

FINANCIAL INTEGRATION FROM A REGIONAL PERSPECTIVE

Remarks by Ms Sinikka Salo in the conference "Changing Foresight Practices in Regional Development - Global Pressures and Regional Possibilities" in Turku 9th June 2006

1. Introduction

Financial markets are often seen as forerunners in globalization. This is understandable, since the immaterial and “weightless” nature of money seems to make geography less relevant in the world of finance than in most other industries. It is easy to present examples which lend support to the view of finance-led globalization. Money can move from one part of the world to another in seconds, and contracts worth of hundreds of millions of euro are made daily in the financial markets, over the telephone, between parties based on different continents. In Helsinki, for example, we may check the prices of shares traded on the New York stock exchange at least as quickly and with greater precision than the prices of vegetables in the open-air market of our home town.

The picture of financial markets as extremely globalized is only partly true, however. It is true that, for some parts of the financial markets, geography has lost its importance already a long time ago, but there are others where international and regional integration is still incomplete and on-going. In the last ten years, very significant progress has taken place in this area. Let me start my brief survey of what financial integration means from a regional perspective by considering some of the recent developments in Europe and in the world as a whole. After that, I will discuss the regional implications of the on-going integration process and finally close with some policy related remarks.

2. Trends in financial integration in Europe

Let me review European financial markets first. Europe has, of course, a long history of international capital movements, both in the form of short-term “hot” money flows and as foreign direct investment in industries across national borders. True integration of European financial markets is much more recent, however. The most visible sign so far

of financial integration in Europe is the euro, the creation of which did indeed start a new era of financial integration in the area. After the adoption of the common currency in 1999, money markets in the euro area were rapidly integrated and interest rates were unified as the result. So, financial conditions in the macroeconomic sense are now pretty much the same in the whole euro area.

However, in Europe, and even in the euro area, large and very important parts of the financial market are not yet completely integrated. Retail banking markets, for example, remain today mainly national in nature, so that cross-border supply of housing loans or deposit accounts is a rare exception rather than a normal part of life. Securities markets are similarly still organized on a national, country-by-country basis so that the trading of stocks issued in another country usually requires rather expensive custody arrangements. Especially the clearing and settlement stage of international share transactions is much more expensive than similar transactions in the domestic market. Other areas where Europe still is financially fragmented include the payment system and the venture capital market. In practice all this fragmentation means that, at least for entities other than banks and large multinational companies, national borders still matter a great deal in European finance.

The European situation is not stagnant, however. The EU authorities, in particular the Commission and also the European Central Bank are pushing hard towards a more complete financial integration of the EU. Last December, the Commission published an important White Paper defining its financial services strategy for the following five years. The goals listed in this paper include a stronger integration of retail markets in banking, insurance, securities, and asset management. Another goal is international supervisory convergence, which is obviously important in the context of financial integration. Finally, the Commission wants Europe to be active also on the global stage, going for active liberalization of financial services in the context of the WTO negotiations, and intensifying regulatory dialogue with the US and other trading partners of the EU in the international financial markets.

Parallel to the work of the Commission and the ECB, the private sector - markets themselves - is also preparing for much closer integration. Very important in this regard are the attempts of the stock exchanges to create larger European and even global market places for the trading of securities. Stock exchange business in its modern form requires large fixed investments in information infrastructure and has therefore very large economies of scale. Trading costs can be much reduced if the processing of trades can be concentrated in bigger centres. At first, the mergers and acquisitions in the stock exchange industry seek to exploit these economies of scale by sharing technology and possibly also processing capacity, and by doing so, cut costs of trading to a fraction of what it is at present. In the medium term, the integration of stock exchanges can be expected to result also in the pooling of listings to form larger, European-level trading lists and the creation of truly unified market places.

Turning to financial institutions, the international consolidation of banking and insurance industries has been long overdue, except for the Nordic area and the Benelux, but it is very likely to gain pace at some not too distant point in the future. The reasons are not too different from those which are now transforming the stock exchange industry. The increasing complexity of both technology and regulation is increasing the economies of scale in banking, too, and is therefore building up pressure for reorganizations in the form of mergers and acquisitions. Meanwhile, the largest euro area commercial banks have formed a new organization, the European Payments Council, to coordinate the creation of a Single Euro Payments Area as required by the ECB and the Commission.

