

Financial Integration and Adjustment Dynamics

Philip R. Lane, IIS-TCD and CEPR

Brussels Economics Forum 2007

Overview

- EMU has had a large impact on level of European financial integration
- EMU just one factor. Bigger picture: financial globalisation.
- Sources of convergence
- Sources of divergence
- Policy Issues

Sources of Convergence

- Less volatile financial environment, in relation to interest rates and exchange rates
- Rise in cross-border two-way financial trade: should generate greater sharing of macroeconomic and sectoral risks
- EMU: doubles bilateral bond holdings (Lane, IJCB, 2006); raises portfolio equity holdings by about 70 percent (Lane and Milesi-Ferretti, 2007); also, increases FDI.
- Rise in risk sharing can tied to cross-border equity holdings
- (Limitation: elimination of domestic-currency bonds)

Sources of Convergence

- Elasticity of idiosyncratic consumption growth to idiosyncratic output growth has declined from 0.8 (1970-1989) to 0.65 (1990-2003) – Giannone & Reichlin (ECB)
- De-linking stronger at medium-term than at short-term (trend versus cyclical shocks)

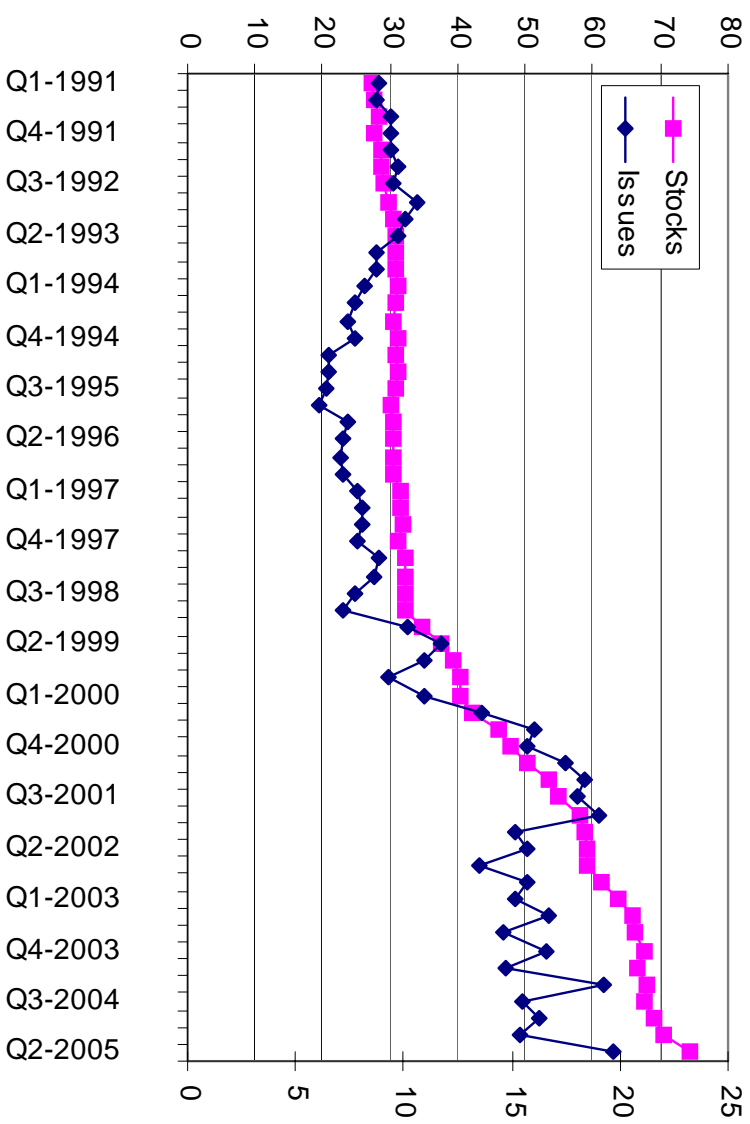
But scale limited:

- tradable financial wealth only one component of overall net worth
- ‘natural’ reasons for financial home bias (?)

