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BENEFITS AND RISKS ARISING FROM PROGRESSIVE INTEGRATION OF FINANCIAL MARKETS IN THE EUROPEAN UNION

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ABSTRACT

One of the reasons of the euro area crisis was a rapid inflow of foreign capital and a large increase in credit in the peripheral countries closing the development gap in relation to the countries of central and north Economic and Monetary Union. An important role in this process was played by freedom of capital movements and progressive integration of financial market, a key element in the creation of economic and monetary union. The purpose of this paper is to present potential benefits and risks arising from progressive integration of financial markets in the European Union.

Key words: integration of financial markets, the European Union, financial crisis.
JEL: F36, G1, G15, G20

1. Introduction

Financial market plays a key role in the economy of each country. Well-functioning economy does not exists without a prosperous, efficient and effective functioning of the financial market. Single financial market is part of the single internal market of EU. Its construction began with the creation of the EEC in 1958 and it can be stated that although its progress is considerable – it is still not fully completed.

Single financial market is a market in which residents (i.e. natural and legal persons whose registered office or place of residence is in the member states of the EU) should be free to do financial operations, and financial institutions from one of the Member State should be able, without limitation, to set their branches up in other member states, as well as provide its services to EU residents across national boundaries, without the need to have branches in other countries.

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Single financial market of the EU is closely linked to the principle of free movement of capital. This means, in essence, that the condition for the functioning of the single financial market is the removal of all obstacles to the movement of capital, financial services, establishment of enterprises in the financial sector. The necessary condition for the creation of such a market is not only the removal of existing barriers, but also the drafting of common law and common standards that are accepted by all Member States (Janicka, 2010).

With the creation and deepening of the single financial market an integration of financial markets is involved, but also the integration of financial institutions operating in the EU and the euro area.

Integration of financial markets is defined as a condition in which there are no barriers and restrictions on access to the financial market and all stakeholders, regardless of location, have equal opportunities to deposit funds and incur liabilities. This means that within the framework of an integrated financial market they have to deal with the same rules of access to the same financial instruments and are treated equally (Baele, et al. 2004).

2. Potential benefits of financial integration

Three basic benefits, which should contribute to integrated financial markets are often mentioned:

1) financial integration should promote economic growth due to a fuller realization of transformation function, allocation, risk protection and supervisory functions;
2) convergence of financial systems, which is a consequence of the integration, should provide uniform transmission of monetary policy impulses to the financial sphere, and on to the real economy;
3) integration of financial markets of the Member States of monetary union should be conducive to consumption smoothing and investment through access to a deep and diversified financial market and risk sharing. In other words, integrated financial markets can smooth and absorb shocks from the real economy, in which they replace the monetary policy that was abandoned by countries of the monetary union (Tchorek, 2014).

There are two channels that are conducive to stabilizing influence of financial markets. One is related to the purchase of foreign assets, and the other with the use of foreign deposit and loan market (Kalemli-Ozcan, Sørensen, Yosh, 2001).

In the first case, smoothing of fluctuations in consumption and investment may take place through the acquisition of income-generating foreign assets (income in the form of dividends, interest, rents from other countries). An integrated financial market creates the possibility of contributing in capital the economy that gives potentially higher rate of return on investment. Investment

risk, which is the result of the deterioration of the economic situation of a member country, spread out over the others. This is due to the fact that holders of financial assets of a country with economic problems are also investors from countries unaffected by the shock, so that they participate in the losses resulting from the reduction in value of financial assets. At the same time entities of the country affected by the shock may have financial assets of issuers from member countries of good economic situation, which gives them a certain revenue and allows the coverage of losses resulting from reduction in value of domestic assets (Tchorek, 2014). In the economic and monetary union wide scale integrated financial market thus creates a mechanism for risk diversification and a kind of "averaging" of income from financial investments.

In the second case, i.e. use of foreign deposit and loan market, we are faced with ex post activity. Asymmetric revenue decline of economic entities affected by the crisis follows. However, access to the international financial market makes it possible to adjust portfolio by buying and selling assets through loans and deposits in the international financial market. Ability to sell assets on the large and deep international market and the possibility of obtaining loans abroad neutralize the negative effects of decline in income.

