European Research Studies
Volume III (1-2), 2000, pp. 3-9

EDITORIAL

The Integration of European Financial Markets And Its Importance For Economic Growth And Financial Stability: Where We Are Now And What We Expect

Costas Siriopoulos

Department of Economics, University of Macedonia[1]

Abstract

This paper discusses the trends for the euro area economy and financial markets. The introduction of the euro constitutes a regime shift, which pervades the very structure of markets and the fundamental attitudes of operators. As such, it will force profound changes. It also highlights the main issues raised in the articles that were selected for publication in this special issue of the E.R.S.J.

1. Introduction

In recent years global economic integration has been accelerated on a multitude of fronts. While trade liberalization has continued, more dramatic changes have occurred in the financial sphere, with a huge expansion in cross-border financial flows as a result of very rapid increases in telecommunications and computer-based technologies. However, it is interesting to note that trade in financial services still is much smaller than often believed. For example, the total for the EU 15 (1995) was around ECU 15bn, which was only about 1% of all trade in goods (Gros and Lannoo 2000). However, the importance of cross-border transactions for financial markets is extremely difficult to documenting since few systematic data exist on trade in financial services. Data on cross-border banking penetration confirm the situation of limited cross-border trade. In the five largest EU countries, only 4.25% of the assets and 6.2% of the liabilities were cross-border in 1996 (White 1998).

Changes in communications and information technology, and the new instruments and risk-management techniques they have made possible, enable an ever-wider range of financial and nonfinancial firms today to manage their financial risks more effectively.

In this environment, characterized by rapid technological progress and continuing deregulation of financial markets, in general, the European Monetary Union (EMU) comes. These processes do of course interact and are likely to

[1] Costas Siriopoulos is also General Manager of EDEKT-OTE S.A., the Pension Fund of the Hellenic Organization of Telecommunications. The present paper expresses personal thoughts.

accelerate the emergence of an integrated European financial market. According to a recent study, technological progress has had a positive impact on reducing European banking costs by about 3% per annum between 1988 and 1995, but large banks benefited more than their small counterparts did (Molyneux 1997).

But in Europe, we emphasize the formulation “the introduction of euro” because this is the really new element brought about by monetary union. The other elements of financial market integration were introduced some time ago: the technology-based developments have so expanded the breadth and depth of markets that regulators increasingly have felt they have had little alternative but to deregulate and free up internal credit and financial markets. Especially, we have the abolition of capital controls (from 1990), the second banking directive (in 1996), and the insurance and investment services directives in 1994 and 1996.

This paper is structured as follows. Section 2 discusses the trends for the euro area economy and financial markets. The combined impact of the introduction of the euro and the other factors of change pose new challenges not only to the market side, but also to the policy side of the financial system. In section 3 we discuss the differences between the member states of EU and the impact on the European integration. Finally, we conclude the paper with a brief presentation of the main issues raised in the articles that were selected for publication in this special issue of the E.R.S.J.

2. European Financial Markets

It is interesting to note that a study by Price Waterhouse (1988) showed that deregulation and integration of financial services in Europe have note only created more efficient and stronger financial institutions there but have also reduced the price of financial products to consumers, and Shapiro (1996) gives some examples of benefits in currency transaction costs due to the single currency in Europe.

From a regulatory point of view, the single market for operators on capital markets is almost complete. With the exception of pension funds, EU markets have been opened up for the free provision of banking, investment and insurance services with a single license: in 1993 for banking, mid-1994 for insurance and 1996 for investment services.

Although legislation is in place, harmonization has gone insufficiently far and implementation leaves much to be desired to make mutual recognition work. Apart from unit trusts, common rules for securities emissions, initial public offerings and stock exchange listings are much less developed. Minimal harmonization is done through directives, which are EU legal instruments, which need to be transposed into national law by the member states.

Europe’s share of world market capitalization amounts to about 25% compared to 49% for North America and 17% for East and South-East Asia. Although the combined GDP of the EU is higher than that of the US, its total stock market capitalization (of 31 national stock exchanges) amounted to only 55% of US stock market capitalization at the end of 1998. Some countries are notable exceptions to the low levels of stock market capitalization observed in continental Europe. These differences reflect differences in corporate culture,

corporate governance and company law, and average size of corporations. European stock exchanges also differ significantly in their interest and ability in attracting foreign listings. Foreign listings do not exist in some exchanges while they are of major importance in others (Germany and UK).

The European bond market is already relatively well integrated at the level of euro area. There was a considerable increase in the participation of private sector issuing in the bond market in recent years. It is expected (Noyer 2000), that over the medium term, in the context of the further development of a "credit risk culture", it can the bond market of the euro area will become increasingly diversified, in particular with regard to the range of participating issuers, and attract more private issuers. Currently, public bonds represent the largest share of total debt outstanding in world bond market, accounting for more than 62%, compared with about 40% for private sector debt.

