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ABSTRACT

What Lies Beneath the Euro's Effect on Financial Integration? Currency Risk, Legal Harmonization, or Trade?*

Although recent research shows that the euro has spurred cross-border financial integration, the exact mechanisms remain unknown. We investigate the underlying channels of the euro's effect on financial integration using data on bilateral banking linkages among twenty industrial countries in the past thirty years. We also construct a dataset that records the timing of legislative-regulatory harmonization policies in financial services across the European Union. We find that the euro's impact on financial integration is primarily driven by eliminating the currency risk. Legislative-regulatory convergence explains part of the total effect, whereas trade has no role in explaining the euro's positive effect on integration.

JEL Classification: F10, F15 and F30

Keywords: euro, exchange rate, financial integration, legislation, regulation and trade

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1 Introduction

The introduction of the single European currency has been one of the most important developments in the international markets over the past century. The sixteen European countries that have so far abandoned their national monies and adopted the euro did so expecting that monetary union and the accompanying integration policies would shield their economies from adverse shocks, smooth consumption, and promote non-inflationary growth. On its tenth anniversary, the debate on the costs and benefits of the euro is as intense as ever.

Given the difficulty of measuring the growth benefits of the euro with limited time-series data, the literature has focused on quantifying the effects of the euro on goods trade (Rose (2000); see Rose (2009) and Baldwin (2006) for surveys). However, examining the effect of the single currency not only on trade, but also on financial integration is fundamental as the free movement of capital across borders is a key prerequisite for the functioning of a currency area (Mundell (1961)). Thus, following the construction of new datasets on cross-border investment for a large number of countries (CPIS data from the IMF), recent studies examine the euro's impact on international capital flows (see Lane (2006b, 2009) and Papaioannou and Portes (2008, 2009) for reviews).¹ These studies augment an otherwise standard gravity equation of financial holdings/flows with an indicator variable that takes on the value one when the two countries are members of the euro area (and zero otherwise). This approach is certainly the natural first step in analyzing whether financial integration is higher among the euro area countries compared to other economies. Yet, this approach does not identify the sources of the euro's effect on financial integration. As Baldwin (2006) forcefully emphasizes in the similar context of the euro's impact on goods trade, it is vital that we investigate the underlying roots of this effect. For example, is the documented positive effect of the euro on financial integration driven by elimination of the currency risk among member countries? Or is it an outcome of various financial sector legislative-regulatory reforms that European countries undertook simultaneously with the euro's introduction? What if the positive effect of the euro on financial integration is simply due to increased goods trade?

In this paper, we address these questions. Our main contribution is to identify the sources of the euro's impact on financial integration.² We do so exploiting a unique (confidential) dataset

¹Lane (2006a) and Coeurdacier and Martin (2008) estimate that the monetary union increased cross-border bond holdings among the euro area countries by 230% and 150% respectively. Similarly Lane and Milesi-Ferretti (2008), Coeurdacier and Martin (2007), and de Santis and Gerard (2007), among others, document that the euro has increased international equity investment among member states by as much as 150%. In the same vein, Spiegel (2009a,b) finds that cross-border bank lending increased three-fold in Portugal and Greece after the euro's introduction.

²In recent work Hale and Spiegel (2009) also investigate the sources of the euro effect using disaggregated firm-level

from the Bank of International Settlements (BIS) that reports bilateral cross-border bank assets and liabilities for twenty advanced economies over the past thirty years. Compared to the previous cross-sectional studies, the rich panel structure allows us to perform a comprehensive before-after analysis of the impact of the single currency on cross-border integration accounting for time-invariant country-pair characteristics and global trends. This is important since a concern with the cross-sectional estimates in the literature is that they might reflect hard-to-account-for and unobserved country-pair factors that are both correlated with the euro and financial integration. Accounting for such factors is essential, as recent studies show that information asymmetries, distrust and cultural dissimilarities are significant determinants of cross-border investment (e.g. Portes and Rey (2005), Portes *et al.* (2001), Aviat and Coeurdacier (2007), Guiso *et al.* (2009), Ekinici *et al.* (2008)) and of banking in particular (Buch (2003); Gianneti and Yafeh (2008); Mian (2006); Papaioannou (2009)).³

We thus start our empirical analysis quantifying the total effect of the single currency on cross-border financial integration. We estimate difference-in-difference specifications that compare the “within” country-pair impact of the single currency among the twelve initial euro area member countries (the “treatment” group) with the general evolution of banking activities across the “control” group of economies (that consists of other EU and non-EU industrial countries). Our results suggest that following the adoption of the euro bilateral bank holdings and transactions increased by roughly 40% among the euro area countries. We obtain similar, though somewhat smaller estimates in the range of 25% – 30%, when we compare the increase in banking integration in the twelve countries that first adopted the euro with the three EU15 nations that have not joined the currency union. Both sets of these estimates, although highly significant, are much lower than the ones found in the previous studies examining the impact of the single currency on various types of capital flows/holdings. This illustrates that failing to account for country-pair fixed-effects (and global trends) can lead to inflated estimates, due to omitted-variable bias.

After quantifying the total impact of the euro in a panel regression framework, we turn to the main focus of our analysis and investigate the roots of this impact. First, we explore the impact of reducing currency risk and eliminating exchange rate fluctuations among the euro area

data on bond issuance before and after the euro. They find that the euro had the largest impact on non-financial firms. Specifically after the introduction of the single currency an increased number of non-financial firms issued euro denominated securities.

³The parallel literature that assesses the impact of currency unions on trade shows that accounting for country-pair unobservables is fundamental. For example while cross-sectional (“between”) studies document that the euro’s impact on trade was as large as 200%, the average fixed-effect (“within”) estimates falls to 8% – 12% (Rose (2009)).

countries. Among policy circles this was always considered to be the main channel of the euro's impact on financial integration and trade. To isolate the effect of the nature of the currency regime from other policies and developments, we use the recent update of the Reinhart and Rogoff (2004) exchange rate regime classification (from Ilzetzki *et al.* (2008)) and construct time-varying measures of the flexibility of bilateral exchange rates. This allows us to control for the fall in the exchange rate volatility among the EU currencies in the 1990s before the euro's adoption, when the EU countries joined the exchange rate mechanism (ERMII). Our panel specifications show that international banking activities increase significantly among pairs of countries that adopt hard pegs. Most importantly for our focus, once we control for the nature of the exchange rate regime, the indicator variable that switches to one after 1999 for the euro area countries drops significantly compared to the unconditional specifications; in addition, in most permutations it becomes statistically indistinguishable from zero. This illustrates that the euro's positive effect is mainly driven by elimination of the currency risk. This result is also interesting in the light of the so-called fear of floating literature, which argues that due to commitment issues, developing countries are unwilling to let their currencies float (e.g. Calvo and Reinhart (2002); Gelos and Wei (2005)). Our results contribute to this body of work by showing a similar pattern even among industrial economies.

Second, we examine the impact of legislative harmonization policies in financial services. Acknowledging that legal, regulatory, and supervisory differences in financial markets are significant impediments to the full integration of capital markets, the EU countries implemented various reforms in banking, insurance, and equity markets over the past decade. Most of these measures were under the umbrella of the Financial Services Action Plan (FSAP), an ambitious initiative launched by the EU Commission and the EU Council in the late 1990s aiming to harmonize the functioning of financial intermediaries. The most important policies of the FSAP were detailed into a set of EU-level laws, the Directives and the Regulations. Among others, the FSAP included new legislation on cross-border M&A activity of financial institutions, money laundering, transparency in capital markets, investor protection, and supervision (see Table 1).

To assess the impact of financial sector reforms on banking integration, we use information from the EU Commission and each of the EU-15 countries and build a new dataset on the implementation of the 27 Directives of the FSAP across member states (see Table 2). In contrast to Regulations that become enforceable immediately across the EU, the Directives are legislative acts that require from member states to achieve some well-specified results, but without clearly dictating the means. Most importantly the EU countries have discretion in the timing of the adoption (transposition) of the

Directives into the domestic legal order. European governments usually delay the transposition of the Directives to national law for various reasons such as shielding local firms from competition and protecting domestic interests. Hence, the transposition of the Directives takes in practice several years and differs considerably across the EU. As a result, we have significant country variation in the adoption time of the 27 legislative acts incorporated in the FSAP.

After constructing this new dataset, we estimate the effects of legislative convergence in the regulation of capital markets and banking on financial integration. Our estimates indicate that cross-border banking activities increased significantly among European countries that quickly adopted the financial services Directives of the FSAP. This result contributes to the law and finance literature (La Porta *et al.* (1997), (1998)), which emphasizes the importance of contracting institutions in shaping financial patterns. To our knowledge, this finding is the first result linking bilateral legislative harmonization on cross-border financial integration. However, although financial services legislative harmonization is a significant driver of banking integration, it cannot explain the total effect of the euro on its own.

