Fragmentation in European Financial Markets: Measures, Determinants, and Policy Solutions

María Abascal[a*], Tatiana Alonso[a], Sergio Mayordomo[b]

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Abstract

This paper measures fragmentation in four European financial markets (interbank, sovereign debt, equity, and the CDS market for financial institutions) and develops a new measure of global fragmentation using these markets as inputs. We find that, during the recent crisis, fragmentation in the interbank market has been, on average, higher in the peripheral countries than in the core ones and it has increased particularly during periods of financial stress. Among the most significant factors that contributed to the high fragmentation levels observed are counterparty risk and financing costs (overall factors), and country-specific factors such as banking sector openness, the debt-to-GDP and the relative size of the financial sector. We also study the short-run effect of the ECB programmes and announcements and find a significant decrease in the daily levels of fragmentation immediately after the implementation of the SMP, 3Y-LTROs and the second CBPP of the ECB as well as key announcements relative to banking union and the OMT. These helped restore investors' confidence in the euro and confirmed the ECB's support for tackling the challenges of the European sovereign debt crisis. Nevertheless, additional measures seem to be necessary to guarantee a new process of re-integration and thus a more stable European banking sector.

Keywords: Eurozone, financial fragmentation, Interbank market, Banking Union.

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a: BBVA Researh.
b: University of Navarra.
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