Financial Integration in the Context of the European Union

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Abstract: As the world continues to see various facets of financial integration, the topic has sparked a great deal of discussions among policy makers and economists. The article analyzes benefits and risks of financial integration in the context of the European Union, which has facilitated global financial integration immensely by creating common currency among European Monetary Union countries and harmonizing regulations across the region. Upon examining main pros and cons of financial integration in detail, I conclude that financial integration can be beneficial in the long-run if corrective and preventive measures are enforced to curtail risks and threats it poses.

Keywords: Financial integration, European Union, European Monetary Union, emerging countries in Europe, benefits of financial integration, risks of financial integration

Introduction

Global financial integration is not a new phenomenon-rather the topic has been debated quite fervently over the past few decades. This demonstrates the rising magnitude of international financial integration and its potential implications-both good and bad. Depending on the divergent results it generates in countries, global financial integration is either a benefactor or a menace.

International financial and capital markets are intertwined as they have ever been. Therefore, the benefits and risks of this interconnectedness are momentous and far-reaching. On the one hand, developed countries enjoy higher returns on investment across international markets. On the other hand, developing countries share risk in the presence of adverse output shocks and smooth consumption. Either way, it spurs growth. Unfortunately, increased financial integration is also associated with mounting volatility and crisis contagion-which may cause one to reassess the benefits.

The introduction of the euro as single currency among the members
of the Economic and Monetary Union (EMU) has brought European financial integration to an unprecedented level. The elimination of currency risk has curtailed uncertainty, spurring investment opportunities across the EU\(^1\). Emerging markets in the EU have become an investment hub, reaping the benefits of financial integration. The risks have been exposed succinctly with the propagation of U.S financial crisis in Europe in 2007-2008, affecting emerging and transition economies deeper.

**Benefits of financial integration**

Financial integration is beneficial to both foreign investors and the host country. On integrated financial and capital markets, foreign investors enjoy a wider range of investment opportunities and greater risk adjusted rates of return. For developing economies, increased financial integration has growth implications with a range of benefits including risk sharing in the presence of adverse shocks, improved financial infrastructure via penetration of foreign financial institutions, and growth-enhancing capital inflows.

**Risk sharing among emu countries**

Integrated financial and capital markets facilitate cross-country income and consumption risk sharing\(^2\). The EU has seen an increase in consumption risk sharing since 1990 (ECB, 2016). The foundation of the European Monetary Union (EMU) and the introduction of the euro as single currency in 1999 have brought financial integration and thereby risk sharing in the region to an unprecedented level.

The creation of the EMU eliminated currency risk\(^3\) and rendered financial markets more transparent, ensuring a higher degree of regional and international financial integration. E.

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1 See Maastricht Treaty—effective since 1993
2 Obstfeld and Taylor (2004) refer to the growth and risk sharing benefits of financial integration as development finance and diversification finance"/(risk sharing portfolio allocation)
3 See “Home bias puzzle", which describes investors' tendency to invest in a large amount of domestic assets, rather than investing in foreign equities. (Equity market under EMU)
Sørensen and Yosha (2007) established a significant correlation between financial integration and risk sharing in their empirical results, in which financial integration was measured by the ratio of foreign assets to GDP. Risk is shared among member countries of the EMU via cross-country foreign assets and liabilities. However, as asset returns in EMU countries converge, the level of risk sharing attained per euro invested abroad sinks. Thus, investments in non-EMU countries may nourish more risk sharing.

Risk sharing mechanisms

Fiscal institutions:
Inter-country income insurance is promoted via tax transfers. Through tax cuts, individuals and governments receive more transfers during economic downturns.

Market channels:
Income is insured via cross-ownership of productive assets\(^4\) in a developed capital market. Income in one country oscillates with output in other countries, for example, if pension or mutual funds in one country are invested internationally.