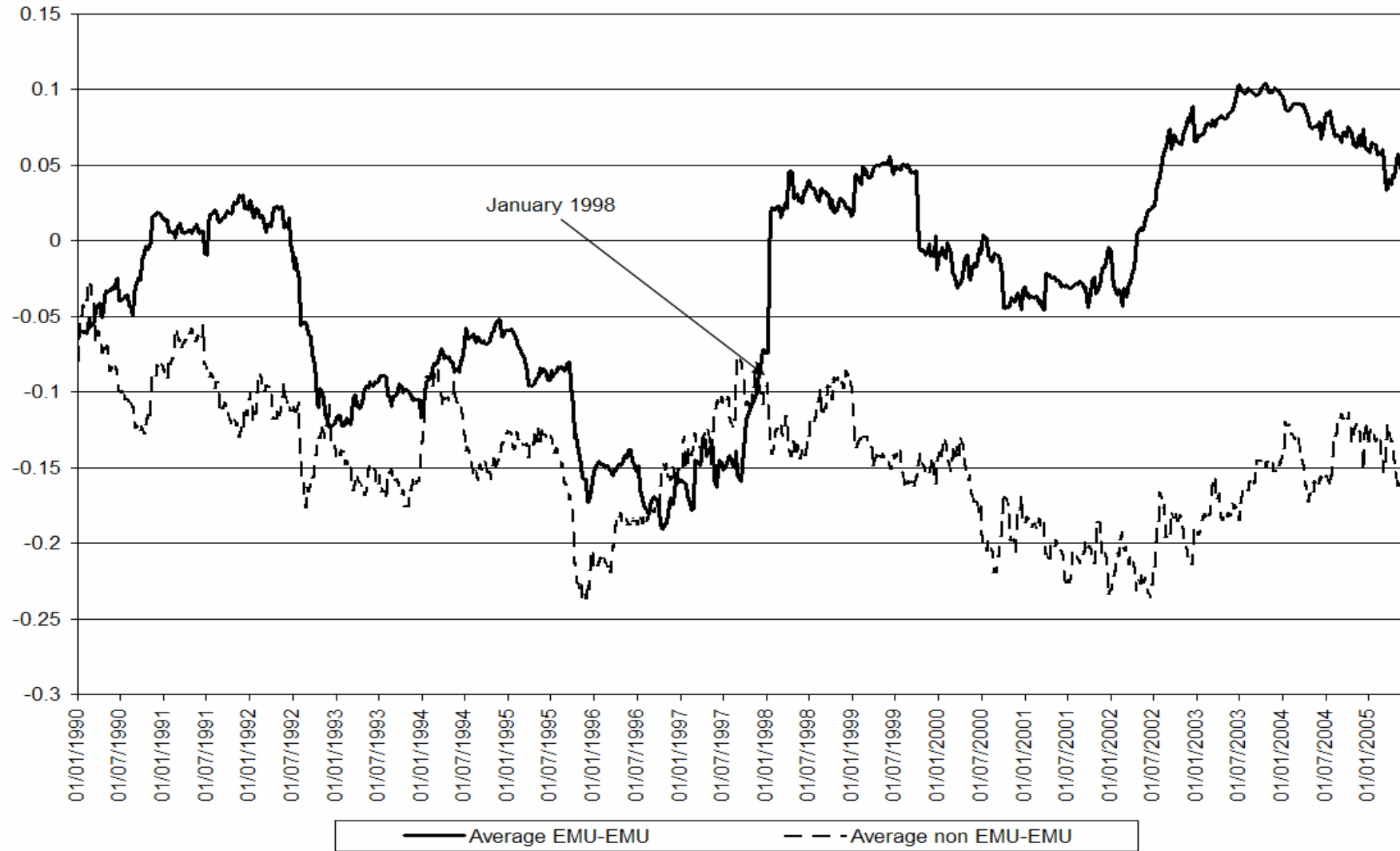
Sources of Divergence

- Large-scale net capital flows can magnify output differentials
 - Also may lead to divergence in local asset prices (e.g. house prices)
 - Intermediated via banking sector (issues for financial stability)
 - Difficult adjustment path if real exchange rate overshoots
 - Accumulated debtor/creditor positions: differential impact of shifts in global financial environment
- Financial globalisation: patterns of implied risk sharing different across member countries in relation to global financial engagements
 - Scale of global financial activity
 - Sectoral, geographical and currency asymmetries

