Fragmentation of the European financial market and the cost of bank financing

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European market fragmentation following the crisis has resulted in a widening of borrowing costs across Euro area countries, with interest rates in countries hardest hit by the sovereign debt crisis rising well above those in the rest of the Euro area. The rapid construction of a banking union is the only way to reduce these large cross country interest rate differentials and help promote recovery, particularly in the distressed countries[2].

The impact of the crisis has halted the process of interest rate convergence, which had been taking place following the creation of the European Monetary Union (EMU), and ushered in a new period in which the interest rate differences between countries have widened. This trend has been exacerbated further in distressed countries after the sovereign debt crisis broke out, and in particular in the case of borrowing costs for SMEs. Currently, the cost of financing for SMEs in distressed countries is twice that in other countries, with Spanish SMEs paying 35% and 77% above Euro area and German SMEs, respectively. Deposit rate convergence has also been reversed, as banks' reliance on retail deposits for funding has driven up financing costs, again particularly for the distressed countries. These higher costs, ultimately passed on to consumers, are adding an additional drag on growth. Examining the case of Spain, we can clearly observe the additional burden of this market fragmentation on businesses and households. In this context, a genuine banking union is the only way to reduce the huge differences currently existing between the borrowing costs paid in different countries of the Euro area.

Until the crisis broke out in mid-2007, the creation of the European Monetary Union (EMU) had enabled the level of integration of European financial markets to progress rapidly. The nominal convergence that took place brought down interest rates in countries where they had started off high, lowering their cost of capital, and so boosting investment. By the same token, when financial integration subsequently went into reverse, the differences in borrowing costs between countries widened, with interest rates in countries hardest hit by the impact of the sovereign debt crisis (referred to here as "distressed countries") rising well above those in other EMU countries. Consequently, distressed countries have seen a bigger drop

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[2] The group of distressed countries consists of Greece, Ireland, Portugal, Cyprus, Italy, Spain and Slovenia.

in investment, which in conjunction with the austerity programmes implemented to meet their deficit and government debt targets, is placing a drag on their possibilities of recovery.

Against this backdrop, it is SMEs that are suffering the worst of the credit squeeze. The rate of bank credit growth has fallen dramatically, with rates turning negative in several EMU countries.

Interest rates on bank loans to businesses and households in the distressed countries are currently much higher than those elsewhere in the Euro area. As the European Central Bank (ECB) acknowledges, bank interest rates respond much more to each country's sovereign risk premium than to the ECB's benchmark rates.

However, the problem is not just the quantity of credit but also the price. The interest rates on bank loans to businesses and households in the distressed countries are currently much higher than those elsewhere in the Euro area. As the European Central Bank (ECB) acknowledges, bank interest rates respond much more to each country's sovereign risk premium than to the ECB's benchmark rates. The effects of monetary policy decisions consequently vary from country to country. The monetary policy transmission mechanism has therefore broken down. Thus, the calls for fresh monetary stimulus frequently heard from various corners may be ineffective and have only marginal effects in the distressed countries. Similarly, the high interest rates on loans in peripheral countries are a damper on otherwise sound investment projects, hindering these countries' recovery.

Against this backdrop, this article aims to analyse how bank interest rates have evolved in the EMU since 2003. As well as analysing how inequalities have evolved between countries, it focuses in particular on a comparison between those countries hardest hit by the sovereign debt crisis and other countries, both in terms of the borrowing costs households and firms face, and bank deposit interest rates. The article analyses the Spanish case in detail, comparing the interest rates set by Spanish monetary financial institutions (MFIs) and those in other Euro area countries. The significant differences in interest rates between the distressed countries and other EMU countries highlight the urgent need to make progress on achieving a genuine banking union. Doing so would be of enormous benefit to Spanish businesses and households, which would be able to borrow much more cheaply than they are able to at the moment.

