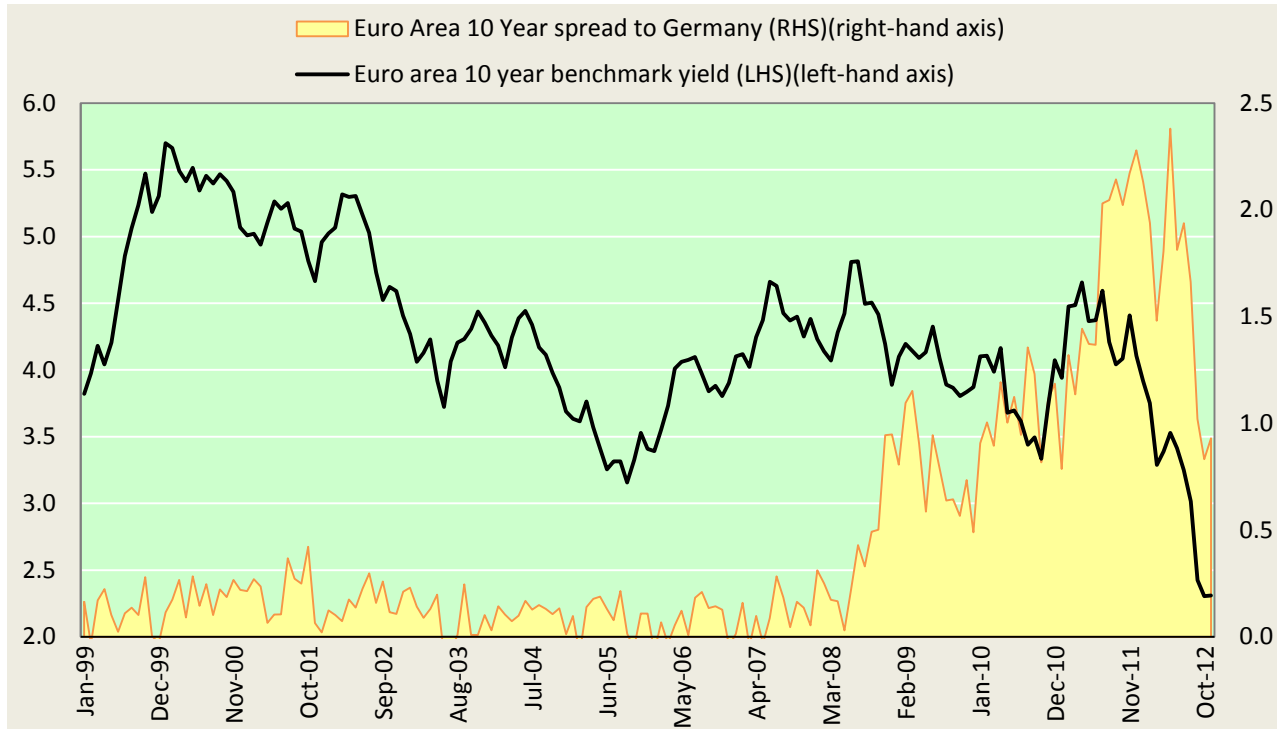
Source: elaboration on UNCTAD statistics (November 2013).

Figure 14. Outward FDI stock (percentage of GDP) in a number of selected countries.



