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Financial integration and growth — Why is Emerging Europe different?

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ABSTRACT

Using industry-level data, this paper tries to explain why financial integration raised growth differentials between externally dependent and less dependent industries in European transition countries, but not in other developing or advanced countries in the years preceding the current crisis. We argue that political integration with countries that have stronger political and economic institutions leads to growth-enhancing foreign investments because investors expect an improvement of institutions in the future. The empirical evidence supports the importance of political integration: within the group of developing countries, the effect of financial integration is larger in countries that are more strongly politically integrated. Such an effect is not found for advanced countries. Our results suggest that political integration can considerably increase the benefits of financial integration in developing countries, even when institutions are still weak.

1. Introduction

Political, trade and financial integration have been the three defining pillars of the "development model" of the European transition countries in the past two decades. Until recently, this model was considered a spectacular success. Since the mid-1990s, the region had experienced an externally financed growth spurt, which does not have many parallels in economic history. The combination of large and persistent current account deficits and high growth rates in the years preceding the crisis prima facie suggests that capital inflows may have been beneficial for economic growth in transition countries.

However, the disastrous impact of the financial crisis on European transition countries has cast doubt on this model. Several countries suffered double-digit percent decreases in GDP in 2009. The benefits of political and trade integration have not seriously been questioned. A reversion of the political integration process is barely conceivable, and the benefits of trade integration are now widely accepted, both by politicians and by academics (see, e.g., Edwards, 1998). The criticism focuses instead on financial integration. The financial crisis was transmitted mainly through financial channels. In addition, financial integration seems to have fuelled the credit boom preceding the financial crisis. This credit boom and the related stocks of private foreign debt are widely believed to have made the region vulnerable to the financial crisis, and are in fact strongly correlated with the extent to which output declined in the region during the crisis (see Berglöf et al., 2009). In addition, the academic literature is far less conclusive regarding the benefits of financial integration than it is with respect to trade integration (see Kose et al., 2009b, for an excellent overview of the literature). However, as was noticed by Prasad et al. (2007), the experience of the European transition countries does not seem to conform to this rather skeptical view of the relationship between financial integration and growth.

This paper explores the reasons for the observed differences between Emerging Europe and other countries. As a starting point, we reassess the stylized fact that financial integration has been more beneficial in European transition economies than in other countries in the years preceding the current crisis. In order to mitigate the endogeneity problems prevalent in cross-country studies, we use the Rajan–Zingales methodology based on industry-level data (see Rajan and Zingales, 1998). Our findings confirm that financial integration disproportionately benefited industries with high needs of external financing in Emerging Europe, whereas no such effect is found for other developing or advanced countries.

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We then carefully examine the potential reasons for this difference. We first analyze whether it can be explained by threshold effects in the factors traditionally analyzed in the literature: financial development, institutional quality, trade integration, and financial integration itself (e.g., Kose et al., 2011). However, the difference between Emerging Europe and other developing and advanced countries remains significant when accounting for threshold effects in these four dimensions. This finding is robust to a large number of different model specifications, in particular to threshold choices.

Our main contribution is to offer a novel explanation based on political integration. So far, political aspects of integration have largely been ignored in the economic literature even though political integration with advanced economies is one of the most distinguishing features of European transition countries. We argue that political integration raises expectations of future reforms, institutional improvements and a commitment to sound economic policy. Through this channel, current political integration may affect investors' decisions and lead to growth-enhancing investments even if the current institutional framework is still relatively weak, as was the case in Emerging Europe. In order to test our hypothesis, we construct a broad index of political integration on the basis of information on regional integration agreements, taking into account four dimensions of political integration: an institutional dimension, policy coordination, attitudes, and political stability. We then test whether the effect of financial integration is affected by the degree of political integration.

Our analysis suggests that differences in political integration can explain why financial integration had much stronger growth effects in European transition economies than in other countries. When political integration is included in the regression, the growth effects of financial integration are no longer significantly different in Emerging Europe and other countries. Moreover, within the group of developing countries, the effect of financial integration is strongest in countries that are most highly politically integrated. Hence, political and financial integration appear to be complementary: political integration considerably increases the benefits of financial integration, and thereby speeds up the transition process in developing countries. In contrast, political integration has no effect on industry growth differentials in advanced countries. This is not surprising, since these countries already have high quality institutions, so that political integration loses its relevance as a signal or commitment device. Political integration plays an important role especially in the early stages of countries' development. We conclude that the growth effect of financial integration in Emerging Europe was different from other developing countries because financial integration was accompanied (or indeed preceded) by advances in political integration.