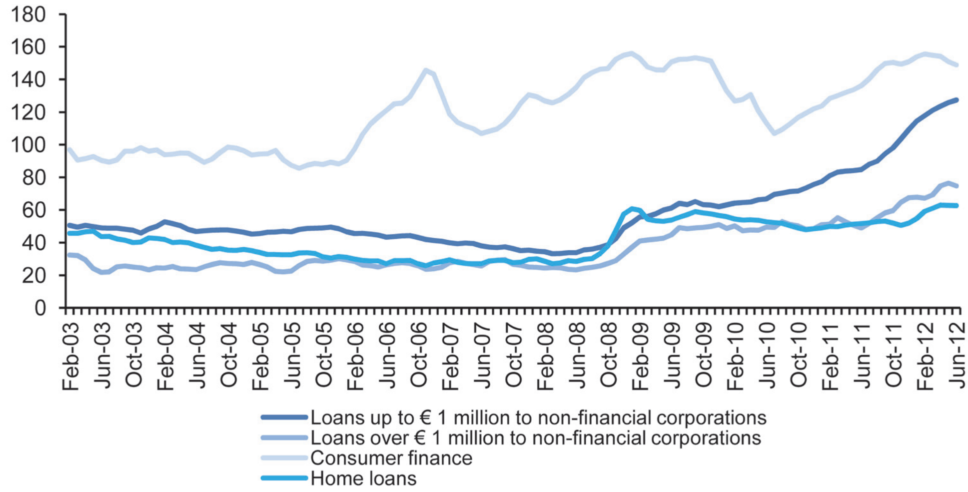
From convergence to divergence in bank interest rates

Using the data reported to the ECB each month since 2003 for EMU MFIs on interest rates on new credit operations, Exhibit 1 shows how cross-country standard deviation of interest rates has varied across the Euro area countries. In the case of credit to non-financial corporations, the bankruptcy of Lehman Brothers in September 2008 represented a turning point in the interest rate convergence prevailing in the preceding years. From this point on, the differences between countries began to widen, with the difference being much more marked in the case of loans of less than a million euros. In mid-2012, the standard deviation of the interest rates on these loans was almost twice that of larger loans.

In the case of residential mortgages to households, since 2008 the differences in interest rates between the countries of the Euro area have also widened. Although they have since stabilised, since that time the level has remained much higher. By contrast, the way the standard deviation of consumer finance has varied over time has been much more erratic, reaching levels in 2012 that were 40% higher than at the start of the period.

Exhibit 1

Cross-country standard deviation of interest rates across the Euro area countries



Source: ECB.

The cost of the bank financing: The impact of the sovereign debt crisis

The creation of the EMU made it possible to bring down nominal interest rates and firms' and households' real borrowing costs. The drop was much more pronounced in countries that started off from higher interest rates, which explains the interest rate convergence between Euro area countries that took place.

However, the impact of the crisis has halted the process of convergence and ushered in a new period in which the interest rate differences between countries have widened, and this was exacerbated further after the sovereign debt crisis broke out. Thus, as Exhibit 2 shows, whereas average interest rates on loans to non-financial corporations of less than 1 million euros in distressed countries increased by 110 basis points (bp) between 2010 and 2012, rates fell by 20 bp in other Euro area countries. With the exception of Slovenia, interest rates have risen by over 100 bp in Cyprus, Greece, Spain, Italy and Portugal, whereas rates have fallen in 6 of the 17 Euro area countries. In the case of larger loans (over 1 million euros) to businesses, the rise observed in the distressed countries also contrasts with the drop seen elsewhere. From 2010 to 2012 the average rate in the first group of countries rose by 86 bp, whereas in the second group it fell by 17 bp. Again with the exception of Slovenia, interest rates rose in all the distressed countries, particularly in Italy, Cyprus, Greece and Portugal, with an increase of more than 100 bp.

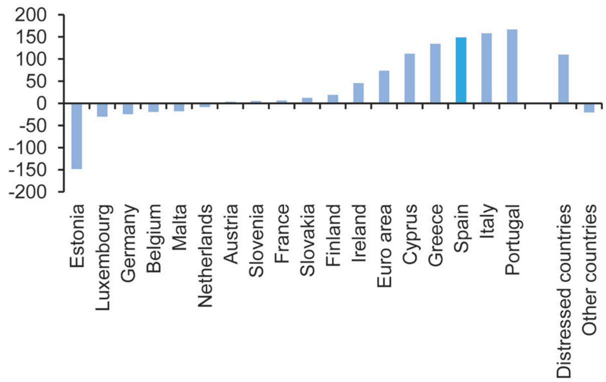
A difference in interest rates between distressed vs. other countries has also emerged in the case of home loans since the outbreak of the sovereign debt crisis. Thus, whereas interest rates have risen by an average of 41 bp in the distressed countries, they have fallen by 3 bp in the others. Nevertheless, the interest rate rise was smaller in comparison with that affecting business loans, with the biggest increases in Italy and Portugal.

