Box 3

FINANCIAL INTEGRATION IN EUROPE: MAIN FINDINGS OF THE 2009 REPORT

In early April 2009, the ECB published the third issue of its report on financial integration in Europe.[1] The main purpose of this report is to contribute to the advancement of European financial integration. In addition, the report is aimed at raising the public's awareness of the Eurosystem's role in supporting this objective of the European Union. The report provides an assessment, based on a set of statistical indicators, of the state of financial integration in Europe. Furthermore, it has a number of special features that provide in-depth assessments of selected issues relating to the financial integration process and gives an overview of the Eurosystem's main activities to foster this process over the past year.

This box summarises the main findings of this year's report, which was largely focused on the impact of the recent financial crisis on the financial integration process. The box also explores

1 ECB, *Financial integration in Europe*, April 2009.

two additional special topics: the role of institutional investors in enhancing financial integration in the euro area and the importance of small and medium-sized enterprises and young innovative companies for the European economy.

The preliminary evidence available suggests that the financial crisis has affected euro area financial integration in a number of ways. The report contains statistical information and analyses that illustrate the impact of the financial crisis on some key segments of the euro area financial system. This year's report also covers aspects of financial development. Financial integration and financial development are normally complementary and mutually reinforcing, as integration helps financial innovation spread across frontiers and financial development, in turn, helps to overcome both frictions in financial markets and cross-border barriers that prevent full integration. However, experience with the ongoing crisis has also shown that some financial innovations (for example, the occurrence of certain types of securitisation through the creation of sizeable off-balance-sheet structures) can be implemented in ways that reduce transparency and lead to excessive risk-taking, ultimately harming financial integration itself. Some caution needs to be taken in drawing definitive conclusions, given that the crisis is still unfolding. However, it is clear that, while action is being taken at the national and international level to restore the proper functioning of the financial sector, careful vigilance will need to be exercised to ensure that the integration of financial markets in Europe is preserved and makes further progress. The Eurosystem is following market developments very closely and has been particularly proactive in ensuring the continued provision of liquidity to the banking sector and in supporting the functioning of money markets.

The impact of the financial crisis on euro area financial integration

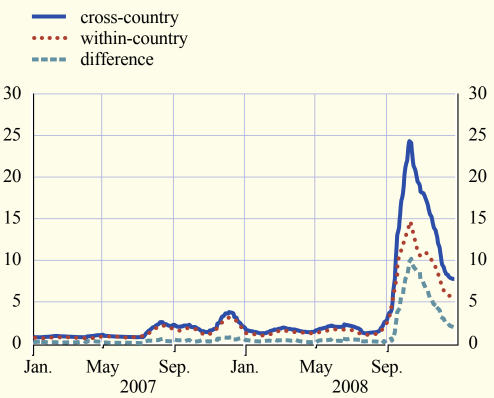
The core question examined in the report was whether and to what extent the ongoing global financial crisis since mid-2007 has led, or may lead, to a retrenchment of financial markets within national borders, and thus to a certain reversal of the European financial integration process. The available evidence presented in the report indicates that the financial crisis has considerably affected the integration of both money and government bond markets, while the degree of integration of other market segments (those for corporate bonds, equities and retail banking products) have thus far been affected less, or not at all.

The usual indicators of integration – such as the cross-country standard deviations of money market rates, or government bond spreads – have deteriorated visibly over the past year and clearly worsened in the last months of 2008. The extent to which the generalised market disruption has resulted in a retrenchment within national borders can be examined by looking at the differences in the impact of the turmoil on domestic and cross-border markets. A first indication on the impact of the turmoil on the integration of the unsecured money market can be drawn from the ECB's annual Money Market Survey,[2] which showed that the share of average daily turnover in unsecured lending to national counterparties in total lending increased from 27.7% in 2007 to 31.8% in 2008 (second quarter). At the same time, the share of transactions with other euro area counterparties declined from 51.2% in 2007 to 47.4% in 2008 (second quarter). Thus, there is some indication of a slightly less integrated unsecured money market. Similar conclusions are reached when looking at the development of money market rates. Chart A compares the overall standard deviation of money market rates across the euro area with the average of