Domestic financial efficiency and economic growth

Financial development may serve as a catalyst for economic growth, while economic expansion may foster efficiency on financial markets. European financial integration has furthered financial development of the member countries by introducing common financial rules and regulations and instigating innovations in technology. Well-functioning financial markets enable more efficient allocation of resources and a higher degree of resiliency to shocks.

The creation of the EMU and thereby the abolition of currency risk have magnified the incentive of both EMU and non-EMU economies to participate in a larger unified market and embrace increased financial integration. In that regard, the benefits of financial integration are manifold. First, externally resident banks acquire a competitive advantage in an integrated inter-bank market. Second, domestic non-banks including large firms enjoy reduced cost of capital and extended financial services by virtue of enhanced domestic financial competition. Extended financial options result from improved quality, pricing and availability of banking services.

Foreign bank entry\(^5\) renders domestic financial markets more efficient via several divergent channels. Firstly, foreign banks introduce new and better skills, management techniques, training procedures, technology and innovative financial products to the financial sector of the economy. Secondly, domestic banks are compelled to slash excess overhead expenses and accept lower

\(^4\) Atanas Christev & Jacquez Melitz (2013) suggest that EMU smoothes consumption through the promotion of tradability of goods, capital in particular, the encouragement of price competition, and contestable home markets, not through typical means of cross-border asset ownership. (See EMU, EU, Market Integration and Consumption Smoothing)

\(^5\) There are also potential threats that arise from foreign bank entry, which will not be discussed in this article. For instance, risks include erosion of local banks’ rents, credit rationing to small firms, and merging of local banks.
profits due to mounting competitiveness. Thirdly, better-functioning credit rating agencies and accounting and auditing firms flourish as the demand for reliable information surges. Lastly, the expansion of the banking sector calls for greater supervision and regulations to produce utmost benefits. In that respect, it should be noted that the share of foreign banks in domestic banking activities does not play a role: the mere presence of foreign banks boosts domestic banking performance.

Weill (2009) investigated the convergence in banking efficiency for European countries between 1994-1995 and found an improvement in cost efficiency for all EU countries. However, cross-country differences in cost efficiency still persist because of country-specific aspects of banking technology including banking regulations and the managerial strategies for information technology. The new members of Central and Eastern Europe (CEE) experienced massive foreign bank entry as they transitioned from a centrally planned economy to a market economy and privatized the banking sector. The empirical results of Ralph de Haas and Iman van Lelyveld (2005) on CEEC suggest that foreign banks stabilize the economy by maintaining a stable credit base during economic downturns, whereas domestic banks shrink their credit base. As a consequence, risks of substantial spillover may be evaded to a certain extent via the presence of foreign banks in the financial system.

**Capital inflows and economic growth: the case of emerging Europe**

The single market for capital and the launch of a common currency are the hallmarks of European integration. In the absence of exchange rate risk, capital is free to flow, engendering broader investment opportunities for developed western economies. As a consequence of capital influx, emerging markets in the EU are provided with the wherewithal to drive up GDP growth. The accession to the EU warranted CEEC’s economic and political stability and thereby increased investment. Moreover, capital influx provides transition economies with a conduit for new technology, management know-how and business networks. In return for all these benefits, the transition economies had to speed up their liberalization and embark on financial and institutional reforms ordained by the higher institutions of the EU.

According to standard economic theory, international capital markets trigger capital flows from capital-abundant countries to capital scarce countries, setting off convergence. In the neo-classical theory, all growth effects of financial globalization are generated by capital flows. However, the neo-classical framework does not specify the composition of capital flows. The structure of capital flows comprises foreign direct investment (FDI), foreign portfolio investment, foreign derivatives and loans and deposits.