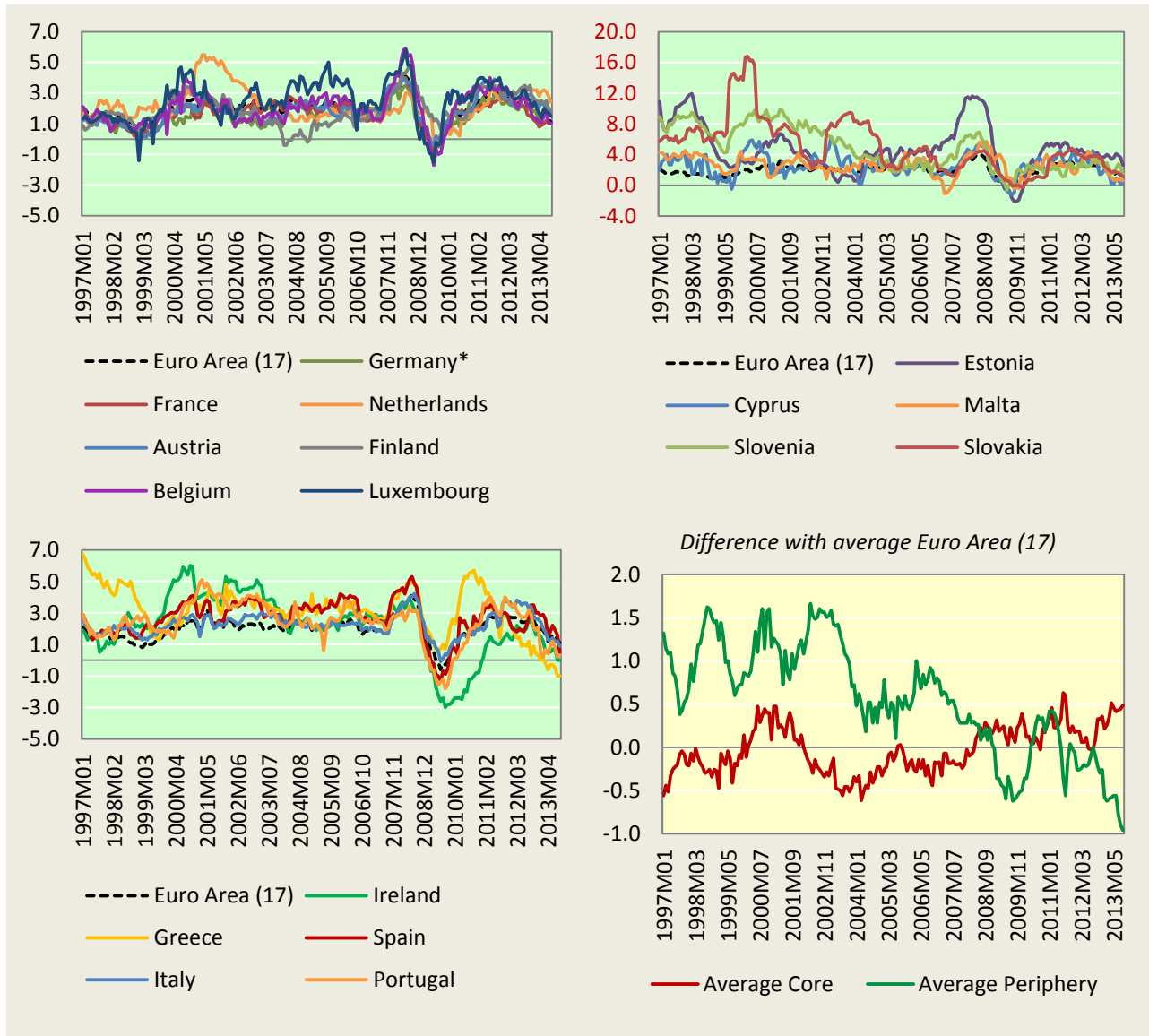
Source: elaboration on UNCTAD statistics (November 2013).

Figure 15. Euro Area 10-year government bond yield and spread to Bund (1999-2012) (percentage).



Source: elaboration on ECB, Datastream and OECD staff calculations (November 2013).