Finally, we investigate whether the spur in cross-border banking integration is driven by an increased volume of transactions in international trade. As goods and asset trade move in tandem (e.g. Obstfeld and Rogoff (2000); Rose and Spiegel (2004); Rose (2005); Aviat and Coeurdacier (2007)) and currency unions raise bilateral trade (e.g. Rose (2000, 2009)), the positive impact of the single currency on financial integration may (partly at least) be coming from goods trade. Although there is a strong “within” correlation between banking activities and international trade, trade can not explain any part of the effect of the euro on financial integration.

The paper is structured as follows. In the next section we discuss the empirical specification and explain in detail our data. Section 3 gives our estimates on the total effect of the euro, and presents our analysis on the impact of the three aforementioned channels on financial integration. Section 4 concludes.

2 Empirical Specification and Data

2.1 Specification

Our baseline specification takes the following form:

$$BI_{i,j,t} = \alpha_{i,j} + \alpha_t + \psi_1 EU1_{i,j,t} + \psi_2 EU2_{i,j,t} + \psi_3 EZ1_{i,j,t} + \psi_4 EZ2_{i,j,t} + X'_{i,j,t}\gamma + v_{i,j,t} \quad (1)$$

The dependent variable (BI) is the average of the log of real bilateral assets and liabilities holdings (or gross flows) of countries i and j in year t , standardized by the sum of the two countries' population. We construct BI using data on cross-border banking activities from the confidential version of BIS's International Locational Banking Statistics Database that reports bilateral positions. We extract from this dataset bilateral stocks and flows covering twenty industrialized countries over the period 1977 – 2007.⁴ Our data covers all the twelve initial euro area countries (Austria, Belgium, Germany, Greece, Luxemburg, France, Finland, Netherlands, Spain, Portugal, Ireland, and Italy), plus the three EU15 non-euro area countries (Denmark, Sweden and the United Kingdom), and Australia, Canada, Japan, Switzerland, and the United States.⁵

Our focus is on the coefficient of the $EZ2_{i,j,t}$ (dummy) variable that takes on the value one if both countries are members of the eurozone in year t and zero otherwise. To isolate the effect of the single currency from an EU-wide effect, we also include in the specification a dummy variable that equals one if the two countries are members of the EU in year t and zero otherwise ($EU2_{i,j,t}$). In all specifications we also control for the unilateral effects of the EU and the euro on banking integration, adding in the specification indicator variables that take on the value one when only one of the two countries is a member of the EU or the euro zone in a given year ($EU1_{i,j,t}$ and $EZ1_{i,j,t}$ respectively).

The three dimensional panel structure allows us to control for year fixed-effects (α_t) and (more importantly) country-pair fixed-effects ($\alpha_{i,j}$). Year fixed-effects account for global trends on banking integration (see Lane and Milesi-Ferretti (2008)), that can be proxied by the euro if not controlled. Country-pair fixed-effects control for all time-invariant bilateral characteristics, such as trust, culture, information asymmetries that affect financial patterns.

Our empirical model constitutes a difference-in-difference specification, where the euro area member countries are the “treatment” group, while the three EU and the five non-EU countries serve as the “control” group(s). Since we include both time and country-pair fixed-effects the coefficients on the indicator variables measure the effect of the EU and the euro membership on banking integration of the participating countries compared to evolution of international banking integration in the other industrial economies.

⁴The Locational Banking Statistics nowadays covers data from roughly forty countries; yet half of these countries started reporting only recently (mostly after 2000) or are “off-shore” centers. Therefore, we only analyze the twenty industrialized countries that appear in the BIS dataset since 1977.

⁵Thus the maximum number of observations are 5,700 ($20 * 19 * 30/2$). Usually bilateral asset and goods trade data contain many zeros that make the logarithmic transformation questionable. Our focus on industrial countries makes our analysis immune to this problem, because we miss just a few observations and only in the beginning of the sample. Our baseline models are estimated in a sample of 5,566 observations.

The other independent variables ($X'_{i,j,t}$) are the flexibility of the exchange rate regime and the bilateral harmonization, which are explained in detail below, and also trade intensity and real GDP per capita.

2.2 Data

Dependent variable

The BIS Locational Banking Statistics database covers all of banks' on-balance sheet exposure, as well as some "off-balance sheet" items. The dataset reports asset and liability holdings of banks located in the main industrial countries ("the *reporting area*") against more than 100 economies (the "*vis-a-vis area*") since the end of 1977. The data includes mainly cross-border bank-to-bank lending activities, such as foreign loans, deposits and long-term debt placed with non-resident banks, including bank's own related offices abroad and subsidiaries.⁶ The data also covers trade-related credit, and holdings of debt securities issued mainly by other banks, and participations of equity and FDI. Yet, BIS documentations suggests that equity portfolio was, until recently, a small fraction of international banking activities (see BIS (2003a,b) and Wooldridge (2002)).⁷ Domestic monetary authorities report to the BIS the currency exposure of local banking institutions and using this information the BIS also reports cross-border flows, which are estimated by the BIS staff as the exchange rate adjusted changes in holdings.

The data is originally expressed in current US dollars. After deflating all series with the U.S. price index, we construct two measures of banking integration, one based on stocks and one based on gross flows. $BI1_{i,j,t}$ is the average of the log of real bilateral assets and liabilities holdings of countries i and j in each year, standardized by the sum of the two countries' population. $BI2_{i,j,t}$ is the average of the log of real bilateral assets and liabilities gross flows, standardized by the sum of the two countries' population in year t .⁸

⁶This is the main difference with the similar BIS Consolidated Banking Statistics Database, used for example by Spiegel (2009a,b). However, Spiegel measures the impact of the euro only for Greece and Portugal.

⁷Unfortunately the data-base does not distinguish between portfolio investment and debt loans.

⁸We also constructed other measures of bilateral banking integration. First, following Rose and Spiegel (2004) we didn't standardize the variables with population (and controlled for the product of log population). Second, following early works on trade we used the log of the average (and alternatively the sum) of bilateral holdings and gross flows (see Baldwin (2006) for a critique of this measure). The results are similar and hence not reported for brevity.

Exchange rate regime

To investigate the impact of currency risk we augment our main specification with a bilateral time-varying measure of the flexibility of the exchange rate regime ($ER_{i,j,t}$). We do so using the latest update of the Reinhart and Rogoff (2004) exchange rate regime classification (by Ilzetzki, Reinhart and Rogoff (2008)). Using data on official and dual (parallel and black) foreign exchange markets, Reinhart and Rogoff (2004) produce two classifications of the exchange rate regime at a monthly frequency from 1946 till the end of 2007. The “coarse” index distinguishes between four regimes, fixed (score of 1), crawling pegs (score of 2), managed floating (score of 3), and free floating (score of 4).⁹ The “fine” grid ranges from 1, indicating a fixed-exchange rate regime (such as the euro), till 13, suggesting a freely floating exchange rate.¹⁰ For our benchmark estimates we prefer the “fine” classification, as it exhibits larger variation and is less correlated with the binary euro area measure ($EZ2$) that we also include in the specification. We also show results with the “coarse” classification for robustness (see Table 5). For both classifications, we construct a bilateral measure of exchange rate flexibility by taking the sum of the log of the scores for each country in the beginning (as of January) of each year ($ER_{i,j,t}^{f,c} \equiv \ln(ER_{i,t}^{f,c}) + \ln(ER_{j,t}^{f,c})$ where superscript f and c indicate the fine and the coarse classification).

Legislative harmonization

The introduction of the euro was accompanied by legislative reforms in financial services. To isolate the impact of these policies we use information from the European Commission and the EU-15 Member States on the implementation of the Financial Services Action Plan (FSAP) and construct a new dataset that measures the degree of legislative harmonization in financial services across European countries.

The FSAP was a major 5-year program launched by the European Union in the end of 1998 with the aim to establish: (1) a single EU wholesale market for financial services, (2) open and secure retail markets, and (3) state-of-the-art prudential and supervisory regulations. The project

⁹There is also a fifth category, free falling, that includes hyperinflation currencies. Yet none of the 20 industrialized countries we consider is ever placed in this category.

¹⁰For example, for most years the US dollar, the Japanese yen, and the Australian dollar get a score around 11 – 13. The Swiss franc ranges from 8 to 12, while the Canadian dollar fluctuates around 8. The variation in European countries is substantial. In general, European currencies appear in intermediate status for most of the 1980s (in the range of 4 to 8); in the early 1990s the majority of countries move to a fixed-regime range (score of 4), and to a fully-fixed regime (score of 1) for the ones that join the euro in 1999. The Deutsche mark is classified as a free floating currency (score of 13) till 1998.

included 42 measures that aimed to create a harmonized EU market for banking, securities and insurance. The most important part of the project consisted of (27) EU-level legislative acts (the Directives) and (2) Regulations. The other measures were Communications and Recommendations of the Commission with the member states on technical issues.

