

The Macroeconomics of Financial Integration: A European Perspective

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Introduction

- European experience with international financial integration quite different to patterns elsewhere
- Net capital flows from advanced to emerging member countries
- Impact of increased cross-border investment positions on macroeconomic interdependence
- Shifts in external adjustment mechanisms

Financial Integration and Convergence

- Global evidence very mixed: Prasad et al (2007), Rodrik and Subramanian (2008), Gourinchas and Jeanne (2007)
- Emerging Asia running surpluses; Africa: low growth and high aid-financed deficits
- Emerging Europe: large and persistent deficits
- Blanchard and Giavazzi (2002), Abiad et al (2008), Herrmann and Winkler (2008)

Why is Europe Different?

- Kose et al (2008): institutional environment central in determining relation between financial integration and growth
- Institutional anchor of EU membership a key differentiating factor
- Other emerging regions do not have close substitutes to assist institutional development

Features of EU Membership

- multi-dimensional institutional commitment; deep-rooted; irreversible
- Complementarities between free capital mobility and other freedoms (trade, labour, establishment)
- Harmonisation between advanced and emerging member countries
- Monetary anchor: the euro
- Financial anchor: EU FSAP and other initiatives
- Surveillance

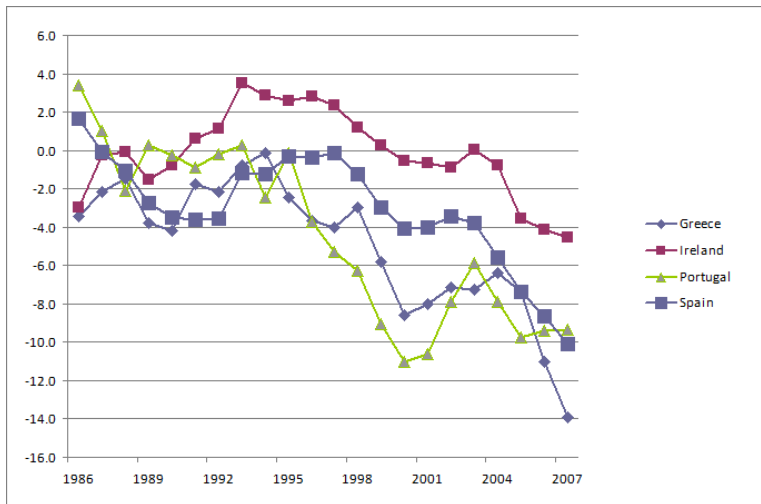
The First Wave: The Club of Four

- Greece, Ireland, Portugal, Spain
- Deficits in 1970s/1980s but not persistent
- Required financial integration in 1990s before persistent net capital flows possible
- Also improvement in macroeconomic discipline

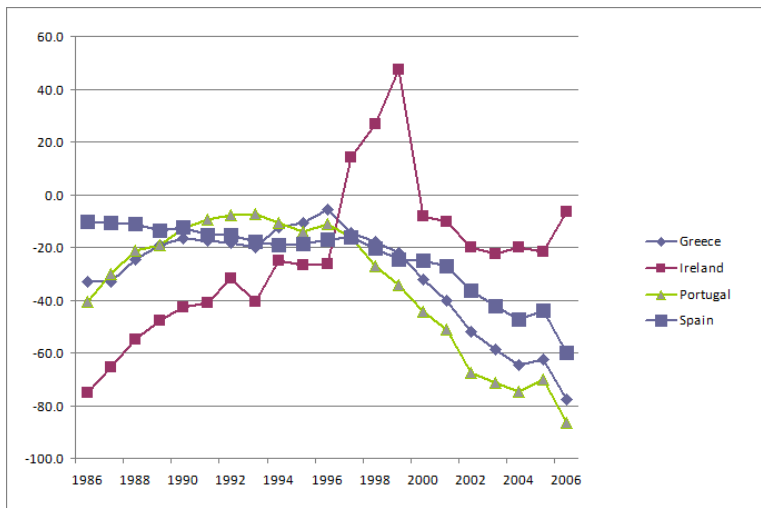
The Second Wave: Central and Eastern Europe

- Persistent and large current account deficits since late 1990s
- High FDI component
- Prominent role for foreign-owned banks
- Differences with other emerging market economies not explained by country-level fundamentals
- Accelerates convergence but also increases vulnerability to sudden stops
- Financial transformation of CEE not complete: catalytic impact of euro membership (Masten et al 2008)