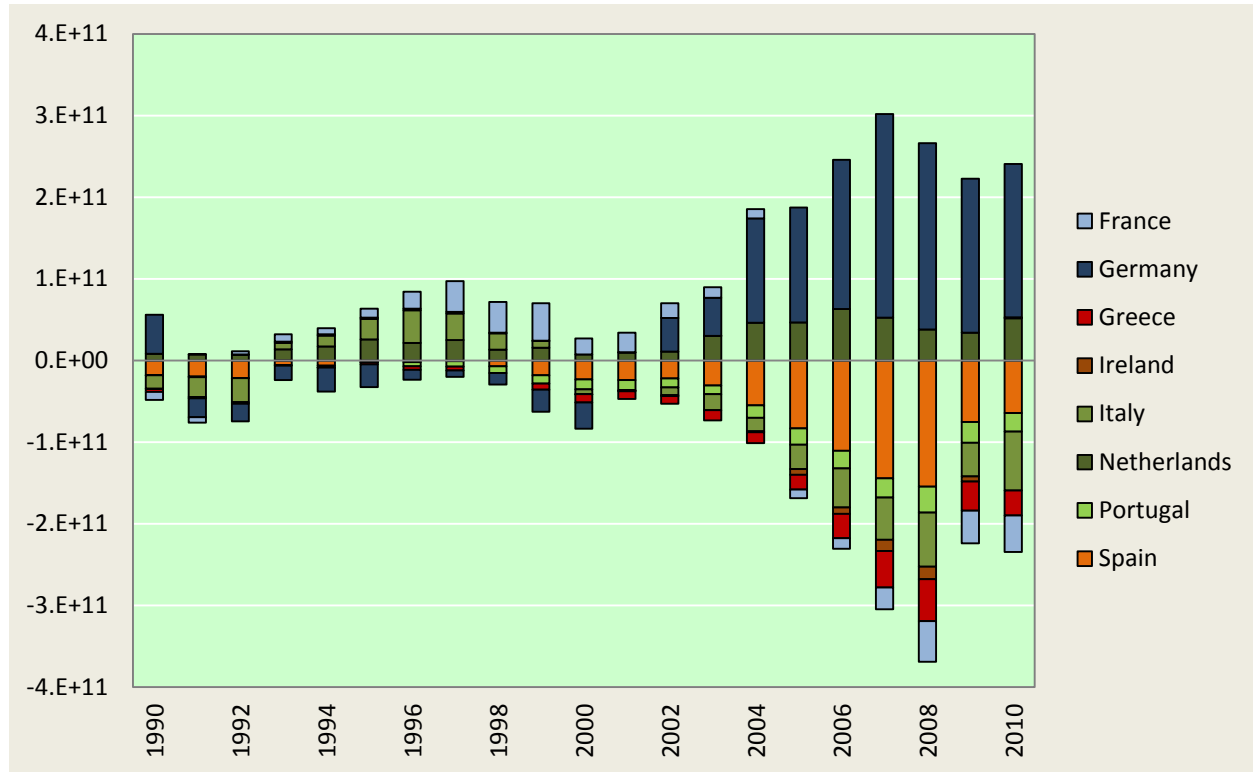
Figure 16. HICP within Euro Area (all-items, monthly data, annual rate of change).



Source: elaboration on Eurostat statistics (November 2013).

