



EUROPEAN POLICY BRIEF



FINANCIALISATION ECONOMY SOCIETY AND SUSTAINABLE DEVELOPMENT

EU Financial Integration and the role of the European Central Bank

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INTRODUCTION

Policy problem: is the financial integration of EU proceeding?

The economic and financial crisis that still affects most European countries has raised growing concerns about the endurance of the integration process of the European Union (EU), and especially of the Euro Area (EA). According to the prevailing interpretation, the European crisis was triggered by the *Lehman Brothers*' collapse and the resulting world-wide financial turmoil, which led to the 'flight to safety' of international investors and eventually hit weakest European economies. This explanation is sustained by both the European Central Bank (ECB) and the majority of other supranational institutions. In fact, the outbreak of the US asset bubble can certainly be regarded as the trigger of the European 'sovereign debt crisis'. However, it is now widely accepted that it has been the permanent deficit in current account (and financial) balances that fuelled the turmoil of sovereign bond markets of EA 'periphery' since late 2009.

Nominal convergence and real divergence

Yet, the very role played by external imbalances has

been undervalued by the most part of European observers, including the ECB. The point is that what was regarded as a process of (nominal) convergence and integration of the EA economies was rather a process of real divergence, threatening the survival of the whole EU. This diverging trend has been mainly due to permanent spreads in both unit labour costs and growth rates of EA member-states. Against this background, ‘bank-based’ monetary policies adopted by ECB *vis-à-vis* the crisis, coupled with the implementation of national restrictive fiscal policies (aiming to reduce government deficit by cutting public expenditures and raising taxes), have ended up fostering rather than smoothing cross-country financial imbalances.

Main purpose of the research

Starting from the above considerations, the research undertaken in Task 3 of Work-Package 2 of FESSUD project aims to address the following questions: has an integrated European financial market been created? What has been the impact of the current crisis on the process of financial integration of the EU? What about the effectiveness of policy measures undertaken by European authorities to face the crisis? If those policies have been scarcely effective, is there a set of alternative interventions to both stop the economic recession and restore the process of economic and financial integration?

EVIDENCE AND ANALYSIS

Monetary policy and integration process

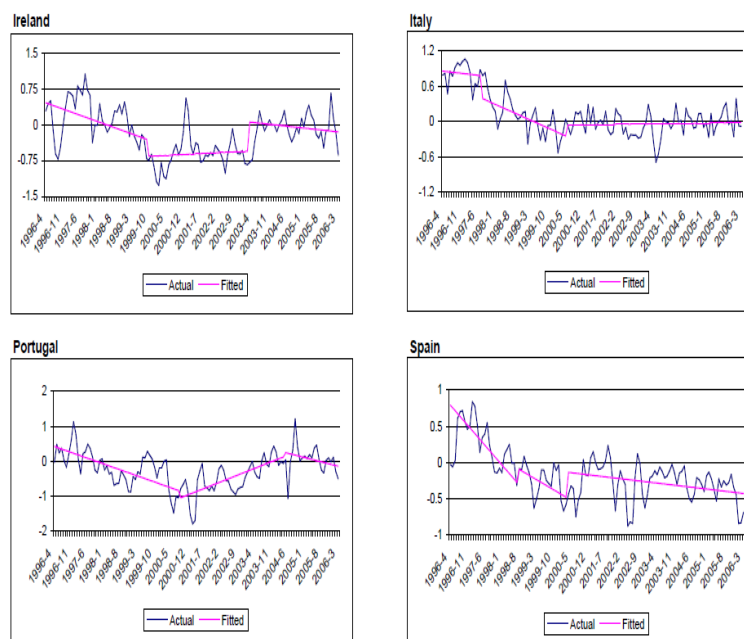
A thorough analysis of the ECB’s documents reveals that the common hypothesis underpinning most ECB’s releases on the state of the EA is that every national business cycle have been converging into a common cycle. Evidence of the convergence would be provided by the converging trend, over the early period after the launch of the Euro, in a number of nominal indicators (such as share prices and ten-year government bond yields), and even in inflation and growth rates of EU (particularly EA) member-states. As a consequence, the usual monetary policy instrument preached by the ECB (i.e. the steering of the short-term interest rate on the unsecured money market) would be the best way to pursue the monetary stability and *therefore* the financial soundness of the EA. This, in turn, would enhance the process of financial integration of European economies as well.