Interest on household consumer finance, however, increased less in the distressed countries after

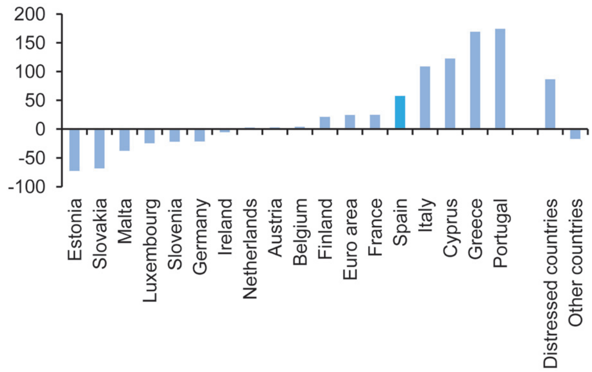
Exhibit 2

Variation (basis points) of interest rates (new credit operations) from 2010 to 2012

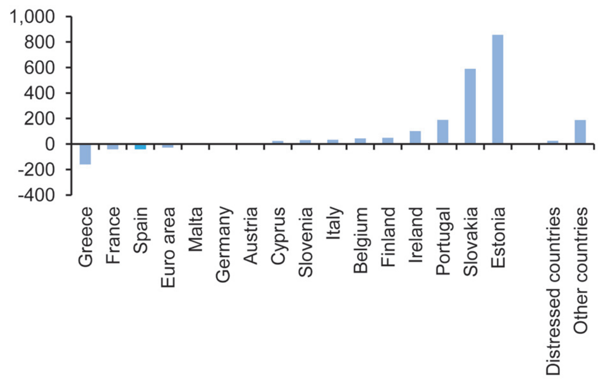
Loans up to €1 million to non-financial corporations



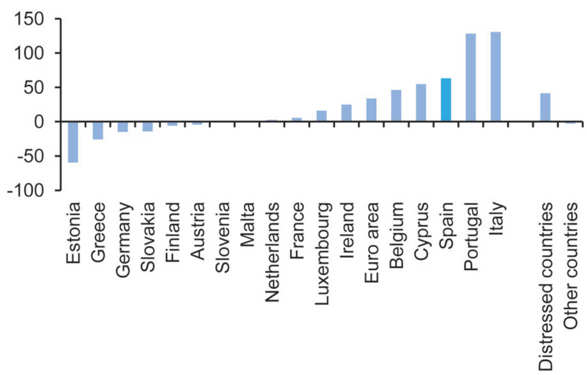
Loans over €1 million to non-financial corporations



Consumer finance



Home loans



Source: ECB and own elaboration.

2010, although this was affected by the anomalous behaviour of Estonia and Slovakia, where interest rates rose by 856 bp and 590 bp, respectively.

Loan interest rates in 2012

What is the current situation of the cost of bank financing paid by firms and households in the various countries of the Euro area? Exhibit 3 shows the ranking of rates from lowest to highest for the four types of loan considered based on average monthly data for 2012. In the case of Euro area non-financial corporations' borrowing costs, the interest rate on loans of less than a million euros is 164 bp higher than that on larger loans, reflecting the penalty SMEs face. In both cases, the distressed countries pay higher interest rates, with a surcharge of 269 bp on smaller loans and 208 bp on larger ones. In other words, firms in the distressed countries face a cost of bank financing that is 85% higher than in the other countries, regardless of their size. This fact alone is, without

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a doubt, sufficient reason to call urgently for the creation of banking union.

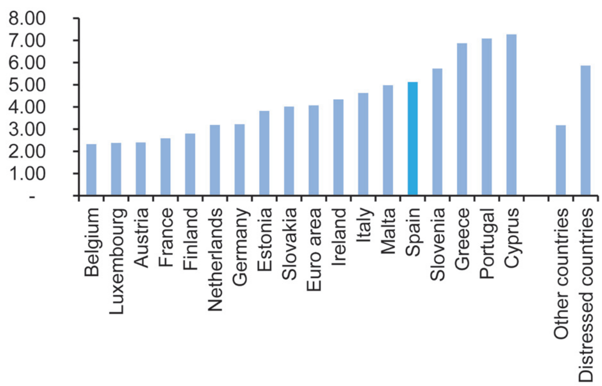
The breakdown of the information by countries reveals the wide range of variation within the Euro area. Thus, for loans of less than a million euros, countries paying more than 50% over the European average (the case of Greece, Portugal and Cyprus) exist alongside others in which loans are more than 40% lower than the average (Belgium, Luxembourg and Austria). And the range of variation is similar for larger loans, with a difference of 494 bp between rates in the countries paying the highest interest (6.66% in Cyprus) and those paying the lowest (Belgium, 1.74%). In countries such as Portugal, Greece and Cyprus the cost of finance is more than twice the European average, whereas in Belgium, the Netherlands and Austria it is 20% lower.