2 ECB, *Euro Money Market Survey*, September 2008.

Chart A Standard deviation of the one-month EURIBOR

(basis points)



Source: European Banking Federation and ECB calculations.

intra-country standard deviations for the EURIBOR. The indicators show that the cross-country dispersion exceeded the domestic dispersion at the height of the financial turmoil (the period from September to November 2008), but also that the gap narrowed towards the end of the year, even though it remained sizeable.[3]

Similar to the money markets, government bond markets have shown clear signs of strain during the turmoil, despite benefiting from "flights to safety" as investors sought to reduce risk. As the turmoil intensified in the autumn of 2008, there was an increase in the cross-country dispersion of yields, which may, in part, have been related to the more difficult market liquidity conditions since then, and also to higher uncertainty and changes in the appreciation of risk and risk premia. Viewed in terms of financial integration, this can be interpreted in different ways. On the one hand, it may indicate increased market segmentation. On the other hand, the increase is also consistent with explanations relating to changes in market fundamentals, such as a repricing of credit risk to reflect relative differences in the creditworthiness of sovereign issuers. In this respect, the report contains a simple econometric exercise to quantify the effects of credit and liquidity risk on government spreads before and after the beginning of the turmoil. By proxying the former with the five-year credit default swap (CDS) premia difference vis-à-vis Germany and the latter with average bid-ask spreads on long-term sovereign bonds, the available evidence shows that the credit risk remained important, while liquidity concerns in some countries seem to have heightened during the turmoil.[4] In particular, a general widening of bid-ask spreads in comparison with the previous year was observed in 2008, which tends to confirm that liquidity became scarce during the turmoil (see Chart B). While German bid-ask spreads changed least, some other countries were affected quite considerably.

Institutional investors and financial integration

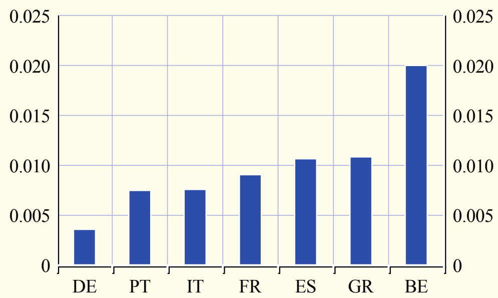
The report also contains an analysis of the importance of institutional investors in the euro area. Institutional investors – investment funds, insurance corporations and pension funds – are important collectors of households' funds alongside banks (who remain the dominant intermediaries), and they are significant shareholders of firms and banks. The increasing role of institutional investors has contributed significantly to the integration of securities markets, as these investors are typically well-diversified across countries. The introduction of the euro and other policies related to the creation of the Single Market (such as the easing of restrictions on the portfolios of pension funds) have increased the scope and reduced the costs of investing in other euro area

3 Both the secured and the unsecured segments (one-month/12-month EURIBOR and EUREPO) present similar patterns. In addition, based on the data available from the Italian electronic platform e-MID, there is evidence that the turmoil may have reinforced the two-tier system of the money market: the cross-border interbank market is dominated by banks with a high credit standing, which can afford to charge each other lower rates, while domestic market activity is driven by smaller banks that have to rely on the liquidity provision of internationally active counterparties.

4 For more details, see Table 1 in the report, p. 38.

Chart B Change in the average bid-ask spread between 2007 and 2008

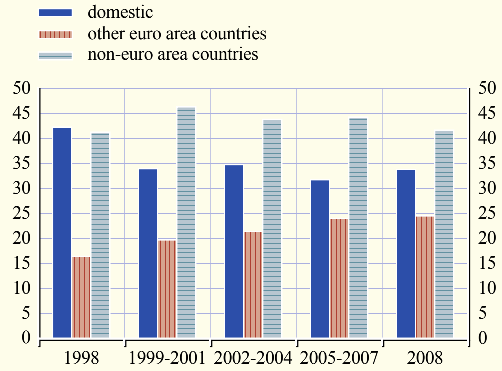
(percentages per annum)



Sources: Reuters and ECB.
Notes: Average of bid-ask spreads, daily data on long-term sovereign bonds (closing prices, snapshot at 6 p.m.) computed in 2007 and 2008. 2008 data for France are relatively limited and must be interpreted with some caution.

