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PRESS RELEASE

Financial integration and fragmentation in the euro area
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Recent decades have witnessed a rapid and intensive process of economic and financial integration throughout the world. Measured in terms of outstanding amounts of external assets and liabilities, financial integration has increased considerably for the euro area since 1999: from 164 % of GDP to 405 % of GDP in the third quarter of 2013. This trend is attributable mainly to capital liberalisation, deregulation and financial innovation. In addition, financial integration in the euro area received an extra boost as a result of the internal market and the introduction of the single currency. However, the outbreak of the financial crisis in 2007 put an abrupt end to the strong increase in integration and risk-sharing. In reality, it was mainly within the euro area that financial integration stalled as measured by de facto indicators.

This article presents a detailed analysis of that integration and fragmentation process in the euro area on the basis of both volume indicators (capital flows) and price measures (interest rates). It examines the dynamics of international capital flows and the external financial position. Regarding interest rates, an analysis through a vector error correction model is performed to identify the drivers of divergences between bank lending rates applied in euro area countries.

This article shows that developments in financial integration within the euro area are largely driven by the financial sector (the banks). Before the crisis, euro area integration was farthest advanced on the interbank market and on the market in fixed-income securities. The principal nominal interest rates had also converged to a considerable extent within the euro area. However, this integration was accompanied by the accumulation of substantial macroeconomic imbalances within an imperfect institutional framework, and it proved unstable in the face of the financial crisis.

The repricing of risks that took place from the start of the crisis caused a strong reversal of the integration process, primarily on the markets where integration had progressed most. When measured by the positions held by the banking sector, financial integration on the market in government paper at the end of 2013 reverted to a level comparable to that at the start of the third stage of EMU at the beginning of 1999. Apart from this decline in the level of integration, the direction of capital flows was reversed for some countries: whereas net capital had previously flowed into countries with an external deficit, since the crisis those countries faced a substantial net outflow of private capital (“sudden stop”). This financial fragmentation phase also threatened the efficiency of monetary policy, with large divergences in benchmark rates along the national boundaries. Partly as a result of the increased home bias, interest rates reflected national risk factors to a significant extent, and the risk perceptions of governments and banks became excessively interconnected. In particular, the macroeconomic situation and the fragility of the financial sector in some countries contributed to the divergence in bank lending rates.

The article also presents the measures taken by European authorities to address this situation. In the short term, the Eurosystem and the European assistance mechanisms (e.g. the EFSF and the ESM) provided for financing mechanisms to ease the immediate pressure on funding. Furthermore, to counter impairments in the monetary transmission mechanism the Eurosystem launched the Outright Monetary Transactions. Next to these measures and in order to ensure a return of sustainable financial integration over the longer term, the institutional framework was adjusted. In particular, the strengthening of economic governance and the creation of the banking union aim to address the underlying causes of the decline in financial integration and create an institutional framework that is likely to foster a more complete and lasting form of financial integration.

Communication
National Bank of Belgium Ltd.
boulevard de Berlaimont 14
1000 Brussels
phone + 32 2 221 46 28
www.nbb.be
Company’s number:
0203.201.340 – RLP Brussels

Most of the countries facing the greatest difficulties have now largely corrected the initial imbalances at the root of the capital outflows, facilitating a return to the international capital markets. However, this article shows that substantial imbalances persist in the financial positions. For instance, net external liabilities in the programme countries increased in the third quarter of 2013 to 113% of their combined GDP, and they were still financed primarily by outstanding ‘official’ credit. Renewed financial integration would contribute towards more sustainable financing of the net external debt of those countries. Restoration of financial integration is also necessary to ensure the proper transmission of monetary policy decisions within the monetary union.