3. Globalization and finance

Globally, the degree of financial integration achieved so far is obviously less than in the euro area or even in the EU as a whole. However, the changes which have taken place at the global level and are still going on have such huge proportions that calling them “epic” would be no exaggeration. The most important part of these developments is the entry of developing Asia into the global financial markets, both as a target and a source of international investment. In particular, the emergence of China as a major player in international financial markets has brought 1.300 million people in contact with world’s

capital resources for the first time. The financial liberalization of India, with its 1.000 million inhabitants, has as large potential as China to transform the world economy.

It seems certain that not more than a small part of the eventual impact on the world financial markets of the opening up of these giant Asian economies has been felt up till now, and much more is yet to come. As we all know, this prospect has attracted an enormous amount of public attention in the last years. Much of the current globalization debate has been in terms of an alleged “flight of capital” to Asia but the facts do not support this idea. In fact, developing Asia has been a large scale capital exporter, not importer, ever since the Asian crisis of 1997. What this means is that any investment from the developed west to developing Asia has been more than matched by investment to the opposite direction, from these relatively poor countries to world financial markets – ultimately much of it in U.S. government securities.

In view of this, a fair characterization of the Asian participation to “globalization” so far could be that it has mainly happened in markets for industrial exports and raw materials imports rather than in capital markets. It has been mainly based on rapid acquisition of technological and commercial know how, and the deregulation which has allowed the Chinese and Indian factories to put this know how into use. True, much of the technology transfer has been made possible by foreign direct investment to China and India, but the net capital flow has so far scarcely reflected the meeting of China’s and India’s capital needs and the capital resources of the developed world.

The reasons why the full potential of developing Asia has not yet been felt in the international financial markets can be found in the painful experience of the Asian crisis of 1997. The crisis was caused by extensive over borrowing by a number of countries in the form of short-term bank loans. The lesson from the crisis was that it exposed the weakness of institutions which are needed to channel capital from developed to the developing world. Serious problems existed in the risk management of the lending banks, but especially in the management practices, economic transparency, and legal systems of the Asian countries.

After the crisis, Asian governments have been very reluctant to allow large-scale dependence from foreign capital, and are effectively using all funds flowing into their countries to accumulate foreign exchange reserves instead of importing more capital goods. They have thus chosen an export-led growth strategy which uses domestic saving as the ultimate source of financing their rapid growth. This has caused a lot of frustration in the west, because of this cautious strategy, developing Asia exports much more to the developed world than imports from it.

However, after the Asian crisis, the international community has started a large scale effort to increase the stability of the global financial markets and so to create better, more secure environment for investing in the developing countries. The International Monetary Fund, in particular, started to work consistently for ensuring good economic governance in all countries of the world. Traditionally, the role of the IMF was to provide emergency support for countries getting into balance-of-payments difficulties such as currency crises. The new role of the IMF is more preventive. It has started two very important programmes for benchmarking economic policy and economic institutions across the world.

In the so called ROSC programme, the IMF reviews the observance of international standards and codes in the areas of: (1) economic and fiscal transparency and availability of data; (2) financial sector standards such as the state of financial supervision, reliability of the payments system, and combating the financing of terrorism; (3) market integrity, including standards for corporate governance, accounting and auditing, and (4) insolvency procedures and creditor rights in each country. In another important programme, the so called Financial Sector Assessment Program, the IMF looks at and reports on the soundness and stability of the financial sector in each country.

The participation to these IMF programs is voluntary, and the Asian giants have not joined yet, but peer pressure and the prospect of concrete benefits in the form of better creditworthiness encourages more and more countries to join these efforts to improve the performance and stability of international financial markets.

All in all, this brief review of current developments in international financial integration suggests to me that even though financial markets are global, they are far from being fully integrated yet, and the full effects of financial integration are still to be felt.

4. Regions in financial integration

The world economy as a whole should benefit a lot from more integration. Financial integration is expected to accelerate economic growth and productivity, as the growing supply of finance and new productive investment opportunities projects will be matched more efficiently with each other than before. The distributive and regional effects of integration are much more complicated, however. An analysis of the effects on economic regions of the kind of financial integration we are currently experiencing is particularly challenging. This is so because of two main reasons.

First of all, the current financial integration cannot be analyzed simply as a case of economic regions moving from financial isolation to sharing a common financial market. That would be the standard approach of international economics, but it does not apply very well. In fact, regions – meaning areas smaller than a country – have been for a long time already financially integrated at the national level. In Finland, for example, the national financial markets have been quite well unified for a long time – certainly for decades – so that speaking of some specific financial markets of the Turku region, where we now are, is not very meaningful. Money, credit and financial investments flow quite smoothly within Finland from one region to another and financial conditions are not too different in different parts of the country. The same can be said of all developed countries nowadays.

