ASPECTS OF THE EURO AREA FINANCIAL SYSTEM FRAGMENTATION

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Abstract

With the emergence of the global financial and economic crisis, a number of side effects have been felt both in the U.S. and especially within Europe, particularly in the euro area. Among those, it stands out the financial-banking market fragmentation issue, a phenomenon discussed and analysed by financial experts, analysts, researchers and political leaders. The term fragmentation can be seen in antithesis with the concept of integration, the presence of one not involving the entirely cancellation of the existence and the effects of the second. However, a reduction in the effects of fragmentation may contribute to the increase of the economic and monetary integration, which is the desired facet for a fully functional European Union (EU). Moreover, in order to create a viable Economic and Monetary Union (EMU), it is essential to reverse the phenomenon of fragmentation of financial markets and restore the path of European integration. Thus, this article proposes to follow the conduct of the phenomenon of fragmentation in the euro area in order to develop some measures which would allow the diminishing of its negative effects.

Keywords: effects of the global financial and economic crisis, EMU, integration, fragmentation, financial system

JEL Classification: G01, G15, F15, F12

1. Introduction

In the literature and in the activity of the practicians, the term of fragmentation is analysed from many points of view, similarly with the term of integration. For instance, at the macroeconomic level, one may speak of regional fragmentation/integration, fragmentation/integration of the euro area, fragmentation/integration of the single market, while at the microeconomic level the issues concern the fragmentation/integration of the banking system,

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fragmentation/integration of the financial markets within a particular country, fragmentation/integration of the different processes within an enterprise or between enterprises.

Concerning the fragmentation at the macroeconomic level, one may speak of a disordered, fast and/or strong movement of capitals from one side of the world to the other or within a particular geographical area, but one may also analyse at the microeconomic level of an individual branch (for instance, if we speak of the banking system, about migration of the debtors and creditors towards "strong" and "safe" banks while avoiding the "small" banks and the banks originating from the euro zone countries that have problems), between different branches of the economy or within an individual institution, such as fragmentation among the products provided by a bank, which causes serious imbalances due to the migration of the banking balance from one side to the other side, where there are positions that are considered to be safer and more attractive (such as lower volume of credits and higher volume of governmental bonds from the core countries of the Euro zone or bonds issued by the government of the host country). Even at the level of a particular region, for instance, the Euro zone, we may speak of fragmentation of the financial market between the core countries and the periphery countries, deeply affected by the sovereign debts crisis. From the available multitude of approaches we selected and focused our analysis on the fragmentation within the EU, and of the Euro zone, particularly.

2. Is the fragmentation phenomenon dangerous for the Euro zone?

The sovereign debts crisis, which started in late 2009, brought again to the forefront[1] the problem of the financial fragmentation within the European Union, within the Euro zone particularly; however, it has been present in various forms and degrees of intensity even before the crisis started. The phenomenon of fragmentation is opposed to the phenomenon of integration, the financial integration being a major component of the economic integration. The very establishment of the European Union is a complex and advanced form of economic, political, legislative, social

[1] *BCE, Financial Stability Review, December 2012 and May 2013, IMF reports, World Economic and Financial Survey, Global Financial Stability Report, Restoring Confidence and Progressing on Reforms, October 2012 and Global Financial Stability Report, Old Risks, New Challenges, April 2013.*

and cultural integration of the composing national economies; the euro zone has an even more integrated financial system designed to support the single currency policy.

Several "elements" help us understand the phenomenon of fragmentation within the EU, among which the current economic crisis from Europe and the triangle companies-institutions-the state.

The current crisis from Europe revealed the, not so fair, policy of the banks of making private profits and of sharing the losses with the tax-payers (Lemaitre, 2008), which shows the disagreement between this policy and the public at large. Under the pretext that the governments are the rescuers of the banks they take excessive risks.

Under the pretext of preserving the stability of the European citizens (political reasons, therefore) the central administrations made lobby is different forms to bail out the private entities (manufacturing companies or financial institutions). The financial assistance was either in the form of state participation to the capital of the private companies (some kind of nationalization), or as different programs supporting the economy or the consumers by cutting the taxes.