Corporate Bond Issues in Euro Area, 1991 to 2005

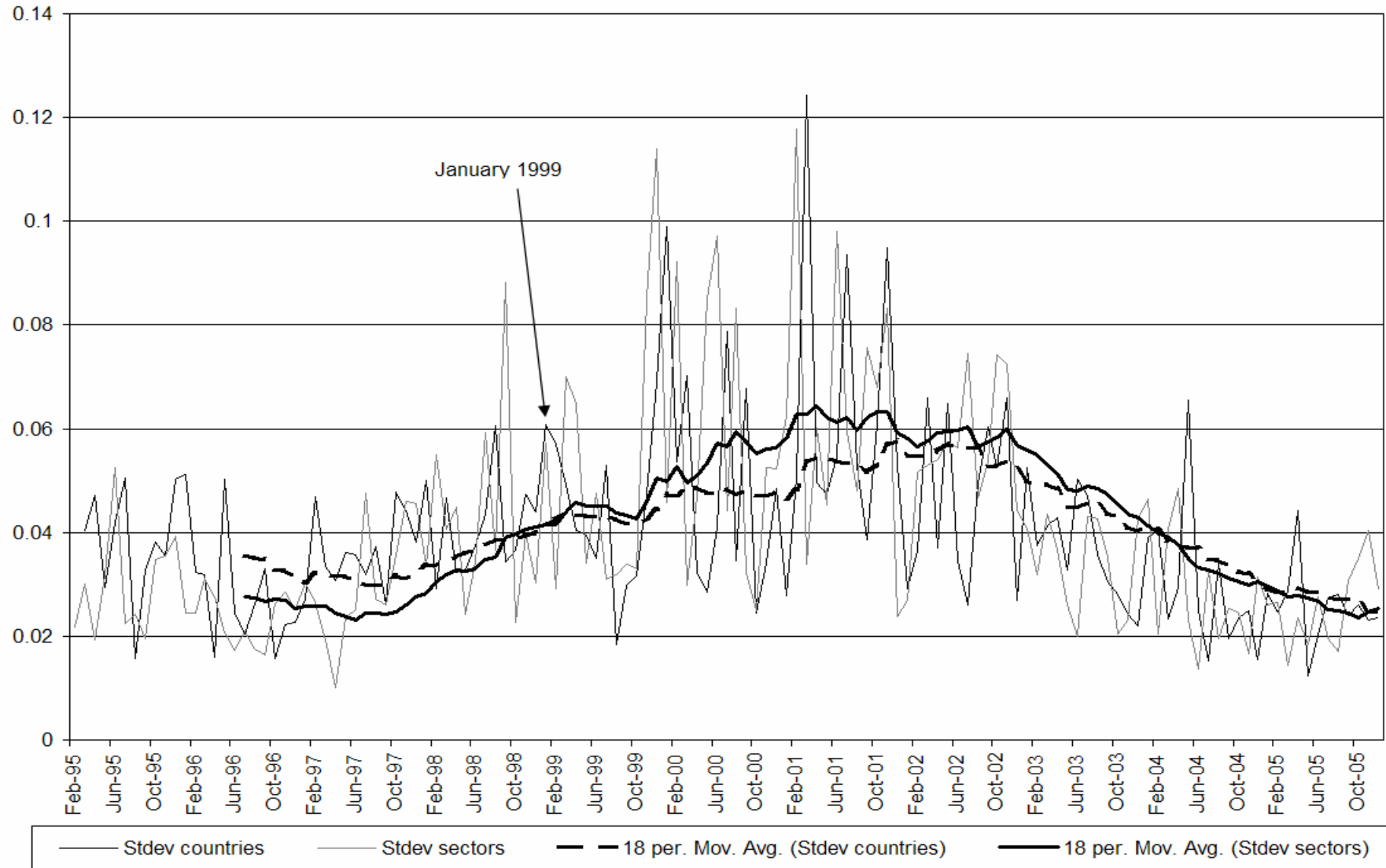


Correlation in Stock Returns



Source: Lane and Walti (2007)

Country versus Sectoral Factors



Foreign Portfolio Equity Holdings, end 2005

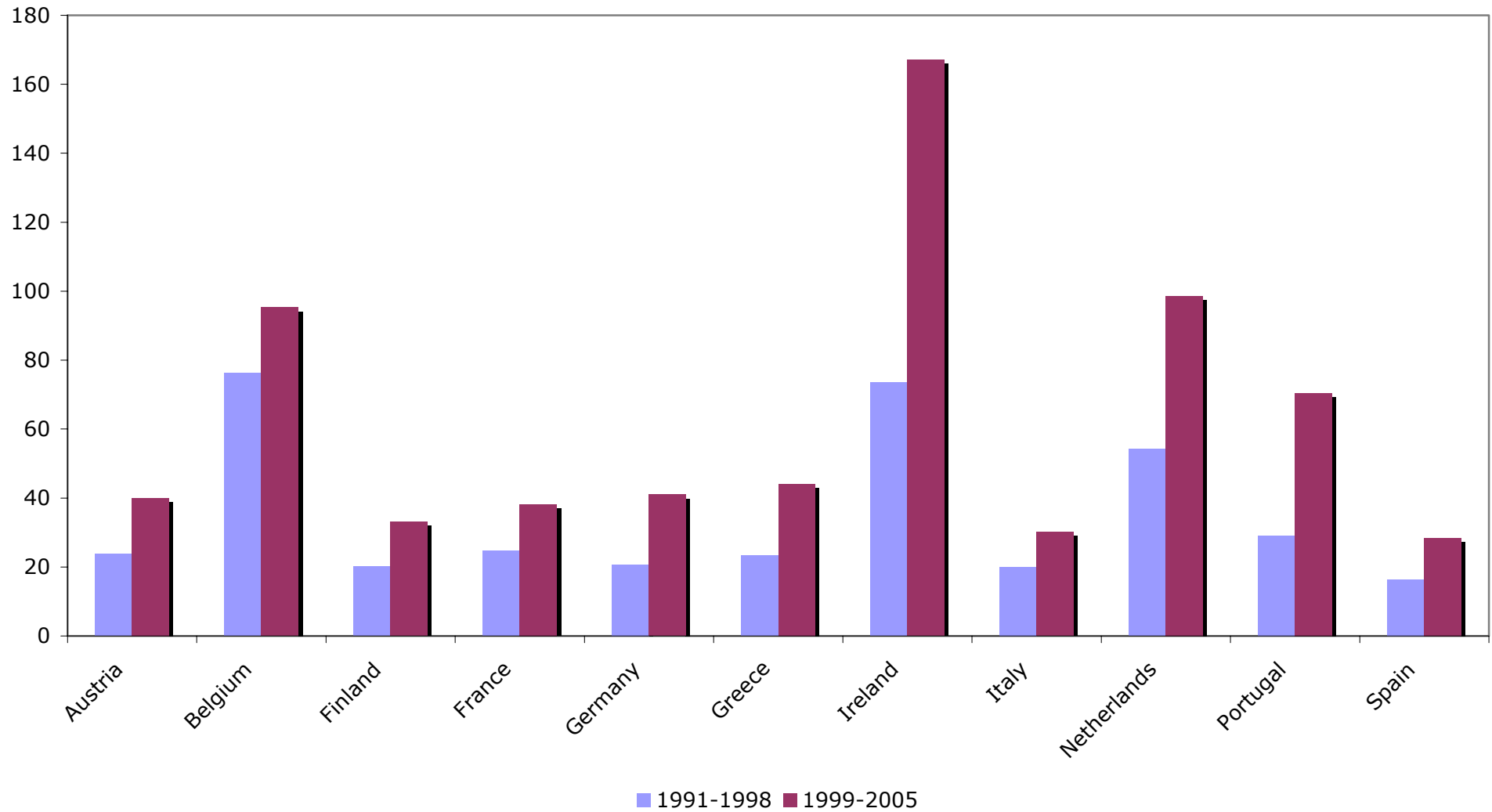
	For. EQ. Assets	EMU share
Austria	20.7	56.0
Belgium	54.3	82.3
France	25.1	50.9
Germany	18.9	70.0
Italy	23.6	72.3
Luxembourg	2363.3	32.1
Netherlands	76.5	24.4
Finland	33.3	38.8
Greece	3.7	45.2
Ireland	190.8	25.9
Portugal	8.6	66.5
Spain	10.9	73.4