Chart C Euro area investment funds' holdings of equities

(percentages of total assets; end-of-year or average for the period)



Source: ECB.
Note: Data refer to holdings of "shares and other equity", which include mutual fund shares.

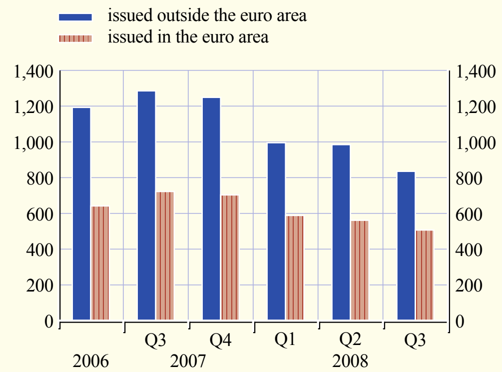
countries for both individual and institutional investors. In fact, the evidence presented in the report shows that the most marked change since 1998 in the portfolios of euro area institutional investors was a significant increase in the holdings of assets from other euro area countries (see Chart C).

The current financial crisis is having an impact on these developments. Available data suggest a sizeable shrinkage of the overall value of the assets managed by institutional investors – in particular investment funds – over the last few quarters, implying a decline in the relative importance of institutional investors vis-à-vis banks as collectors of households' funds. However, Chart D shows that the most remarkable drop in equity investment since the summer of 2007 is related to shares issued outside the euro area. The decline of investment in shares issued in other euro area countries has been relatively modest by comparison.

These movements reflect both valuation effects and withdrawals of funds by households as they rebalanced their portfolios in the light of the financial crisis. In the longer run, it is conceivable that structural factors reassert themselves and that institutional investors will resume their important role of contributing to euro area financial integration.

Chart D Euro area investment funds' holdings of equities

(EUR billions)



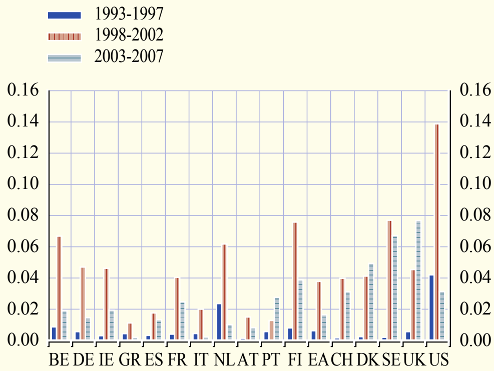
Source: ECB.
Note: Data refer to holdings of "shares and other equity", which include mutual fund shares.

Financing of small and medium-sized enterprises and young innovative companies in Europe

Finally, the report investigates the financial characteristics of, and conditions for, two categories of non-financial corporations in the euro area, namely small and medium-sized enterprises and young innovative companies. Small and medium-sized enterprises account for approximately two-thirds of European employment, and their dependence on bank finance makes them important for the conduct of monetary policy, while young innovative companies account for a large part of European innovation and growth. The analysis in the report highlights that both small and medium-sized enterprises and young innovative companies tend to face more stringent financial constraints than large firms, which may have an adverse effect on their ability to invest in capital and in research and development, hence hampering their innovation efforts and growth prospects.

Chart E Venture capital financing (early investment stage)

(percentages of GDP; by country of management)



Sources: European Private Equity and Venture Capital Association, PricewaterhouseCoopers and Eurostat.
Note: EA stands for euro area.

Furthermore, the report reviews the role of venture capital in relaxing the financial constraints on innovative effort by young innovative companies and small and medium-sized enterprises. While the importance of venture capital backed, early-stage finance in Europe has increased in recent years, the venture capital industry in many euro area countries is still at a rudimentary stage, as shown in Chart E. The report argues that differences across countries are caused by constraints in the supply of venture capital and that policies to improve the structure of credit markets and to stimulate the European venture capital industry may be valuable initiatives for facilitating the access of small and medium-sized enterprises and young innovative companies to finance.