For households, the biggest differences in interest rates are in the case of consumer finance loans, where the range of variation between the maximum value in Estonia (19.6%) and the minimum in Finland (3.7%) is almost 16 percentage points. By contrast, the differences are much smaller in the case of residential mortgages, with a range of 3.4 percentage points. The distressed countries pay

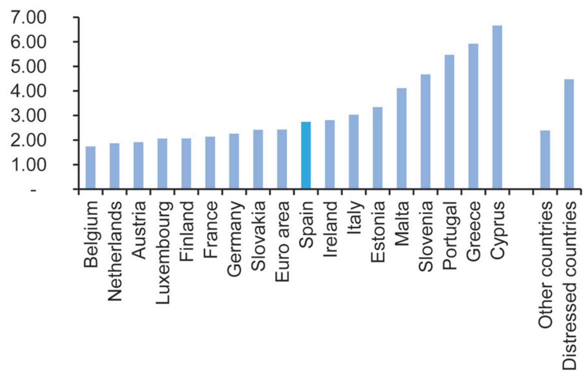
Exhibit 3

Loan interest rates (new credit operations) in the Euro area countries 2012 (percentage)

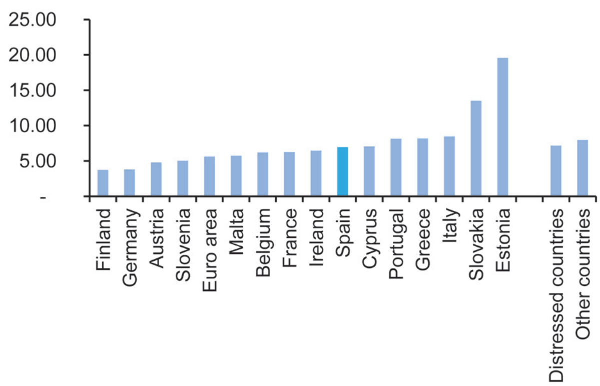
Loans up to €1 million to non-financial corporations



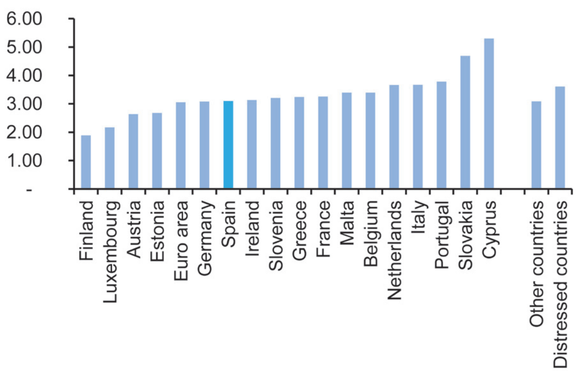
Loans over €1 million to non-financial corporations



Consumer finance



Home loans



Source: ECB and own elaboration.

Table 1

Loan interest rates (new credit operations) in the Euro area: Distressed vs. other countries