Until its official completion at the end of 2003, the EU legislative bodies (the EU Council and the European Parliament with the assistance of the EU Commission) passed most of the initially planned measures. In particular, the EU bodies passed 21 Directives and 2 Regulations. The remaining 6 Directives were initiated with some delay, but their circulation took place before the end of our sample period (end of 2007). Unlike Regulations that become enforceable immediately after their passage across all EU member states, Directives have to be transposed within a certain period in the legal order of the member states. Usually the transposition time takes a couple of years, as it entails various technical modifications and adaptations. In general, European governments prefer to adopt Directives rather than Regulations. It is common practice for member states to delay the transposition of the Directives for technical reasons (some countries need to change internal laws or/and create new institutions to incorporate the directive into national law), but mainly for domestic policy considerations, such as protecting local firms, shielding national industry interests, etc.¹¹ The bottom-line is that there is significant heterogeneity on the adaptation timing across countries, which is essential for our purposes.

Table 1 gives the title, the date of circulation by the EU Commission, and the deadline for the respective transposition for each of the 27 Directives of the FSAP. Table 2 reports the date of the transposition for each Directive across all EU15 member states. There is sizable heterogeneity on the timing of the transposition across member states. Take for example the first Directive of the FSAP on Settlements that was circulated by the Commission in late 1998. Only half of the EU-15 countries transposed the Directive in the following year. France, Luxemburg, and Italy took three years to incorporate this Directive into national law. The transposition pace of the Directive on the Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate was notoriously slow. Although the transposition mandate expired in late 2004 (following an adoption time framework of two years), it was only incorporated in time only by four countries (namely Denmark, France, Finland and the UK). Most countries took five years to transpose this important financial legislation into national law.

¹¹Numerous assessments conclude that this system of transposition was too slow, rigid, and failing to distinguish between essential framework principles and implementing rules (see the so-called Lamfalussy report). The Takeovers Directive, for example, had been discussed and negotiated at the EU level for 12 years. Likewise it took more than 30 years for EU governments to agree, vote, transpose and implement the European Company Statute Directive.

To create the bilateral harmonization variable ($HARM_{i,j,t}$) we first define twenty-seven indicator variables that equal one starting at the year of the transposition of each directive into national law in each country, and zero otherwise. Second, we construct a country-level time-varying legal transposition measure ranging from zero to twenty-seven by summing up the values of the indicator variables for each Directive ($LEX_{i,t}$). Third, we construct the bilateral harmonization index by taking the sum of the logs of one plus the legislation measure for each country (i.e. $HARM_{i,j,t} \equiv \ln(1 + LEX_{i,t}) + \ln(1 + LEX_{j,t})$).¹² For robustness we also construct the LEX and $HARM$ indicators using the initial twenty-one Directives that were passed by the Commission before the official completion of the FSAP.

3 Results

3.1 Total Effect

Table 3 reports our results on the total (aggregate) effect of the euro on banking integration.¹³ Columns (1)-(2) of Panel A report unconditional estimates in the maximum sample of twenty countries and thirty years with the stock and the flow based measures of banking integration. The coefficient on the $EZ2$ indicator variable is positive and statistically significant at the 1% level in both permutations. This indicates that bilateral banking activities among the euro area countries increased significantly after the adoption of the single currency. In contrast, the $EU2$ variable enters with an insignificant estimate. This suggests that it was the adoption of the single currency rather than being a member of the EU that has contributed to the increase in financial integration. The coefficient on $EZ1$ that equals one when one of the two counterparts has adopted the euro is insignificant, suggesting that the unilateral impact was much smaller than the large bilateral effect.

While in the specifications reported in columns (1)-(2) we do not condition for other covariates, the inclusion of country-pair fixed-effects accounts for most of the usual control variables of standard gravity equations of financial flows, such as distance, colonial ties, and land areas, all of which have been shown to affect integration. In addition, the country-pair fixed-effects account for other hard-to-measure time-invariant bilateral factors that affect financial linkages, such as trust,

¹²For robustness we also used the sum and the product of the logs of the countries' scores in transposition. We also simply took the sum of the country measures of legislative harmonization, again finding almost identical results. We prefer the logarithmic transformation because the harmonization variable is skewed. In addition, since the dependent variable is also specified in logs this transformation makes the interpretation of the coefficients easier.

¹³To account for serial correlation and potentially for country-pair specific heteroskedasticity, standard errors are clustered at the country-pair level (Bertrand *et al.* (2004)).

cultural similarities, and information asymmetries. Gravity equations typically include the product of bilateral GDPs in the set of explanatory variables. The main idea is that larger-richer economies are able to attract more foreign investment, by providing a larger set of diversification opportunities (e.g. Martin and Rey (2004)) and offering collateral (e.g. Gertler and Rogoff (1990)). In columns (3) and (4) we repeat estimation controlling for the log of the product of real per capita GDP of the two countries in each year (using data from World Bank’s World Development Indicators database). Size is a significant correlate of cross-border financial holdings and flows, even after conditioning on country-pair unobservables and time trends. Yet the coefficient on the indicator variable that equals one when both counterparts are members of the euro area ($EZ2$) remains significant at the 1% level.

In columns (5)-(8) we repeat the estimation, dropping observations from the late 1970s and the 1980s. As cross-border banking activities increased drastically since the early 1990s, when the initial stages of the EMU were designed and implemented, it is important to explore the sensitivity of our estimates in this dimension. In addition, focusing in the 1990s and the 2000s allows us to examine the effects of the single currency with the same number of pre and post-1999 observations, something always useful in before-after event studies. The estimate on the indicator variable that switches to one when both countries join the euro area ($EZ2$) is stable and remains highly significant.

The most conservative estimate of the coefficient on $EZ2$ (in the specifications where we also control for GDP p.c.) implies that—compared to the general increase in banking integration across our group of industrial economies—cross-border banking activities between the euro area countries increased by 40% – 45% after the adoption of the single currency ($\exp(0.35) = 1.41$). While this effect is large, it is much smaller in magnitude than the estimates of Lane and Milesi-Ferretti (2008), Lane (2006a), de Santis and Gerard (2006) and Coeurdacier and Martin (2007), who, using IMF survey data and cross-sectional approaches, estimate that the euro has increased bilateral equity and bond holdings by around 100%, if not more. Our more conservative estimates is due to the inclusion of country-pair fixed-effects that accounts for all time-invariant bilateral factors that affect financial linkages. Indeed when we do not include country-pair fixed-effects and pool the data, we also find significantly larger coefficients. We similarly find much larger estimates when we simply control for country (rather than country-pair) fixed-effects or when we perform random effects panel estimation.

Yet, the interpretation of our within results is somewhat different than the cross-sectional estimates. The coefficient on $EZ2$ in Table 2 measures the (average) increase in bilateral banking

activities in a pair of countries that has adopted the euro compared to the evolution of international banking activities in the control group of countries. The cross-sectional estimates in contrast measure how much larger are financial linkages of the euro area countries compared to that of other economies in the post-1999 period.

The average bilateral effect of the euro on cross-border banking activities reported in Panel A of Table 3 is also lower than the estimates of Spiegel (2009a,b), who, using BIS consolidated banking statistics for Portugal and Greece over the period 1985 – 2006, finds that the single currency have increased the banking activities three-fold. Besides the different sample period and the somewhat different estimation method, the main reason for this difference is the extent of the data. Spiegel (2009a,b) focuses on two small euro area countries, while we investigate the impact of the single currency in all twelve initial members of the euro area.¹⁴ We thus explored whether the impact of the single currency was larger for small euro area countries compared to large economies. The estimates (not reported for brevity) are similar for the two group of countries (small and large) and almost identical to the coefficient reported in Panel A of Table 3.¹⁵

Panel B of Table 3 reports results of otherwise similar to Panel A specifications, estimated however only in the EU15 sub-sample. Although in Panel A we did control for unilateral and bilateral effects of EU membership, one may worry that there are different dynamics in the EU than the larger group of industrial countries. To account for this, we re-estimated the specifications in the EU15 sample. The coefficient on the indicator that switches to one for the twelve countries that adopted the single currency after 1999 remains statistically different than zero in all permutations. This reassures that (the more efficient) estimates in the full sample of countries do not reflect an EU-wide effect or different patterns in banking activities in the EU. The coefficient drops somewhat, implying that banking activities among the euro area countries increased by 25% ($\exp(0.21 - 0.25) - 1 = 23\% - 29\%$), compared to the evolution of banking integration in the three European countries that have opted out of the currency union.