In order to cope with these expenditures, the national states were forced to take loans, through the mediation of the same financial institutions. Under the present conditions, the loans came from other developed states. If problems appear in these developed states too, the above-mentioned triangle runs the risk of breaking.

The contagion caused by the manifestations of the crisis is feared both by EU officials and by the rest of the world. This is the reason why in the EU there are a lot of discussions about bailing out the banks from the states that have problems (Greece, Spain, etc.). Within this context there are increasing demands to establish a single banking monitoring system, the European Banking Union, as well as to introduce measures aiming to save and preserve the health of the credit institutions and the stability of the financial system, to divide the activity of the banks.

The establishment of the Single European Bank Surveillance System actually is the first step towards the establishment of the European Banking Union, which means the development of a single framework to cure the "problem banks", uniformization of the schemes which guarantee the bank deposits and the establishment of a mechanism of fiscal assistance from the governments.

All these steps at are the pillars of the European Banking Union, whose establishment is very important in order to avoid the current fragmentation within the Euro zone. It has been quite clearly, for instance, that the German banks avoided the French market these recent years. Also, the German and the French banks started to pull out from Spain, while the Spanish banks pull out from Portugal. The situation from Greece is even worse, very many European banks withdrawing from there. These movements of the banks cause unwanted and dangerous effects: they complicate the mechanism of monetary transmission particularly in the Euro zone, they prevent the free circulation of the capital and isolate the banks with problems from the Euro zone.

The *fragmentation of the Euro zone* ultimately leads to the *fragmentation of the single market*, which is the main pillar of the EU. Subsequently, the fragmentation of single market could blow a devastating effect on all the national economies, both within the EU and at the regional and worldwide level too.

The draft of regulation for the Single European Bank Surveillance System includes several provisions, three of which are mostly debated: the institution which to monitor the banks throughout Europe; the number of banks to be included in this system and whether the banks from the member states that are not within the Euro area should be included or not within this system.

These provisions have both supporters and contenders. The supporters of the last two provisions invoke the same requirement, which is to preserve the integrity of the single market of the financial services.

Under the pretext of a better protection of the economy, of the clients and of the financial sector, the EU financial experts recommended the division of the banking operations: separation of the investment banking from the commercial banking. These recommendations have already been implemented by several countries such as Great Britain and the USA. The European proposal demands that the two operations (investment banking and commercial banking), but that they maintained within the same universal commercial bank, preserving thus some group synergy. The investment banking services will be allowed only for the banks which have deposits. The separation of the two operations should become compulsory only if the value of the traded assets and of the assets available for sales exceeds by 15-25% the total value. The European financial experts consider that in this way, the banks would become more simple and easier to monitor.

EU recommendation is strongly criticised both by the banks and by some analysts who consider that the banking system will suffer due to additional financial efforts.

Given the power of the large banking groups and, therefore, their reluctance towards this recommendation, the authorities may demand a deeper separation in order to require the division of the large banks. Currently, in the EU there are very many banks with a rather precarious capitalization. The demanded division would just weaken further their capital and therefor increase the operational costs of these banks, which would, of course, end up being borne by the clients.

Although the fragmentation of the financial market started on the background of the sovereign debts crisis (consequence of the global economic and financial crisis), it continues to disturb the existence of EU countries and will continue to do so even after the misbalances will be solved, thus affecting the capacity of the banks to provide credits to the economy. The economic and financial crisis produced strong disturbances within the banking market by the build-up of sovereign debts within the portfolio of the banking system, particularly in the countries experiencing hard timed (Greece, Ireland, Cyprus, Italy, Spain, Portugal and Slovenia). As this problem was noticed, the EU banking system, particularly the banking system within the Euro zone, tried to reduce gradually their exposure to these countries, so that indebting turned even more difficult and getting loans became restrictive not just for those particular countries, but also for the banking system from these states affected by the sovereign debts crisis. Thus, the phenomenon of financial market fragmentation within the Euro zone is the result of the difficult conditions encountered by the issuers of sovereign debts bonds, of the liquidity and capital constraints affecting the financial sector (the banking sector particularly), but also of the current overall economic situation, the economy still being in a state of stagnation.

