EU Financial Integration: Is There a 'Core Europe'? – Evidence from a Cluster-Based Approach

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Abstract: This paper identifies groups of financially integrated countries from a macro-level view. It innovates by applying an inter-temporal cluster analysis to eight euro area countries from 1995-2002. Our results indicate that euro countries were divided into two stable groups in the pre-EMU period. Back then, geographic proximity and country size might have played a role. This situation has changed remarkably with the introduction of the euro. The findings suggest as well that EU financial integration takes place in waves, and that there might exist maximum similarity barriers.

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1. Introduction

It is important to measure the progress of financial integration from a variety of perspectives (see EU Commission, 2004a, 4). Direct, qualitative approaches identify economic and regulatory barriers; whereas indirect, quantitative approaches analyze the observable consequences of these barriers (see Schüler and Heinemann, 2002, 35). Micro-level analysis focuses on a separate assessment of, for example, individual financial market segments, value-chain elements, and efficiency indicators, whereas macro-level analysis performs a simultaneous assessment of these areas. All approaches provide insights into the impact of integration initiatives, and provide guidance for the drivers of integration, namely market forces, collective action within the market community and public authorities, in their targeting of future action (see ECB, 2003, 53).

From a quantitative micro-level view, the progress of EU financial integration is by now well-documented. A rich literature on EU financial integration has developed over time, and a broad set of sophisticated methods and indicators have been applied.[2] The numerous findings are reflected in a variety of recent studies, such as the taking stock of indicators in the EU Commission's first Financial Integration Monitor[3], and in the manifold publications of the ECB-CFS research network on EU financial integration.[4] This research shows "that different market sectors have attained different levels of integration" (Baele et al., 2004, 81). In fact, "(…) 'integrated wholesale markets, fragmented retail markets' is how most mainstream analyses would probably summarize the state of the euro area banking business" (Manna, 2004, 7). Some of the remaining challenges and deficiencies are currently being tackled within the framework of the FSAP, but the debate on a post-FSAP agenda has already begun.[5] "Such a debate naturally has to start with a (...) review of the accomplishments to date" (Walter, 2004, 3).

The aim of this paper is to contribute both to the micro-level research and to the discussion about the post-FSAP-agenda by shedding further light on the EU financial integration process from a macro-level perspective. Although the perspective is different, the underlying motivation, that is the assessment of the status quo, progress, and trends in EU financial integration, corresponds to that of the micro-level research. However, our research questions differ:

1) Are there stable groups of financially more closely integrated countries?
2) Are there two or more speeds of financial integration across groups of European countries?
3) Do some EU countries form a financially integrated 'Core Europe'?
4) Is the choice of Germany as a benchmark for measuring the progress of EU financial integration justified?

The task that links these research questions is to find empirical evidence for the intuition that financially more closely integrated countries exist. In answering the stated research questions, we hypothesize that the barriers to financial integration - regulatory, legal, tax-related, geographical, cultural, and historic - will be visible in the building of country groups, if this exists. 'Mobility barriers' should prevail in fragmented EU financial markets, and should have led to the formation of stable groups of financially more closely integrated countries. The well-documented reduction and removal of these barriers over time should have reduced the differences between these groups as well as between individual countries. In turn, this reduction in differences, that is this financial integration process, should have translated into a change of the groups' composition. With increasing degrees of financial integration, it could be expected that countries leave their traditional group, join other groups, or form new groups.

The insights provided by our research are of value for EU policy initiatives. If it can be verified that the old EU member states have formed stable, financially more closely integrated groups in the past, and that the groups' composition could be changed, it should be possible to derive implications from these results for the current efforts to fully integrate the ten young EU member states into the emerging EU financial system.[6] Such verification adds in particular to the discussion of whether the undisputable differences between the old and young EU member states, and, more narrowly, between the current and potentially new euro countries, might