Futures exchanges are obvious victims of EMU. In 1998, there were 23 futures and options exchanges in Europe, compared to 7 in the US. Derivative exchanges are highly affected by EMU, because of the disappearance of exchange rate differentials and the convergence of interest rates. An integrated bond market is likely to have a single yield curve. It should thus be served by a single futures contract, or a single contract at each maturity (Gros and Lannoo 200).

The forces that have transformed financial institutions in the last decades in Europe and elsewhere throughout the world can be summarized in two words: globalization and technology. In other words, if the EU can get on top of these two biggest challenges, that is developing the information society and integrating its financial markets, it will have taken a massive step forward, creating a sustainable strong European economy.

3. Differentiation between countries

However, in spite of all the efforts, the European financial markets remain fragmented: prices differ widely for the same financial products depending on where they are offered, supplementary pension funds cannot operate on a cross-border level, pension funds are not yet included in the EU regulatory framework for financial services, there is not yet a single set of accounting standards, which can be used in each member state, issuers raising capital have to provide different prospectuses for different member states in different languages, the financing structure of firms differs with considerable differences in their dependence on external funds, the level of venture capital in Europe is still only one fifth of that in the USA, cost structures differ, labor markets are still organized along national lines. All these means that Europe's employment is losing out, because of fragmentation, complexity, legal uncertainties and procrastination.

Other questions are also important: how capital markets EMU might affect? Are there benefits from portfolio diversification? Will EMU lead to a more US-style capita market? How will asset allocation patterns evolve along the different segments of capital markets? How will financial centers be affected? How will the different national practices in taxation, accounting and corporate governance change with the introduction of euro? Given the competition among stock

exchanges and the uncertainty of the exchange industry in Europe, will the exchanges merge (Noia 2001)? Is there enough space for some of them to survive? How will their governance structure be affected? What about the integration with off-European stock exchanges? What will be the role of regulators?

The European Union has started to react to this situation in several ways: by addressing the shortage of venture capital (Risk Capital Action Plan 1998); by completing the integration of Europe's financial markets (Financial Services Action Plan 1999); by proposing a new legislation on pension funds; the full implementation of the Investment Service Directive (ISD); by further harmonization of conduct-of-business rules in the ISD; by the increased cooperation among supervisors. These efforts will be enforced with EMU and the introduction of the euro:

- A larger and more liquid bond market reduces the cost of funding debt both for governments and for private sector.
- In organized markets, the effects are clearest in derivative markets, which is the obvious victim of EMU.
- In the area of equity markets, integration will take more time because stock exchanges are affected much more by differences in taxation, company law and attitudes towards corporate governance, and the idiosyncrasies of the markets, which will persist for a longer time period.
- As the markets will become more integrated, it is expected that the benefits from portfolio diversification will be smaller.
- In the presence of cross advantages in marginal costs, implicit merger of exchanges will become a strategic option, which improve their welfare, and regulators should favor implicit mergers, eliminating all obstacles to listing and desisting in exchanges and to trading, implementing full remote access.
- As very long-term investors, pension funds should have the possibility to invest significantly in shares and risk-capital markets and to manage schemes on a cross-border basis. The central aim is to ensure that pension funds have sufficient freedom to decide on how their assets should be managed, on the one hand, and that future pensioners get a high level of protection, on the other.
- The EU will adopt several directives regarding harmonization of basic accounting standards- based on International Accounting Standards (IAS), auditing of accounts and rules on disclosure. This will reduce costs for business and vastly improve market transparency.

4. A review of papers in this issue

The articles that make up this special issue (two volumes of E.R.S.J.) of the journal address various aspects relating to the European economic and financial markets and each of them contribute to a better understanding of the operation of the European markets, which in turn is influenced by various national financial markets.

1. *A.J.Kondonassis and A.G.Malliaris* illustrate the difficulties of the current global monetary system by reviewing its recent historical record, and argue

that its stability can be strengthened by implementing the lessons learned from European Monetary System (EMS) from its beginning to the recent formation of the EMU.

