

Terms of reference

3. Five years of an enlarged EU – Financial integration and stability in an enlarged EU

Background

Financial integration in the EU is expected to promote financial-market development, higher productive potential and improved economic performance in all 27 Member States. The new Member States have a specific interest in these matters as their level of financial development is so much lower compared to the mature economies in the EU. Financial deepening may provide a significant boost to growth, but may also have unfavourable effects. Asset-price movements in some new Member States have attracted massive capital inflows and have fuelled consumption and inflation. Real interest rates have fallen to very low levels, further stoking aggregate demand and asset valuations. Current-account imbalances widened within the EU driven by a general reduction in risk premia and by loosened credit constraints. While these developments are not necessarily indicative of economic problems, they can result in the accumulation of potentially problematic imbalances in presence of structural rigidities or if they are associated with a sectoral misallocation of resources.

Aims of the essay and key questions to be tackled

The aim of the essay is to study the impact of financial integration and how it promotes the efficient functioning of the EU economy. With respect to country coverage, Romania and Bulgaria should be included where possible. The focus of the assessment is the 5 year period between 2004 and 2009, but often it will be necessary to have a broader time frame to understand developments. Indeed, the perspective of EU accession had been a driver in the economic transition of new Member States. As far as method is concerned, in addition to a macroeconomic approach with a relevant empirical dimension, also case studies of a particular sector, market or country will be highly welcome as they are concrete and potentially very effective in passing a message or illustrating a point. However, also with case studies the cross-country perspective may not be forgotten.

The essay may zoom in on a particular aspect of the issue or cover more domains, reflecting the state of the art in the literature on the topic:

- The role of financial markets in spurring growth, including through maturity transformation, information enhancement and risk diversification;
- The extent to which financial integration contributes to achieving scale effects and specialisation;
- The ability of financial integration to dampen local credit crunches and smooth income and consumption through the availability of financial instruments and through cross-border risk-sharing;
- To what extent the notable reduction in currency risk in some countries has weakened market discipline on national developments to contain economic and financial imbalances growing to unsustainable levels;
- Foreign ownership of financial institutions and the effectiveness of financial supervision by the home and guest country; the possibilities to take effective measures to control credit growth.