Geographical impacts of financial integration

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Financial markets are usually seen as forerunners in globalization, since the immaterial and weightless nature of finance seems to make geography less relevant than in most other industries. This picture of finance as the most global of businesses, however, is only partly true. 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. Globally, the most important of the on-going processes is the financial opening up of the big emerging market economies, which poses huge challenges for international policy coordination and the development of institutions; at the European level, retail banking markets and payments systems are still very fragmented and a lot of work is needed to achieve the goal of a single market at least in the euro area. Finally, at the subnational level, the impact of financial integration is mostly felt through the changes in the variety of services and customer relationships available to SME's and households. At each of these levels, 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.

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Introduction

Financial markets are often seen as forerunners in globalisation. 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 globalisation. Money can move from one part of the world to another in seconds, and contracts worth 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 globalised is, however, only partly correct. 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, highly 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. I shall discuss the regional implications of the on-going integration process and finally close with some policy-related remarks.

Trends in financial integration in Europe

Let me review the European financial markets first. Europe has 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 (see e.g., Giovannini & Mayer 1991). True integration of European financial markets is much more recent, however. The most visible sign so far of financial integration in Europe is the common currency euro, the creation of which indeed started 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 e.g., interest rates were unified as the result. Hence, financial conditions in a macroeconomic sense are now rather similar throughout the euro area.

However, in Europe, and more specifically 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 a cross-border supply of housing loans or deposit accounts is a rare exception rather than the norm. Similarly, securities markets are still organised on a national, country-by-country basis so that the trading of stocks issued in another country usually requires rather expensive custody arrangements. The clearing and settlement stage of international share transactions in particular is much more expensive than similar transactions in the domestic market. Other sectors where Europe is still 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 have a substantial influence in European finance (Jokivuolle & Korhonen 2004).

The European situation is not stagnant, however. Various EU authorities, the Commission and the European Central Bank (ECB) in particular, 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 (European Commission 2005). 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, supporting active liberalisation 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 with the work of the Commission and the ECB, the private sector – i.e. the 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 greatly reduced if the processing of trades is concentrated into bigger centres (see Hasan & Malkamäki 2001; Schmiedel et al. 2006). At first, mergers and acquisitions within the stock exchange industry seek to exploit these economies of scale through sharing of technology and processing capacity and by doing so, cutting trading costs to a fraction of the larger, European-level pools of trading lists and creation of truly unified market places.

Turning to financial institutions, the international consolidation of banking and insurance industries has long been overdue, with the exception of the Nordic area and the Benelux countries, but it is very likely to soon gain pace. 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 reorganisations in the form of mergers and acquisitions. Meanwhile, the largest commercial banks in the euro area have formed a new organisation, the European Payments Council, to coordinate the creation of a Single Euro Payments Area as required by the ECB and the Commission (ECB 2006).

Globalisation and finance

Globally, the degree of financial integration achieved so far is obviously smaller than in the euro area or even in the whole EU. However, the past and present global level changes also 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 1300 million people for the first time in contact with world's capital resources. The financial liberalisation of India, with its 1000 million inhabitants, has a potential similar to China to transform the world economy.

It seems certain that only a small part of the eventual impact on the world financial markets arising from the opening up of these giant Asian economies has yet been experienced, and much more is to come. This prospect has attracted an enormous amount of public attention in the last years. Much of the current globalisation debate has focussed on the alleged "flight of capital" to Asia, but the facts do not support this belief. In fact, ever since the Asian crisis of 1997, the developing Asia has been a capital exporter rather than importer. In other words, 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 – in many cases ultimately to the U.S. government securities (see IMF 2004).

In view of this, a fair characterization of the Asian participation in "globalisation" so far denotes to 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 deregulation, which has allowed Chinese and Indian factories to apply this know-how. Although much of the technological transfer has been initiated by foreign direct investment in China and India, so far the net capital flow has scarcely reflected the congregation of China's and India's capital needs with the capital resources of the developed world.