McKinnon (1996) stated that the countries which share single currency can avoid the effects of asymmetric shock by diversifying their sources of income by adjusting the structure of the portfolio. Such adjustments are conducive to a stronger integration of financial market, where there are no major problems with the flow of capital between individual countries and their financial markets. In this context, an integrated financial market neutralize negative effects of asymmetric shocks. Hence, the conclusion underlying the adoption to the euro area countries that do not meet the exact requirements of the theory of optimum currency area, that a common currency can function in one area of countries vulnerable to asymmetric shocks as long as they "insure" themselves through financial sector (Mongelli, 2002). As shown by the experiences of recent years such a role of financial market integration did not fully found its confirmation

Financial integration in the euro area and more broadly in the EU is still not completed. This integration has taken place in the money market and the treasury bond market, which are essential for effective conduct of monetary policy. There are still, however, segments of the financial market, e.g. stock market or retail banking, where the degree of integration is relatively low (ECB, 2016).

In addition, as indicated by the latest report of the European Central Bank (ECB) as a result of the financial crisis and the euro crisis in certain segments of the financial market reduction of the share of debt securities (especially bonds) of other euro area countries in the portfolios of investors has been observed in recent years. Similarly, the share of cross-border deposits in banks has decreased, while the share of cross-border bank loans is increasing (ECB, 2016). The market of retail financial services in the EU is still defragmented, which is largely associated

with decentralized and diverse range of regulations on consumer protection. It promotes strengthening of the situation in which financial services are created for national buyers. Furthermore, to enhance integration, it is also necessary to address the issue of supervision of financial institutions in the euro area. The mere introduction of a common currency was, therefore, not a sufficient stimulus to the dynamic evolution of the financial sector, but a necessary condition are appropriate institutional arrangements, legal and market (Tchorek, 2014). Speaking of financial integration, the so-called cross-sectorial integration should also be taken into account, reflected in linking financial activities in various sectors of the financial market. This integration proceeded rapidly in the past two decades preceding global financial crisis. Its "powerhouse" were mergers and acquisitions that led to formation of large cross-border financial conglomerates (Iwonicz-Drozdowska, 2009).

Banks and other financial intermediaries – similarly to businesses – were searching how to diversify sources of income. One way is to expand the scope of activities to other segments of the financial market, which particularly matched customers' expectations. Banks and insurance companies built around themselves large conglomerate-type structure, which as a result of mergers and cross-border acquisitions are mostly transnational.

3. Negative effects of financial integration in the light of the euro area crisis

The process of creating in Europe a large financial conglomerates (on the basis of universal banks) was accompanied by hopes that they will become institutions which cross-border operations will accelerate economic integration of Europe (Tumpell-Gugerell, 2005). Today it is known that the opposite happened. One of the main causes of recent global financial crisis was that since the 80s banks were allowed to merge traditional deposit and lending activities with investment activities in capital markets, and create and implement a mechanism of transfer of credit risk through securitization processes. This allowed to transfer risk from one to the other market segments, on other financial intermediaries and their clients. Transferring credit risk to entities other than banks contributes to blurring boundaries between various segments of the financial markets.

Negative side of integration of financial markets, in particular in cross sectorial terms, appeared in the European market due to the subprime crisis. The key causative mechanisms of the crisis, in the context of financial market integration are:

- dissemination of a model, in which banks granting loans transferred risks to others through securitization and credit derivatives (i.e. the model originate-to-distribute),

- development of financial engineering, creation of complex financial instruments difficult to measure, in many cases, not being a subject to trade on liquid markets,
- financing model involving the renewal of short-term borrowings to finance long-term assets,
- expansion of financial institutions and an increase in interdependence between them (institutions too connected to fail) and their use of large-scale financial leverage (Konopczak, Sieradzki, Wiercicki, 2010).

The result of these irregularities and failures of financial market were deep losses incurred by banks (financial conglomerates), as a result of falling prices of securitized bonds, referred to as toxic. Strong transactional links (mutual displays), and often capital between European banks (financial conglomerates) have launched a process of contagion (contagion effect) and domino effect. It is worth noting that European banks, often presenting themselves as innocent victims of American investment banks, from whom they bought toxic bonds (mainly CDO, Collateralized Debt Obligations), in fact were also involved in their emissions.

The transformation of national banks to – often transnational – financial conglomerates, since the establishment of monetary union, led to a significant expansion of the territorial scope of activities of these financial institutions. In the hands of such institutions most of the debt of EU countries was found. As a result of the global financial and economic crisis, some Member States have experienced a deep crisis in public finances and deficit in the current account turnover. As a result, unexpectedly for many financial intermediaries in Europe, treasury bonds issued by governments of the euro area countries, where financial crisis has led to fiscal crisis have become "toxic" securities. This strong link between banking sector (or broader financial) and public sector, has led to negative feedback – a condition in which one sector crisis immediately led to a crisis of another, quickly spreading to other countries (Fig. 1).