2. *A.G.Merikas* examines the impact of European integration in the context of globalization on correlations between stock market returns and especially in periods of crisis in Europe, US and Japan. The results of his study show that stock market integration in Europe has increased in recent years though it is not yet complete.
3. *S.Karagianni* tests the Wagner's Law in European countries. Especially, she looks the long run and causal relationship between government spending and income, applying six different functional forms using data for the EU-15 over the period 1949-1998. She found limited support in favor of Wagner's Law in most European countries.
4. *H.Mertzanis* describes the different broad systems of corporate governance existing in continental Europe, the UK and the USA, identifies certain differences, and discuss the question of whether corporate governance structures in the different European countries will completely converge with one another.
5. *N.Niarchos and C.A.Alexakis* investigate the possibility of a long-term predictive relationship among the major European stock markets for the time period 1992-1996. Their results indicate that the stock exchange of London "leads" and the Athens stock exchange "follow" some of the other European markets.
6. *T.Mariolis* discuss the division of labor in European Union. Especially, he investigates whether the conclusions that emerge from the usual Ricardian model retain their validity within the context of more realistic models.
7. *P.C.Smith, G.S.Vozikis, and A.Merikas*, discuss the transition process of the Eastern European Countries from the "old" economy to the "new" market economy. Especially, they discuss the impact of business education and entrepreneurship, in order to accomplish their adjustment to the new market principles effectively.
8. *T.V.Stamatopoulos* study the interdependence of consumer prices and exchange rate of drachma for the first 15 years period since Greece's accession into the European Community (1981-1995). He concludes that the exchange rate of the GRD do not converge to its long-run values.
9. *C.Kyrtsou and V.Terraza* examine the volatility behavior of the Athens Stock Exchange using daily and intra-daily data. Their results sow that endogenous factors, such as local information, play a more important role in emerging than in developed capital markets.
10. *G.Karathanassis and C.Patsos* investigate the presence of long-range dependence and nonlinear dynamics in stock returns using data from the Athens Stock Exchange. The empirical findings support the hypothesis of short-term memory.
11. *E.G.Tsionas* takes up posterior analysis of the stochastic frontier model with random effects when panel data is available. He shows how posterior distributions of parameters can be derived and how firm-specific efficiency measures can be computed.

12. *K.V.Kosmidou and C.Spathis* examine the impact of the euro on Greek banks through a cost-benefit analysis. Their analysis show that during the period 2002-2007 banks will face a loss in their profits, but in the long-term this figure will be reversed.
13. *D.Vasiliou and Z.Frangouli* investigate the impact of concentration ratio of the Greek commercial banking market on banks' return on equity. They use cross-section time series econometric techniques and data for the period 1993-1997. The results indicate that the financial variables are important determinants of banks' profitability though are different across different banks.
14. *M.Doumpos, S.H.Zanakis, and C.Zopounidis* developed a framework for assessing investment risk in 51 foreign countries according to 27 different criteria. They use multivariate statistical methods and multi-criteria decision analysis (UTADIS and MHDIS).
15. *F.Voulgaris, D.Asteriou and G.Agiomirgianakis* investigate the determinants of capital structure for the Greek manufacturing SMEs (1-100 employees). Their study is based on a panel data set consisted of a random sample of 142 manufacturing SMEs in Greece for the time span 1989-1996. Their results give the parameters affecting the capital structure of Greek SMEs.
16. *H.Harissis,* reviews the literature relating to the theoretical basis of the Capital Asset Pricing Model (CAPM). The derivation of the CAPM is presented, followed by the empirical tests of it. There exists some further research however which is also presented, that criticize the CAPM, since it has often been challenged by statistical studies that fail to verify the validity of the model, as an adequate description of the way assets are priced.
17. *S.Staikouras, E. Dinenis* examine the impact of exchange and interest rate changes on the common stock returns of the insurance companies in the UK. All general and life insurance firms listed in the London Stock Exchange are selected for this purpose. An augmented market model with the additional variables of the interest and exchange rate indices is employed to test both the pricing question and the factor sensitivity of the particular sample. A seemingly unrelated regression (SURE) multivariate estimation with both cross-equation restrictions and within equation nonlinear constraints on the parameters is employed. The main implications of this investigation are i. that both kinds of insurance companies are negatively and equally affected by unanticipated changes in interest rates and ii. that the changes in exchange rates seem to inversely affect the general insurance companies, while the life insurance firms seem to be insensitive.
18. *C.Kazantzis* discuss the necessary steps for banks to adjust their services and products in order to achieve competitiveness in the new banking era. Especially, he discusses the impact of new technology in the banking sector.

It is hoped that the points raised in this article and other articles to follow will provide the opportunity for further discussion of the challenges and the opportunities, which will arise during the process of further European financial integration.

References

Greenspan, A., 1998, “The globalization of finance”, Cato Journal, 17(3).

Gros, D., and K. Lannoo. 2000, *The euro capital market*, J.Wiley.

Molyneux, P., 1997, “Internet and the global challenges for financial services in Europe”, Presented at a CEPS seminar, Brussels, October.

Moshirian, F., 1999, “Challenges for further global financial integration”, *Journal of Multinational Financial Management*, 9, pp. 209-216.

Noia, C.D., 2001, “Competition and integration among stock exchanges in Europe: Network effects, implicit mergers and remote access”, *European Financial Management*, 7(1), pp. 39-72.

Noyer, C. 2000, *The outlook for the euro area economy and its financial markets*, Presented at the conference “*European Capital Markets*”, Paris 24 February.

Price Waterhouse, 1988, *The cost of non-Europe: Financial services*, Submitted to the European Commission.

Shapiro, A.C., 1996, *Multinational financial management*, 6th edition, Allyn and Bacon, USA.

White, W.R. (1998). *The coming transformation of continental European Banking*, BIS Working Paper, No. 54, June, Basel.