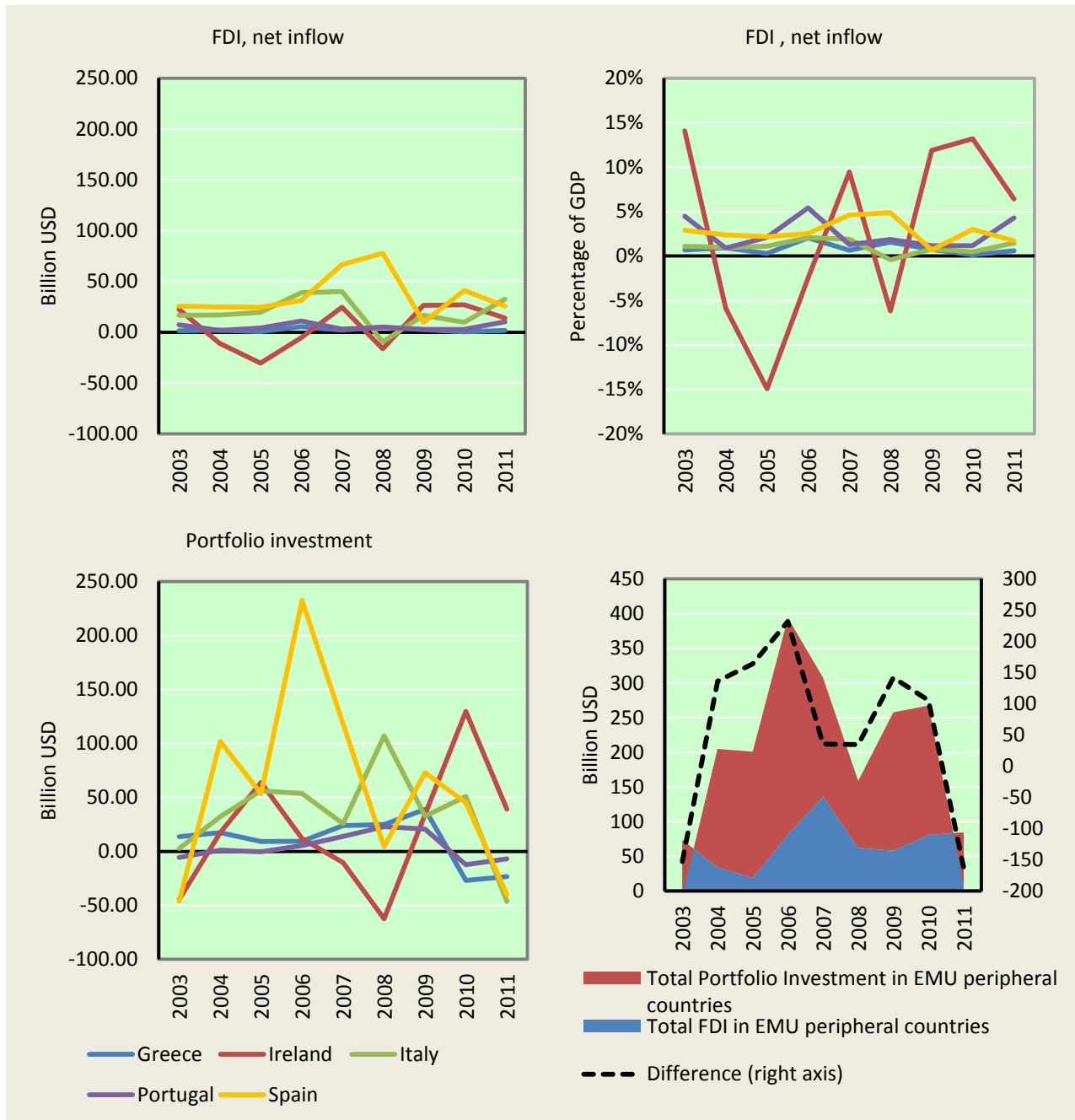
Notes: 'Core' includes Germany, France, the Netherlands, Austria, Finland, Belgium and Luxembourg; 'Periphery' includes Ireland, Greece, Spain, Italy and Portugal. Notes: * until 1990 former territory of the FRG.

Figure 17. Current account balances of a number of selected Euro Area countries (annual, million USD, current prices)