After creating euro area elimination of exchange rate risk, introduction of a common monetary policy, increased competition between financial intermediaries and cross-border mobility of capital contributed to integration of financial markets and increase of availability of funding sources. Almost complete integration of wholesale financial market segments contributed to lower interest rates and increase of money supply (Tchorek 2013).

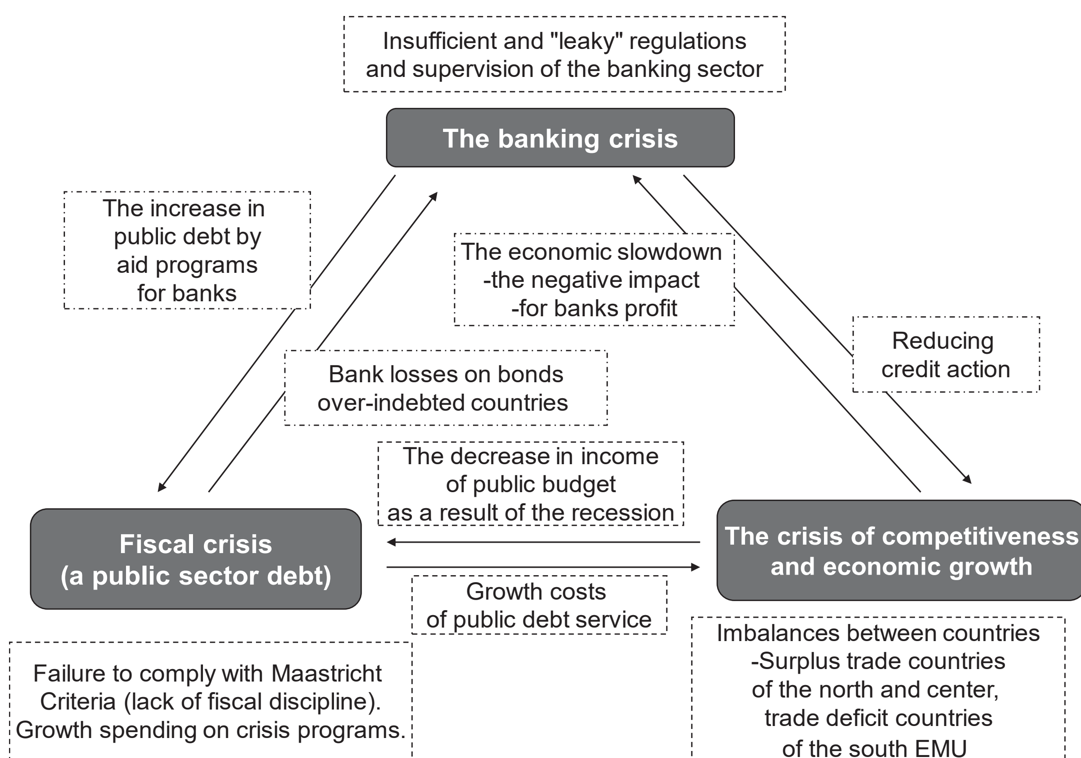

Figure 1. Interdependent crises in the euro area
Source: Own study based on (Shambaugh, 2012).

Inflow of foreign capital and lending began to rapidly grow in the countries closing development gap at a time when the process of financial liberalization characterizing the initial phase of Economic and Monetary Union accelerated. Liberalization of financial flows has launched a growth in turnover on capital markets of the EU and at the same time did not foster accumulation of domestic savings when credit became readily available and inexpensive (Woreta et al., 2010). Figure 2 illustrates the inflow of private capital into the economies of Greece, Spain, Portugal and Italy in relation to GDP, broken down into two periods - before and after the "explosion" of financial crisis. In these countries, before the crisis, substantial positive balance of flows and reversal of this situation after the crisis unfolded was seen. Significantly, the inflow of capital to these countries in the years 1999-2007, consisted mainly of investments in debt instruments (including fiscal) and flows within the banking sector, while capital inflows in the form of foreign direct investment was less pronounced (Fig . 2).