Why standard measures are not sufficient

Eight year after the outbreak of the US 'subprime crisis' and the subsequent spreading of the financial contagion to Europe, it should be clear that the basic issue with the EA was not the convergence of a number of EA member-states' nominal parameters. Rather, the problem was the persistence of the spreads in inflation (and income growth) rates between 'peripheral' and 'core' EA economies. In other words, the point is not whether the short-term interest rate targeted by the ECB should either be raised or be lowered (and how much) when EA countries are hit by a shock, but that a unique real rate of interest does not exist, because of the different trends in EA member-states' unit labour costs.

Real interest rates differ within the EA, due to different national inflation rates

Chart 1. Real interest rate differentials against the EA average in some selected countries (1996-2006).





Source: Arghyrou M.G., Gregoriou A. and Kontonikas A. (2009), “Do real interest rates converge? Evidence from the European union”, *Journal of International Financial Markets*, Vol. 19, No. 3, pp. 447-460.

Note: blue line = actual values; pink line: fitted deterministic-trend in three-sub periods.

A ‘bank-based’ bias

The ECB underestimated the structural causes, and hence the *long-term nature*, of the EA crisis. Yet, it clearly saw the early signals of the possible trans-Atlantic financial markets’ contagion. In this regard, it must be recognized that the Eurosystem took measures which were unprecedented in nature, scope and magnitude, in order to face the EA crisis. In addition to the reduction of the target interest rate to historical low levels, the ECB adopted a number of unconventional *credit support measures* (including the lengthening of the maturities of open market operations, the adoption of a ‘fixed-rate tender’ and ‘full-allotment’ lending procedure, and the extension of the list of assets eligible as collaterals by credit institutions) and introduced the *Securities Market Programme* (SMP) to restore liquidity in EA government (and private) secondary debt security markets. However, the magnitude of the outright purchases of sovereign bonds (that is, of ‘market-based’ measures) remained always narrow compared

to both the credit-support or ‘bank-based’ measures and the overall debt market of Euro member-states. As has been observed, this choice was based upon the argument that the EA financial system would correspond to the ‘bank-based’ pure-type. It was this theoretical position that, to a degree at least, justified the reluctance of the ECB to intervene directly in the sovereign bond market of members in difficulty (until September 2012 at least). Notice, finally, that it is too early to say if the launch of the quantitative-easing programme in March 2015 will lead to a durable change in the ECB philosophy.

The strategic role of collateral markets

Yet, financial stability depends crucially on the state of *collateral* markets, as this latter affect interbank funding. More precisely: i. the perceived degree of liquidity of collaterals determines the single bank’s chances to access market funding; ii. government bonds of high income countries have become the most important collateral in Repurchase Agreements (or REPOs) and hence the main source of interbank funding. As a consequence, if the central bank tries to support uncollateralized funding markets (through ‘bank-based’ liquidity provisions), without supporting collaterals’ (i.e. government bonds’) markets as well, this is likely to be insufficient to restore financial stability. Notice that here is the reason why, in recent years, some scholars have been arguing that both the duration and the timing of the unconventional measures adopted to face the crisis seem to suggest that the ECB used them more as a political instrument to extract fiscal commitments from national governments, than as a true stabilizing intervention. However that may be, it seems plain that the safeguard of the EA requires the ECB to stabilize peripheral government bond markets, as it has started doing since Autumn 2014 (particularly since March 2015).

The introduction of the Euro and the reduction in uncertainty

The introduction of the Euro on January 1st 2002 as a circulating currency was preceded by a climate of confidence pervading both European institutions and the most part of European economics literature. The same atmosphere permeated the early years of the EA. The common belief was (not without empirical evidence) that the European unification process was raising a growing degree of integration, particularly among countries which adopted the single currency. It was admitted that the degree of financial integration of money markets (measured by the so-called ‘uncovered interest rate parity’ condition applied to asset prices) had been highly volatile over the previous decade. However, the EA equity market – it was said – had

been gaining in importance in world financial markets since the mid-1990s. Accordingly, reduced exchange rate uncertainty (linked to the adoption of the Euro), along with the convergence in interest and inflation rates, were regarded as the driving force behind the process of development of a fully integrated European financial market.