Furthermore, although it rather seems to be some kind of regional problem, the sovereign debts crisis from the Euro zone may be serious threat to the global financial stability[2], on the background of the persisting feeling of incertitude on the markets, which contributes to the deficient distribution of the capitals both at the level of a country or region, both between countries and geographical areas of the world.

The countries affected by the sovereign debts crisis display *considerable pressures on the financial crisis due to the lack of access to financing*, which produces imbalances of capital allocation

[2] *IMF, World Economic and Financial Survey, Global Financial Stability Report, Restoring Confidence and Progressing on Reforms, October 2012.*

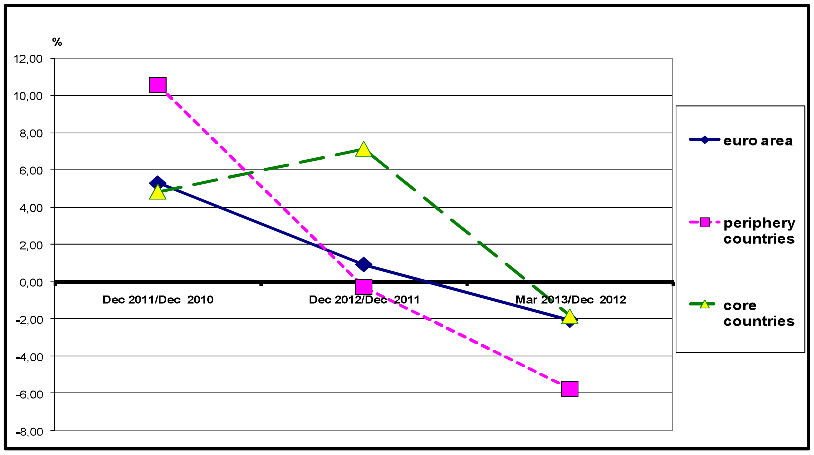
and which disturbs the price of the assets. Fragmentation was also noticed within the banking system by “clogging” the transmission channel of the funds from the lenders to the borrowers. The non-financial sector, mainly the SMEs suffer most on the short term in the countries affected by the sovereign debts crisis. For instance, in these countries, the financing cost for the SMEs is twice as high as in other countries, in Spain, the financing cost for the SMEs being 35% higher than the average of the Euro zone (Maudos, 2013). The disturbance of the non-financial system due to the restricted access to financing is reflected sooner or later on the financial system of a particular country, affecting ultimately the financial stability of that country spreading, by contagion, in wider areas (such as the Euro zone, all the EU).

An indicator of the financial fragmentation is the relocation of the bank deposits. Thus, the investors and the large companies, showing an increased sensitiveness to the variations in the state of the countries affected by the sovereign debts crisis, moved their deposits from these countries to “safer” countries, sometimes within the same geographical area. For instance, the deposits from the Euro zone countries with problems migrated towards other countries from the Euro zone (since the end of 2011, this internal relocation of the deposits reached 6 billion Euro, according to ECB (BCE (*Financial Stability Review*, December 2012)).

We may also notice the *orientation of the financial decisions towards their own country*, both concerning the accumulation of sovereign debt and concerning the credits for investments, in order tod decrease the cross-border exposure. This phenomenon can be seen from the decreasing inter-banking credit of the banks resident in the countries less affected by the sovereign debts crisis towards banks from the countries affected by the sovereign debts crisis. For instance, as of the end of 2011, the cross-border credits decreased by 17% for the banks located in countries experiencing difficulties, compared with just 2% in the rest of the Euro zone (BCE, 2012).