The reasons for the yet incompletely accomplished potential of developing Asia in the international financial markets lie behind 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. This exposed the weakness of the 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 the legal systems of the Asian countries.

Since the 1997 crisis, Asian governments have been reluctant to allow large-scale dependence on foreign capital, and are effectively using all funds flowing into their countries for accumulating foreign exchange reserves rather than importing more capital goods. Thus, they have chosen an export-led growth strategy, which uses domestic saving as the ultimate source for financing their rapid expansion. This cautious strategy has caused a lot of frustration in the West, as exports to the developed world from the developing Asia clearly exceed the imports.

However, after the Asian crisis, the international community has started a great effort to increase the stability of the global financial markets and to create a better, more secure environment for investing in the developing countries. The International Monetary Fund (IMF), in particular, started to work consistently for ensuring sound economic governance in all countries of the world. Traditionally, the role of the IMF has been to provide emergency support for countries falling 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.

Under the so-called ROSC (Reports on the Observance of Standards and Codes) 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 (cf. Schneider 2003).

Participation in these IMF programs is voluntary, and the Asian giants have not yet joined in. However, 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.

In summary, the current developments in international financial integration suggest 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.

Regions in financial integration

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

First, the current financial integration cannot be analysed simply as a case of economic regions moving from financial isolation to sharing a common financial market. This would be the standard approach of international economics, but here it does not apply very well. In fact, regions – referring to areas smaller than a country – have been financially integrated at the national level already for a long time. In Finland, for example, the national financial markets have been quite well unified for decades, so that speaking of some specific financial markets of say, the present-day Helsinki region, is not viable. 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 holds true for all developed countries at present.

Under the circumstances, the impact of financial integration on economic regions cannot be analysed satisfactorily by using the simplest tools of international economics or economic geography. Instead, the question is, how financial integration between nations affects economic regions within countries. This is a much more complicated issue, as we cannot assume that international financial integration will have a similar impact on all regions within a given country. Furthermore, regions have different policy concerns from those of nations: national economic policy has to do with "hard" methods like taxation and financial regulation. Regional policy makers, however, are more concerned on aspects that can be regionally differentiated, such as infrastructure and education, as well as promoting cooperation between firms in regional industrial clusters, etc. Hence, the emphasis on "soft" and proactive policies is greater at the regional than national level.

The second reason which complicates the analysis of the impact of financial integration is that our key concern is not 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 (see O'Brien 1992). This contrasts with the standard approach which would analyse 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.

Focussing on these "second-round" or indirect effects of financial integration is essential as in most regions, the financial services industry forms a relatively small portion of the economy. In Finland, for example, financial services account for about 1.6 per cent of all jobs, and in Germany, the respective value is 3 per cent. While the direct employment impacts 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 therefore, a unified theory of the role of financial markets in the economy is not really available (see Levine 1997). The market for savings is analysed by macroeconomics; the market for risk is analysed using the theory of finance; and the market for corporate control is analysed using the theory of industrial organisation. Finally, the intermediation of payments is usually analysed in the context of monetary theory (or recently, network economics). In many financial relationships, these different functions of financial markets appear intertwined, but they are nevertheless conceptually separate and their purposes and impacts on financial integration are also different.

The functions of finance in the economy

Market for savings

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

Let us first look at the macroeconomic aspect. 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 as they help them to transfer their 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 this perspective of financial intermediation in space the resources are not moved in time at all, but only from one place to another (cf. Obstfeld & Rogoff 1995).

There is a 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 keep investment demand relatively subdued. This may denote that Europe is to join Japan as one of the significant capital exporters of the world – unless Europe's government deficits remain too large and use 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. At the same time, both saving and investment will increase as 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 emphasises the equalising 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 equalise the capital intensities of regions and hence equalise 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, see e.g., Helpman & Krugman 1986 for a famous exposition), the classical view is no longer considered as the whole truth. New economic geography emphasises the importance of economies of scale in many industries. In these 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 previously been invested ("sunk") in a particular industry in a particular region. For these kinds 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 in these financial centres is higher than in other cities.