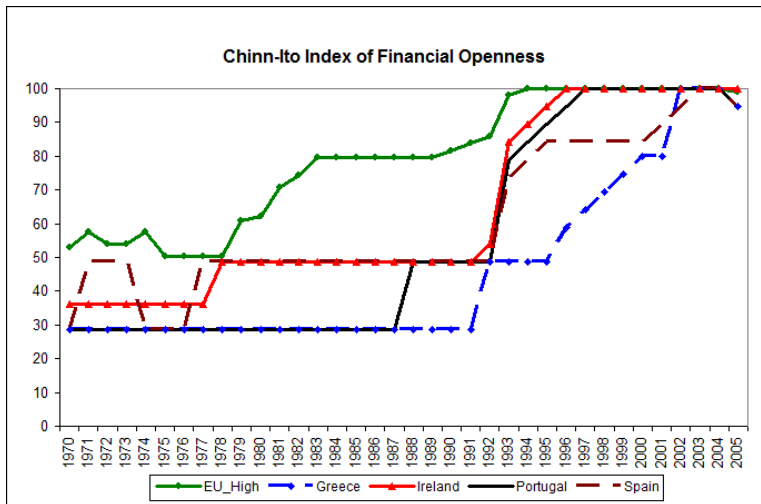
Current Account Balances 1986-2007



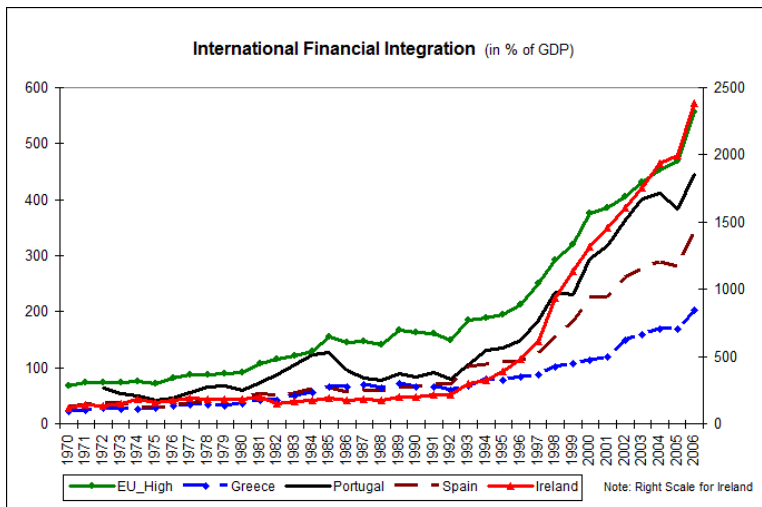
Net External Positions, 1986-2006. Note: Ratios of net foreign assets to GDP. Source: Updated version of Lane and Milesi-Ferretti (2007a).