Perceived positive effects of cross-border capital flows

It was admitted that the process of European financial integration could pose some 'challenges' or 'costs', besides the well-known claimed benefits (notably, higher risk sharing, lower intermediation costs, higher specialization and efficiency of domestic productions). More precisely, the onset of the US crisis of 2007 shifted progressively the focus of ECB's analysts from the advantages to the potentially destabilizing impact of financial integration. In this regard, it was recognized that the increasing interdependence of individual EA markets could increase the risk of systemic contagion and bankruptcy chain-reactions in the case of financial turmoil. In addition, 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 (due to the relative loss in price competitiveness, under the monetary union), were cited as costs linked to the process of integration. However, the prevalent opinion (within the European institutions at least) was that the constitution of prudential supervising mechanisms and authorities, along with the adoption of austerity fiscal measures, were sufficient to reduce the risk to an acceptable level.

Why confidence about the integration remained so high

The two decades of increasing European financial integration, before the meltdown of the US subprime mortgage market, led ECB's analysts to remain quite confident even after the onset of the crisis. Some statistics illustrate this. First, the EA 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 EA residents of foreign assets (reported in the asset side of EA 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. Second, foreign investment within the EA increased remarkably after the launch of the Euro. Intra-EA portfolio investment expanded significantly from 2001 to 2007 and remained quite high even in 2009. This contributed to the decline of yield spreads vis-à-vis

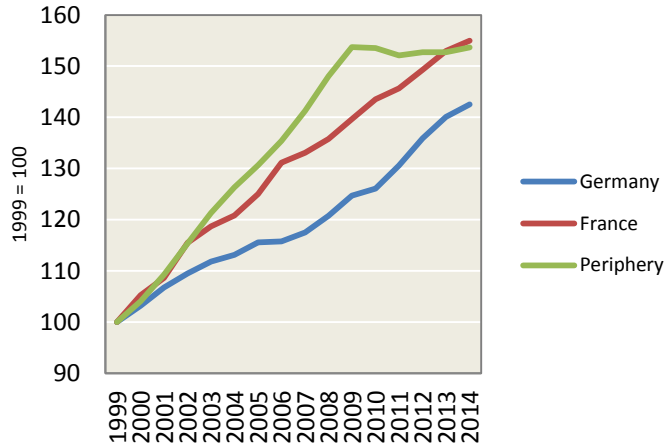
German *bunds* until September 2008. Third, in the same period, intra-euro bank exposure also increased remarkably within the EA. More precisely, peripheral EA member-states attracted considerable flows of capitals in the years prior to the crisis, mostly from Germany and France. In fact, until 2007 German and French banks expanded their cross-border operations and increased lending (through local subsidiaries and branches) especially within the EA. Consequently, a further increase in the degree of financial integration was expected even in 2010, after a short period of financial and economic resetting though. This is the reason why the ECB's staff remained always quite confident about the process of integration.

Permanent imbalances in current (and financial) accounts between EA member-states

The increasing financial flows among EA economies have been reflecting into their current account balances. Since the early 2000s the inflation rates of EA member-states followed different trends. In Germany and the Netherlands inflation remained far below the 2% target threshold set by ECB governing council, whereas peripheral countries (and France) registered inflation rates higher than 2%. Different inflation rates were the result of different trends in unit labour costs and these latter, in turn, reflected different trends in nominal wage rates. Interestingly, it seems that labour productivity has not played a major role (see Charts 2 to 4). Whatever the main cause, Germany and the Netherlands benefited from large and increasing current account surpluses (mainly due to trade balance surpluses). By contrast, peripheral countries and France registered permanent current account deficits, involving a sharp deterioration of their net external asset position (see Charts 5 and 6). These intra-EA imbalances turned out to be unsustainable in the long run (even though the EA as a whole has always had a balanced or even a surplus current account with the rest of the world).