¹⁴While we include in the specification country-pair fixed-effects to account for all time-invariant country-pair factors, Spiegel (2009a,b) includes source-country and recipient-country fixed-effects and directly controls for bilateral gravity factors (such as distance and common language). When we replace the country-pair fixed-effects with country fixed-effects the coefficient on the indicator variable that takes on the value one when both countries are euro area members retains significance and becomes significantly larger, much closer to Spiegel’s estimate.

¹⁵We thank Mark Spiegel for proposing this robustness check.

3.2 Channels

We now investigate the role of the exchange rate regime, harmonization policies in financial services, and trade on financial integration. This allows us to understand the underlying reasons for the total effect of the euro documented in Table 3. We start examining the effect of each channel. Then we simultaneously control for all of these factors and explore the sensitivity of our results.

Exchange rate risk The most immediate effect of the euro was to eliminate currency risk among member countries. Even before 1999 exchange rate fluctuations among the legacy currencies were limited. One of the criteria of the Maastricht Treaty of 1992 that set the rules for monetary union was that member countries had to join the exchange-rate mechanism (ERM II) for two consecutive years without devaluating its currency during the period. Yet, although exchange rate variability was lower for European countries participating in the ERM in the nineties than in previous years, foreign investors still had to bear a risk of an abrupt misalignment or a currency attack (as for example in the UK in September of 1992, in France in early 1993, or in Spain in 1992 and 1993).

To investigate the effect of exchange rate variability risk, in columns (1)-(2) of Table 4 we augment the baseline specification with the bilateral exchange rate flexibility measure, $ER_{i,j,t}^f$, based on “fine” classification of Reinhart and Rogoff (2004).¹⁶ The coefficient on the variable that reflects the bilateral flexibility of the exchange rate regime is negative and significant at the 1% confidence level.¹⁷ This suggests that banking activities have increased significantly among pairs of countries that have adopted more rigid currency regimes. This finding fits with the evidence from the fear of floating literature (e.g. Calvo and Reinhart (2002); Klein and Shambaugh (2008); Gelos and Wei (2005)). This research argues that in order to attract foreign capital, emerging economies are unwilling to let their currencies float; and even when monetary authorities in developing countries argue that they do not manage the currency in practice they do so (Reinhart and Rogoff (2004)). While this body of work focuses on developing economies, our panel evidence in Table 4 shows a similar pattern across developed countries.

In addition to its direct effect on integration, controlling for bilateral exchange rate flexibility also makes the coefficient on the indicator variable that equals one when the two countries are

¹⁶Since the product of log GDP p.c. enters always with a highly significant coefficient, we always include it in the specifications. The results are similar if we drop this variable from the estimation.

¹⁷We also estimated models using the sum of the exchange rate grid of the two countries. The results are similar. We also used the product of the logs of the two countries’ classification score. The bilateral exchange rate regime index enters always with a negative and significant estimate.

members of the euro area ($EZ2_{i,j,t}$) insignificant. While in some perturbations (reported below in Table 5) the estimate on the $EZ2$ retains significance, this is only at 10% – 20%. In addition the estimate falls considerably even when it is borderline significant compared to the unconditional specifications reported in Table 3. This suggests that the positive effect of the single currency mainly comes from the fall in exchange rate volatility.

Legislative Harmonization The euro was supported by various legislative and regulatory harmonization policies in financial services. Although some reforms occurred before 1999 (mainly with the adoption of the First and the Second Banking Directive), European banking markets remained fragmented till the eve of the monetary union (e.g. Hartmann *et al.* (2003)). The main objective of the Financial Services Action Plan (FSAP) was to tackle this issue and with its various legislative acts to create a single liquid financial market.

In columns (3)-(4) of Table 4, we augment the baseline specification with our newly constructed harmonization index ($HARM_{i,j,t}$) that sums the log number of the transposed Directives of the FSAP across the two countries (LEX) in each year. We remove (for the time) the exchange rate regime index from the set of explanatory variables, since we want to investigate the role of each channel one at a time. The coefficient on $HARM$ is positive and significant at the 1% level. This implies that legislative and regulatory harmonization policies in financial services had a significant positive effect on cross-border banking integration. As we control for EU and the euro area membership (with the four indicator variables), the significantly positive estimates on the bilateral harmonization index suggests that legislative harmonization in financial markets also had a first-order effect on cross-border banking integration that works on top of the general positive effect of the euro area membership.

Once we control for legislative-regulatory policies among the EU-members states, the coefficient on the indicator variable that equals one when both counterparts are members of the Eurozone, $EZ2$, drops compared to the unconditional estimates (in Table 3). It retains significance though (at the 10%). This suggests that while financial sector harmonization policies did boost cross-border banking activities, the effect of the euro on integration goes only partially through legislative harmonization in financial services.

Our results demonstrating a significant correlation between legislative harmonization and financial integration reveal that legal system differences may explain the lack of international diversification and other puzzles in international macro (e.g. Obstfeld and Rogoff (2000)). In addition our results provide empirical support to the “contractual view of finance” (Shleifer and Vishny

(1997)). The empirical literature on law and finance shows that country-level differences in investor protection can explain a sizable portion of the variability in financial markets size (see La Porta *et al.* (2008) for a review). Our results contribute to this body of work by showing that legal harmonization has also an effect on bilateral financial linkages. In addition most likely the effect of legislative harmonization policies in financial services is larger than our estimates suggest, since our index contains some measurement error. For example the transposition of the Directives into the domestic legal order differs to some extent across countries. Most importantly, actual enforcement of the EU legislation differs considerably across the EU (e.g. Djankov *et al.* (2003, 2008)) and thus the de-facto impact of the transposition might also be different than the de-jure effect that our estimates reflect.

Trade Starting with Rose (2000) a voluminous literature shows that currency unions increase international trade (see Baldwin (2006) and Rose (2009) for reviews). In the case of the euro, while initial (cross-sectional) studies document an (unrealistically) high effect, recent (panel) studies estimate that the single currency increased bilateral trade approximately by 8% – 14% (e.g. Flam and Nordstrom (2008)). Thus, another potential channel explaining the spur in financial integration among the euro area countries compared with other developed economies could stem from increased trade in goods. To account for this channel, in columns (5) and (6) of Table 4, we augment the baseline specification with the average of the log of bilateral exports and imports as a share of the two countries’ population ($TRADE_{i,j,t}$), using data from IMF’s Direction of Trade Database.

The coefficient on $TRADE_{i,j,t}$ is positive and significant, suggesting that trade in goods and bank claims go in tandem (e.g. Rose and Spiegel (2004) and Rose (2005)). Compared to the previous literature our results demonstrate that the strong trade-finance nexus is present even when we control for country-pair fixed-effects and global trends. Yet, trade linkages cannot explain the total impact of the euro on integration at all. The coefficient on the $EZ2$ indicator in columns (5)-(6) is quite similar to the analogous estimates in Table 3. In addition the estimate remains statistically significant at the 1% level. Thus while trade is a significant correlate of financial integration, it can not account for the large effect of monetary union documented in Table 3.

3.2.1 All channels and sensitivity checks

There is a possibility that each channel is proxying one another. Thus, in Table 5 we augment the specification with all three variables that capture the exchange rate channel, the legislative

harmonization reforms in financial markets, and trade. We also explore the sensitivity of our results by presenting results with the alternative exchange rate index (ER^c) based on the "coarse" regime classification (in columns (5)-(8)) and the legislative harmonization index ($HARM$) using only the initial 21 Directives of the FSAP (in columns (3), (4), (7), and (8)). As we lose 15% of our sample when we control for goods trade (due to some gaps on IMF's Direction of Trade Statistics), in Table 6 we report otherwise identical to Table 5 specifications, but without trade in the RHS.

The ER index that sums (the log) of the exchange rate regime of the two countries enters with a negative coefficient in all permutations of Tables 5 and 6. The coefficient drops by 20% – 50% compared to the estimates in columns (1)-(2) of Table 4, where we didn't control for legislative harmonization policies in financial services and trade. Yet the estimate is statistically significant in all but two of the sixteen specifications. Turning now to the effect of legislative harmonization policies in financial markets, the results in Tables 5 and 6 show that the FSAP had a significantly positive impact on spurring cross-border banking activities across Europe. In all specifications the harmonization index enters with a coefficient that is at least two standard errors above zero. The estimate (around 0.07 – 0.09) is also quite similar to the more parsimonious specifications in columns (3)-(4) of Table 4. As we control for exchange rate fluctuations, GDP differences, and trade, this result is encouraging for European policy makers, who are in the process of further promoting legislative and regulatory harmonization in financial markets. Trade continues to enter with a significantly positive elasticity. As long as the estimate is not driven exclusively by reverse causation, this suggests that besides more immediate effects, the euro could speed financial integration indirectly through goods market integration.