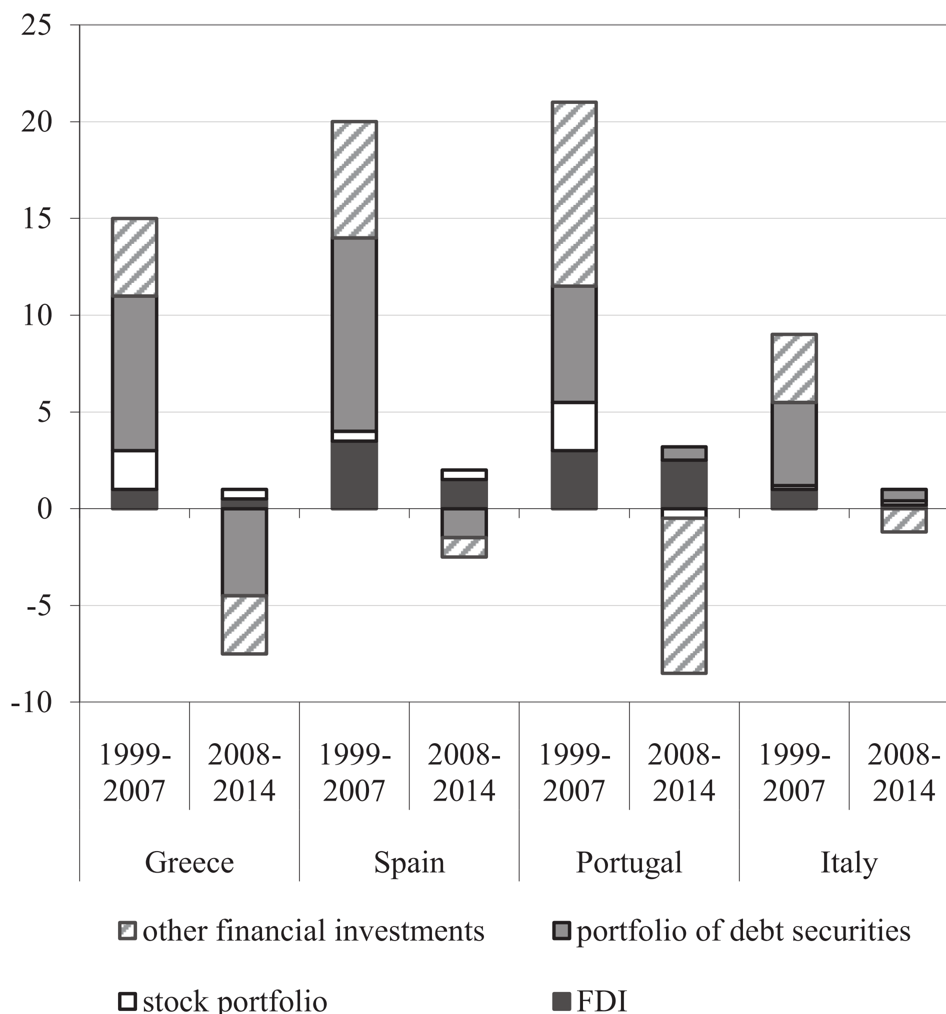

Figure 2. The cumulative flow of private capital to Greece, Spain, Portugal and Italy in 1999-2007 and 2008-2014 (% to GDP)

Source: ECB.

Assumptions of endogenous theory inspired by A.K. Rosa researches, private capital flowing to the countries of northern and central euro area, should support the increase in productivity and sustainable long-term growth of income levels in southern countries (peripheral). The problem was that it was driven largely for unproductive use (consumption) or to sectors that did not cause the increase of international competitiveness of the economies of recipients' capital. When the global financial crisis unfolded, the amount of external private funding began to decline and this decline continued in the post-crisis period.

Increased financing availability was accompanied by a lack of adequate prudential regulations and a weakening of market discipline towards borrowers. This was particularly evident in the case of public debt. Countries less

economically stable and less competitive in the euro area benefited from credibility of other Member States, such as Germany.

This situation is illustrated in Table 2. It shows how, in 2005-2008, differences in interest rates of treasury bonds among the member states of the euro area decreased. The phenomenon of interest free ride was supported by excessive confidence in the financial markets, which could not effectively punished countries leading wasteful fiscal policy by higher interest rates. It also resulted from the principles of regulation in the banking sector assigning risk free weight to treasury securities (Hannoun, 2011).