Chart 2. Trend in hourly wages (index numbers: 1999 = 100). 'Periphery' includes Greece, Ireland, Italy, Portugal and Spain.

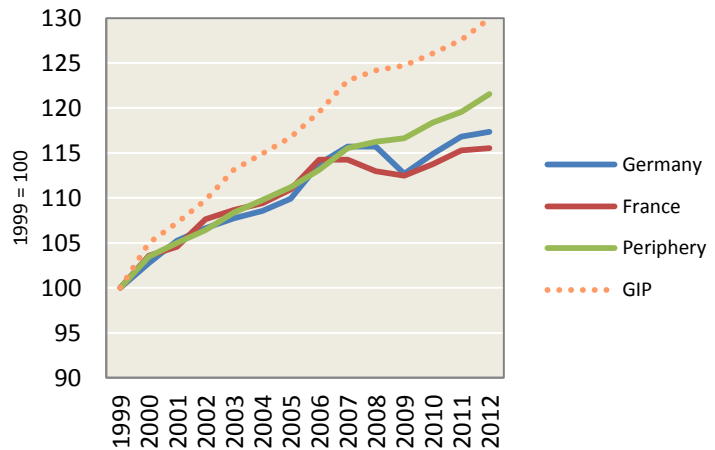
Since the introduction of the Euro, wages have increased more in the Periphery (and in France) than in Germany



Source: our elaboration on OECD statistics (August 2015).

Chart 3. Trend in GDP per hour worked (index numbers: 1999 = 100). 'Periphery' includes Greece, Ireland, Italy, Portugal and Spain. 'GIP' only includes Greece, Ireland and Portugal.

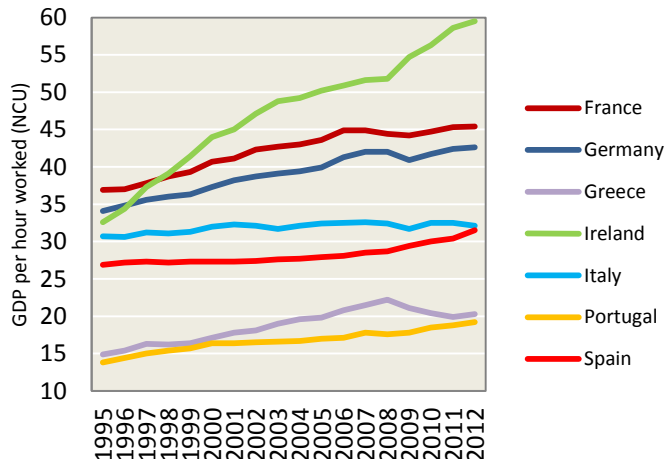
Labour productivity grew faster in the 'Periphery' (particularly in Greece, Ireland and Portugal) than in Germany



Source: our elaboration on OECD statistics (August 2015).

Chart 4. GDP per hour worked (constant prices in NCU) in some selected EA member-states.

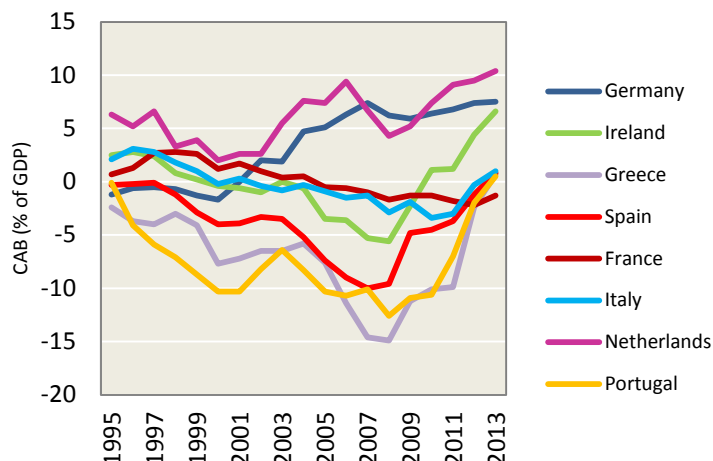
Ireland is marked by the highest GDP per worked hours, ahead of France, Germany and Italy



Source: our elaboration on OECD statistics (August 2015).

