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Financial Linkages Across European Borders: Dangerous Liaisons or an Unmissable Opportunity?

Good morning. I am delighted to be here today, to talk about cross-border financial linkages as a key channel of transmission of shocks and as an unmissable opportunity for policy coordination, particularly within Europe.

Financial systems in advanced and emerging European economies have undergone remarkable changes over the past decade. Western European banks, for example, have dominated bank lending flows to emerging economies since the mid-1990s. By end-2007, their assets in emerging economies reached 10% of advanced-economy GDP, compared to a combined 2.5% of GDP for Canadian, Japanese, and U.S. banks. Emerging Europe, in turn, stands out as the main recipient of bank lending flows. Foreign claims in terms of destination GDP are the highest among emerging regions.[1]

As cross-border ownership of assets has increased, it has revealed not only important benefits associated with financial integration, but also new risks.[2]

Surely, greater financial integration has shown its ability to disperse claims to a broader range of portfolios, so that risks are better spread. In particular, financial integration holds great potential to smooth incomes through cross-border asset diversification, and thus stabilize the economy in the face of asymmetric shocks. Empirical work on the United States estimates that two-fifths of the income effect from local shocks is smoothed away through asset holdings across state lines. A similar analysis for European countries shows that, since 1999, risk sharing has begun to emerge also across these economies, although the extent to which financial integration is able to insure incomes against country-specific shocks is still limited and uneven across regions – with estimates below 10% in all regions.[3]

Adjusting well to shocks means having a system that is not only resilient but also reallocates resources more efficiently across sectors and across firms, thereby fostering growth. Also, improved, risk-adjusted growth opportunities appear to be related to future advances in integration. This empirical regularity indicates that the countries whose integration has been faster benefit most from a virtuous dynamics in which financial integration and improved real prospects are mutually reinforcing. And Europe is found to be the region that has benefited the most from such dynamics.[4]

At the same time, though, financial integration poses new challenges to market investors and policymakers. Cross-border ownership of assets exposes financial institutions such as banks to macroeconomic, financial, and asset price fluctuations in the countries where they hold positions. Increasingly complex linkages across market segments and borders make the transmission of shocks in the international economy and the pattern of risk

[1] *Arvai, Driessen and Ötker-Robe (2009); Maechler and Ong (2009); and Balakrishnan, Danninger, Elekdag and Tytell (2009).*

[2] *Sgherri (2008).*

[3] *Kalemli-Ozcan, Sørensen and Yosha (2003).*

[4] *De Nicolò and Ivaschenko (2008).*

dispersion more opaque, creating uncertainty for agents and policymakers about where the ultimate risks lie.

Right now, within Europe, the unfavorable feedback loop across borders appears to be in full swing.[5]

The current financial turmoil originating in the United States was propagated through direct exposure to toxic assets and a reassessment of the viability of existing banking models. Wholesale liquidity evaporated, complex assets proved to be difficult to value, lack of transparency about counterparty risk undermined trust, and markets took a dim view of leverage. Hence, many banks came under severe pressure and several had to be bailed out or resolved, a process that is still ongoing.

Model-based analysis suggests that the initial financial shock was transmitted to the real economy, primarily through the asset price channel and in a more differentiated fashion through the credit channel. In addition to confidence and wealth effects adversely affecting demand, the fall in equity prices – which often amounted to more than 50% – raised the cost of capital and dampened investment. Such a shock is estimated to have had its strongest impact on the advanced economies of Europe, but the Baltic economies would seem similarly sensitive. Central European economies appear more moderately susceptible, while Southeastern Europe is more insulated.[6] These model findings are consistent with the view that banks operating in emerging Europe, which relied more on traditional business models, were initially not affected by direct exposure to toxic assets.