As a natural consequence of these aspects shown above, the *availability of foreign finances to support the private non-banking sector decreased, while the differences in the cost of financing increased*. The rate of credit increase displayed a negative growth (more than -5%) in the Euro zone periphery countries affected by the sovereign debts crisis (Figure 1), the situation displaying large difference within the entire EU. The decreasing demand for credits in the euro zone countries in difficulty was not accompanied by the decrease of the interest rates for the bank loans, which shows that the offer of credits plays an important role in the preservation of this situation, the Euro zone still being dominated by a strong risk aversion and by a macroeconomic environment which still is extremely frail. Furthermore, the companies and the population from the countries affected by the sovereign debts crisis are much more dependent on the bank credits, fact which worsens their perspectives of getting the financing they need.

Figure 1 – Foreign credits of the banks towards the non-banking sector form the Euro zone, annual growth (%)



Source: BIS data, calculations by the author. The core countries are considered to be: Finland, Germany, Luxemburg, Netherlands, Belgium, Estonia, France, Malta, Austria, Slovakia, while the periphery countries are considered to be: Greece, Ireland, Cyprus, Italy, Spain, Portugal and Slovenia

Actually, as a consequence of the unfavourable evolutions and of the tensions displayed by the markets of the sovereign debts, a higher credit risk is perceived and associated to the banks from the Euro zone, particularly to the banks from the countries having difficulties to manage their sovereign debts. As the credit risks increase, the banks from the countries affected by the sovereign debts crisis recorded higher costs for refinancing. Thus, the lower volume of credits taken by the companies and by the population can be perceived as a response reaction to credit limitation showing the fragmentation of the inter-banking monetary market. In 2012, part of the deficit of funds felt on the market of the inter-banking credit, securitized or not, was covered by ECB operations, particularly by the *LTROs*, aimed to inject liquidity within the system. Besides the lower volume of loans, a lower volume of the inter-banking cross-border deposits was recorded. For instance, according to ECB (*Financial Stability Review*, December 2012), in mid 2012, the inter-banking cross-border deposits accounted for just 20% of the total inter-banking deposits within the Euro area, compared to 45% in 2008.

The sovereign debts crisis put pressure on the banking markets by deteriorating the financing perspectives, which contributed to the fragmentation of the banking sector from the Euro zone and not only. The sovereign risk affected in many ways the financing conditions of the banks. Thus, the sovereign debts "embedded" into the balances among the purchased debts titles, lead to a higher exposure of the banks to the evolution of the debts, weakening at the same time the perception of the investors about the quality of the banking system particularly in the countries strongly affected by the evolution of the public debts.

At the same time, the expansion of the sovereign risk questions how much and what part of the banking portfolio is still sustainable, so that the banking system can continue to borrow. The shift of debts from one state to another, through the banking system, perpetuates the contagion effect between states, deteriorating the financing conditions both within the Euro zone countries and the EU as a whole, and at the level of the banking system.

It is difficult to foresee, both in time and space, the conjugated effect of the sovereign debts crisis on the banking system from the Euro zone and on the economies from the Euro zone countries, but it is visible that fragmentation remained an important problem which threatens the financial stability from this part of the world. ECB, through the standard and non-standard measures taken from the very moment when the sovereign debts crisis started to show up, tried to alleviate the dangers threatening the financial stability of the Euro zone and to correct the transmission mechanism of the monetary policy, the local conditions for credit having to reflect the adjustment of the key interest rates of ECB monetary policy. The European Council too joined ECB measures to limit the adverse effects of the sovereign debts crisis by establishing possibilities for direct recapitalization of the banks through the European Stability Mechanism, as the Single Supervisory Mechanism became operational in June 2012, in the attempt to break the adverse relations between the sovereign debts crisis and the functioning of the banking system.