Foreign Bond Holdings, end 2005

	For: Bond Assets	EMU share
Austria	70.4	65.7
Belgium	88.8	81.7
France	56.4	66.0
Germany	35.9	68.9
Italy	31.6	63.8
Luxembourg	2677.6	60.3
Netherlands	95.5	69.8
Finland	44.4	74.2
Greece	26.8	34.4
Ireland	267.8	48.1
Portugal	53.6	64.2
Spain	38.7	63.5

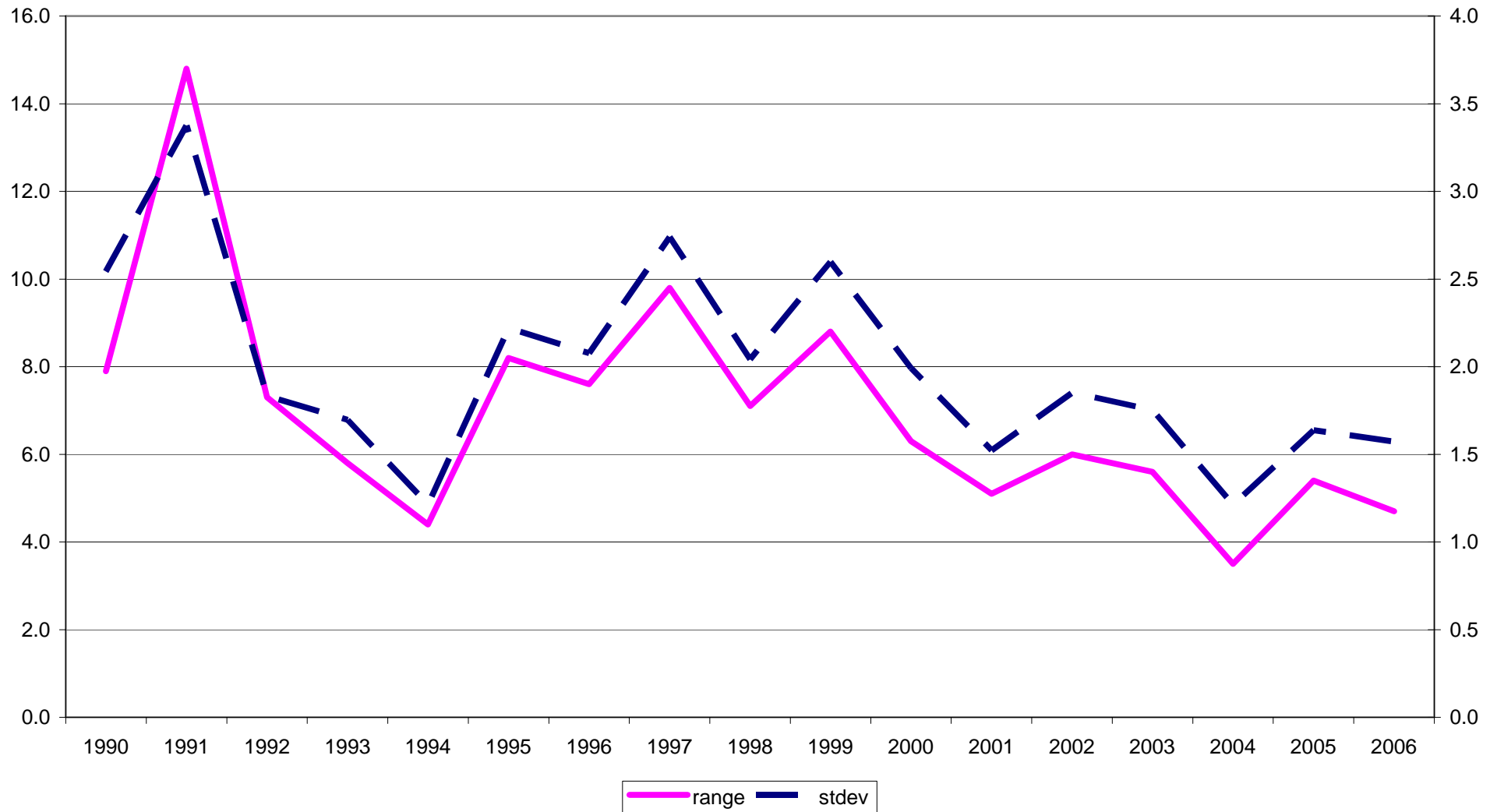
Cross-Border Bank Positions, % GDP

Cross-Border Bank Positions



Distribution of Current Account Balances, 1990-2006