	Distressed countries (%)	Other countries (%)	Distressed-other countries (bp)
a) Loans up to € 1 million to non-financial corporations			
2003	4.8	3.9	86.9
2004	4.4	3.7	68.3
2005	4.4	4.4	-0.2
2006	5.1	6.0	-94.7
2007	6.2	5.5	62.0
2008	8.0	6.0	208.1
2009	4.9	3.7	123.1
2010	4.8	3.4	138.7
2011	5.7	3.6	205.7
2012	5.9	3.2	269.3
b) Loans over € 1 million to non-financial corporations			
	Distressed countries (%)	Other countries (%)	Distressed-other countries (bp)
2003	3.7	3.2	43.9
2004	3.4	3.0	39.1
2005	3.4	3.0	43.6
2006	4.2	3.8	35.2
2007	5.2	4.9	27.4
2008	5.8	5.3	50.8
2009	3.7	2.8	96.2
2010	3.6	2.6	104.8
2011	4.5	2.9	157.5
2012	4.5	2.4	208.2
c) Cosumer finance			
	Distressed countries (%)	Other countries (%)	Distressed-other countries (bp)
2003	8.3	7.7	61.1
2004	7.7	7.1	68.4
2005	7.5	8.0	-46.0
2006	7.8	8.3	-41.4
2007	8.3	7.8	48.8
2008	8.7	7.3	135.3
2009	7.6	6.1	146.5
2010	6.9	6.1	83.0
2011	7.0	7.6	-51.1
2012	7.2	8.0	-78.9
d) Home loans			
	Distressed countries (%)	Other countries (%)	Distressed-other countries (bp)
2003	4.1	4.0	12.2
2004	3.9	3.6	22.4
2005	3.8	3.5	24.1
2006	4.5	4.2	21.7
2007	5.3	5.2	2.5
2008	5.6	5.4	19.3
2009	3.6	3.5	10.7
2010	3.2	3.1	8.2
2011	3.8	3.4	43.0
2012	3.6	3.1	52.3

Source: ECB and own elaboration.

somewhat higher interest rates (52 bp more), with Cyprus (5.3%) being the country with the most expensive home loans.

The fragmentation of the European financial market since 2007: Distressed *vs.* non-distressed countries

The current fragmentation of the European financial market, which is forcing firms to pay very different borrowing costs, is a relatively recent phenomenon. In fact, as Table 1 shows, for smaller loans the difference stayed under 100 bp until 2007 and in the case of loans over a million euros it did so until 2010. However, in the last few years the interest rate charged by banks in the distressed countries was more than 100 bp higher than that in other Euro area countries. This difference peaked in 2012 in the case of both loans of less than a million euros (where the difference is 269 bp) and those of more than a million euros (with a difference of 208 bp).

In the case of loans to households for home purchases, the differences between interest rates across the Euro area have always been relatively small. However, since the outbreak of the sovereign debt crisis the difference between the interest rates in the distressed and other countries has widened. Specifically, it was in 2012 that the gap was widest (52 bp). By contrast, in the case of consumer finance loans, there have been years in the past (2005 and 2006) when distressed countries benefited from low interest rates, a situation which was repeated in 2011 and 2012.

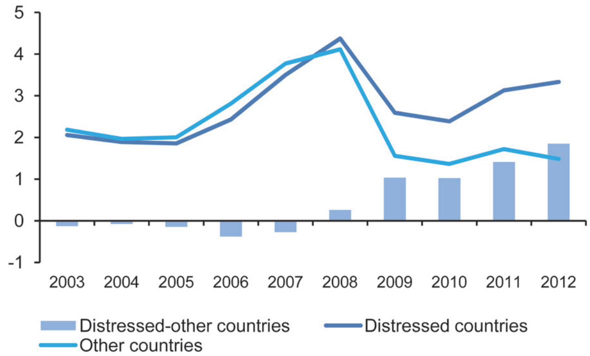
The cost of bank deposits

As the latest ECB report (April 2013) on the integration of European financial markets shows, the convergence in interest rates on bank deposits that prevailed up until 2007 came to a halt with the crisis and has given way to a completely different situation in which the differences have increased. Indeed, the standard deviation of interest on time deposits of up to one year offered to households across Euro area countries was multiplied by a factor of 3.2 between December 2007 and December 2012, while that on deposits from businesses was multiplied by 5.1.

What this widening divergence in interest rates on deposits implies is that the fragmentation of banks' sources of funding (interbank and debt markets) has forced MFIs to make extensive use of retail deposits as their source of finance. In the distressed countries this has meant banks have raised their interest rates and are offering rates well over the market interest rate, with all the repercussions this has on their bottom line. As Exhibit 4 clearly shows, while from 2003 to 2007 the interest rate on deposits in distressed countries was below that in other countries, subsequently the situation was inverted and a gap opened up, first appearing in 2009 after the bankruptcy of Lehman Brothers in September 2008 (which put huge strains on the financing markets), and then again in 2011 and 2012, albeit to a lesser extent, in the context of the sovereign debt crisis. In particular, in 2012 the interest rate on time deposits of up to a year in the distressed countries was almost twice that in other countries.

