FOREIGN BANKS ESSENTIAL TO GROWTH: New evidence of the importance of banking sector integration for Europe's economic future

Foreign banks can keep a country's economy afloat when its domestic banks are suffering from a crisis. That is the central finding of research by **Isabel Schnabel** and **Christian Seckinger**, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015. Their study suggests that the EU's banking union and planned capital markets union are key building blocks for future European growth.

The financial and sovereign debt crises have fragmented the European finance sector, with banks moving out of foreign countries and closing their branches. This has often been supported by politicians, who have made bailouts conditional on banks lending more to local companies.

The new study looks at the real effects of this fragmentation, studying the growth rates of different countries whose banking sectors are more integrated than others. It finds that foreign banks often make capital easier to access when local banks are floundering in a crisis, meaning that growth still stays strong. The authors conclude:

> 'Banking sector integration is crucial for economic growth in the European Union, particularly in the current phase of fragmentation and deleveraging. The strong negative growth effects of financial fragmentation call for additional international efforts to overcome protectionist tendencies on the national level.'

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This paper investigates the real growth effects of banking sector integration in times of financial fragmentation and bank deleveraging during recent years in the European Union. The main finding is that foreign banks are particularly important for economic growth during times of crisis and when domestic banks reduce their business.

The study is motivated by the concerns of European policy-makers that the broad fragmentation process in the European financial system since the crisis hampers European growth prospects. Before the crisis, the process of banking sector integration in Europe was seen as a key feature of the convergence process in which East European transition as well as periphery countries could catch up to the core and at the same time finance current account deficits over a longer time horizon.

Since the financial and sovereign debt crisis, however, this has changed completely. Since then, the European banking sector has experienced a strong process of fragmentation. Banks began to reduce business in foreign countries by withdrawing capital and closing branches and subsidiaries.

Particularly in Europe, regulatory and political pressure appears to have reinforced the process of fragmentation. Politicians conditioned the rescue packages in many cases on measures that reinforced fragmentation. For example, Commerzbank was rescued under the condition of shifting their focus on lending towards German small and medium firms. In the UK, banks could obtain cheap central bank funding on condition of supporting local corporations.

The researchers use econometric analysis to investigate the effects of banking sector integration on economic growth. The methodology analyses differences between industry production growth rates in countries with different degrees of banking sector integration.

Industries are characterised by their inherent need for external capital to finance their capital expenditures in addition to using internal financing. If banking sector integration reduces financial constraints for industrial firms, industries that rely heavily on external capital should benefit more in terms of economic growth. Based on this idea, the study finds that during times of crisis and strong deleveraging, the growth effect of banking sector integration is exceptionally strong.

Based on their results, the researchers conclude that banking sector integration is crucial for economic growth in the European Union, particularly in the current phase of fragmentation and deleveraging. Therefore, concerns of European politicians and officials of the ECB about the adverse growth effects of the continuing disintegration process in the European banking sector seem to be legitimate.

Further fragmentation of the European banking sector is likely to make financial constraints even more severe. The robustness of strong negative growth effects of financial fragmentation calls for additional international efforts to overcome protectionist tendencies on the national level.

The Banking Union and the planned Capital Markets Union may set the stage for a new era of financial integration in Europe, which the researchers believe is an important building block of future growth in the European Union.

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Financial Fragmentation and Economic Growth in Europe
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