This being the case, the impact of financial integration on economic regions cannot be analyzed satisfactorily by using the simplest tools of international economics or economic geography. Instead, we must ask, how financial integration between nations affects economic regions within countries. This is a much more complicated question, because we cannot assume that international financial integration will have a similar impact on all regions within a given country, and secondly, because regions have different policy concerns than nations: national economic policy has to do with "hard" things like

taxation and financial regulation. Regional policy makers, however, are more concerned on things which can be regionally differentiated, like infrastructure and education, as well as promoting cooperation between firms in regional industrial clusters, etc. Hence, the emphasis on “soft” and proactive kinds of policy is greater at the regional than national level.

The second reason which complicates the analysis of the impact of financial integration is that we are not mainly interested in the impact of integration on the financial services industry itself, but rather on the impact of financial integration on the regional economy as a whole. This contrasts with the standard approach which would analyze the effect of integration of an industry on the structure and performance of that same industry. Here, however, we are mostly interested in the effects outside the financial services industry.

Focusing on these "second-round" or indirect effects of financial integration is essential because in most regions, the financial services industry is relatively small part of the economy. In Finland, for example, financial services account for about 1.6 per cent of all jobs, and in Germany, 3 per cent. While the direct employment effects of financial services are not negligible, it is clear that the indirect effects of the financial industry are much greater. This is because finance is a necessary input to virtually any sector of the modern economy, and the performance of financial markets is therefore a precondition of good performance of the economy as a whole.

How does finance influence the rest of the economy? The financial markets are, firstly, a market for channelling savings to investment; secondly, a market for risk; thirdly, a market for corporate control; and, finally, they provide an infrastructure for making payments. These functions of financial markets are in fact studied by quite different branches of economic theory, and a unified theory of the role of financial markets in the economy is therefore not really available. The market for savings is analyzed by macroeconomics; the market for risk is analyzed by the theory of finance; and the market for corporate control is analyzed by the theory of industrial organization. Finally, the intermediation of payments is usually analyzed in the context of monetary theory (or recently, network economics). In many financial relationships, these different functions of financial mar-

kets appear intertwined, but nevertheless they are conceptually separate and their purposes and impacts in financial integration are also different.

5. The functions of finance in the economy

5.1. Market for savings

The ongoing financial integration process concerns each of the four functions of financial markets. Therefore, we must take all of them into account when trying to get a full picture of what future financial integration will mean to regions.

Let us look at the macroeconomic aspect first. Viewed from this perspective, what the financial markets do is transfer resources in time and in space. From the point of view of a saver, financial markets are useful, because they help her to transfer her resources forward in time – just as from the point of view of a borrower, the markets enable a transfer of resources backwards, from the future to the present. From the geographic point of view, however, the very same transfer of resources happens in space: the resources flow from the location of the saver to the location of investment. From that perspective – the perspective of financial intermediation in space – the resources are not moved in time at all, but only from one place to another.

There is reason to believe that the importance of intercontinental capital flows could even grow in the future. This is because some economic fundamentals suggest that regional differences in the propensity to save and invest should grow in the future. One of the fundamentals is population ageing in the highly developed parts of the world. This ageing, especially in Europe and Japan will increase saving in these parts of the world and keep investment demand there relatively subdued. This could mean that Europe would join Japan as one of the significant capital exporters of the world – unless Europe's government deficits remain too large and use the resources which otherwise could be invested productively in the emerging economies of the world.

The effect of financial integration of the market for savings is that the market rates of return on capital will generally converge as a result of it. At the same time, both saving and investment will increase, because on average, savers will get a higher rate of return for saving, and similarly on average, investors' capital costs will decline. Who actually collects the benefits from this process depends on the initial situation of savers and investors in different parts of the world.

The classical view of this process emphasizes the equalizing force of financial integration. According to this view, the rate of return for capital is generally highest in countries or regions where capital is relatively scarce and other resources relatively ample; by the same token, the rate of return is lowest where capital is relatively ample. The effect of financial integration is, consequently, to equalize the capital intensities of regions and hence equalize productivity and real income differentials as well.