Table 1. Profitability treasury bonds (in %) of selected euro area countries

Kraj	**Average profitability in the years:**									
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
France	3.4	3.8	4.3	4.2	3.7	3.1	3.3	2.5	2.2	1.7
Germany	3.4	3.8	4.2	4.0	3.2	2.7	2.6	1.5	1.6	1.2
Greece	3.6	4.1	4.5	4.8	5.2	9.1	15.8	22.5	10.1	6.9
Spain	3.4	3.8	4.3	4.4	4.0	4.3	5.4	5.9	4.6	2.7
Italy	3.6	4.1	4.5	4.7	4.3	4.0	5.4	5.5	4.3	2.9

Source: Own study based on (Górka, Łuszczyk 2015).

Since May 2010, resulting from an increase in debt of euro area countries (first Greece, then Ireland, Spain, Portugal and Italy), downgrading of debt rating of these countries resulted in a sharp increase in interest rates on bonds issued by these countries in order to cover the growing budget deficit (Tab. 1).

Dynamic and uncontrolled increase in public debt causes an escalation of risk and uncertainty in the financial markets, including, in particular, on debt market (Kata et al., 2015). It manifests itself mainly by raising profitability of debt securities (Szkudlarek, 2013). This of course increases the cost of public debt servicing and credit rolling or further issues of bonds intended for repurchase of previously issued bonds, leading to a further increase (classic debt trap). Increased borrowing needs of government leads, among other things, by the increase in interest rates, to the effect of pushing private investments and – as indicated by S. Fischer – to reducing productivity of production factors (Fischer, 1993).

Table 2. The deficit of public finances sector in chosen euro area countries in 2007-2014 (% of GDP)

Specification	Years								Average 2007-2014
	2007	2008	2009	2010	2011	2012	2013	2014	
EU[1]	-0.6	-2.2	-6.3	-6.2	-4.1	-3.7	-3.0	-2.6	-3.6
Euro Area[2]	-0.9	-2.5	-6.7	-6.4	-4.5	-4.3	-3.3	-3.0	-4.0
Countries of the north and centre									
Austria	-1.3	-1.4	-5.3	-4.4	-2.6	-2.2	-1.3	-2.7	-2.7
Belgium	0.1	-1.1	-5.4	-4.0	-4.1	-4.1	-2.9	-3.1	-3.1
Finland	5.1	4.2	-2.5	-2.6	-1.0	-2.1	-2.5	-3.3	-0.6
France	-2.5	-3.2	-7.2	-6.8	-5.1	-4.8	-4.1	-3.9	-4.7
Netherlands	0.2	0.2	-5.4	-5.0	-4.3	-3.9	-2.4	-2.4	-2.9
Germany	0.2	-0.2	-3.2	-4.2	-1.0	-0.1	-0.1	0.3	-1.0
Slovakia	-1.9	-2.3	-7.9	-7.5	-4.1	-4.2	-2.6	-2.8	-4.2
Countries of the south/ Peripherals countries									
Greece	-6.7	-10.2	-15.2	-11.2	-10.2	-8.8	-12.4	-3.6	-9.8
Spain	2.0	-4.4	-11.0	-9.4	-9.5	-10.4	-6.9	-5.9	-6.9
Ireland	0.3	-7.0	-13.8	-32.3	-12.5	-8.0	-5.7	-3.9	-10.4
Portugal	-3.0	-3.8	-9.8	-11.2	-7.4	-5.7	-4.8	-7.2	-6.6
Slovenia	-0.1	-1.4	-5.9	-5.6	-6.6	-4.1	-15.0	-5.0	-5.5
Italy	-1.5	-2.7	-5.3	-4.2	-3.5	-3.0	-2.9	-3.0	-3.3

[1] by 2013 - EU-27, in 2014 - EU-28 (plus Croatia)

[2] Euro Area - by 2013 -17 countries, in 2014 - 18 countries (plus Latvia).

Source: Eurostat http://ec.europa.eu/eurostat/statistics-explained/index.php.

Table 2 presents how public finance deficit of north and center countries of euro area was shaping compared to south countries (more peripheral). The consequence of a very high budget deficits of peripheral countries, which have occurred in these countries since 2008 and took place over the next few years, was a quick build-up of public debt (Tab. 3).

Fall in prices of treasury bonds of peripheral countries in the euro area as a result of growing public debt caused the loss of European banks (financial conglomerates), increasing risk of their insolvency. It also raised concerns about the solvency of governments, if they had to use taxpayers money to rescue banks. The existence of such concerns contributed to speculation on falling prices of Italian and Spanish treasury bonds.

Financial institutions (including hedge funds) speculated (using derivatives) on an increase in long-term interest rates on the treasury bond market. When this type of speculation proved effective, media and the comments of market analysts

raised concerns about the possible insolvency of the governments of Spain and Italy, as a result of a significant increase in the cost of public debt servicing (Sławiński 2015). Insolvency of Greece, in fact, has become a fact.

