The Banking Sector and Recovery in the EU Economy†

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The financial crisis of the last three years has seen a dramatic change in the EU financial sector. Since the early 1990s, with the completion of the internal market, there had been a growing trend towards an EU financial services market. Banks were becoming more international with greater regional coverage within the EU (and the world) resulting in a more efficient use of capital in the EU economy and enhanced competition. The benefit of this growth in "European" banks was expected to arise from both efficiency gains within the sector and also from a more efficient allocation of capital across wider European economy, all leading to higher growth. Experience has shown that the expected changes in the banking sector within the EU did, in fact, translate into welfare benefits for consumers in the period prior to the current crisis.

Since the 1980s similar changes were also taking place in the US. As a result of the savings and loan crisis of the 1980s there was a concern in the US that banks, which were confined to single states, were more at risk from idiosyncratic shocks affecting individual states. This prudential concern for geographical diversification seems to have been less of an issue within the EU in the move towards financial integration.

As a result of the completion of the EU internal market, banks within Europe have become larger and more international. However, the current financial crisis has seen the collapse of some banks within the EU and many more banks have been either partly or fully nationalised because of their inability to deal with their losses. Because of the national basis of banking regulation within the EU it has fallen to individual member governments to rescue "their own" banks rendering the EU banking system more "national". This contrasts with the situation in the US where banking regulation was a Federal responsibility and where there has

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been no move to return to a system of smaller “State” banks. This paper shows that the result of the EU approach to dealing with the financial crisis has been a greater concentration of banks on their “home” markets and a decline in participation by domestic banks in foreign markets. This will reduce the average scale of banks in many economies, especially in the smaller economies.

We have used a micro data set to investigate the impact of size on banks’ net interest margin and have shown that larger banks have smaller spreads between borrowing and lending rates for firms and households, while smaller banks generally charge more for their loans. As we have competition between deposit takers this largely reflects the fact that larger banks charge their borrowers less. Lower borrowing costs for households results in higher incomes, consumption and investment in housing. Lower borrowing costs for firms results in higher investment and, hence, a higher capital stock. Taken together the result of lower borrowing costs is higher sustainable national output.

Having established the inverse relationship between bank size and the net interest margin we then consider the implications of the changes in the EU banking system for growth in the EU economy. Three factors affect the long-run impact of this change in the structure of the banking system on output. First, countries with a higher capital-output ratio are more affected: Germany, which has a more capital intensive economy than France is, as a result, likely to be more affected than France. Second, countries with a greater dependence on the banking sector than on equity to fund business investment are also more likely to be affected. Third, the effects are likely to be largest in small countries because of their dependence on bank funding and because the shock to their banking systems is larger.

Given these estimates of the size of the likely change in the bank margin and, therefore, in borrowing costs, we then look at the possible impact of the reduction in bank size on sustainable output in the Euro Area countries. We do this using the NIESR global macro-economic model, NiGEM. We first investigate the impact on output in large and small countries showing that the effects are generally larger in small countries, and also larger in economies that are more dependent on bank finance for their business investment decisions. If the recent increase in sovereign spreads propagates into the banking system of peripheral economies this will result in significantly lower growth than would otherwise be the case in Greece, Portugal, Ireland, Spain and Italy. However, in the case of Ireland a substantial share of domestic output is accounted for by multinational companies, both foreign and national. These firms are not dependent on the Irish capital markets (including banks) to fund their activities and, hence, should be less affected by a higher cost of domestic funding. However, smaller domestically

owned firms in Ireland will suffer the full adverse effects of the increase in margins.

Generally, the model results suggest that an illustrative one percentage point increase in borrowing costs would cut Euro area output by ½ per cent within four years and by ¾ of a per cent in the long run. If the growth over the last three years in government borrowing costs compared to Germany persists, and if these increased spreads propagate themselves into the largely nationalised banking system of high debtor countries, this will cause a sharp slowdown in activity. The impact will be particularly felt in Greece, and to a lesser extent in Spain, Portugal, Ireland and Italy. While Euro area growth would be 0.1 or 0.2 lower for a couple of years with an illustrative one percentage point increase in borrowing, under these circumstances output growth in Greece might be 1 ½ percent lower than it would have been for three years.

A more "national" and fragmented banking system within the EU will have broader implications for the financing of economic activity in Europe. Larger firms, especially multinational firms would be favoured over smaller firms because of their ability to access capital markets directly (through corporate bonds) and also because they have access to the banking sectors in the different jurisdictions in which they operate. Small and medium sized enterprises, and especially households, which are more dependent on the domestic banking system will be most affected. The different approaches to dealing with the financial crisis in the EU and the US will also probably favour growth in the US economy in the medium term.

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