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Gains from financial integration in the European Union: Evidence for new and old members☆

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Abstract

We estimate the benefits of financial integration resulting from international risk sharing among the 25 EU countries. Under full risk sharing, country-specific output shocks are diversified across the EU members and output volatility of an individual country is not reflected in its consumption. The gains from risk sharing are expressed as the utility equivalent of a permanent increase in consumption. We report positive potential welfare gains for all the EU countries if they move toward full risk sharing. Ten country-members who joined the Union in 2004 would potentially obtain much higher gains than the longer-standing 15 members.
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1. Introduction

In 2004, 10 central European countries became members of the European Union (EU).[1] In general, the enlargement of the EU is considered a welcome development. Still, the entry of new, mostly emerging-market, economies with a history of relatively high macroeconomic volatility sometimes raises concerns among policy-makers and the public. We claim that such concerns do not take into account the stabilization-enhancing effects of economic integration brought about by the EU enlargement. We estimate potential gains from financial integration for the pre-2007 European Union (EU-25). Our criterion of integration is the degree to which a country's consumption is insulated from country-specific output shocks ("risk sharing").[2] In the case of full risk sharing, all country-specific output shocks (changes in terms of trade, fluctuations in production, policy reforms, natural disasters, etc.) are completely diversified and output volatility of an individual country is not reflected in its consumption.

We empirically show that if the 25 EU country-members move toward full risk sharing, all of them would gain from diversifying country-specific risks.[3] The 10 newer EU members would have much higher potential gains than the 15 longer-standing members.

The merits of greater openness to cross-border capital flows are often disputed because of the recent financial crises and instability in a number of the emerging-markets (see Rodrik, 1998; Bhagwati, 1998; Stiglitz, 2002). While excessive output volatility is undesirable for any economy, the inability of individual members of the eurozone to reduce the impact of the adverse output shocks by monetary and exchange-rate policy instruments is a major concern for the current and prospective members of the European Monetary Union (EMU). Optimum currency area (OCA) literature originated by Mundell (1961) and McKinnon (1963) suggests that the lack of independent monetary policy may lead to a significant loss of welfare and even break-down of a monetary union if the union members exhibit non-synchronized (or "asymmetric") output fluctuations and international capital mobility is limited.[4] The full capital mobility version of OCA subsequently advanced by Mundell (1973) posits that macroeconomic asymmetry does not preclude countries from forming an OCA as long as they effectively share their output risks. Clearly, the conclusions about the desirability of economic and possible monetary integration should take into account the risk-sharing opportunities integration brings.

[1] The pre-2004 EU included Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and United Kingdom; we call them "the EU-15 members" throughout the paper. Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic, and Slovenia joined the EU on May 1, 2004. We call them "the new EU members." We do not consider Romania and Bulgaria who became EU's 26th and 27th members in 2007.

[2] In the literature risk sharing is often referred to as "consumption smoothing" and "consumption insurance." We use the three terms interchangeably, unless explicitly say otherwise. We refer to the difference between country-level and the EU-wide variables as "country-specific."

[3] We express the welfare gains from risk sharing as the increase in the level of a representative EU resident's (or, by extension, a country's) permanent consumption that would generate the same expected utility gain as lower variability of consumption under full risk sharing. This metric is common in the risk-sharing literature (see Prasad et al., 2003 for review).

[4] Other OCA criteria include a high degree of labor mobility and close trade ties between he potential currency area members. McKinnon (2004) reviews the development of the debate in the context of exchange-rate regime choice in an easily readable review.

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