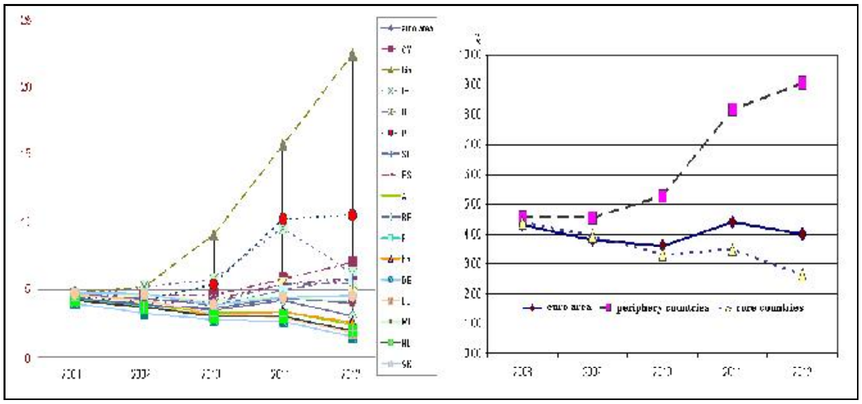
The operational costs, which are still very high, may lead to a process of disordered disintermediation at bank level, thus causing the fragmentation of the banking market. The eligibility conditions for credits are still tightened on the background of these high costs, particularly for the small companies, which don't have at all an easy access on the capital market. For instance, according to the report on the financial stability from May 2013, ECB showed that the average interest rates for new loans taken by SMEs (of about 1 million Euro) in Germany and France were at historical low limits, below 3%, while the similar rates reached values of 4.5-5% in Italy and Spain. This leads to the fragmentation of the market for banking financing, contributing to the economic divergence of the countries from the Euro zone. Actually, it might be even worse the fact that besides the fragmentation of the financing by the migration of the capital from one country to another, a process of relocation of the companies may occur, based on reasons of economic, fiscal, politic and social environment, plus the actual conditions of financing from the banking market of a particular country.

Of course, it is only normal and natural that there are differences of cost between the products offered by the financial-banking system, which enables an efficient allocation of the capitals within a particular country of between countries. However, if the differences are noticeable (both geographically and in time), they may lead to important migrations of the capital towards more attractive areas, and this will create a local "vacuum" of financing which is difficult to cover on the short and medium term. This has actually happened within the Euro zone, producing a strong divergence between the interest rates for the credits granted by the core countries and by the periphery countries. The fast migration of the capitals from the countries at the "periphery" of the Euro zone towards the core countries may lead to the phenomenon of *sudden stop* and even to currency crises.

At the same time, the monetary transmission mechanism showed to have flaws, particularly since even though ECB reduced the monetary policy interest rates, this was not been seen in the interest rates for the credits granted by the periphery countries.

If we watch the interest rates for the long-term governmental bonds according to the Maastricht criterion over the period 2008-2012, we may notice that the gaps widened between the core countries and the periphery countries affected by the sovereign debts crisis (Fig. 2).

Figure 2 - Interest rates for the long-term governmental bonds according to the Maastricht criterion (%)



Source: BIS data, calculations by the author. The core countries are considered to be: Finland, Germany, Luxemburg, Netherlands, Belgium, Estonia, France, Malta, Austria, Slovakia, while the periphery countries are considered to be: Greece, Ireland, Cyprus, Italy, Spain, Portugal and Slovenia

The graph shows a “compression” or reduction of the gaps between the yields of the long-term governmental bonds in the core countries and an increase, or “explosion” of them in the periphery countries. Thus, over the period 2008-2012, the minimal values were reported for Germany, while the largest values were reported for Malta, Ireland and, lately, for Greece, the differential between the minimal and maximal data increasing strongly from just 0.83% in 2008 to 21% in 2012. The higher volume of such bonds in the portfolio of banks increased the risks assumed by the banks and, implicitly, the cost of their products. Hence, the investors were worried by the possibility of higher costs of bank recapitalization, of higher risks attached to the fiscal consolidation of the Euro zone countries (particularly the countries having difficulties with the public debt) and of an even deeper economic contraction. Thus, the withdrawal of a significant share of investors active on the market of the sovereign debts in the countries from the periphery of the Euro zone affected the banking market from these countries by a lower volume of deposits of the non-resident people and by a lower availability to provide financing,

Regarding the bank assets, although the European countries made important efforts to recapitalise, strengthening their balance and preventing an important reduction of the assets, however, according to IMF[3], from the end of the third quarter 2011, until the end of the second quarter 2012, the total assets (excluding the derivatives and the intangible assets) of the largest banks in the EU decreased by 600 billion USD or 2% of the total bank assets.