Investment abroad incurs information costs for foreign investors. The Pecking Order of Razin et al. hierarchically
classifies capital flows as debt and equity portfolio as well as foreign direct investment in terms of information asymmetries. FDI enables a transfer of know-how and thereby is essential for foreign investors to overcome information asymmetries. Therefore, FDI predominates foreign portfolio investment in developing countries. Although Pecking Order excludes bank loans, Bolton and Freixas (2000) and Hull and Tesar (2001) stress the roles of bank loans in the early stage of economic development. Information asymmetries are mitigated over time, adjusting the capital structure of the economy and instigating convergence.

The EU promises better prospects for its new members in terms of investment. Buch and Piazolo (2001) conclude that EU membership impacts cross-border-capital and trade flows positively and triggers changes in capital structure. The underlying reasons are less uncertainty and diminished information costs for cross-border investment due to massive institutional reforms. Therefore, transition economies have become a hub for investment, assuring higher returns for investors based on favorable business and legal environments.

CEEI have embraced transition into a market economy and financial integration on their part to finance domestic investment with foreign savings. CEEI underwent an extensive degree of capital account liberalization and eradicated entry barriers for foreign financial institutions. Furthermore, they not only welcomed longer-term capital by establishing full current account convertibility, but also opened up to

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Table 1.1: Central and Eastern European Countries: Foreign Direct Investment Sources

<table>
<thead>
<tr>
<th>Column1</th>
<th>EMU</th>
<th>United Kingdom</th>
<th>United States</th>
<th>Denmark</th>
<th>Sweden</th>
<th>Switzerland</th>
<th>CEEC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>87.0</td>
<td>5.3</td>
<td>5.7</td>
<td>1.0</td>
<td></td>
<td></td>
<td>1.0</td>
</tr>
<tr>
<td>Croatia</td>
<td>81.4</td>
<td>1.8</td>
<td>1.1</td>
<td></td>
<td>2.7</td>
<td>13.0</td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>82.3</td>
<td>5.3</td>
<td>4.3</td>
<td>1.0</td>
<td>1.9</td>
<td>4.4</td>
<td>0.9</td>
</tr>
<tr>
<td>Estonia</td>
<td>47.4</td>
<td>0.7</td>
<td>1.5</td>
<td>3.4</td>
<td>46.1</td>
<td></td>
<td>0.8</td>
</tr>
<tr>
<td>Hungary</td>
<td>79.2</td>
<td>7.3</td>
<td>8.1</td>
<td>0.7</td>
<td>2.3</td>
<td>1.5</td>
<td>1.0</td>
</tr>
<tr>
<td>Latvia</td>
<td>25.7</td>
<td>1.1</td>
<td>-0.6</td>
<td>15.7</td>
<td>44.6</td>
<td></td>
<td>13.5</td>
</tr>
<tr>
<td>Lithuania</td>
<td>23.5</td>
<td>0.5</td>
<td>2.8</td>
<td>34.7</td>
<td>24.5</td>
<td></td>
<td>14.0</td>
</tr>
<tr>
<td>Poland</td>
<td>73.1</td>
<td>7.4</td>
<td>9.3</td>
<td>2.9</td>
<td>3.8</td>
<td>3.1</td>
<td>0.3</td>
</tr>
<tr>
<td>Romania</td>
<td>89.4</td>
<td>1.3</td>
<td>7.7</td>
<td>0.4</td>
<td></td>
<td></td>
<td>1.1</td>
</tr>
<tr>
<td>Slovakia</td>
<td>83.5</td>
<td>8.6</td>
<td>0.7</td>
<td></td>
<td>1.4</td>
<td>5.8</td>
<td></td>
</tr>
<tr>
<td>Slovenia</td>
<td>95.5</td>
<td>1.6</td>
<td>0.0</td>
<td></td>
<td></td>
<td></td>
<td>3.0</td>
</tr>
</tbody>
</table>

NOTE: Importance of selected countries as sources of FDI stocks in the Central and Eastern European Countries for 2002. EMU is the European Monetary Union. Source: Lane and Miletti-Ferretti, IMF, 2006

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6 Buch (1999) suggests that the accession to the EU will impact capital flows into CEEC qualitatively, rather than quantitatively.
short-term portfolio capital to a lesser extent. This reform progression, higher convergence, and reserve ranges appealed to developed economies for investment. Among those transition economies, a varying level of investment has been registered.