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

Market for risks

Let us now turn to the second function of financial markets, the transfer of risk. Financial markets allow investors to diversify their assets so that the overall risk 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 (Stulz 1981).

This implies that 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 depress financial asset prices less than before integration and therefore, required rates of return decline and asset prices generally appreciate as a result of increased diversification possibilities. The biggest gainers from this process 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 increasing 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 specialise in a more courageous way than they otherwise could. Thus, financial integration favours, or even enables, greater regional specialisation and concentration of business, especially for companies which are large enough to benefit from the possibility of an internationally diversified ownership. As a result of increased diversification of asset holdings, savers are able to isolate themselves better from economic fluctuations taking place in their home region.

Market for control

The third function of financial markets is to transfer control (Jensen & Ruback 1983). Buying a large number 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 as if the market works well, this control will end up with those owners who can put resources to most efficient use. Also, selling some corporate control to outside investors will allow innovators to 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 better managed will change owners and be reorganised. 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. The role of foreign direct investment in technology transfer has been understood already for some time (see UNCTAD 1998).

Over the last ten years, financial integration has probably had the greatest impact just through the market for corporate control. This is apparent from the example of China, which has been a major exporter of capital for about 10 years now, since 1997. In net terms, China has been investing abroad more than other countries have invested in China. For Chinese development, however, the important issue has not been the net capital flow – which was outward in any case – but rather the foreign direct investment. The effect of this phenomenon is that instead of capital as such, China has been importing foreign control, management and technology in large amounts and this has actually revolutionized the Chinese economy and also the world economy in the process.

In the public debate 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. A 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 makes 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 this may be in each case.

The importance of control and trust for financial relationships is very important at the fundamental level due to the 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 (Leland & Pyle 1977).

The importance of monitoring, screening and control emphasise the value of proximity. This is why information concerns put certain limits on how far financial integration can go. Hence, 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 be felt mainly in those financial services which are capable 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 also exist categories of financial services which cannot be commoditised 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 commoditised, because if it were, 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 a venture capitalist who knows the firm and its management and has some control on the way it is developed (Zook 2002).

Private equity investment does not necessarily need to be locally or regionally based. Indeed, financial integration may well increase such investment in the long range due to specialised expertise that 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.

Provision of a payment system

Last but not least on 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, denoting to 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 financial services such as mortgages, time deposits, asset management, and life insurance would become much more competitive. The high fees charged currently on 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 the payments industry can be expected mainly in the euro area where the creation of the Single Euro Payments Area is already under way (Salo 2006). The completion of this project will not only facilitate payments in the area but it will also make financial services more competitive. In this way, the benefits to businesses from operating in the euro are would be strengthened.

Conclusions from a regional perspective

Financial integration holds great promise in terms of growth efficiency and economic opportunities, but it also requires significant adjustments in public policy and private business performance. Financial integration is a great equaliser 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 emphasised. 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 in time become much more important for economic success. 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 supports the growth of importance of other dimensions of competitiveness.

It is interesting to note that those dimensions of competitiveness which are emphasised 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 also emphasises the importance of regional coordination of policies regarding things such as infrastructure, education, and business promotion.

There are, however, limits to how far financial integration can proceed. These limits are determined by the fact that many financial relationships require trust and information that is hard to establish from a distance. As the structure of financial services is likely to consolidate to bigger units and concentrate in large cities in the future, these information concerns constitute a counterforce to such 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 specialised ones. Therefore, in order to combine the benefits of specialised information, geographic proximity and efficient size, the creation of strong, specialised business clusters will be even more essential in the future to ensure the success of a region in the international financial integration, financial consolidation, and tougher competition. It is the challenge for local policy makers and business communities to act as catalysts in the formation of such structures.

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