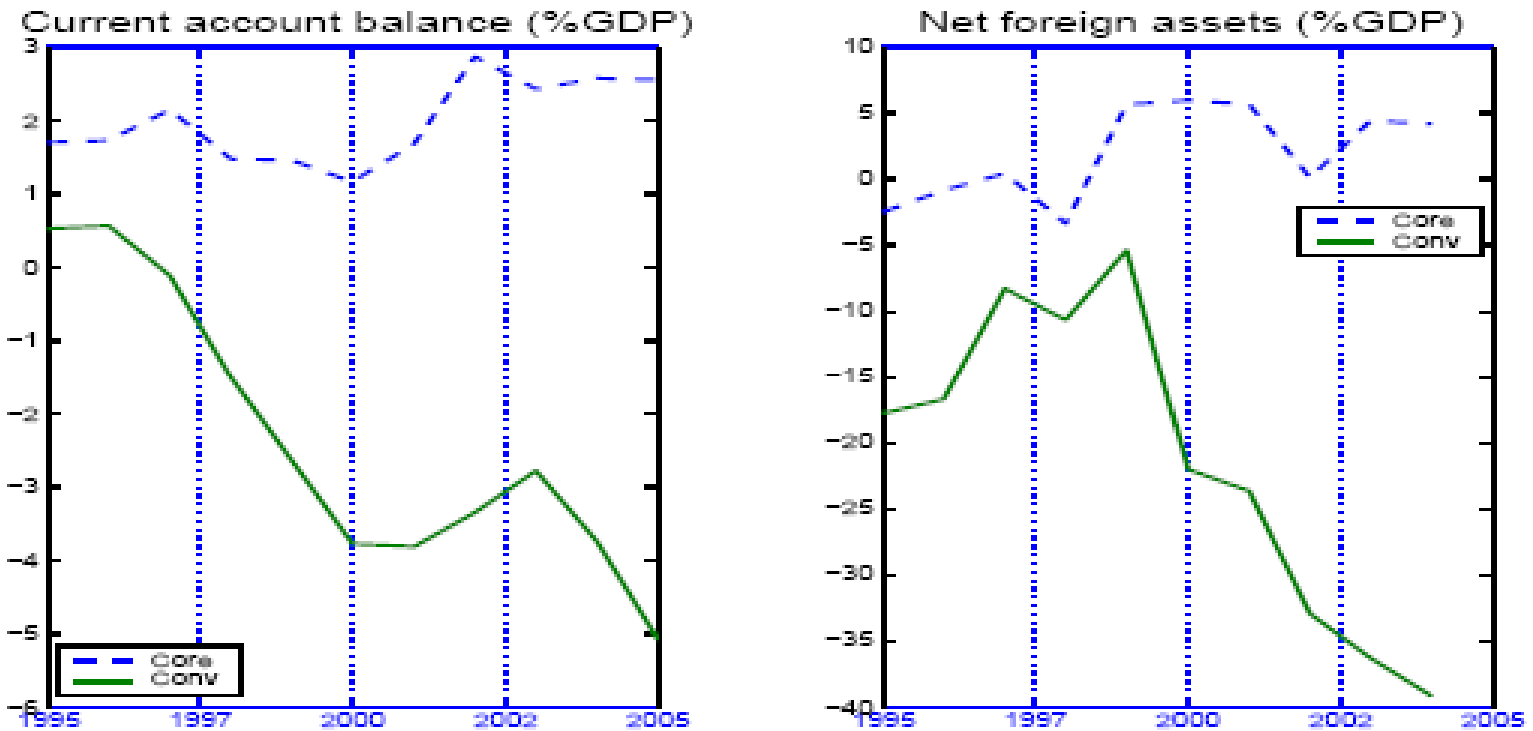
Current account to GDP ratio



Average Current Account Balances

	1990-1998	1999-2006	Dif
Portugal	-2.2	-8.7	-6.5
Greece	-2.4	-6.4	-4.0
Spain	-1.6	-4.9	-3.3
Ireland	1.8	-1.1	-2.9
Italy	0.5	-0.9	-1.4
France	0.9	0.4	-0.5
Belgium	4.3	4.1	-0.3
Luxembourg	10.5	10.9	0.4
Netherlands	4.1	4.8	0.7
Austria	-1.4	-0.5	0.8
Germany	-0.5	1.9	2.4
Finland	0.5	7.2	6.8

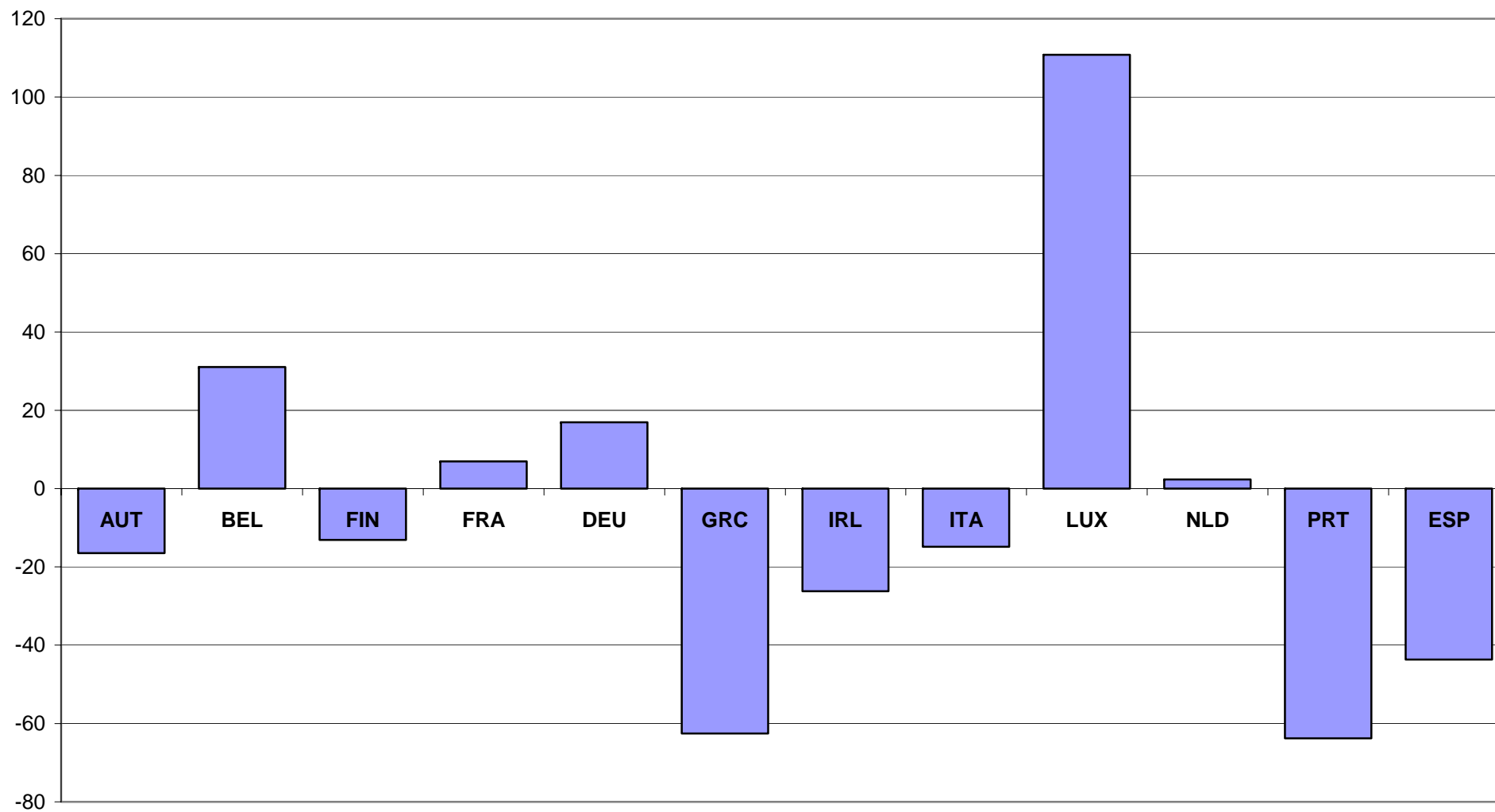
Current Account Dynamics: Core and Periphery