In almost all perturbations in Tables 5 and 6 the coefficient on $EZ2$ turns insignificant. Even in the specifications that the estimate retains significance, this is borderline and the coefficient drops considerably compared to the unconditional estimates in Table 3. Combined with the results in Table 4, the elimination of exchange rate risk seems to be the most important channel. Yet, legislative harmonization policies in financial services have also crucially contributed to the spur of cross-border financial linkages across the EU in the past decade. In contrast goods trade, while a significant correlate of banking integration, is not behind the large unconditional effect of the single currency documented in Table 3.¹⁸

¹⁸This is not to say that other policies and reforms did not have any effect. The EMU project included many policies that is hard-to-precisely pin down and measure. To name a few: With the adoption of the TARGET system (Trans-European Automated Real-time Gross settlement Express Transfer system) in 2000-1, payments between credit institutions within the euro-area take place in a single platform, in real-time and at a harmonized transaction fee. By reducing transaction costs, TARGET had most likely a positive effect on cross-border financial transactions.

We performed many robustness checks to explore the sensitivity of our main results. As already shown in Table 3 we estimated the specifications only in the 1990s and the 2000s to account for potential different dynamics in the two sub-periods. As the results in Tables 5 and 6 show our results are not sensitive to different ways to measure the nature of the exchange rate regime or the legislative harmonization policies of the FSAP. We also experiment with alternative measures of trade intensity finding similar results.¹⁹ In Table 7 we explore whether our results are driven by Luxemburg and Switzerland, the two countries with the largest share of foreign bank and liabilities in our sample.²⁰ Columns (1)-(4) report simple specifications (analogous to the models in Table 3) that estimate the total effect of the single currency on banking integration. The coefficient on the indicator variable that takes on the value one when both countries are members of the euro area retains its economic and statistical significance. The most conservative estimate in column (4) implies that following the adoption of the euro cross-border banking activities by approximately 50%, compared to the general increase in the other industrial economies ($\exp(0.402) = 1.49$). Yet once we control for the nature of the exchange rate regime and legislative harmonization (in (5)-(6)) the estimate on *EZ2* turns insignificant as in our previously reported results. As before, although trade in goods is also correlated with banking activities (column (7)-(8)), this cannot account for the effect of single currency on financial integration.

4 Conclusion

The introduction of the euro has been one of the most important policy experiments in international economics over the past decades. The initial focus of the literature was to investigate the effect of the euro on trade integration. Following the development of new datasets on cross-border investment, recent studies examine the euro’s impact on financial integration, documenting a large effect. Yet, we still do not know the exact mechanism through which the euro affects financial integration. This is the main task we undertook in this paper.

We construct a new dataset of legislative-regulatory harmonization policies in financial intermediation across the European Union in the last decade. We merge this newly constructed database

Similarly the number of payment systems was reduced from seventeen to six in 1999, minimizing transaction costs (see Kalemli-Ozcan *et al.* (2009) for a detailed summary of the technical and infrastructure steps that the EU bodies have taken to homogenize the various market segments for financial services).

¹⁹Our measure of trade intensity follows Calderon *et al.* (2007). We also experiment with other proxy measures of trade, such as the (log and the level) of average bilateral exports and imports as a share of GDP, finding similar results.

²⁰The results are similar if we exclude only Luxemburg or only Switzerland or if we also drop the United Kingdom.

with the confidential version of BIS's Locational Banking Statistics that records bilateral financial linkages among twenty industrial countries in the past thirty years. The rich panel structure allows us to reassess the euro's impact on financial integration accounting for all time-invariant country-pair factors, such as trust, culture, and information frictions.

Our analysis reveals the following robust regularities.

First, our "within" before-after analysis shows that while the total effect of the euro on financial integration is highly significant, it is quantitatively much smaller from what has been reported in the previous studies that relied on cross-sectional approaches and data covering the last decade.

Second, our "channels" analysis shows that the euro's impact is primarily driven by the elimination of currency risk across member countries. Legislative-regulatory harmonization policies in financial markets have also contributed significantly to the spur of cross-border lending and investment across Europe, and can explain part of the euro's impact. In contrast, while goods trade is a significant correlate of cross-border lending, it can not explain the euro's large impact on financial integration.

Our results have some straightforward policy implications. The fact that legislative-regulatory harmonization policies have a direct effect on financial integration on top of all the other channels and country/time factors is quite encouraging for European policy makers, who are currently in the process of promoting further harmonization. Future research should investigate the effect of such reforms on other aspects of integration, such as cross-border M&A activity, vertical and horizontal FDI, outsourcing, and risk taking by banks.

5 Data Appendix

Banking Integration 1 [BI1]: Banking integration index based on bilateral cross-border holdings (stocks) of banks. Data on bank’s cross-border bilateral stocks of assets and liabilities come from the confidential version of BIS’s Locational Banking Statistics. For each country-pair and year there are up to four observations. *i*) asset holdings (stocks) of banks located in country *i* in all sectors of the economy in country *j*; *ii*) asset holdings (stocks) of banks located in country *j* in all sectors of the economy in country *i*; *iii*) liabilities (stocks) of banks located in country *i* to country *j*. *iv*) liabilities (stocks) of banks located in country *j* to country *i*. The data is originally expressed in current US dollars. First, we deflate the four series with the US deflator. Second, we standardize the series by dividing asset and liabilities with the sum of the two countries population in each year (using data from World Bank’s World Development Indicators Database). Third, we take the average of the log value of real bilateral assets and liabilities in each year. *Source: Bank of International Settlements, Locational Banking Statistics (2008).*

Banking Integration 2 [BI2]: Banking integration index based on bilateral cross-border gross flows of banks. Data on bank’s cross-border bilateral gross flows of assets and liabilities come from the BIS Locational Banking Statistics. For each country-pair and year there are up to four observations. *i*) asset flows of banks located in country *i* in all sectors of the economy in country *j*; *ii*) asset flows of banks located in country *j* in all sectors of the economy in country *i*; *iii*) liability flows of banks located in country *i* to country *j*. *iv*) liability flows of banks located in country *j* to country *i*. The data is originally expressed in current US dollars. First we deflate the four series with the US deflator. Second we take the absolute value of (net) flows. Third, we standardize the series, by dividing asset and liability flows with the sum of the two countries population in each year (using data from World Bank’s World Development Indicators Database). Fourth, we take the average of the log value of real bilateral gross flows in assets and liabilities in each year. *Source: Bank of International Settlements, Locational Banking Statistics (2008).*

Euro Area Both [EZ2]: Bilateral index of membership in the euro area. The measure is an indicator variable that takes on the value one if both countries are members of the euro-zone in year *t* and zero otherwise. *Source: European Central Bank.*

Euro Area One [EZ1]: Bilateral index of membership in the euro area. The measure is an indicator variable that takes on the value one if only one country is member of the euro-zone in year *t* and zero otherwise. *Source: European Central Bank.*

European Union Both [*EU2*]: Bilateral index of membership in the EU. The measure is an indicator variable that takes on the value one if both countries are members of the EU in year t and zero otherwise. *Source: EU Commission.*

European Union One [*EU1*]: Bilateral index of membership in the EU. The measure is an indicator variable that takes on the value one if only one country is member of the EU in year t and zero otherwise. *Source: EU Commission.*

Exchange Rate Flexibility [*ER*]: Bilateral index of the flexibility of the exchange rate, based either on the "fine" or "coarse" regime classification of Reinhart and Rogoff (2004). In the "fine" classification the country-specific index ranges from 1 to 14 where lower values suggest a more rigid regime, whereas in the "coarse" classification the index ranges from 1 to 5. We construct the bilateral index by taking the sum of the log classification of countries i and j in the beginning (January) of each year t ($ER_{i,j,t} = \ln(ER_{i,t}) + \ln(ER_{j,t})$). *Source: Ilzetzki, Reinhart, and Rogoff (2008) and Reinhart and Rogoff (2004).*

Legislative Harmonization in Financial Services [*HARM*]: Index of regulatory-legislative harmonization in financial services based on the transposition of the Directives of the Financial Services Action Plan (FSAP). The FSAP was launched in 1998 and included 27 EU-wide legislative acts (the Directives) that require from member countries to transpose in due time to the domestic legal order. Until the official completion of the plan in the end of 2003, the EU legislative bodies (the Commission and the Council) had initiated 21 of these laws. The remaining 6 Directives were initiated before the end of our sample and thus we include them in our analysis. However, Directives do not become immediately enforceable across the EU. EU member states have considerable discretion in the transposition (adoption) of these acts. We construct the bilateral harmonization index in three steps. First, for each country we define 27/21 indicator variables that equal one starting at the year of the transposition of each Directive into national law and zero otherwise. Second, we create a country-time varying legislation measure ranging from 0 to 27/21 by summing the values of the 27/21 indicator variables for each country ($LEX_{i,t}$). Third, we take the sum of the log value of the legislation measure for each country in each year (i.e. $HARM_{i,j,t} \equiv \ln(1 + LEX_{i,t}) + \ln(1 + LEX_{j,t})$). *Source: EU Commission's league tables (http://ec.europa.eu/internal_market/finances/index_en.htm). The Commission also provides links to the national legislative acts of the EU15 member countries. We were thus able to track down the exact timing of national legislative acts that transposed the Directives.* *EU Commission.* For details on the FSAP see http://ec.europa.eu/internal_market/finances/docs/actionplan/index/fs_en.pdf.