Because of the phenomenon of fragmentation, in the first quarter of 2012, much of the process of de-intermediation which contributed to the decrease of bank assets, is due to the policy of banks to reduce the size of their balance by de-investment and reduction of the less important activities (such as Great Britain), by the decrease of the assets in other currencies (for instance, the French banks reduced their exposure towards the assets expressed in US dollars), by selling their branches in other parts of the world (for instance, the Danish banks closed their subsidiaries from the United States and Latin America, while some Austrian banks sold their subsidiaries from Easter Europe counties), by separating the banking activity from other activities (such as from the insurance activity, in Denmark) (IMF, 2012). Therefore, we should not be surprised by the increasing gaps between the core and the periphery countries in terms of credits granted for the economy, this process gaining speed in the first groups of countries and crashing in the second group because of the significant reduction of the exposure of the banks towards the countries from the periphery of the Euro zone.

At the same time, the phenomenon of fragmentation can also be a consequence of the reactions to the persistence of risks related to the redenomination of the Euro (the countries aiming to revert top the local currencies). Although the risk of redenomination is not significant, meaning that it will actually happen, however, the important banks from the EU, particularly from the Euro zone, tried to compensate locally the assets with the liabilities and to limit financing by the “mother” banks for their representatives in the periphery countries.

Furthermore, according to IMF (2012), the European banks used their subsidiaries from the periphery countries of the Euro zone to obtain financing through LTROs refinancing operations, and some cross-border banks operating in the periphery countries used, through their branches, the sovereign debts of the particular periphery countries to obtain liquidity from the local central banks. This situation is also due to the regulations which aim to protect the local depositors. As an adverse effect of these regulations is that, wanting

[3] *IMF, World Economic and Financial Survey, Global Financial Stability Report, Restoring Confidence and Progressing on Reforms, October 2012.*

to avoid contagion, some host countries imposed restrictions to the banks from the periphery countries to obtain funds from other countries through their branches. Actually, each country tried to protect against a possible outflow of capitals or against contagion with the sovereign debts crisis through the banking system, thus deepening further the gaps between the core and the periphery countries of the Euro zone. These gaps led to the fragmentation of the financial-banking market, concomitantly with a phenomenon of financial "repression"[4].

Conclusions

At the beginning of 2013, the fragmentation of the banking market was still a problem, the financing costs remaining still very different depending on the country where the bank had its headquarters and on the bank size. The financing costs remained extremely high, even for the large banks from the Euro zone, even though they are privileged and have an easier access to financing. As of February 2013, the process of issuing bonds slowed significantly due to the incertitude related to the elections in Italy and after the official assistance for the banking sector from Cyprus. Although issuing binds means that the activity is resuming, we may say that the still persistent volatility of the financing markets can produce a deterioration of this process. Hence, it is extremely important that bank surveillance is strengthened; by improving the system of regulations bank surveillance could provide a coherent and predictable framework for bank financing.

Thus, in order to reduce the phenomenon of market fragmentation, it is necessary to stabilise the market that provides financing for the economy, particularly of the banking market, to temper the strong movement of the capitals and to release the process of European integration solving, at least partially, the fiscal-budgetary problems within the Euro zone.

The banks from the Euro zone hold an important share of the Romanian banking system. Hence, Romania, next to the other "host" countries of the banks from the Euro zone, must get involved in solving the problems of a possible contagion from the Euro zone

[4] *According the IMF, the financial repression refers to the fact that the local banks are encouraged or asked to buy part of the national governmental bonds, which makes them reduce their portfolio of assets provided for the purchase of these assets thus remaining within their own parameters of debt payment.*

banking system, particularly to avoid the fragmentation of its financial system.

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