Table 3. Public debt in chosen euro area countries in 2007-2014 (% of GDP)

Specification	Years								Growth 2014-2007 (p.p.)
	2007	2008	2009	2010	2011	2012	2013	2014	
EU[1]	59.0	62.5	74.8	78.3	80.9	83.6	85.4	92.3	27.2
Euro Area[2]	66.3	70.1	79.9	83.8	85.9	89.1	91.1	86.8	28.9
Countries of the north and centre									
Austria	64.8	68.5	79.7	82.4	82.1	81.7	81.2	84.2	19.4
Belgium	86.9	92.2	99.3	99.6	102.1	104.0	104.5	106.7	19.8
Finland	34.0	32.7	41.7	47.1	48.5	53.0	56.0	59.3	25.3
France	64.2	67.8	78.8	81.5	85.0	89.2	92.2	95.6	31.2
Netherlands	42.7	54.8	56.5	59.0	61.3	66.5	68.6	68.2	25.8
Germany	63.5	64.9	72.4	80.3	77.6	79.0	76.9	74.9	11.3
Slovakia	29.8	28.2	36.0	41.1	43.5	52.1	54.6	80.8	58.1
Countries of the south/ Peripherals countries									
Greece	103.1	109.3	126.8	146.0	171.3	156.9	174.9	178.6	75.5
Spain	35.5	39.4	52.7	60.1	69.2	84.4	92.1	99.3	63.8
Ireland	24.0	42.6	62.2	87.4	111.1	121.7	123.3	107.5	83.6
Portugal	68.4	71.7	83.6	96.2	111.1	124.8	128.0	130.2	61.8
Slovenia	22.7	21.6	34.5	37.9	46.2	53.4	70.4	53.5	23.6
Italy	99.7	102.3	112.5	115.3	116.4	122.2	127.9	132.3	32.6

[1] by 2013 - EU-27, in 2014 - EU-28 (plus Croatia)
[2] Euro Area - by 2013 -17 countries, in 2014 - 18 countries (plus Latvia).
Source: Eurostat http://ec.europa.eu/eurostat/statistics-explained/index.php.

Situation on the market of treasury bonds of peripheral countries stabilized after the intervention of the European Central Bank, which in August 2012 announced the OMT program (Outright Monetary Transactions). In this framework, the ECB has committed to intervene in the market of treasury bonds if interest rates of their profitability will rise above the level, which the ECB considers to justify its intervention. This meant that the ECB expressed its readiness to act as lender of last resort not only to banks, but also governments. OMT may only provide partial and temporary barrier before an unfavourable

feedback for the euro area between banking crisis (more broadly financial) and the fiscal crisis.

Relatively strong integrated financial markets before the crisis were in its result subjected to fragmentation as a result of aversion to finance over-indebted economies and outflow of capital from these countries (Fig. 1). This was due to the loss of confidence in financial markets on the sustainability of the euro area and the lack of crisis management mechanisms.

4. Conclusions

By the time of the crisis, growth in the economies of euro area Member States (especially southern Europe) was largely a result of a demand generated by low interest rates and easy access to cheap credit. Influx of capital from outside and activity of large European banks (and generally large financial conglomerates) strongly supported lending, investments in the real economy, and also on the financial markets, rise in prices of financial assets and tangible assets, such as real estate. The integration of financial markets in the euro area favoured the growth of speculation on the financial market and related markets. Environment of low interest rates and the possibility of additional capital for banks through securitization have led to dynamic growth of debt in both households and businesses.

Collapse of the financial markets triggered by the subprime crisis in the US, resulted in a deep banking crisis in the EMU, whose negative effects have moved rapidly to the real economy, and then imprinted a negative impact on public finances of individual Member States. Key transmission channel of the crisis on real economy was financial system and highly integrated financial market.

Euro area crisis has proven, through coupling between the banking sector and the real economy and the system of public finances, how important is the financial system for macroeconomic balance. The foundation of economic and monetary integration in Europe is the single financial market, which is part of the EU internal single market. One of the key freedoms on which the European single market lays is the free movement of capital. In turn, progress in creating a single financial market is determined not only by removing barriers and restrictions on the movement of capital, but also by the progress in financial integration. The integration of financial markets may, however, bring a lot of risks, which is why it is important that the process of financial integration progressed in parallel with the process of economic and social convergence of countries belonging to the economic and monetary union.

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