Research Fellowship Programme - Future of the EMU

Essay on Post-crisis financial (dis-)integration in EMU

Background

EMU has acted as a powerful catalyst to financial market integration. Between 1999 and 2008, interbank money markets fully integrated while cross-border interbank transactions expanded. Cross-border consolidation among banks accelerated and a significant market in euro-denominated private sector bonds emerged. Also equity markets integrated faster than elsewhere, financial market infrastructure advanced and regulatory and supervisory convergence was reinforced. While the euro stimulated both the supply of and the demand for cross-border capital and financial services, economic theory suggests that the integration of financial markets fostered financial development and so raised the efficiency of the economy. In addition, the euro-area economy was expected to benefit from integrated financial markets as a channel for managing asymmetric shocks.

There is, however, some evidence that the financial integration process in Europe has, as a result of the crisis, partly been halted or indeed reversed in some segments of the market. Cross-border capital flows have fallen sharply and there are also signs of EU banks partly retrenching behind national borders. Disruptions in the functioning of the inter-bank money markets suggest that integration in these markets was not as solid and advanced as assumed before the crisis. The observed fragmentation also raises the question of the robustness of the efficiency gains from integrated financial markets and the role played by financial markets in cushioning the impact of asymmetric shocks.

Aims of the essay and key questions to be tackled

The objective of the essay is to document how the financial crisis has impacted on financial integration, evaluate consequences for the effective functioning of EMU and review warranted adjustments to the EU's legislative programme in the area of financial services. It should take a wide and explorative view to identify issues that could be relevant for policy makers and help inform the redesign of the financial sector governance that is underway. Against this objective, the project will not necessarily endeavour to provide a model-based analysis or apply sophisticated quantitative estimation techniques, but is expected to support the analysis with suitable empirical evidence, wherever appropriate and possible, and rigorous economic reasoning.

A review of the statistical evidence of cross-border retrenchment in financial markets observed during the financial crisis would be a suitable starting point for the analysis. In this context, the essay could try to assess whether there are systematic differences across types of financial institutions or activities (i.e. banks, securities trading, asset management, perhaps also insurance), whether financial institutions receiving state aid from national governments or under restructuring obligation reduced cross-border activity more than other institutions, or to what extent cross-country differences in the focus on home markets could be related to the funding problems of the sovereign.

A second work strand could analyse the implications of the fragmentation forces for the functioning of EMU. Beyond the impact of financial fragmentation on the efficiency of wholesale financing, implications for activity outside the financial sector and for growth in the euro area should also be considered. Of interest could also be to analyse whether and how country differences in the transmission of monetary policy in EMU could change with a financial system that is more fragmented along national borders.

Of particular interest would also be the analysis of the interaction between the identified fragmentation and regulatory and supervisory policies. Based on an assessment of the factors that have fostered or hampered financial fragmentation, the essay could propose and discuss financial services policies required to reverse the potential fragmentation trend. Particular attention should be attached to the possible role of cross-country differences in the implementation of financial regulation, of the EU architecture of financial supervision and of a possible EU-wide framework for resolution and restructuring of financial institutions and its potential role in breaking the link between banks' cost of funding and sovereign risk.