Since the early 2000s, Germany and the Netherlands have recorded current account surpluses, whereas other EA countries have incurred deficits

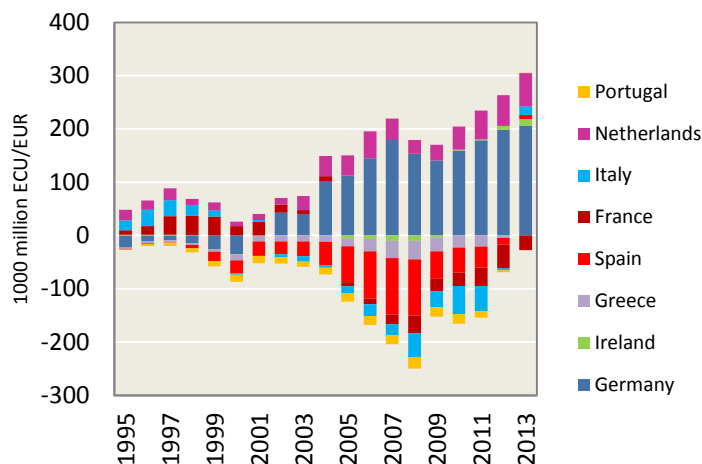
Chart 5. Current account balances (% of GDP) in some selected EA member-states.



Source: our elaboration on Eurostat statistics (August 2015).

CAB imbalances increased remarkably until the crisis, but they reduced sharply afterwards

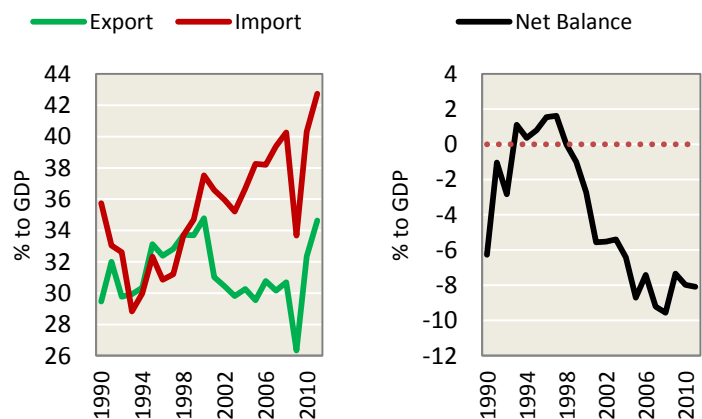
Chart 6. Current account balances (1000 million ECU/EUR, current prices) of some selected EA member-states.



Source: our elaboration on Eurostat statistics (August 2015).

Since the launch of the Euro, France has incurred an increasing trade deficit vis-à-vis Germany

Chart 7. Export, import and trade deficit of France vis-à-vis Germany (% of French GDP).



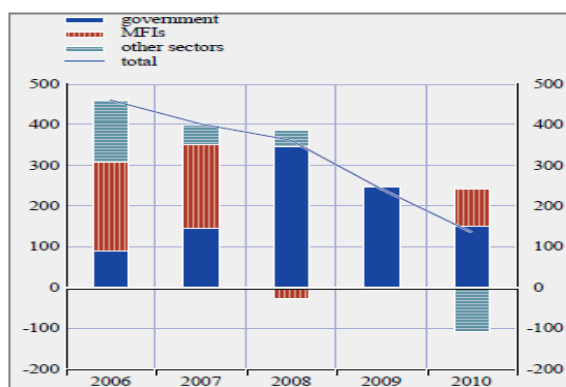
Source: our elaboration on OECD statistics (August 2015).