Trade [*TRADE*]: Index of bilateral trade intensity/integration. The measure is the log of bilateral real (deflated with the US price deflator) exports and imports as a share of two country's GDP. This measure follows Calderon *et al.* (2007). *Source: IMF's Direction of Trade Database (2008).*

Real Per Capita GDP [*Real p.c. GDP*]: Index of the economic importance of the two countries. The measure is the log of the product of real per capita GDP of the two countries in each year. *Source: World Bank's World Development Indicators Database (2008).*

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Table 1: Legislative Measures (Directives) of the Financial Services Action Plan (FSAP)

Directive No.	Directive Title	Deadline
1	1998/26/EC Implementation of the Settlement Finality Directive	
2	2000/46/EC Directive on the taking up, pursuit and prudential supervision of the businesses of electronic money institutions	27/04/2002
3	2000/64/EC Directive amending the insurance directives and the ISD to permit Information exchange with third countries	17/11/2002
4	2001/17/EC Directive on the reorganisation and winding-up of Insurance undertakings	20/04/2003
5	2001/24/EC Directive on the reorganisation and winding-up of banks	5/5/2004
6	2001/65/EC Directive amending the 4th and 7th Company Law Directives to allow fair value accounting	9/10/2004
7	2001/86/EC Directive supplementing the Statute for a European Company with regard to the involvement of employees	10/10/2004
8	2001/97/EC Directive amending the money laundering directive	15/06/2003
9	2001/107/EC 1st Directive on UCITS (Undertakings for Collective Investments in Transferable Securities)	13/08/2003
10	2001/108/EC 2nd Directive on UCITS (Undertakings for Collective Investments in Transferable Securities)	13/08/2003
11	2002/13/EC Directive amending the solvency margin requirements in the insurance directives	20/09/2003
12	2002/47/EC Directive on financial collateral arrangements	17/12/2003
13	2002/65/EC Directive on the Distance marketing of Financial Services	1/01/2004
14	2002/87/EC Directive on the supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate	11/8/2004
15	2002/83/EC Directive amending the solvency margin requirements in the insurance directives	20/09/2003
16	2002/92/EC Directive on insurance mediation	15/01/2005
17	2003/6/EC Directive on insider dealing and market manipulation	12/10/2004
18	2003/41/EC Directive on the prudential supervision of pension funds	23/09/2005
19	2003/48/EC Directive on the taxation of savings income in the form of interest payments	1/1/2004
20	2003/51/EC Directive modernising the accounting provisions of the 4th and 7th Company Law Directives	1/01/2005
21	2003/71/EC Directive on prospectuses	1/07/2005
22	2004/25/EC Directive on Take Over Bids	5/20/2006
23	2004/109/EC Transparency Directive	1/20/2007
24	2004/39/EC Directive on Markets in Financial Instruments (update of ISD) - MiFID	1/20/2007
25	2005/56/EC 10th Company law Directive on cross-border mergers	12/15/2007
26	2006/48/EC Directive on the relating to the taking up and pursuit of the business of credit institutions	12/31/2006
27	2006/49/EC Directive on the capital adequacy of investment firms and credit institutions	12/31/2006

The Table reports the timing of circulation by the EU Commission of the 27 Directives of legislative-regulatory harmonization in banking, insurance, and capital markets included in the Financial Services Action Plan (FSAP). See Section 2.2 on details of the FSAP.

Table 2: Transposition Date (Year Quarter) for the Directives of the Financial Services Action Plan (FSAP)

Directive	AT	BE	DE	DK	ES	FR	FI	GR	IE	IT	LU	NL	PT	SE	UK
1998/26/EC	1999 Q4	1999 Q2	1999 Q4	2000 Q2	1999 Q4	2001 Q2	1999 Q4	2000 Q1	1999 Q1	2001 Q2	2001 Q1	1999 Q1	2000 Q1	2000 Q1	1999 Q4
2000/46/EC	2002 Q2	2003 Q2	2002 Q3	2005 Q1	2002 Q4	2003 Q1	2003 Q1	2003 Q2	2002 Q2	2002 Q2	2002 Q2	2002 Q3	2002 Q1	2002 Q2	2002 Q2
2000/64/EC	2003 Q3	2004 Q1	2002 Q1	2004 Q1	2002 Q4	2006 Q1	2004 Q2	2004 Q4	Not Yet	Not Yet	2001 Q3	2003 Q1	2000 Q4	2000 Q3	2003 Q2
2001/17/EC	2003 Q3	2004 Q4	2003 Q4	2006 Q3	2003 Q4	2005 Q1	2004 Q2	Not Yet	2003 Q2	2003 Q2	2004 Q2	2004 Q2	2003 Q2	2006 Q2	2003 Q2
2001/24/EC	2003 Q3	2004 Q4	2004 Q1	2004 Q2	2005 Q2	2004 Q4	2004 Q2	2006 Q2	2004 Q2	2004 Q3	2004 Q2	2005 Q2	2006 Q4	2006 Q1	2004 Q2
2001/65/EC	2004 Q1	2005 Q1	2004 Q4	2002 Q1	2004 Q1	2004 Q4	2004 Q4	2006 Q2	2004 Q4	2005 Q1	2006 Q2	2005 Q3	2004 Q2	2004 Q1	2004 Q4
2001/86/EC	2004 Q4	2004 Q4	2004 Q4	2004 Q2	2006 Q3	2005 Q3	2004 Q4	2006 Q2	2006 Q4	2005 Q4	2006 Q3	2005 Q1	2005 Q4	2004 Q4	2004 Q4
2001/97/EC	2003 Q2	2004 Q1	2002 Q3	2005 Q1	2003 Q3	2004 Q1	2003 Q2	2005 Q4	2003 Q3	2004 Q1	2004 Q4	2001 Q4	2004 Q2	2005 Q1	2004 Q2
2001/107/EC	2003 Q3	2004 Q2	2004 Q1	2004 Q1	2004 Q1	2003 Q4	2004 Q3	2004 Q4	2003 Q4	2003 Q4	2003 Q1	2005 Q3	2004 Q1	2004 Q2	2004 Q1
2001/108/EC	2003 Q3	2004 Q2	2004 Q1	2005 Q3	2004 Q1	2003 Q4	2004 Q3	2004 Q4	2003 Q4	2003 Q4	2003 Q1	2005 Q3	2004 Q1	2004 Q2	2004 Q1
2002/13/EC	2003 Q3	2004 Q1	2004 Q1	2004 Q1	2004 Q1	2004 Q2	2004 Q2	2005 Q1	2005 Q1	2004 Q1	2004 Q2	2003 Q4	2003 Q4	2004 Q2	2004 Q1
2002/47/EC	2003 Q4	2005 Q1	2004 Q2	2004 Q4	2002 Q4	2005 Q1	2004 Q1	2004 Q4	2004 Q1	2004 Q3	2005 Q3	2004 Q2	2004 Q2	2005 Q2	2005 Q4
2002/65/EC	2004 Q4	2006 Q1	2004 Q4	2005 Q3	Not Yet	2005 Q2	2005 Q2	2005 Q2	2004 Q4	2005 Q4	Not Yet	2006 Q1	Not Yet	2004 Q2	2004 Q4
2002/87/EC	2005 Q1	2005 Q1	2005 Q1	2004 Q3	2005 Q2	2004 Q4	2004 Q3	2006 Q2	2005 Q1	2005 Q3	2006 Q4	2007 Q1	Not Yet	2006 Q3	2004 Q3
2002/83/EC	2003 Q3	2004 Q2	2004 Q1	2004 Q1	2004 Q1	2004 Q2	2004 Q2	2005 Q1	2005 Q1	2004 Q1	2004 Q2	2003 Q4	2003 Q4	2004 Q2	2005 Q1
2002/92/EC	2004 Q4	2005 Q1	Not Yet	2005 Q3	2006 Q3	2005 Q4	2005 Q3	2005 Q1	2005 Q1	2006 Q2	2005 Q4	2005 Q3	2006 Q4	2005 Q3	2005 Q1
2003/6/EC	2005 Q1	2005 Q3	2004 Q4	2005 Q2	2005 Q4	2005 Q3	2005 Q3	2005 Q3	2005 Q3	2005 Q2	2006 Q2	2005 Q4	2006 Q2	2005 Q3	2005 Q3
2003/41/EC	2005 Q3	2006 Q4	2005 Q3	2005 Q4	2005 Q1	2006 Q2	2006 Q2	2005 Q3	2005 Q3	Not Yet	2005 Q3	2006 Q1	2006 Q1	2006 Q1	2005 Q4
2003/48/EC	2004 Q1	2005 Q3	2005 Q1	2004 Q2	2004 Q1	2003 Q4	2004 Q1	2005 Q1	2003 Q4	2005 Q2	2005 Q2	2004 Q1	2005 Q3	2005 Q3	2005 Q1
2003/51/EC	2005 Q1	2006 Q1	2004 Q4	2002 Q1	2005 Q1	2004 Q4	2004 Q4	2006 Q3	2005 Q1	Not Yet	2006 Q2	2005 Q3	2005 Q1	2006 Q1	2005 Q1
2003/71/EC	2005 Q3	2006 Q3	2005 Q3	2005 Q2	2005 Q1	2005 Q3	2005 Q3	2005 Q4	2005 Q3	Not Yet	2005 Q3	2005 Q3	2005 Q2	2005 Q3	2005 Q3
2004/25/EC	2006 Q2	2007 Q3	2006 Q3	2005 Q2	2007 Q3	2006 Q2	2006 Q4	2006 Q2	2006 Q2	2007 Q4	2006 Q2	2007 Q4	2006 Q4	2006 Q3	2006 Q2
2004/109/EC	2007 Q4	Not Yet	2007 Q4	2007 Q4	2007 Q4										
2004/39/EC	2007 Q2	2008 Q3	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2007 Q1	2007 Q2	2007 Q2	2007 Q4	2008 Q3	2007 Q4	2007 Q4	2007 Q1	2007 Q1
2005/56/EC	2007 Q4	2008 Q3	2007 Q2	2007 Q2	Not Yet	2008 Q3	2007 Q4	Not Yet	2008 Q2	2008 Q3	2007 Q1	2008 Q3	Not Yet	2008 Q1	2007 Q4
2006/48/EC	2007 Q1	2007 Q4	2006 Q4	2007 Q1	2008 Q1	2007 Q2	2007 Q1	2007 Q3	2007 Q1	2007 Q1	2007 Q4	2007 Q1	2007 Q2	2007 Q1	2007 Q1
2006/49/EC	2007 Q4	2007 Q4	2006 Q4	2007 Q1	2008 Q1	2007 Q2	2007 Q1	2007 Q3	2007 Q1	2007 Q1	2007 Q4	2007 Q1	2007 Q2	2007 Q1	2007 Q1