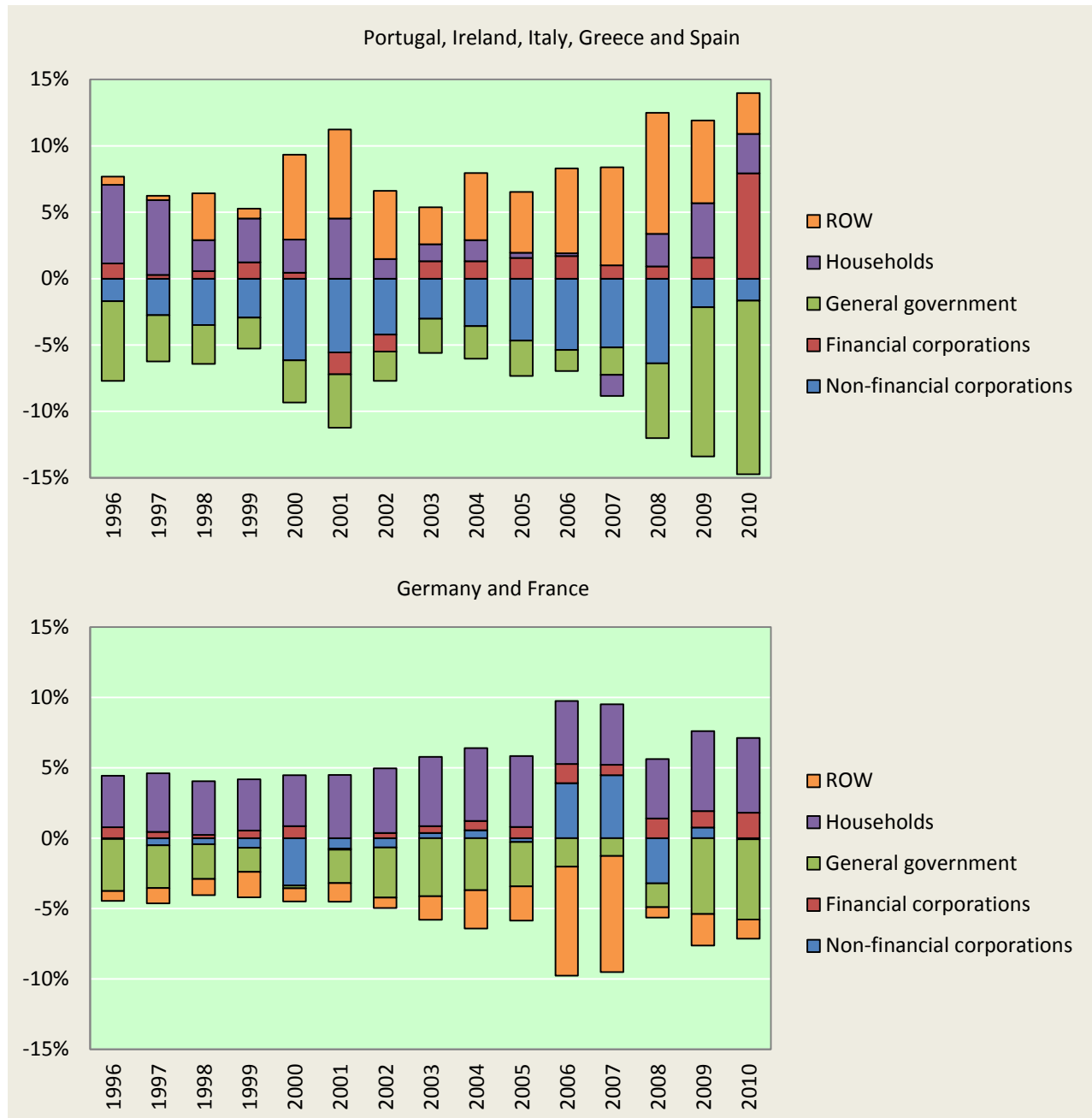
Source: elaboration on World Bank statistics (February 2012).

Figure 18. Foreign direct investments and portfolio investments (net of 'liabilities constituting foreign authorities' reserves', LCFAR) in a number of selected Euro Area countries.



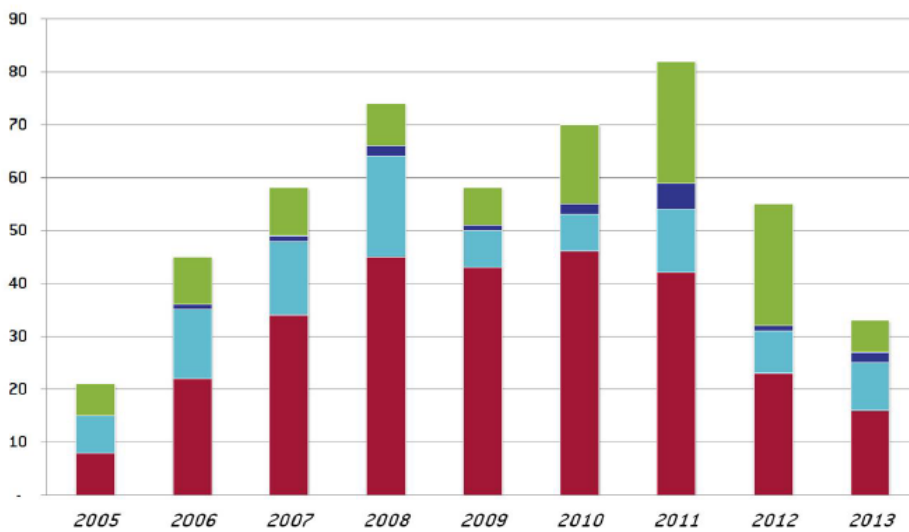
Source: elaboration on World Bank, IMF and Balance of Payments Statistics Yearbook statistics (October 2012).