The impact of the crisis on capital flows

Turning to financial flows, the post-*Lehman* turmoil and the onset of the so-called 'sovereign bond crisis' of Eurozone's member-states impacted heavily on the cross-border capital flows, which were (and are still) regarded as the main means of integration. In fact, the integration trend was suddenly replaced by 'home-bias' tendencies and 'flight-to-safety' behaviours of investors. More precisely, the crisis entailed a remarkable deleveraging of external debts of the private sector and, in particular, of the banking sector. In addition, the most part of investors shifted from equity to debt instruments and from private securities to government bonds (see Chart 8). Still, the higher income European economies were remarkably affected by the crisis. Not only capital flow reversed, but their volatility increased sharply. Finally, after a decade marked by a deleverage of government sector, this latter became the main (and often the only) net borrower from abroad.

After *Lehman's* collapse, investors shifted from equity to debt instruments and from private securities to government bonds

Chart 8. Non-EA residents' investment in EA debt by issuing sector (billion Euros, annual flows).



Source: Forster K., Vasardani M. and Ca' Zorzi M. (2011), "Euro Area Cross-Border Financial Flows and the Global Financial Crisis", ECB Occasional Paper Series, No. 126, July 2011.

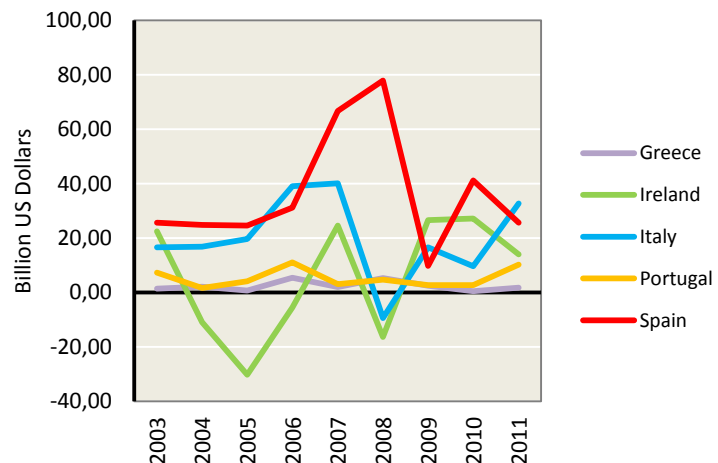
Reversal of capital flows and the future of EA and EU

In 2009, due mainly to ECB's interventions, the retrenching trend of capitals seemed to reverse, leading ECB's analysts (and many economists) to prefigure a 'medium-period' return on pre-crisis levels of cross-border financial activity. In this regard, the enhancing of financial regulation and supervision, coupled with ECB's credit support measures and the strengthening of governments' 'macroeconomic discipline', were regarded as the main road to restore financial markets' confidence and hence economic growth and financial integration. It was admitted that too low (real) financing costs in 'peripheral' countries could contribute to rise current account divergences in the EA, but ECB's staff kept focusing just on 'structural reforms' which would have been 'inadequate to

support growth over the long-term horizons'. Yet, most recent reports and working papers released by international institutions clearly recognise not only that austerity policies are depressive, but also that the size of the fiscal multipliers in advanced economies has been dramatically underestimated (e.g. FMI, "Coping with High Debt and Sluggish Growth", World Economic Outlook, Washington, October 2012; and O. Blanchard & D. Leigh, "Growth Forecast Errors and Fiscal Multipliers", IMF Working Paper 13/1, January 2013). Furthermore, the very intensity of foreign investments (which is usually regarded as a standard measure of financial integration) turned out to be a major driver of instability for peripheral EA economies (think of Spain and Ireland). Notice that most peripheral countries' capital inflows (in the period from the launch of Euro to 2007) were relatively short-term financing (mainly in the form of cross border deposits from abroad). By contrast, FDI (which are usually considered a less volatile form of investment than portfolio investment) played a secondary role (see Charts 9, 10, 11, 12). Thus, if it seems undeniable that a new gigantic financial space was created in Europe from the 1980s to the 2000s, the absence of an adequate European institutional framework exposes it to external shocks, however small, therefore jeopardizing its survival.