The Table reports the year and quarter of the transposition of each of the 27 Directives of the Financial Services Action Plan (FSAP) by EU15 countries. See Section 2.2 on details of the FSAP. Table 1 reports a brief description of each Directive. Data on the transposition of the legislative-harmonization Directives are retrieved from the EU Commission and each of the EU15 countries.

Table 3: EU membership, Euro area membership, and Banking Integration (cont.)

Panel B: Panel Fixed-Effect Estimates in the EU15 Sample of Countries

	Sample Period: 1978-2007				Sample Period: 1990-2007			
	<i>BII-Stocks</i> (1)	<i>BI2-Flows</i> (2)	<i>BII-Stocks</i> (3)	<i>BI2-Flows</i> (4)	<i>BII-Stocks</i> (5)	<i>BI2-Flows</i> (6)	<i>BII-Stocks</i> (7)	<i>BI2-Flows</i> (8)
euroone (<i>EZ1</i>)	-0.1272	-0.0858	-0.2914	-0.1871	-0.1598	-0.0823	-0.2451	-0.1341
t-stat	(0.51)	(0.48)	(1.24)	(1.07)	(0.77)	(0.47)	(1.16)	(0.75)
euroboth (<i>EZ2</i>)	0.4007	0.2593	0.2484	0.1654	0.2981	0.2527	0.2276	0.2099
t-stat	(2.21)	(2.01)	(1.75)	(1.52)	(2.43)	(2.79)	(2.21)	(2.59)
Real p.c. GDP			2.8298	1.7456			2.2911	1.3923
t-stat			(5.37)	(4.93)			(4.19)	(4.05)
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Country-Pair FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2260	2259	2260	2259	1679	1678	1679	1678
Within R-squared	0.624	0.687	0.704	0.720	0.525	0.580	0.585	0.602
Country-pairs	105	105	105	105	105	105	105	105

The Table reports panel fixed-effect estimates. All specifications include year fixed-effects and country-pair fixed-effects. Panel A reports coefficients estimated in the full sample of countries, while Panel B reports coefficients of otherwise identical specifications estimated only in countries that are EU members. In both Panels, columns (1)-(4) give coefficients of specifications estimated in the period 1978-2007, while columns (5)-(8) report coefficients of specifications estimated in the period 1990-2007.

In odd-numbered columns, the dependent variable (banking integration) is the average of the log of real bilateral assets and liabilities holdings of banks in countries i and j in year t , standardized by the sum of the two countries' population in each year (*BII*). In even-numbered columns, the dependent variable (banking integration) is the average of the log of real bilateral gross flows in assets and liabilities of banks in countries i and j in year t , standardized by the sum of the two countries' population in each year (*BI2*). *EU1* is an indicator (dummy) variable that takes on the value of one if only one counterpart in each pair of countries is member of the EU in year t and zero otherwise. *EU2* is an indicator (dummy) variable that takes on the value one if both countries are members of the EU in year t and zero otherwise. *EZ1* is an indicator (dummy) variable that takes on the value of one if only one counterpart in each pair of countries is member of the euro area in year t and zero otherwise. *EZ2* is an indicator (dummy) variable that takes on the value one if both countries are members of the euro area in year t and zero otherwise. *Real p.c. GDP* is the log of the product of real per capita GDP of the two countries in year t . The Data Appendix gives detailed variable definitions and data sources. t -statistics based on country-pair specific (clustered) heteroskedasticity and autocorrelation are reported in parenthesis below the coefficient estimates. The Table also reports the number of country-pairs, the number of observations, and the within R-squared.

Table 4: Euro Membership, Exchange Rate Regime, and Banking Integration
Panel Fixed-Effects Estimates

	<u>Exchange Rate Regime</u>		<u>Legislative Harmonization</u>		<u>Trade</u>	
	<u><i>BII-Stocks</i></u>	<u><i>BI2-Flows</i></u>	<u><i>BII-Stocks</i></u>	<u><i>BI2-Flows</i></u>	<u><i>BII-Stocks</i></u>	<u><i>BI2-Flows</i></u>
	(1)	(2)	(3)	(4)	(5)	(6)
euone (<i>EU1</i>)	-0.4337	-0.3020	-0.4661	-0.3239	-0.6409	-0.4527
t-stat	(2.91)	(2.50)	(3.27)	(2.75)	(4.46)	(3.84)
euboth (<i>EU2</i>)	-0.0684	0.1242	-0.0882	0.1001	-0.0733	0.1249
t-stat	(0.53)	(1.23)	(0.70)	(1.02)	(0.57)	(1.23)
euroone (<i>EZ1</i>)	-0.8097	-0.5265	-0.4089	-0.2596	-0.2799	-0.1480
t-stat	(4.42)	(3.31)	(2.64)	(1.79)	(1.82)	(1.02)
euroboth (<i>EZ2</i>)	-0.1504	-0.0104	0.2426	0.2503	0.3256	0.3125
t-stat	(1.04)	(0.08)	(1.71)	(2.27)	(2.59)	(3.18)
Exchange Rate	-0.2828	-0.2007				
t-stat	(4.52)	(3.66)				
Financial Legislation			0.1075	0.0951		
t-stat			(2.90)	(2.95)		
Trade					0.2618	0.1878
t-stat					(3.75)	(3.09)
Real p.c. GDP	3.1393	2.1783	3.0307	2.0914	3.7237	2.6419
t-stat	(8.72)	(8.36)	(7.92)	(7.55)	(11.57)	(10.77)
Observations	5566	5566	5566	5566	4882	4882
Within R-squared	0.606	0.618	0.599	0.616	0.668	0.653
Country-pairs	190	190	190	190	190	190

