MORE, NOT LESS, FINANCIAL INTEGRATION NEEDED IN EUROPE

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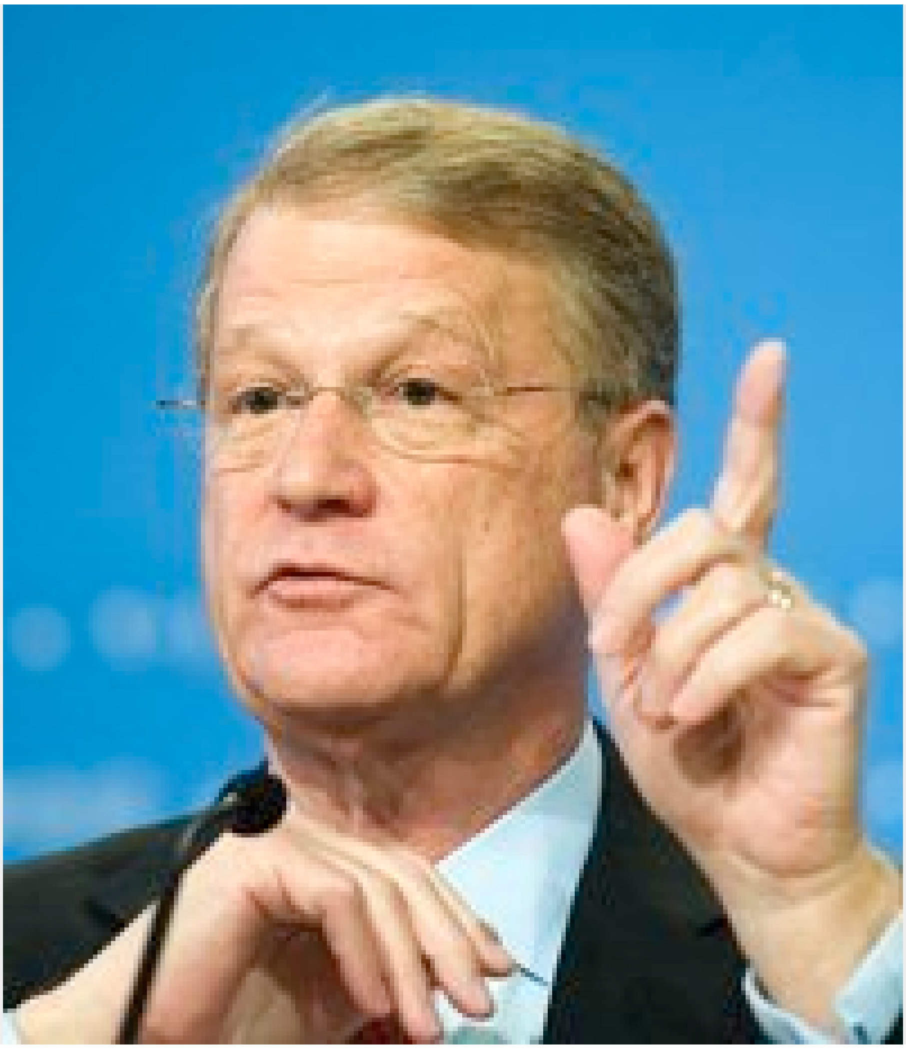

Category: Opinions

Policies to promote deeper integration of Europe's banks should be part of the solution to its financial problems, says the IMF's Antonio Borges

El fomento de la integración de los bancos europeos debería ser parte de la solución de los actuales problemas financieros, según Antonio Borges, Director del Departamento Europeo del FMI. Para prevenir futuras crisis hay que aumentar la supervisión económica, tanto a nivel nacional como regional.

Banks are at the heart of Europe's problems today. Yet it would be wrong to conclude that the crisis was caused by too much financial integration. In fact, the real problem may have been that there was too little financial integration.

In the run-up to the global crisis, countries in the euro area periphery, and countries in emerging Europe that had fixed their currency to the euro, had very high current account deficits. These deficits turned out to be dangerous: when the capital flows suddenly slowed, the result was a deep crisis.

European financial integration and particularly the introduction of the euro likely facilitated these high current account deficits. Interest rates in Europe converged at low levels, as foreign exchange risk was eliminated within the euro area, and as confidence in macroeconomic stability increased. The result was a big boost to investment and reduced saving in countries that previously had been living with high interest rates.

Yet it would be wrong to conclude that the crisis was caused by too much financial integration. The problem was not that capital flows were too large – it was that they were not used wisely. Capital flows boosted demand rather than supply, and imports rather than exports, and thereby contributed to large and ultimately unsustainable increases in external debt. Too many were oblivious of these risks – financial markets paid little attention until it was too late, and government policies did too little to address market failures.

The real problem may have been that there was too little financial integration. Although some elements of the financial system are highly integrated, cross-border mergers and acquisitions in the euro area are still limited. As a result, banking flows to the euro area periphery during the boom years largely took the form of debt rather than equity, which exposed banks in the periphery to rollover risk.

Europe has been integrated enough to foster large credit inflows but not enough to resolve crises quickly. The EU fostered financial integration by adopting a common currency but it did not put in place effective instruments to handle cross-border risks or mitigate the build-up of imbalances financed by cross-border financial flows.

With banking problems addressed at the national rather than EU level, banking and sovereign problems in euro area periphery countries exacerbated each other. Sovereign debt problems worsened as a result of the fiscal costs of banking problems, and concerns about the public sector increased the problems.

How would more complete financial integration, together with pan-European institutions, have made it easier to resolve the crisis? Banking problems would
have had fewer fiscal consequences. If domestic markets had been more open to foreign bank ownership, national public sector policies for supporting and recapitalising banks would not have been the only options.

Banks would have suffered less spillover from sovereign debt problems, as deposit guarantees and other implicit guarantees would not have depended on underwriting by the state. It would have been easier to consolidate the financial sector. Consolidation is now occurring slowly, if at all, and often within borders.

If a pan-EU supervisory regime had been in place, excessive exposures or expansions of banking systems might have been spotted, and ill-considered unilateral policy moves avoided. With all that said, financial integration alone is not enough to address the current crisis.

Ultimately, economic growth depends on productivity, which some countries have struggled to raise over the past decade despite access to foreign capital. To boost sustainable growth, better policies are needed at the national level, with better governance at the EU level. Further European economic integration would unlock substantial efficiency gains, in particular if it dismantled many obstacles to cross-border competition that still exist.

To prevent future crises, we need more vigilance, both nationally and across borders, better institutions to deal with financial sector problems, and more, rather than less, financial and economic integration.

Antonio Borges is Director of the IMF's European Department. He was previously Vice Chairman and Managing Director of Goldman Sachs International, and Professor of Economics and Dean of INSEAD

Business School. He also served as Deputy Governor of the Bank of Portugal.