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Measuring financial market integration in the European Union: EU15 vs. New Member States ☆

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A B S T R A C T

This paper quantifies financial market integration in the European Union, using a large array of credit and bond market indicators, stock market indicators, as well as indicators based on household and firm decisions. It focuses on comparing the evolution of the European Union before the Eastern enlargement (EU15) with that of the 12 New Member States (NMS) that joined after 2000. It documents improvements in the integration of the credit and bond markets as well as stock markets for both groups within the EU27, the heightened heterogeneity brought about by the NMS, but also a reversal of the integration process over the recent years (corresponding to the financial crisis), divergence disrupting both the EU15 core and the NMS. For all the decades of achievements within both the EU15 and NMS groups in terms of credit and stock market integration, the ultimate goals of financial market integration, perfect capital mobility and full international risk sharing remain out of reach.

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1. Introduction

Measuring financial market integration in absolute terms is a practical impossibility. There are many forms of barriers that segment national markets, ranging from straightforward legal obstacles to subtle cultural biases that require very different amounts of time and effort to be dismantled. At a given point in time, many different battles are fought against barriers to cross-border financial transactions and success or failure can be encountered in various proportions, depending on the standpoint of the viewer. Two strategies are available in order to gain more focus. The first is to zoom in on a single and narrowly defined

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market segment and its particular measure of integration. Specialization in this sense, becomes an essential tool for expanding the state of knowledge in the area. However, its findings are limited to the chosen (sub)field of research. The second strategy focuses on a certain region or group of countries and uses a large amount of indicators relevant to various aspects of market integration in order to construct a general perspective on the achievements and setbacks of the process.

This paper uses the latter strategy, putting together a large number of indicators, as various pieces of an incomplete puzzle, with the aim to provide a general perspective on the process of European financial market integration. The list of indicators covers various aspects relevant to integration, such as evolutions in credit and money markets, stock markets as well as the impact of aggregate production and consumption decisions. Using a large array of indicators leads to a comprehensive but mixed view on the achievements in terms of integration. Some segments of the market are more easily aligned to their foreign counterparts, whereas some areas are more strongly dependent on local (segmenting) factors. A typical example refers to the different evolutions for the money market rates (one of the best examples of a fast integrating market segment) and mortgage rates where markets harbor more idiosyncrasies. However, positive evolutions as well as the less successful areas are especially important since the experience of the pre-enlargement European Union serves as an example and reference to the East-European New Member States (NMS).

The Eastern enlargement is a European decision, which transcends mere economic reasons. It is atypical in many respects, as it means extending the European Union “umbrella” over a set of countries that come from a different past and have quite uneven evolutions in trying to put it behind them. For these countries, financial integration deserves plenty of focused attention, since, if accomplished at a higher pace, it has the ability to act as a catalyst and offset imbalances in other fields. In the context of the current financial crisis, the element of risk and contagion which is the reverse of the medal when it comes to financial market integration becomes relevant as well. Applying several tests for financial integration for the NMS from Central and Eastern Europe (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia) as well as Cyprus and Malta (which also joined the EU in 2004) shows that there is considerable heterogeneity among the NMS which is brought about in the EU27. The recent financial turmoil however adds divergence at all levels within EU15 as well as NMS.

The remainder of this paper is organized as follows. Section 2 discusses the special case of the European Monetary Union (EMU) and the motivation for a more thorough investigation of the process of financial integration taking place in Europe. Section 3 reviews the results of various tests of financial integration applied to the 27 members of the EU as well as to the EU15 and NMS subgroups. Section 4 makes some concluding remarks.

2. The European (Monetary) Union — the case for faster integration

L'Europe se fera par la monnaie ou elle ne se fera pas was Jacques Rueff's prophecy in the 1950s. European integration is a long process of economic cooperation on increasingly higher levels: a customs union, the single market, macroeconomic convergence, exchange rate coordination and ultimately a common currency. On January 1, 1999, eleven European Union countries formed a monetary union. Greece joined them two years later. Slovenia, Cyprus, Malta, Slovakia and Estonia are the most recent members of the Euro Area. For 17 European countries now, exchange rates have been fixed, the euro was introduced as the common currency, the European Central Bank began operating and implementing the common monetary policy, and all Euro Area government bills and bonds have been denominated in euro.

The case for the common currency draws on Mundell's Theory of Optimum Currency Areas (1961). In this early work, Mundell (1961) advocates the role of flexible exchange rates as a substitute for other adjustment mechanisms such as price and wage rectifications or central fiscal transfers and warns against common currencies that do not match their optimum areas. This initial view points out that an independent national monetary policy with exchange rate flexibility is the most efficient way to deal with asymmetric shocks even for small countries. A later view of Mundell (1973a,b) “rediscovered” by McKinon (2000) contains the novel argument that having a common currency across countries can mitigate asymmetric shocks by better reserve pooling and portfolio diversification. A country suffering an adverse shock can better share the loss with a trading partner when both countries hold claims on each other's output in a common currency. Residents of a country can insure ex-ante their income source against fluctuations resulting from an asymmetric shock by holding claims on dividends, interests and revenues

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