The Table reports panel fixed-effect estimates. All specifications include year fixed-effects and country-pair fixed-effects. In odd-numbered columns, the dependent variable (banking integration) is the average of the log of real bilateral assets and liabilities holdings of banks in countries i and j in year t , standardized by the sum of the two countries' population in each year (*BII*). In even-numbered columns, the dependent variable (banking integration) is the average of the log of real bilateral gross flows in assets and liabilities of banks in countries i and j in year t , standardized by the sum of the two countries' population in each year (*BI2*). *EU1* is an indicator variable that takes on the value of one if only one counterpart in each pair of countries is member of the EU in year t and zero otherwise. *EU2* is an indicator variable that takes on the value one if both countries are members of the EU in year t and zero otherwise. *EZ1* is an indicator variable that takes on the value of one if only one counterpart in each pair of countries is member of the euro area in year t and zero otherwise. *EZ2* is an indicator variable that takes on the value one if both countries are members of the euro area in year t and zero otherwise. *Real p.c. GDP* is the log of the product of real per capita GDP of the two countries in year t . Exchange Rate is a bilateral time-varying measure of the flexibility of the exchange rate regime (based on the “fine” classification of Reinhart and Rogoff (2004) and Ilzetzi, Reinhart and Rogoff (2008)). Financial Legislation is a bilateral time-varying measure of legislative and regulatory harmonization policies in financial services based on the transposition of the 27 Directives Financial Services Action Plan (FSAP). Trade is the log of real imports and exports as a share of the two countries' GDP. The Data Appendix gives detailed variable definitions and data sources. t -statistics based on country-pair specific (clustered) heteroskedasticity and autocorrelation are reported in parenthesis below the coefficient estimates. The Table also reports the number of country-pairs, the number of observations, and the within R-squared.

Table 5 Notes

The Table reports panel fixed-effect estimates. All specifications include year fixed-effects and country-pair fixed-effects. In odd-numbered columns, the dependent variable (banking integration) is the average of the log of real bilateral assets and liabilities holdings of banks in countries i and j in year t , standardized by the sum of the two countries' population in each year ($B11$). In even-numbered columns, the dependent variable (banking integration) is the average of the log of real bilateral gross flows in assets and liabilities of banks in countries i and j in year t , standardized by the sum of the two countries' population in each year ($B12$).

$EU1$ is an indicator variable that takes on the value of one if only one counterpart in each pair of countries is member of the EU in year t and zero otherwise. $EU2$ is an indicator variable that takes on the value one if both countries are members of the EU in year t and zero otherwise. $EZ1$ is an indicator variable that takes on the value of one if only one counterpart in each pair of countries is member of the euro area in year t and zero otherwise. $EZ2$ is an indicator variable that takes on the value one if both countries are members of the euro area in year t and zero otherwise. Real p.c. GDP is the log of the product of real per capita GDP of the two countries in year t .

Exchange Rate is a bilateral time-varying measure of the flexibility of the exchange rate regime based on the "fine" (in columns (1)-(4)) or the coarse (in columns (5)-(8)) classification of Reinhart and Rogoff (2004) and Ilzetzki, Reinhart and Rogoff (2008)). Financial Legislation is a bilateral time-varying measure of legislative and regulatory harmonization policies in financial services based on the transposition of the 27 Directives Financial Services Action Plan (in columns (1), (2), (5) and (6)) or the initial 21 Directives (in columns (3), (4), (6), and (7)). Trade denotes the log of real bilateral imports and exports as a share of the two countries' GDP. The Data Appendix gives detailed variable definitions and data sources. t -statistics based on country-pair specific (clustered) heteroskedasticity and autocorrelation are reported in parenthesis below the coefficient estimates. The Table also reports the number of country-pairs, the number of observations, and the within R-squared.

Table 6: Euro Membership, Exchange Rate Regime, Financial Legislation Harmonization Policies, and Banking Integration

	Fine Classification & FSAP 29 Directives		Fine Classification & FSAP 21 Directives		Coarse Classification & FSAP 29 Directives		Coarse Classification & FSAP 21 Directives	
	<i>BII-Stocks</i>	<i>BI2-Flows</i>	<i>BII-Stocks</i>	<i>BI2-Flows</i>	<i>BII-Stocks</i>	<i>BI2-Flows</i>	<i>BII-Stocks</i>	<i>BI2-Flows</i>
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
euone (<i>EU1</i>)	-0.4306	-0.2993	-0.4307	-0.2994	-0.4237	-0.2918	-0.4239	-0.2918
t-stat	(2.93)	(2.51)	(2.93)	(2.51)	(2.88)	(2.45)	(2.88)	(2.45)
euboth (<i>EU2</i>)	-0.107	0.0882	-0.1073	0.0875	-0.1054	0.0879	-0.1057	0.0871
t-stat	(0.86)	(0.91)	(0.87)	(0.90)	(0.85)	(0.91)	(0.86)	(0.91)
euroone (<i>EZ1</i>)	-0.8603	-0.5716	-0.8606	-0.5725	-0.5384	-0.3579	-0.5388	-0.3592
t-stat	(4.71)	(3.57)	(4.71)	(3.58)	(3.36)	(2.43)	(3.36)	(2.44)
euroboth (<i>EZ2</i>)	-0.2043	-0.0599	-0.2046	-0.0609	0.1204	0.1571	0.1201	0.1558
t-stat	(1.40)	(0.47)	(1.40)	(0.48)	(0.95)	(1.55)	(0.95)	(1.54)
Exchange Rate	-0.2662	-0.1849	-0.2662	-0.1847	-0.2964	-0.2265	-0.2966	-0.2264
t-stat	(4.22)	(3.36)	(4.22)	(3.36)	(4.60)	(4.01)	(4.60)	(4.01)
Financial Legislation	0.0854	0.0792	0.087	0.0819	0.0847	0.0774	0.0865	0.0802
t-stat	(2.36)	(2.51)	(2.34)	(2.52)	(2.39)	(2.49)	(2.38)	(2.51)
Real p.c. GDP	3.1029	2.1445	3.1016	2.1428	3.0896	2.1380	3.0883	2.1364
t-stat	(8.55)	(8.20)	(8.54)	(8.20)	(8.56)	(8.25)	(8.55)	(8.24)
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Country-Pair FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	5566	5566	5566	5566	5566	5566	5566	5566
Within R-squared	0.608	0.620	0.608	0.620	0.610	0.622	0.610	0.622
Country-pairs	190	190	190	190	190	190	190	190

The Table reports panel fixed-effect estimates. All specifications include year fixed-effects and country-pair fixed-effects. For details on the specification, see the notes of Table 5. Table 6 reports otherwise identical to Table 5 specifications but without trade in the set of explanatory variables. The Data Appendix gives detailed variable definitions and data sources. t-statistics based on country-pair specific (clustered) heteroskedasticity and autocorrelation are reported in parenthesis below the coefficient estimates.

Table 7 Notes

The Table reports panel fixed-effect estimates. All specifications include year fixed-effects and country-pair fixed-effects. In odd-numbered columns, the dependent variable (banking integration) is the average of the log of real bilateral assets and liabilities holdings of banks in countries i and j in year t , standardized by the sum of the two countries' population in each year ($B11$). In even-numbered columns, the dependent variable (banking integration) is the average of the log of real bilateral gross flows in assets and liabilities of banks in countries i and j in year t , standardized by the sum of the two countries' population in each year ($B12$).

$EU1$ is an indicator variable that takes on the value of one if only one counterpart in each pair of countries is member of the EU in year t and zero otherwise. $EU2$ is an indicator variable that takes on the value one if both countries are members of the EU in year t and zero otherwise. $EZ1$ is an indicator variable that takes on the value of one if only one counterpart in each pair of countries is member of the euro area in year t and zero otherwise. $EZ2$ is an indicator variable that takes on the value one if both countries are members of the euro area in year t and zero otherwise. Real p.c. GDP is the log of the product of real per capita GDP of the two countries in year t .

Exchange Rate is a bilateral time-varying measure of the flexibility of the exchange rate regime based on the “fine” classification of Reinhart and Rogoff (2004) and Ilzetzki, Reinhart and Rogoff (2008)). *Financial Legislation* is a bilateral time-varying measure of legislative and regulatory harmonization policies in financial services based on the transposition of the 27 Directives Financial Services Action Plan. *Trade* denotes the log of real bilateral imports and exports as a share of the two countries' GDP. The Data Appendix gives detailed variable definitions and data sources. t -statistics based on country-pair specific (clustered) heteroskedasticity and autocorrelation are reported in parenthesis below the coefficient estimates. The Table also reports the number of country-pairs, the number of observations, and the within R-squared.