Our paper is related to the fast growing empirical literature on the relationship between financial integration and economic growth, surveyed by Kose et al. (2009b). Much of that literature focuses on the troubling finding that financial integration and economic growth are not positively, but negatively correlated. In an influential paper, Prasad et al. (2007) show in a sample of 65 developing, non-transition countries that current account surpluses had a *positive* impact on growth between 1970 and 2004, implying that countries relying on foreign financing grew more slowly than countries relying on domestic savings, which contradicts the neoclassical view. Gourinchas and Jeanne (2007) refer to the negative correlation of capital flows and economic growth in developing countries as the allocation puzzle. Gourinchas and Jeanne (2006) show in a calibrated neoclassical model that welfare gains from financial integration are expected to be small. They argue that one must consider channels that go beyond the textbook neoclassical model in order to generate a larger impact.[1]

Studies using disaggregated data tend to draw a somewhat more positive picture of financial integration than country-level studies (see Kose et al., 2009b). Using industry-level data, Prasad et al. (2007) find evidence of *threshold effects*: financial integration appears to have positive growth effects once the financial system is sufficiently developed. In our study, we follow this literature in using disaggregated data and integrating threshold effects in the analysis. Several studies (starting with Bekaert et al., 2005) have found evidence of a beneficial effect of financial integration through equity market liberalization.[2] The overall picture of the benefits of financial integration is still mixed at best, with scant or no evidence to suggest that financial integration supports economic growth in developing countries.

Another strand of the literature explains the mixed findings on financial integration by the dynamic properties of the liberalization process. Kaminsky and Schmukler (2008) show that financial liberalization leads in the short-run to more stock market volatility in (non-transition) emerging markets. However, in the long-run, volatility declines. In contrast, advanced countries are found to profit already in the short-run. As we will see, regarding the dynamics, countries in Emerging Europe appear to resemble advanced rather than other developing countries as there is evidence of substantial benefits already in the short- to medium-term.

Only few studies have focused on European transition countries. Guiso et al. (2004) apply the Rajan and Zingales (1998) methodology to test for the effect of financial development (rather than financial integration) on economic growth using industry-level data (61 countries over the period 1981–1995, excluding transition countries) and firm-level data (firms from 26 countries, among them 11 transition countries, between 1996 and 2001). Their results indicate that financial development has a "growth dividend" in Europe, and they speculate that this will also translate into positive growth effects of financial integration. This view is supported by Abiad et al. (2009) who show in a country-level panel regression framework that financial integration measured by current account deficits had a positive growth effect between 1975 and 2004 in Europe, but not in the rest of the world.[3] Thresholds in institutional quality and financial integration itself can only partially explain the differences between Europe and the rest of the world.[4] In his comment to Abiad et al. (2009), Imbs (2009) criticizes the use of country-level data and stresses that a significant part of the Europe effect remains unexplained — two issues that this paper intends to tackle.

The paper proceeds as follows. Section 2 reassesses the stylized fact that Emerging Europe is different. It presents industry-level evidence showing that externally dependent industries in Emerging Europe benefited substantially more from financial integration than those in other developing and advanced countries. Section 3 focuses on the role of political integration. We first discuss the theoretical channel through which political integration may affect the relationship between financial integration and economic growth. We then describe the construction of the political integration index. Section 4 analyzes the reasons for the observed difference between Emerging Europe and other countries. We find that political integration can explain this difference, whereas financial development, institutional quality, trade integration, and financial integration cannot. This finding proves to be robust to various changes in the model specification. Section 5 concludes.

2. Is Emerging Europe different?

2.1. Empirical model

The starting point of our analysis is the observation that current account balances in European transition countries were negatively

[1] Relaxing two assumptions, Hoxha et al. (2009) estimate welfare gains from financial integration that are by a factor of 8.6 larger than those of Gourinchas and Jeanne (2006).

[2] See also De Nicolò and Juvenal (2010). In Emerging Europe, equity markets at best play a subordinated role.

[3] The number of observations from transition economies in their sample is rather small.

[4] When threshold effects are included, the "Europe effect" drops by up to one third and remains highly significant.