The classical view may, however, be too simplistic. As the result of the emergence of the so-called "new economic geography" (a school of thought associated especially with Paul Krugman and his co-authors), the classical view is no longer seen as the whole story. New economic geography emphasizes the importance of the economies of scale in many industries. In those industries, the rate of return on capital is not necessarily a declining function of previous investment, but may well be an increasing function of the amount of capital which has been invested ("sunk") previously in a particular industry in a particular region. For this kind of industries, the integration of markets can lead to agglomeration and concentration to centres where the economies of large-scale operation can be best achieved.

A perfect example of the economics of agglomeration is the financial services industry itself. Especially in securities markets, the benefits of large scale operation are so important that the financial services industry concentrates in great cities such as London or Frankfurt even though the cost of labour and land is higher in these financial centres than in other cities.

Fortunately, the benefits of concentration emphasized by new economic geography can also be achieved in smaller cities, at least in the case of narrowly focused “niche” industries. Even Finland has several examples of firms which are world class players in their markets even though they may not be very big companies as such and even if they are not located in some large metropolis.

5.2. Market for risks

Let us now turn to the second function of financial markets, to transfer risk. Financial markets allow investors to diversify their assets so that the overall riskiness of their portfolios is reduced. Also, the markets allow entrepreneurs to sell some of their business risks to outside investors so that firms can grow faster and take more investment risk. The markets also price risks and this affects capital costs for firms and the return expectations of savers. Generally, riskier projects must have higher rates of return than less risky ones in order to be realized. Financial integration will mean that some of the risks which were not possible to get rid of before, will become diversifiable risks after integration. So, the process of financial integration reduces the prices of those risks which it helps to diversify.

Because of this, capital costs of firms are reduced and, at the same time, the obtainable risk/return mix is improved for savers. Because certain risks will become cheaper, they will depress financial asset prices less than before integration and therefore required rates of return will decline and asset prices will generally appreciate as a result of increased diversification possibilities. The biggest gainers from this are the companies which before integration represented “dominant risks” in their home country but which thanks to integration can spread their ownership and their business risks internationally. Nokia is a perfect example of this. It would be very risky and virtually impossible to have an industrial giant like Nokia in Finland without the broad international ownership made possible by financial integration.

What then is the regional dimension of the growing possibilities to diversify investment risks in world markets? An important effect is that integration makes it possible for companies, operating in their home regions, to finance larger investments and specialize in a

more courageous way than otherwise. Thus, financial integration favours, or enables, greater regional specialization and concentration of business, especially for those companies which are large enough to benefit from the possibility of an internationally diversified ownership. Another side of the same coin is that, as a result of increased diversification of asset holdings, savers are able to isolate themselves better from economic fluctuations happening in their home region.

5.3. Market for control

The third function of financial markets is to transfer control. Buying a large amount of shares in a company will give the investor some control in its management. Actually, corporate control is at least as important object of trading in the stock market than funds themselves. This has very important economic functions, because if the market works well, control will end up with those owners who can put resources into most efficient uses. Also, selling some corporate control to outside investors will enable innovators get much more capital than would be possible otherwise. This is actually the main principle of the venture capital industry.

In financial integration, the market for corporate control will work so as to spread the most efficient management methods from region or country to another. Companies which could be managed better will change owners and be reorganized. The effect of this is that the market value of "best practice" management and "best practice" technologies will increase at the expense of substandard management and production practices. The market for corporate control is thus crucial for innovation and productivity improvements.

Over the last ten years, financial integration has had the greatest effect just through the market for corporate control. This is apparent from the example of China, which has been a major exporter of capital since 1997, for about 10 years now. As I already mentioned, in net terms, China has been investing abroad more than other countries have invested in China. But for Chinese development, the important thing has not been the net capital flow – which was outward in any case - but foreign direct investment. The effect of this is that instead of capital as such, China has been importing foreign control, management

and technology in a very large scale and this has actually revolutionized the Chinese economy and also the world economy in the process.

In the public debate in the press about international financial integration, the corporate control aspect of integration is carried out under the rubric "foreign ownership". In the media, the question is posed by contrasting international, distant ownership with local or national ownership. The popular worry is that distant ownership is by its nature destructive, whereas local ownership is often seen as more sensitive to requirements of fairness.

Regionally, the international integration of the market for corporate control means that global instead of national best practice increasingly becomes the norm for the efficiency of corporate management. Another beneficial effect is that new start-up companies could have a wider choice of potential investors to contact, and consequently a higher probability of finding one with enough expertise to understand the particular business idea in question, whatever than may be in each case.