Figure 19. Financial accounts by sector: average of Euro Area distressed countries (Portugal, Ireland, Italy, Greece and Spain) vs. average of non-distressed countries (France and Germany).



Source: elaboration on OECD statistics (March 2013).

Figure 20. Total number of EU17 banks being bought by other banks.



Source: Sapir and Wolff (2013), on SL Financial Database and Bruegel Computations.

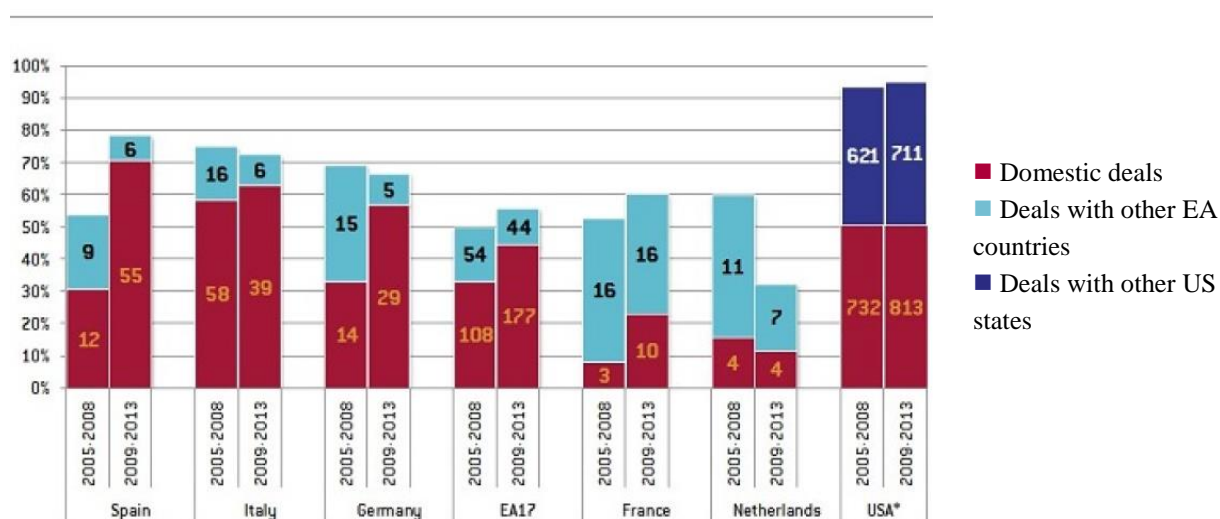
Notes: ■ banks in the same EA country; ■ banks in other EA countries; ■ banks in EU non-EA countries; ■ banks in ROW.

Figure 21. Total number of M&A deals involving EA17 banks.