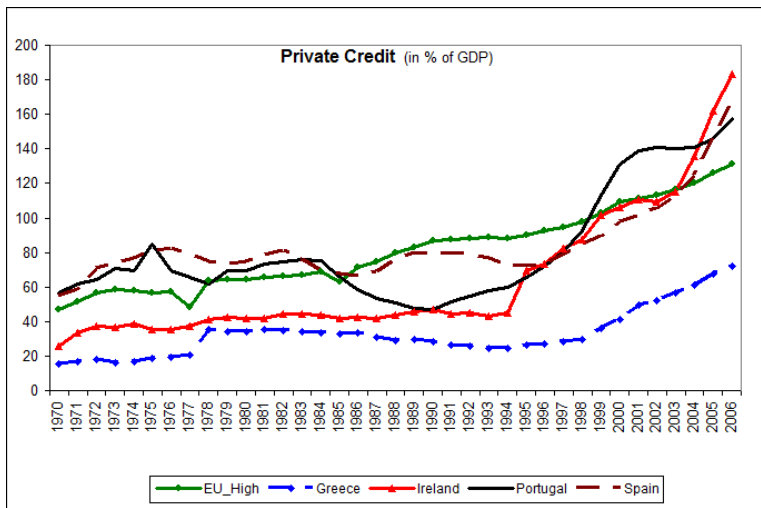
Chinn-Ito Index for EU4



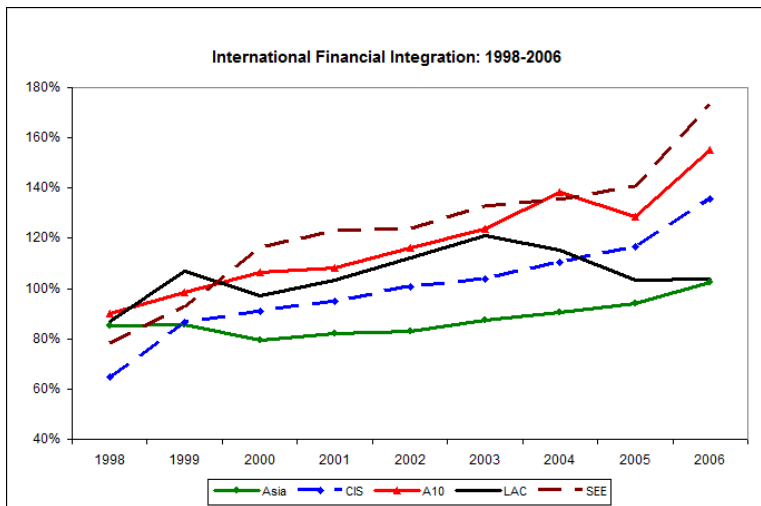
International Financial Integration: EU 4 Group. Note: Author's calculations based on extended version of dataset reported in Lane and Milesi-Ferretti (2007a).



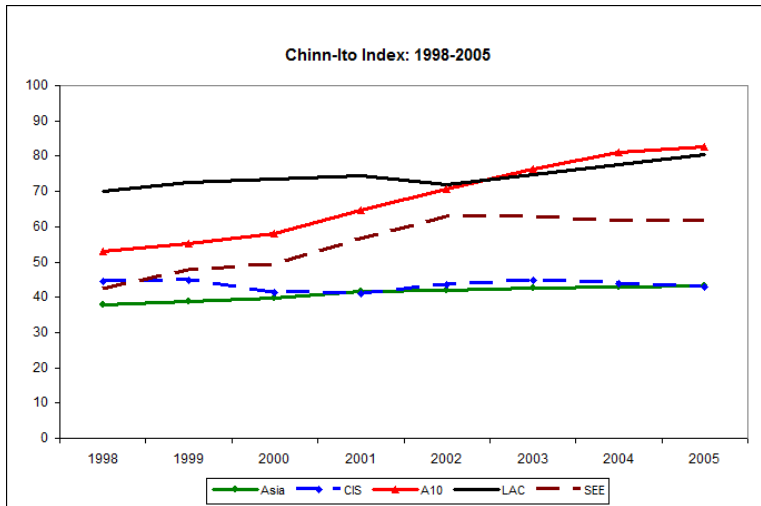
Financial Development: EU4. Note: Ratio of Private Credit to GDP, 1970 to 2006



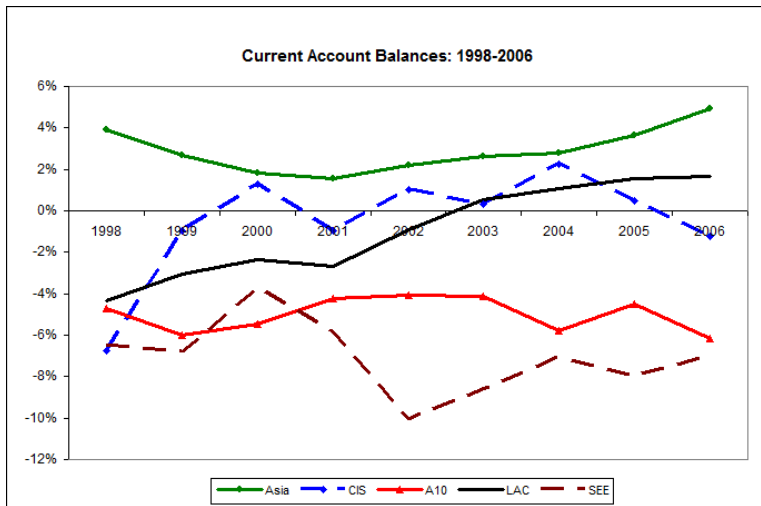
Trends in International Financial Integration, 1998-2006.



Chinn-Ito Index: Emerging Market Groups.