The countries that undertook reform faster and were characterized by initial conducive environment have successfully drawn foreign investment. On the contrary, countries that sluggishly responded to the institutional reform performed poorly in attracting investment. In addition, unit labor costs, host and source country size, and proximity are also crucial in driving investment into the transition economies and spurring growth.

The Czech Republic, Estonia, and Hungary were the best performers, attaining the highest level of capital inflows in the region, with Poland following suit. Estonia liberalized all its capital account as early as in 1994. Net capital inflows into these countries considerably surpassed 5 percent of the GDP. Moreover, mid- and long-term financial credits have been relaxed enormously in the Czech Republic, Hungary, and Poland, reaching 50 percent of their potential. On the contrary, Slovenia lagged quite behind in terms of liberalization, imposing reserve requirements on inflows of financial credits and enforcing official authorization on capital outflows. In the east, Bulgaria and Romania were sluggish in adjusting regulations and thereby pulled the least investment among their peers up to the beginning of 2000. Thus, it can be concluded that the countries that liberalized their capital accounts earlier and transitioned faster into the market economy were able attract more foreign investment upon joining the EU in 2004 and 2007.

Risks of financial integration

Starting from the 1980s, developing countries especially in East Asia and Latin America enforced large-scale financial and capital market liberalization as part of trade agreements with industrial nations such as the U.S. In the late 1990s, a wave of crises swept through these developing countries, causing an enormous decline in output level and a surging unemployment rate. Prominent economists such as Joseph Stiglitz attribute the roots of these crises to the extensive abolition of capital restrictions and financial liberalization undertaken by developing countries. This implies that there are also enormous risks associated with financial integration that can ignite recessions and instability.

Financial crisis contagion

The outbreak of the U.S subprime mortgage crisis in 2007 impacted the entire international financial system. The scale and scope of the crisis rivaled the Great Depression of the 1930s. The collapse of the housing market in the U.S culminated in the bankruptcy

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7 Demirgüç-Kunt and Detragiache (1999) found that the probability of banking crises is higher in liberalized financial systems.
8 Frankel and Rose (1996) argue that foreign interest rates are crucial in determining the probability of financial crises in developing countries.
of Lehman Brothers, a sprawling investment bank, denying the rampant notion that megabanks are “too big to fail”. The effects of the crisis soon rippled through Europe, evolving into a sovereign debt crisis. The financial interconnectedness revealed domino effects of crisis contagion, evaporating the confidence and trust in the global financial system. The causes of a crisis are numerous. **Firstly**, macroeconomic shocks or volatility in commodity prices may result in a crisis, causing immense fluctuations in capital flows and asset prices. **Secondly**, local shocks via trade links and competitive devaluations can affect other economies, and trigger speculative attacks and thereby a crisis. A shock that broke out in only a particular region or sector can expand into the entire economy. Therefore, a crisis can be contagious.

Einchengreen et al (1996) defined contagion broadly\(^9\) as the rising probability of a crisis at home when there is a crisis elsewhere. When a crisis propagates, exchange rates, stock prices, sovereign spreads and capital flows fluctuate heavily from one country to another. Irrespective of underlying economic fundamentals, a crisis may affect countries with sound fundamentals or weak fundamentals. **The contagion is the spillover effects (or the cross-country co-movement) not related to economic fundamentals** (Masson, 1999). There are three key channels that transmit a crisis: real links, financial links and herding behavior. **First of all**, real links are largely defined by trade and FDI. When two countries partner in trade and compete for FDI in the international capital market, then the currency devaluation in one country undermines the price competitiveness of the other country. As a result, other trade partners are also forced to devalue their currency, and the shock spreads. **Secondly**, financial links associate the financial interconnectedness of different countries via diversification of financial portfolios. To hedge against risk, international investors start to engage in extensive selling of assets in the third countries when a crisis erupts in one country. As a result, the crisis takes its toll on the third countries where the crisis was not originated, instigating a downward spiral of falling asset values. **Lastly**, herding behavior\(^10\) or panic diffuses the shock through asymmetric information. As discussed in the previous section, information is costly for foreign investors. Thus, investors in one country start reacting to external shocks based on how other markets are reacting due to lack of information. These panics concern markets of both developed and developing countries. Herding behavior is common among the investors in developed countries as developing countries are a terra incognita in terms of investment.