Foreign Direct Investment in peripheral countries reduced sharply after Lehman's collapse

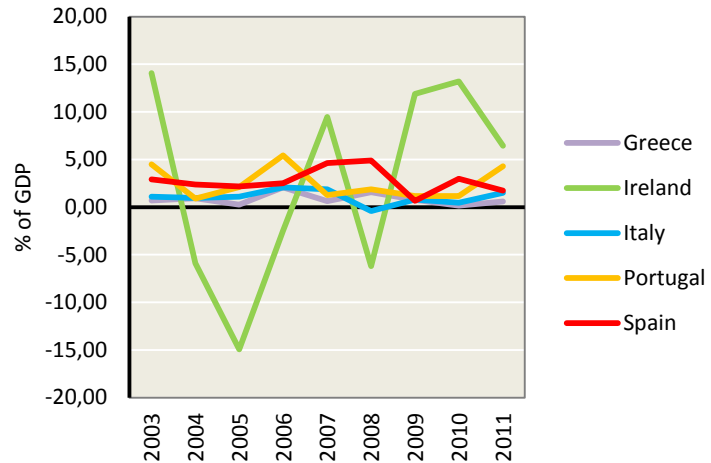
Chart 9. Net inflow of Foreign Direct Investment (billion USD) in some EA member-states.



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

The sharp reduction in Foreign Direct Investment to GDP mainly affected Spain and Ireland

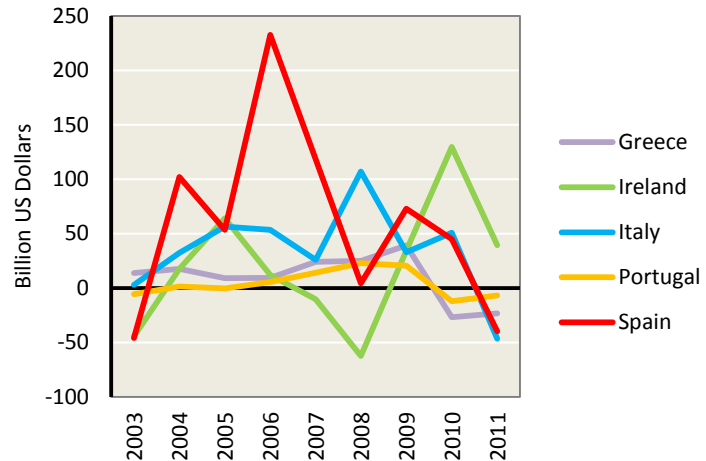
Chart 10. Net inflow of Foreign Direct Investment (% of GDP) in some EA member-states.



Source: our elaboration on statistics by Word Bank (IMF and Balance of Payments Statistics Yearbook) (October 2012).

Portfolio Investment in EA peripheral countries has been high and volatile

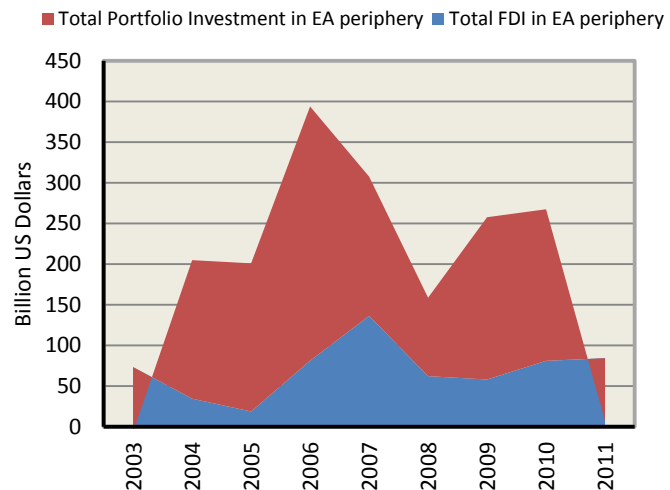
Chart 11. Net inflow of Portfolio Investment (billion USD, net of liabilities constituting foreign authorities' reserves, LCFAR) in some EA member-states.



Source: our elaboration on statistics by Word Bank (IMF and Balance of Payments Statistics Yearbook) (October 2012).