Exhibit 4

Deposit interest rates (new deposit operations with maturity up to 1 year) from households in the Euro area countries (percentage)



Source: ECB and own elaboration.

Obviously, these higher financing costs were passed on in the interest charged on loans to customers, with the inevitable negative impact on investment.

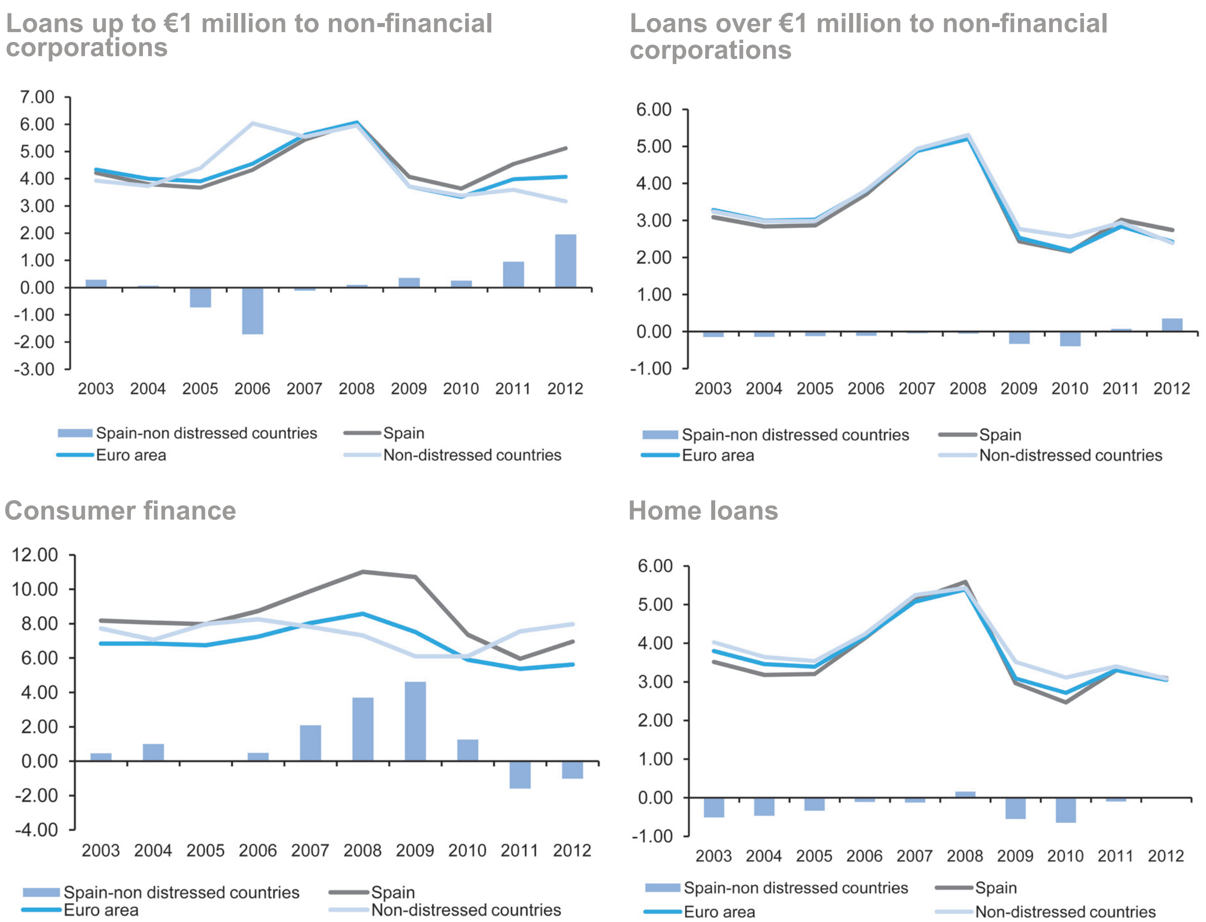
The cost of bank financing in Spain

In the specific case of the cost of bank financing in Spain, Exhibit 5 shows how interest rates on loans to businesses and households have varied since 2003, compared to the Euro area average, and that of non-distressed countries. What is interesting about this comparison is to analyse the extra costs Spanish businesses and households face, and thus the potential savings they would make if they paid rates similar to those that have not suffered the effect of the sovereign debt crisis on their interest rates.