There are two distinct hypotheses on contagion. **Firstly**, the “globalization hypothesis” suggests that trade and financial links disperse shocks. The countries that are heavily integrated into the international financial and capital market are more heavily prone

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9 Contagion can be understood as cross-country spillover effects.
10 Herding behavior is associated with multiple equilibria.
to shocks. This type of contagion is rooted in macroeconomic fundamentals. Secondly, the “wake-up call hypothesis” ascribes the contagion to the behavior of investors and other financial agents. Namely, investors deduct information about vulnerability of other international markets from a crisis erupted in one country. Irrespective of fundamentals, the crisis disseminates to other economies. These “irrational” spillovers comprise financial panics, herding, loss of confidence and increased risk aversion.

Financial institutions can be at the core of crisis contagion. According to the “common creditor argument”, when a country is financially tied to the crisis epicenter through a major bank lender, the crisis propagates quickly through that link. Moreover, mutual funds aggravate the volatility of asset prices and thereby the contagion by selling assets in one country when prices plummet in another.

Empirically, contagion is defined by the following factors: (i) unexplained correlations, (ii) contagious news, (iii) increasing probabilities, and (iv) clustering of extreme returns. In real life, the adversities of a crisis are translated into multiple turbulent phenomena such as significant fluctuations in credit volume and asset prices; interruption of financial intermediation and the supply of external financing; severe balance sheet problems and government supports such as liquidity interjection and recapitalization.

The consequences of a financial crisis are both dire and costly. A financial crisis not only causes a recession, but also exacerbates it to a great extent. The real economy suffers immensely as consumption, investment, industrial production, employment, export and imports plummet, undermining the welfare of the country. Characterized by weak domestic demand and heavy contraction in credits, the economy struggles several years before it can attain its pre-crisis level of macroeconomic aggregates. Moreover, fiscal outcomes of the economy are severe following a financial crisis as gross fiscal outlays and net fiscal costs of resolving financial distress and restructuring the financial sector are massive. The economic growth diminishes heavily as the credit supply breaks off and liquidity dries up, culminating in economic contraction.

**Destabilizing mechanisms of capital flows**

As discussed in the previous sections, many developing countries were able to reap the benefits of financial integration and experienced higher growth rates through several indirect channels. However, there appears to be a poor direct relationship between financial integration and economic growth. Moreover, empirical results suggest a significant correlation between financial integration and macroeconomic volatility. The studies of Eswar S. Prasad and Kenneth Rogoff (2007) conclude that consumption may have become even more volatile in emerging markets as a result of low to moderate levels.

Capital inflows are systematically

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11 When foreign banks call loans and contract credit lines, the original crisis gets worse.
destabilizing after vast liberalization\textsuperscript{12}. This feature is associated with exceptional pro-cyclicality\textsuperscript{13} in developing countries. When economic conditions are good, capital flows into the country, fueling economic growth and increasing employment, while capital rushes out when the economic circumstance deteriorates or when investors’ perceptions of risks alter. During the boom cycle, foreign investment pours into the country, while it flees when the bust cycle\textsuperscript{14} sets in, which is called “capital flight”.