The importance of control and trust for financial relationships is very important. At the fundamental level this is so because of problems of asymmetric information which are inherent to financial contracts. Economists classify these problems to cases of "hidden action", where monitoring and shared responsibility is needed to ensure that both parties fulfil their share of the contract, and to cases of "hidden information" where screening and risk sharing is important to make sure that projects or securities are as good as they are claimed to be when financial contracts are made.

The importance of monitoring, screening and control emphasize the value of proximity. This is why information concerns put certain limits to how far financial integration can go. As I have already pointed out, financial integration in itself is a force which favours the concentration of financial activities to larger units and to large financial centres. However, this force will mainly be felt in those financial services which are possible to render "at arm's length". These services include securities, deposits, payments, and nowadays even routine insurance and consumer credit.

It can be argued, however, that there exist also categories of financial services which cannot be commoditized to be rendered at arm's length. These are services where tacit information on companies, individuals or investment projects is necessary for successful business. The best example of this is the venture capital finance of start-up companies. Private equity investment to small and medium-sized companies is by definition not commoditized, because if it was, the stock could be traded in open markets. But the nature of information problems implies that the stocks in small firms are more valuable to the venture capitalist who knows the firm and its management and has some control in the way it is developed.

Private equity investment does not necessarily need to be locally or regionally based. Indeed, financial integration can well increase such investment at long range, because specialized expertise can be at least as important for successful investment as geographical proximity. However, other things being equal, distance does matter in private investment. Thus, we can predict that information concerns will remain a counterforce to pressures for geographic concentration, in those categories of financial services in which private information is essential.

5.4. Provision of a payment system

Last but not least in the list of the functions where financial integration will matter is the payment system. The current fragmentation of the payment system is, most serious in the segment of retail payments, meaning the payments to and from households and small firms. This is, first and foremost, a hindrance to effective competition in the financial services industry. If fast, reliable, and unified international systems of account transfers and direct debit were established, the market for such financial services as mortgages, time deposits, asset management, and life insurance would become much more competitive. Current high fees of international credit card transactions could also be reduced by more intense competition in that sector.

In the medium term, further progress in the international integration of payments industry can mainly be expected in the euro area where the creation of the Single Euro Payments Area is already under way. The completion of that project will not only facilitate pay-

ments in the area but also make financial services more competitive. In that way, the benefits to businesses from operating in the euro are would be strengthened.

6. Conclusions from a regional perspective

To conclude, financial integration holds great promise in terms of growth efficiency and economic opportunities, but also requires significant adjustments in public policy and private business performance. Financial integration is a great equalizer in the sense that the more it progresses, the less geography matters for the provision and availability of financial services. However, this does not necessarily mean that regions will become more equal as a result.

When financial barriers go down, the importance of other regional factors than finance is emphasized. This means that the quality of less mobile factors such as the skills of the labour force, communications and other local infrastructure, and the level of informal business networks in the region, will become much more important for economic success than before. Where these prerequisites for success are not competitive, the region will suffer economically from financial integration despite the increasingly equal access to financial services. In fact, it is the increasingly equal access to finance which is precisely the reason why other dimensions of competitiveness will grow in importance.

It is interesting to note that those dimensions of competitiveness which are emphasized by financial integration are usually the responsibility of policy makers at the local or regional level. This means that financial integration increases the responsibility of local governments for the economic success of the regions where they work and emphasizes also the importance of regional coordination of policies regarding things such as infrastructure, education, and business promotion.

However, there are limits to how far financial integration can proceed. As I mentioned, these limits are determined by the fact that many financial relationships require such trust and information which is hard to establish from a long distance. As the structure of financial services is likely to consolidate in the future to bigger units and continue to con-



concentrate to large cities, these information concerns constitute a counterforce to these tendencies, especially in the financing of small, growing, and medium sized firms.

But even the venture capital industry and the financing of SME's cannot escape the fact that sufficient scale is necessary for financial services. Also in the future, small and diverse concentrations of firms will find financing more difficult than larger and more specialized ones. Therefore, in order to combine the benefits of specialized information, geographic proximity and efficient size, the creation of strong, specialized business clusters will be even more essential in the future to ensure the success of region in the environment of international financial integration, financial consolidation, and tougher competition. It is the challenge of local policy makers and business communities to act as catalysts for the formation of such structures.