In the case of business loans of less than a million euros, in the years prior to the crisis, Spanish SMEs had a cost of bank financing somewhat below the average for both the Euro area average and

Exhibit 5

Loan interest rates (new credit operations): Spain and Euro area (percentage)



Source: ECB and own elaboration.

non-distressed countries. However, since 2008 the situation has been the reverse, particularly in 2011, and more intensely in 2012, with the interest rate on loans in Spain 195 bp higher than in non-distressed countries and 105 bp higher than the Euro area average.

In the case of larger loans, Spanish businesses began to pay higher rates than their peers in either the Euro area or non-distressed countries in 2011, with a difference of around 35 bp. Therefore, it was Spanish SMEs that suffered the restrictions on access to finance more acutely, paying an average interest rate 238 bp higher than that paid by large firms in 2012. In the Euro area as a whole, banks also set higher average interest rates on business loans of less than a million euros. However, the difference compared with rates on larger loans is narrower than in Spain (164 vs 238 bp).

These higher interest rates Spanish SMEs pay are consistent with the results of the recent ECB survey on SMEs' conditions of access to finance. According to the survey, 47% of Spanish SMEs said that banks had become less willing to lend over the last six months, the highest rate in the Euro area, jointly with Greece. Similarly, 73% of Spanish SMEs reported that banks were charging higher interest rates, compared with a figure of 39% of SMEs in the Euro area as a whole.

In the case of home loans, interest rates in Spain have always been at levels similar to the Euro area average, the difference never exceeding 30 bp. In 2011 and 2012 the difference was negligible, compared to both the European average and non-distressed countries.

In the case of consumer finance loans, on the other hand, interest rates in Spain have always been above the Euro area average, reaching a maximum difference in 2009, the year in which Spanish banks set an interest rate 43% higher (320 bp) than EMU banks and 75% (462 bp) higher than banks in the non-distressed countries.

What impact has the fragmentation of the financial system had on deposits rates in Spain?

The previous sections of this article have described how, since the start of the crisis, and more markedly in the context of the sovereign-debt crisis, a gap has opened up between interest rates on bank deposits in distressed countries and the rest of the Euro area. The loss of confidence in the interbank

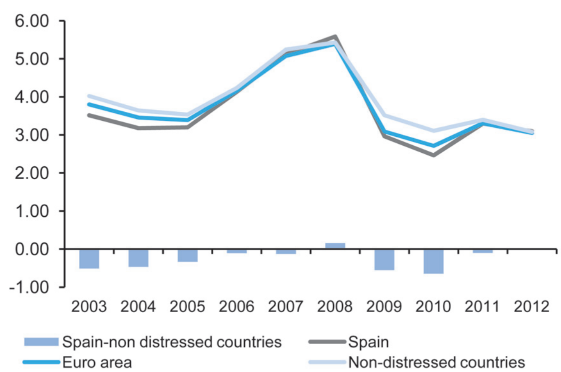
In Spain, the restrictions on access to wholesale markets have at times triggered a battle to attract deposits, with a negative impact on banks' bottom lines.

market and closure of the wholesale funding markets have forced banks in distressed countries to turn to retail deposits to meet their financing needs. In Spain, the restrictions on access to wholesale markets have at times triggered a battle to attract deposits, with a negative impact on banks' bottom lines. As Exhibit 6 shows, the

Exhibit 6

Interest rate (new deposit operations) of time deposits: Spain and the Euro area (percentage)

Household deposits up to 1 year



Source: ECB and own elaboration.

interest rate on time deposits in Spain in 2012 was 116 bp higher than the average for non-distressed countries, equivalent to paying financial charges that were 80% higher. This situation is completely the opposite of that in the years prior to the crisis, when Spanish banks set interest rates on deposits that were similar to those of other European banks.

The need to restore financial integration: The importance of banking union

Lowering the cost of capital is crucial to reactivating economic growth. The drop in the cost of access to finance that took place with the convergence in interest rates following the launch of the euro enabled countries starting out with high interest rates to benefit from a convergence towards the lower levels existing in other countries. This was one of the main routes along which financial integration drove their growth.