However, the flight to safety associated with the intensification of the financial crisis in late 2008 rapidly put paid to the notion that emerging economies would decouple in a meaningful way. Indeed, one of the key features of the ongoing financial crisis is a severe repricing of risk at a global level, with important crisis events ratcheting up risk aversion.[7] The ensuing international portfolio reallocation led to a decline in the relative price of domestic assets in emerging economies. The pressure to reduce leverage in parent banks in advanced countries and higher perceived risks drove up credit yields and led to a reduction in inflows to most emerging economies, resulting in a collapse in their credit growth, albeit from high levels.

Evidence from past episodes of systemic banking stress in advanced economies (the Latin American debt crisis of the early 1980s and the Japanese banking crisis of the 1990s) shows that the decline in capital flows tends to be sizeable and long lasting. Since then, banking globalization has continued and risks of large scale de-leveraging associated with common lender effects have risen. Given the large share of external financing through banks, a number of emerging European economies is likely to suffer substantially from a drought of capital inflows.[8]

As a consequence, all of Europe now sits in one boat facing the same rough weather – and emerging and advanced economies will have to jointly coordinate a course out of it.[9]

5 *Everaert (2009).*

6 *Galesi and Sgherri (2009).*

7 *Lombardi and Sgherri (2009).*

8 *Balakrishnan, Danninger, Elekdag and Tytell (2009).*

9 *Čihák and Mitra (2009).*

Governments and central banks have indeed taken unprecedented actions to address this crisis, which have helped to prevent an outright meltdown of the financial sector and even more serious consequences for GDP growth and employment. At the same time, though, the crisis has revealed a lack of coordination that may have contributed to the crisis itself and that is now threatening the effectiveness of the European policy response for a speedy recovery.

The coordination gap is most obvious in the financial sector where – prior to the crisis – national regulators as a group missed the opportunity to reign – in regional financial institutions. One problem was insufficient information sharing between home and host supervisors of cross-border entities, which left some problems undetected. Another was the need for macro-prudential regulation (concerning, for instance, capital requirements and countercyclical loss provisions), which might have been obvious from an aggregate European but not always from a national one. These problems, which have yet to be fully resolved, illustrate the simple truth that allowing regulatory and supervisory coordination to lag behind financial market integration is never a good idea.

Inevitably, the lack of coordination also hampered – and continues to trouble – the crisis resolution effort. The ECB has boldly stepped up and provided liquidity for the euro area and some selected European countries. It has little or no say, however, on the crisis clean-up. Here the to-do-list remains long, including the urgent need for full loss recognition, consistent stress testing to evaluate prospective losses, recapitalizing viable institutions while resolving others, and ring-fencing of impaired or difficult-to-value assets. But despite an intensifying discussion of an European approach, the bulk of this agenda still rests squarely with national authorities. This could prove self-defeating. Without an organized and region-wide approach to calibrate the parameters of these interventions, they could easily open up the door to unwanted policy arbitrage. Such a development would severely limit the effectiveness of the European crisis effort and create political trouble spots at the wrong time. On a similar vein, there is an urgent need to move ahead (and quickly) with the establishment of a European financial stability framework to coordinate crisis management across the region. Once again, creating a robust burden-sharing scheme for cross-border institutions will require a larger role for European institutions, in particular the EU.[10]

Another area of coordination are monetary and exchange rate issues. For instance, the ECB has been fairly selective in its currency support to non-euro area countries, although the benefits of currency swap agreements and a clarification of the euro roadmap for new EU Member States appear to be substantial. Given the strong feedback

[10] *Čihák and Fonteyne (2009).*

loops between emerging Europe and the euro area, filling the coordination gap in all of these areas will help to avoid unwanted volatility in currency and financial markets.

Let me, hence, conclude my intervention by arguing that, if there is a lasting lesson from the crisis for Europe, it is that a tightly integrated region requires a regional perspective from policy makers. Undeniably, the economic and financial integration of Europe's economies has been a tremedous success story in recent years, and the current storm provides an opportunity to strengthen and weather-proof some of its institutions – an opportunity that should not be missed. In other words, to plot the course out of the current storm, we will need more Europe not less.

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