Current Account Balances, 1998-2006



Net Foreign Asset Positions, 1998-2006

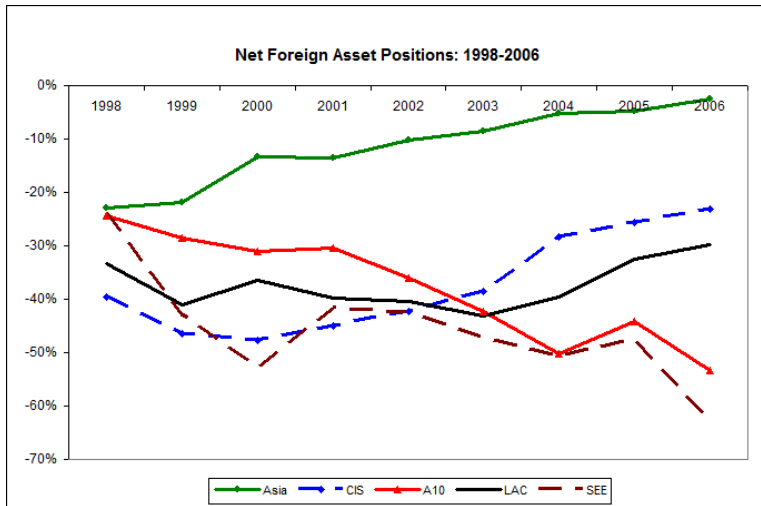


Table: Level and Composition of Foreign Liabilities

	1998			
	FLY	PEQL	Shares FDIL	DEBTL
CEEC	57.3	5.4	31.8	62.8
Em. Asia	54.0	6.1	28.0	65.9
LAC	60.0	7.3	29.4	63.2
CIS	52.2	0.3	31.0	68.7
SEE	51.0	2.3	15.4	82.3

Table: Level and Composition of Foreign Assets

	1998				
	FAY	PEQA	Shares FDIA	DEBTA	FXRES
CEEC	50.9	5.8	15.8	40.2	38.3
Em. Asia	50.0	2.1	8.2	27.4	62.4
LAC	36.9	9.8	19.6	42.5	28.1
CIS	56.3	2.5	2.5	63.2	31.8
SEE	55.3	2.5	6.7	42.9	48.0

Table: Financial Development Indicators

	Year	CEE	Em.Asia	LAC	CIS	SEE
Private Credit	1998	26.6	61.5	36.4	8.1	28.7
	2006	52.7	58.1	34.8	23.1	39.2
Stock Market Capitalisation	1998	10.8	27.0	20.7	1.2	3.7
	2006	31.1	57.5	40.1	14.3	38.3
Debt Securities	1998	44.6	54.9	40.5		29.7
	2006	66.0	70.8	60.7		51.2

Table: World Bank Institutional Quality Indicators.

		CEE	Em. Asia	LAC	CIS	SEE
Governance Indicator	1998	62.0	44.3	48.8	33.3	36.0
	2006	63.0	41.3	45.8	33.0	44.8
Doing Business Rank	2006	45.0	88.6	90.5	96.3	99.8

Europe and Financial Globalisation

- Current International Financial Linkages: Europe and the rest of the world
- Future Trends

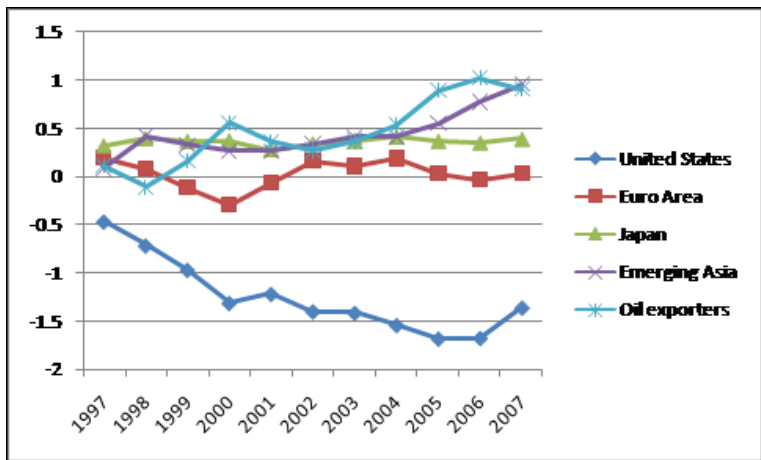
International Financial Linkages

- Global integration versus Regional integration: greater scope for diversification; facilitates globalisation of production
- But greater exposure to external shocks
- Growth in global cross-border investment positions
- Asymmetric: global imbalances
- Asymmetric: "Long Equity, Short Debt"
- Indirect channels

Europe's External Linkages

- Intra-European bias: gravity factors
- Currency bias: big shift to euro
- Divergence between advanced and developing regions
- Limited level of direct holdings
- Main channel indirect: global pricing factors

Global Imbalances. Note: Current Account Balances, scaled by global GDP. Source: IMF's World Economic Outlook (April 2008).