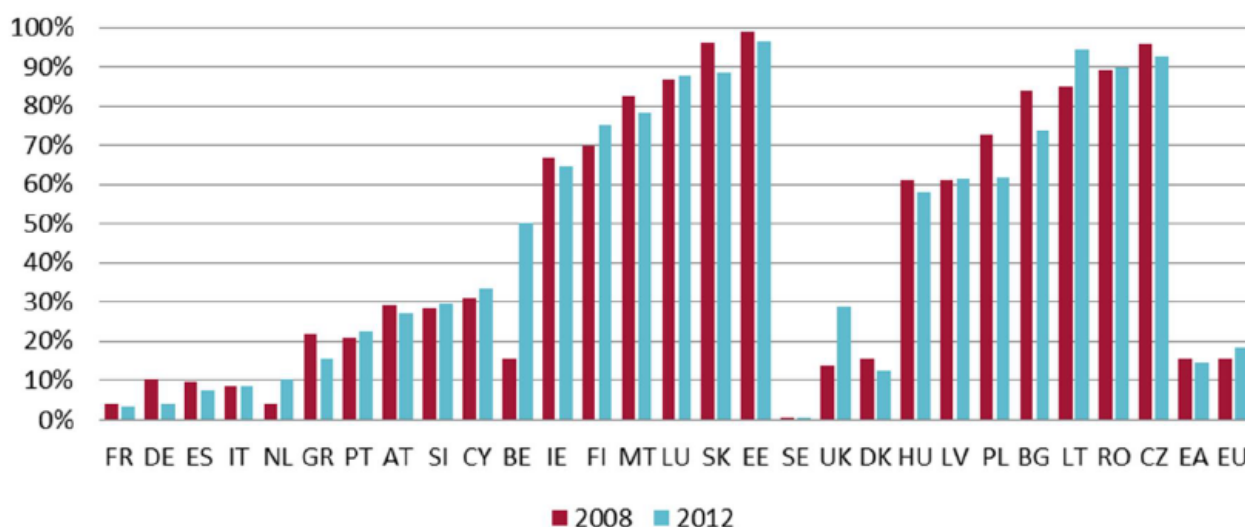
Source: SL Financial Database and Bruegel Computations. Notes: ■ banks in the same EA country; ■ banks in other EA countries; ■ banks in EU non-EA countries; ■ banks in ROW.

Figure 22. Shares of bank acquisitions by country (number of acquisitions in labels).



Source: Daluiso (2013), on SL Financial Database and Bruegel Computations.

Figure 23. Percentage of the banking system which is foreign owned.*



Source: Sapir & Wolff (2013). Notes: * total assets of foreign owned subsidiaries/branches as percentage of total banking system assets.

Legend: FR = France, DE = Germany, ES = Spain, IT = Italy, NL = Netherlands, GR = Greece, PT = Portugal, AT = Austria, SI = Slovenia, CY = Cyprus, BE = Belgium, IE = Ireland, FI = Finland, MT = Malta, LU = Luxemburg, SK = Slovakia, EE = Estonia, SE = Svezia, UK = United Kingdom, DK = Denmark, HU = Hungary, LV = Latvia, PL = Polonia, BG = Bulgaria, LT = Lithuania, RO = Romani, CZ = Czech Republic, EA = Euro Area, EU = European Union.

Table 1. Changes in ownership structure of Romanian banking sector, 1990-2011.

	Number of institutions					Share in total assets			
	1990	1998	1999	2005	2011	1998	1999	2005	2011
State-Owned	5	7	4	2	2	75%	50%	6%	7.4%
Domestic private capital	2	13	11	7	4	9%	6%	31%	7.3%
Foreign private capital	0	16	19	30	36	15%	43%	62%	85%
Total	7	36	34	39	41	100%	100%	100%	100%

Source: Gabor (2013)'s calculations on data from National Bank of Romania Annual Reports 1992, 1999, and the Financial Stability Report 2006.

INFORMATION ON FESSUD

Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number : 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?

THE PARTNERS IN THE CONSORTIUM ARE:

Participant Number	Participant organisation name	Country
1 (Coordinator)	University of Leeds	UK
2	University of Siena	Italy
3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
6	Poznan University of Economics	Poland
7	Tallin University of Technology	Estonia
8	Berlin School of Economics and Law	Germany
9	Centre for Social Studies, University of Coimbra	Portugal
10	University of Pannonia, Veszprem	Hungary
11	National and Kapodistrian University of Athens	Greece
12	Middle East Technical University, Ankara	Turkey
13	Lund University	Sweden
14	University of Witwatersrand	South Africa
15	University of the Basque Country, Bilbao	Spain

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