Portfolio Investment in EA peripheral countries has been higher (and more volatile) than FDI

Chart 12. Net inflow of both Portfolio Investment and FDI (billion USD) in EA Periphery.



Source: our elaboration on statistics by Word Bank (IMF and Balance of Payments Statistics Yearbook) (October 2012).

Policy implications

The harshness of current recession requires the European authorities to take extraordinary measures (in nature, scope and magnitude). The role of the government sector and of the central bank should be radically re-thought. Differently, the survival of both the EA and the EU could be at risk.

Recommendations: a new set of policy measures

A new set of policy measures is necessary in order to avoid the implosion of the EA and of the EU as a whole. In this regard, the following proposals are advanced:

(1) A direct and credible stated permanent intervention of the ECB (and the Eurosystem) in the government bond primary market in order to reduce long-term interest rates below a given threshold (say 2%, therefore supporting economic growth and employment), as well as to sustain collaterals' market (therefore supporting both governments' finance and the interbank fund market as well).

(2) The abolition or, at least, the renegotiation of the 'austerity' measures (fiscal compact, the balanced budget rule inserted into national constitutions, etc.) in favour of *coordinated* fiscal policies, related to the trend in of the balance of payments of each country. In this regard, the following measures could be implemented to absorb external imbalances:

(2.1) Expansive fiscal policies in 'surplus' countries, coupled with 'over the counter' investment plans (aiming to support labour productivity level) in 'deficit' countries;

(2.2) A 'wage standard' which sets a minimum target domestic wage share on national income and links the nominal wage growth to the balance of payments: the larger the current account surplus of a given country the higher should be the rate of growth of nominal wages in that country, and vice versa.

(3) The introduction of capital controls on portfolio and derivative investments, aiming to prevent speculation on government bonds and other strategic assets.

The common purpose of above proposals is to start an internal engine of the European internal demand,

allowing, at the same time, to reduce current account imbalances among European countries and to absorb the unemployed labour-force.

RESEARCH PARAMETERS

FESSUD is a multidisciplinary, pluralistic project which aims to forge alliances across the social sciences, so as to understand how finance works in real word and how it could be changed to better serve economic, social and environmental needs. Some central issues that FESSUD aims to address are: what is financialization? What lessons can be drawn from the crisis about the nature and impacts of financialization? What are the requisites of a financial system able to support a process of sustainable development, broadly conceived? In particular, Task 3 of Work Package 2 deals with the state of financial integration in EU and aims to address the following questions: has an integrated European financial market been created? What has been the impact of the current crisis on the process of financial integration of EU? What about the effectiveness of policy measures undertaken by European authorities to face the crisis? Is there a set of alternative policies to restore the process of financial integration and face the economic recession?

PROJECT IDENTITY

PROJECT NAME	Financialisation Economy Society and Sustainable Development (FESSUD)
COORDINATOR	Professor Malcolm Sawyer. University of Leeds, UK. Email: fessud@leeds.ac.uk
CONSORTIUM	University of Siena, Italy School of Oriental and African Studies, UK Fondation Nationale des Sciences Politiques, France Pour la Solidarité, Brussels, Belgium Poznan University of Economics, Poland Tallin University of Technology, Estonia Berlin School of Economics and Law, Germany Centre for Social Studies, University of Coimbra, Portugal University of Pannonia, Veszprem, Hungary National and Kapodistrian University of Athens, Greece Middle East Technical University, Ankara, Turkey Lund University, Sweden University of Witwatersrand, South Africa University of the Basque Country, Bilbao, Spain
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WEBSITE	fessud.eu
FOR MORE INFORMATION	Helen Evans: fessud@leeds.ac.uk
FURTHER READING	A. Brown, D. Spencer and M. Veronese Passarella, "The nature and variegation of financialisation: a cross-country comparison", <i>FESSUD Working Paper Series</i> , forthcoming. M. Veronese Passarella, "The Process of Financial Integration of EU Economies", <i>FESSUD Working Paper Series</i> , No. 30, 2014. M. Veronese Passarella, "Financial Integration in the European Union: an Analysis of the ECB's role", <i>FESSUD Working Paper Series</i> , No. 4, 2013.