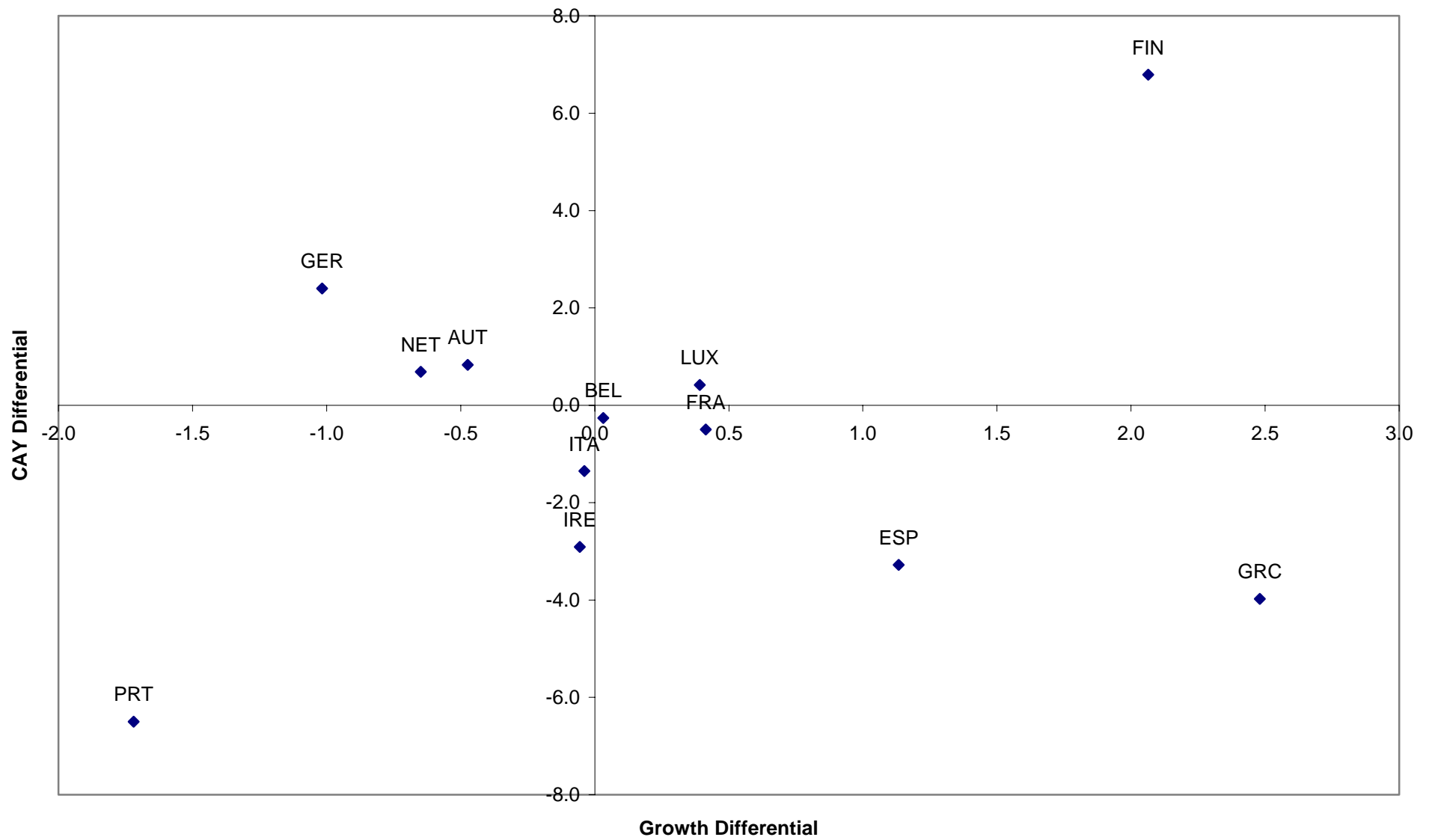
Source: Fagan and Gaspar (ECB, 2007)