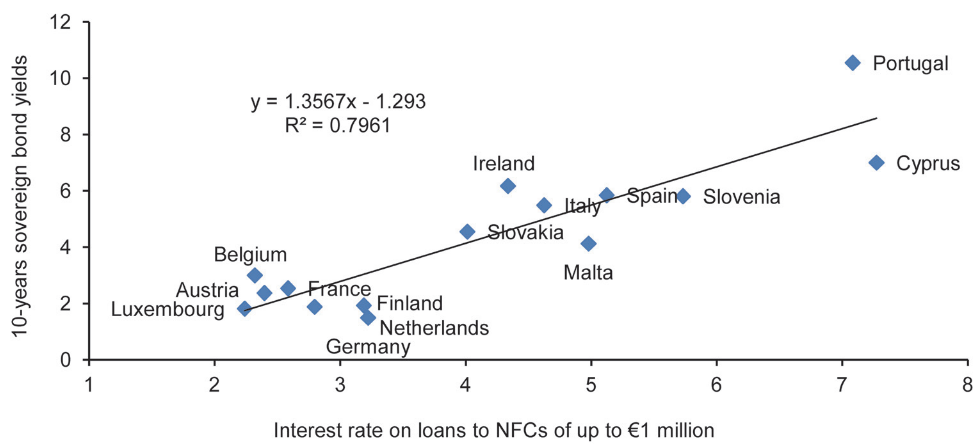
However, over almost six years of crisis the process of financial integration has gone into reverse. The fragmentation of the banking market has meant a widening of the difference in the cost of finance between countries, such that a gap has opened up between the countries worst affected by the sovereign debt crisis and the rest. Thus, in 2012 businesses in the distressed countries paid interest rates on loans of up to a million euros –the predominant form of financing among SMEs– that were 85% higher than those paid by companies elsewhere in the Euro area.

In a scenario of financial fragmentation such as that currently existing in Europe, the extent to which bank lending rates respond to the ECB's benchmark rate varies widely from one country to the next and is very limited in the distressed countries. Thus, the interest rates set by the

The interest rates set by the banks are powerfully influenced by the country's sovereign risk premium, such that the main channel of monetary policy transmission has broken down.

Exhibit 7

Relationship between loan (new credit operations) and sovereign debt interest rates for the Euro area countries 2012 (percentage)



Note: Greece is excluded as the high interest rate on 10-year government bonds (22.5%) distorts the graph.
Source: ECB and own elaboration.

banks are powerfully influenced by the country's sovereign risk premium, such that the main channel of monetary policy transmission has broken down. As Exhibit 7 shows, using 2012 data for the countries of the Euro area, there is a powerful correlation between interest rates on bank loans to businesses (taking those of less than a million euros as the reference) and sovereign debt (ten-year government bond yields).

In this context, implementation of a banking union needs to be accelerated in order to restore the effectiveness of monetary policy. The roadmap endorsed by the European Council in December 2012 represents a serious commitment to construction of a banking union, although the priority has been given to setting up a European banking supervisory mechanism, putting the creation of the banking crisis resolution fund and authority, and the European deposit guarantee fund second. This two stage strategy is pragmatic in that it means building a banking union from the pillar around which there is greatest consensus. It should be borne in mind that creating a genuine banking union demands that all three pillars be put in place, as the IMF urged in its latest financial stability report.

Until banking union is achieved, major differences between countries in terms of borrowing costs will persist. It is therefore necessary to create mechanisms to enable credit to reach businesses and households in the necessary quantity at affordable prices. This is a view both the ECB and IMF have backed recently. The ECB has announced new unconventional monetary policy measures and, in its *Global Financial Stability Report,* the IMF called for non-bank financing mechanisms and that any supply constraints to SME financing should be addressed as a priority to ensure that the financial system is able to play its role in facilitating economic recovery. In any event, the priority needs to be for rapid construction of a genuine banking union, as it is the only way to reduce the huge differences currently existing between the interest rates paid by businesses and households in different countries of the Euro area.

The roadmap endorsed by the European Council in December 2012 represents a serious commitment to construction of a banking union. As the Spanish government has rightly argued, the rapid implementation of a banking union will speed up the economic recovery Spain so badly needs.

As the Spanish government has rightly argued, the rapid implementation of a banking union will speed up the economic recovery Spain so badly needs. The most recent information available, dating from February 2012, shows that Spanish firms are paying interest rates on bank loans of less than a million euros that are 35% higher than the Euro area average, 79% than in non-distressed countries, and 77% higher than in Germany. Consequently, it is necessary to continue making progress on structural reforms so that the economy gains competitiveness, and to eliminate the current fragmentation in the bank lending market.