Global Configuration of Net Foreign Asset Positions. Note: Scaled by global GDP. Source: IMF's World Economic Outlook (April 2008)

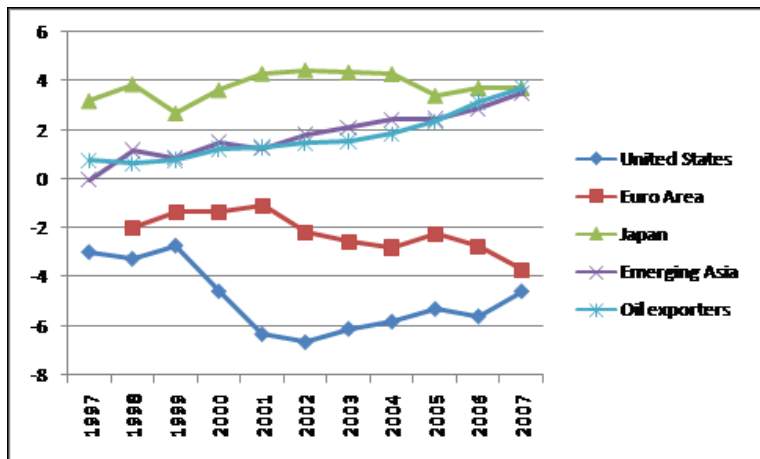


Table: Geographic Distribution of International Investment Position of the Euro Area

	EU27	US	China	Japan	ROW	Offshore
FDIA	36.7	19.9	0.8	2.2	29.5	10.8
FDIL	44.6	23.8	0.1	2.8	16.0	12.7
PEQA	24.2	33.3	1.7	9.0	21.0	10.8
PDA	36.4	32.1	0.1	3.3	14.1	12.8
OIA	52.0	13.3	0.6	1.7	21.4	10.0
OIL	47.7	12.8	0.5	2.4	21.0	14.2

Table: Foreign Currency Exposures. Note: FX^{AGG} is index of aggregate foreign currency exposure; $NETFX$ is aggregate foreign currency exposure, scaled by GDP. Source: Lane and Shambaugh (2008).

	FX^{AGG}	$NETFX$
Bulgaria	3.6	5.3
Czech Republic	17.4	26.8
Slovak Republic	1.1	1.7
Estonia	2.4	4.8
Latvia	-11.2	-18.5
Hungary	-11.2	-18.0
Lithuania	-8.7	-8.5
Slovenia	8.3	11.7
Poland	-10.5	-10.1
Romania	-3.0	-2.4

Future Trends

- Financial and institutional development: convergence in external balance sheets between advanced and developing regions
- Shift in direction of net capital flows: China the world's biggest debtor? (Dollar and Kraay 2006)
- International crisis management

Financial Integration and External Adjustment

- Cross-border financial impact of currency movements
- Cross-border financial impact of asset price movements (equity, FDI, debt securities)
- Leverage in external positions and liquidity risk

Exchange Rates and the Valuation Channel

- Differences between advanced and emerging economies (US this decade versus East Asia in 1990s)
- Intra-EMU: cross-border positions largely in euro: insulation
- Aggregate Europe exposed to dollar but not as much as Emerging Asia
- Euro Area: currency losses of 5 percent of GDP over 2000-2006 (ECB)

Asset Prices and the Valuation Channel

- Textbook model: external debt pays non-contingent fixed interest rate
- Increasing importance of tradable assets in international balance sheets
- Also increase in variable-return FDI
- State-contingent returns: potentially good for risk sharing
- Relation between growth and external sustainability altered
- Also volatility in net external position

External Leverage

- Positive expected returns from 'long equity, short debt' position
- Risk: exposure to liquidity run on liability side
- Foreign-currency debt: a problem
- Intra-EMU: country-specific liquidity problem
- Lessons from current crisis

Conclusions

- European success in facilitating 'downhill' capital flows
- Shifting nature of European role in global financial system: direct and indirect linkages
- External adjustment dynamics altered by international financial integration