Net International Investment Positions, end 2005

NFA to GDP ratio, 2005

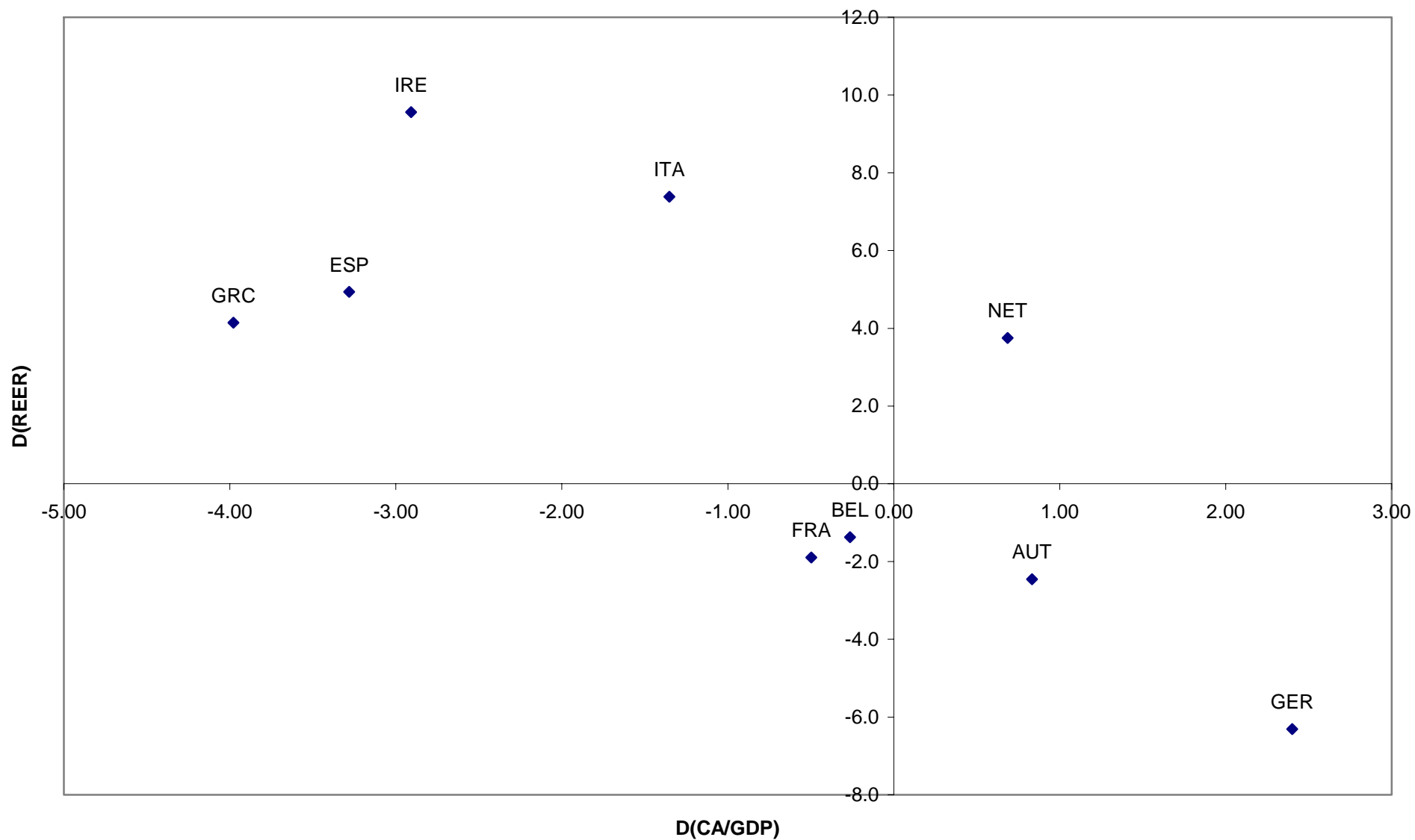


Output Growth and Current Account



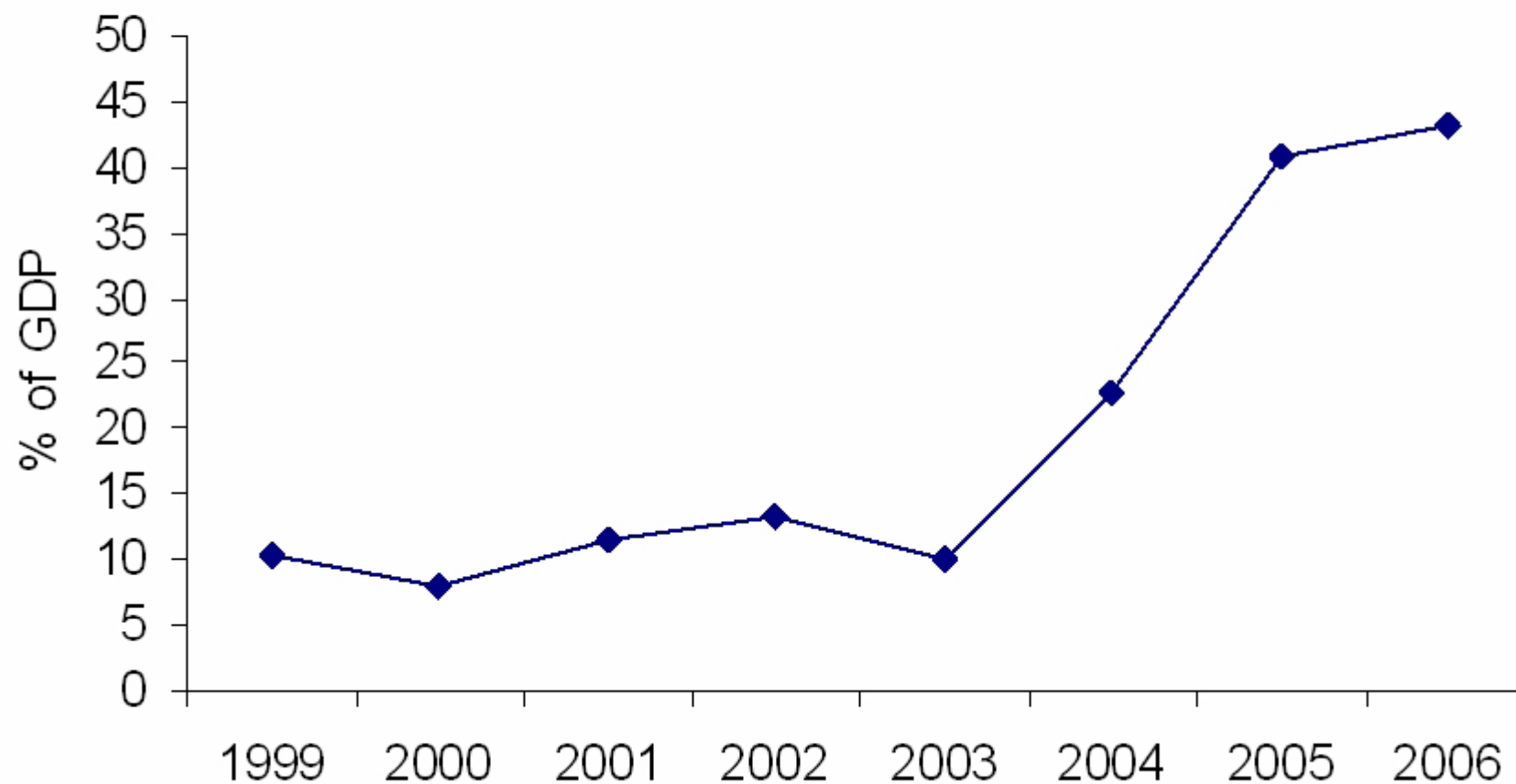
1999-2006 minus 1990-1998

Current Account and Real Exchange Rate



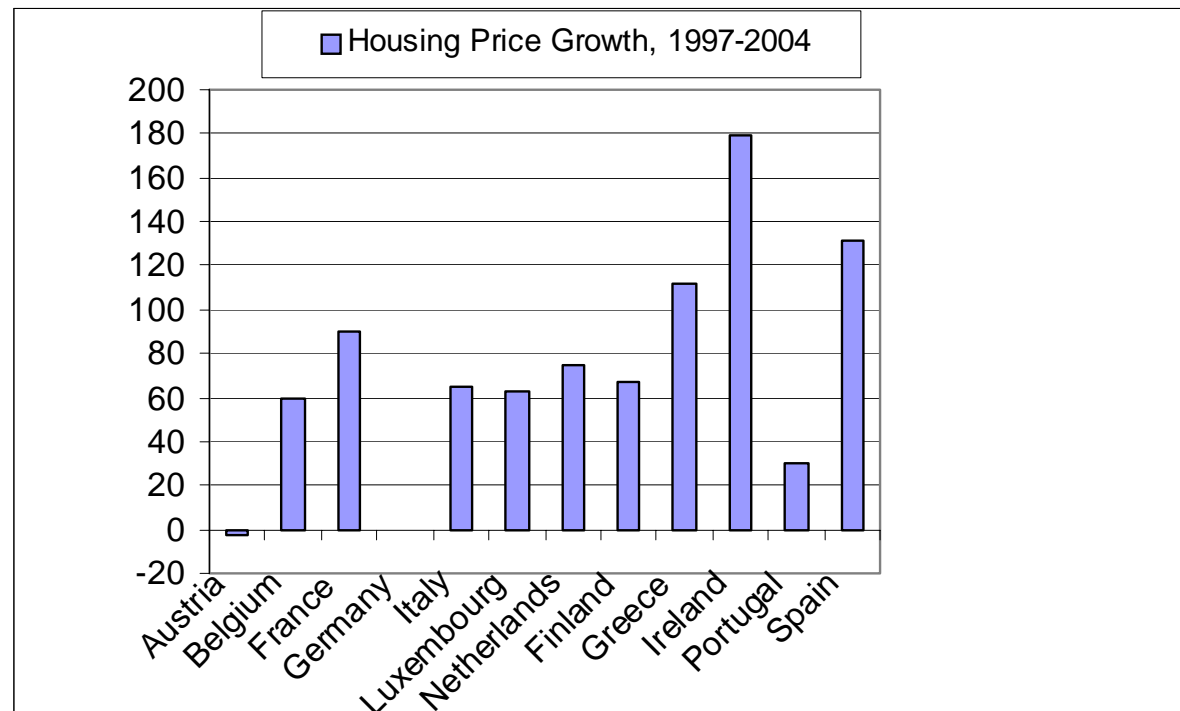
1999-2006 minus 1994-1998

Net position of credit institutions in Ireland vis-a-vis Irish residents



Source: Honohan (2006, updated)

Housing Price Growth, 1997-2004



Policy Issues

- Reap welfare gains from integrated financial markets
- Amplifying impact of net capital flows reinforces importance of avoiding procyclical fiscal policy
- (Special issue: asset-based tax revenues)
- Promoting flexibility in labour market and wage formation
- Role of migration flows
- Banking stability