As evidenced by a number of financial crises in the last century, macroeconomic policies behave highly pro-cyclically in times of instability. When the economy starts to shrink, budget deficits are cut and interest rates are lifted, aggravating the contraction of economic activities. Moreover, exchange rates, interest rates, domestic credit and asset prices oscillate largely, instigating changes in investment and savings decisions. “\textit{Even if international capital flows do not trigger excess volatility in domestic financial markets, it is still true that large capital inflows can spark off inflation in the presence of a fixed exchange rate system}” (Kaminsky, 2007). As a result, the competitiveness of a country may be undermined as exchange rate appreciates due to distortions in relative prices.

Financial and capital markets differ from markets for goods and services in terms of fundamental asymmetry. While asymmetries on the ordinary markets can be managed in a relatively efficient and predictable manner, imperfections on the capital markets are non-trivial, which can have dire economic consequences. Moreover, international capital markets are plagued with information asymmetries ensuing from geographical and cultural differences. Cross-border contract enforcement also affects information imperfections. As Rodrik (1998) put it, asymmetric information fuels moral hazard inducing excessive financing of risky projects. Even worse, asymmetric herding behavior prompts severe volatility and contagion effects, resulting in excessive fluctuations in asset prices and frequent crises\textsuperscript{15}.

The composition of capital pouring into a country plays a crucial role. Short-term speculative capital inflows are more volatile than long-term investments. While FDI is beneficial for long-run growth transferring technology and boosting capital stock of the country, short-term arbitrage seeking capital inflow may destabilize the financial system. Short-term commercial credits are non-volatile, whereas speculative capital inflows are subject to interest rate differentials, exchange rate expectations, and country risk assessments for the short-run. Although, FDI is the largest component of capital flowing into

\textsuperscript{12} Tornell and Westerman (2002) demonstrate that many emerging markets experienced twin crises due to lending booms that occurred after vast liberalizing of financial markets.

\textsuperscript{13} Kaminsky Reinhart, and Vegh (2004) suggest that developing countries are characterized by pro- cyclical macro-policies, whereas developed countries tend to have countercyclical macropolicies.

\textsuperscript{14} See the endogenous unstable dynamics put forward by Minsky (1982). He argues that market agents take risks excessively in financial booms, which leads to crises.

\textsuperscript{15} See the endogenous unstable dynamics put forward by Minsky (1982). He argues that market agents take risks excessively in financial booms, which leads to crises.
emerging markets, the effects of short-term capital flows are non-negligible.

Last but not least, capital inflow causes misallocation of external resources on the international capital market. As countries vary in terms of risk, capital is liable to concentrate in a few emerging markets that may render higher marginal returns. As a result, other developing countries may be deprived of foreign investment to nurture domestic growth through the mechanism of risk sharing.

The case of CEEC: Complications caused by the risks of capital flows

The burgeoning period of global capital account liberalization came with an aftermath of economic collapses in emerging markets. The CEEC-s were not unscathed by the rampant crises owing to underlying macroeconomic and institutional vulnerabilities that were inevitable in many of those transition economies. The global financial crisis of 2007 exposed economic, financial and political fragilities of both developed and developing nations. However, the latter emerged as the real victim of increased globalization. As evidenced by output decline in late 2008 and the first half of 2009, emerging Europe was struck by the crises more severely than any other regions in the world.

As EU enlargement promised better assessments of country risk, the rate of capital inflow into CEEC has intensified since 2000\(^{16}\), with the greatest shares flooding into Bulgaria, Romania and the Baltic countries from mostly the Euro zone in recent years. In CEEC, net capital inflow that constituted 8.9% of the GDP rose up to 21.7% of GDP in 2007\(^{17}\) (BNP Paribas, 2011). Regarding the composition of capital inflow, the countries such as Hungary, Poland, Lithuania and the Czech Republic received the greatest share of portfolio investment. Portfolio investment tends to flow into countries with more developed and liquid financial markets. Conversely, Romania and Bulgaria saw more FDI inflows and less portfolio investment. This accounts for the varying structure of gross foreign liabilities in these countries.

The capital influx into CEECs was accompanied by destabilizing effects after the global financial crisis of 2007-2008. Capital inflows plunged from 7% of GDP in the first half of 2008 to 1.9% in the second and came to a complete standstill in 2009 due to the mounting global risk over assets (BNP Paribas, 2011). For instance, Hungary, Slovakia, Romania, Bulgaria and even Poland have experienced a significant drop in FDI inflows. The volatile nature of portfolio investments took its toll on Hungary, instigating a crisis\(^{17}\). Moreover, the situations in Hungary, Latvia and Romania have escalated even to the extent that they received international support from the IMF and the EU to recover.

The enormous rise in capital inflows led to overheating in many of these emerging economies. Particularly, the countries with a fixed exchange rate regime faced inflationary pressure due to increased lending, which played a

\(^{16}\) From the beginning of this decade until the first half of 2008, the economies of central and eastern Europe (CEE) experienced large capital inflows from the West, a credit boom and rapid expansions in both consumption and investment. (EBRD, 2009)

\(^{17}\)
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A crucial role in the formation of asset bubbles. For example, the inflation rate in Bulgaria rose up to 12% in 2008. The asset bubbles concentrated in the real estate markets of the Baltic countries, Poland and Bulgaria. The domestic demand and the welfare of the countries plummeted when the bubbles burst during the recessions.

**Policy implications**

The risks of increased capital inflows have been so colossal and detrimental that many economists have started questioning whether the drawbacks of financial integration outweigh its gains. While developed economies surmount financial distress and instability much better and faster, developing countries suffer prolonged recessions. Therefore, a number of policies to mitigate the risks arising from capital flows have been put forward.

Krugman (1998), Stiglitz (2000), and Tobin (2000) propose capital controls to reduce the volatility of capital influx. Developing countries are devoid of economic diversification and automatic stabilizers such as countercyclical fiscal policies to cope with increased fluctuations. Government interventions may be effective in decreasing a large degree of risk taking and making countries more resilient to external shocks. Capital controls contain restrictions on capital inflows and restrictions on capital outflows. By restricting harmful short-term capital inflows, the influx of long-term productive capital such as FDI can be encouraged. Moreover, restrictions on capital outflows have also been effective to alter the capital structure beneficially.

Capital controls may also be ineffective when domestic and foreign capital had become difficult to distinguish as a result of increased financial integration. Therefore, better risk management should be enforced via improved domestic financial system. Arming with effective regulations and supervision within the financial sector is essential in avoiding financial crisis or its contagion effects. In this regard, excessive risk-taking should be discouraged when markets are vastly imperfect. Moreover, risk may be effectively managed by evading huge asset-liability mismatches and ensuring sufficient capitalization of banks and transparency of investors. As a result, countries will be more flexible to external shocks and be enabled to prevent a crisis through corrective measures in the event of shocks.
Conclusion

Amidst growing arguments weighing pros and cons of international financial integration, the article presents key benefits and risks of this phenomenon in the milieu of the European Union. The region is exceptional in the sense that currency risk is non-existent among EMU countries thanks to the creation of the euro.

Foremost benefits are realized via risk sharing, foreign bank entry and increased capital inflow to foster growth. First, EMU countries ensure output against idiosyncratic shocks and finance domestic investment via foreign savings. Second, transition economies have improved its financial system via foreign bank entry. Third, CEEC have experienced increased capital inflows, particularly FDI, to spur growth.

Risks include crisis contagion and destabilizing volatility after vast liberalization. Due to lack of automatic stabilizers and well-functioning financial systems, negative effects of financial integration have been more disturbing to the emerging markets such as CEEC. Therefore, capital controls and risk management methods have been suggested as the principal tools to maximize benefits of financial integration at minimum risk. At last, I conclude that international financial integration can be beneficial in the long run if the risks are averted through stabilizing measures.
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References


