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Has the Financial Integration affected the European Union (EU) trade with the New Member Countries from Central and Eastern Europe (CEEC) during 1994–2013?



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ABSTRACT

This study would examine whether the European financial integration has affected the CEEC exports to the EU countries during 1994–2013. The results indicate that the higher stock market and bank development have negative rather than positive effect on exports. The lack of the positive stock market capitalization effect can be attributed to the timing of the euro adoption during the financial crisis. The lack of the positive bank credit effect can be explained by the lack of bank credit increase for exports despite the EU bank presence. Second, the results suggest that the higher CEEC skill endowment has boosted exports before their EU membership. This can be due to the implementation of the free trade agreements since the 1990s. On the contrary, the higher EU skill endowment has decreased exports as the EU countries have lower demand for the labor-intensive products. Third, the positive CEEC technology spillover effect on exports has decreased with distance due to the higher transaction costs involved. In contrast, the EU technology spillover has boosted exports regardless of their distance.

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1. Introduction

The Central and Eastern European countries (CEEC) have developed very close trade ties with the European Union (EU) countries before joining the EU membership. The CEEC have relied on the EU countries as their major export markets as they have accounted for more than half of their total exports (Caporale, Rault, Sova, & Sova, 2012). The trade liberalization has been facilitated by the implementation of the free trade agreements since 1995. The agreements have granted mutual market access free of duties and quantitative restrictions for all manufactured products. Given the access to the larger markets, the CEEC have gradually shifted their export emphasis from the labor-intensive to technology-intensive products. The latter type of products has accounted for the growing share of the CEEC exports to the EU countries. This has helped to reduce their technological gap with the EU countries over time (Hornok, 2010). Nonetheless, the higher trade growth has still been impeded by the non-tariff barriers such as technical standards. The CEEC membership to the EU since 2004 has ultimately eliminated these remaining barriers to boost their trade flows (Marques, 2011). This has given the CEEC to have greater access to the affluent EU markets for their high-technology exports. More importantly, the CEEC have joined the European Monetary Union (EMU) by adopting the single currency (euro). Among the thirteen CEEC, seven of them have joined the EMU between 2008 and 2015, whereas the rest of them have been in negotiations with the eurozone countries to

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follow suit. This has contributed to their stable export growth through the elimination of exchange rate volatility. The stable euro currency value has also boosted their exports to the non-eurozone countries (Cieslik, Michalek, & Mycielski, 2012). The CEEC membership to both the EU and EMU would become the major driving forces for their long-term export growth.

This study examines the European financial integration effect on the CEEC trade flows with the EU countries during the period 1994–2013. Due to their EMU membership, the CEEC financial markets have become partially integrated with those of the EU countries since the early 2000s. The elimination of exchange rate volatility has further boosted the EU capital flows to the CEEC financial markets. More importantly, the CEEC stock market and bank development would accelerate in terms of size and liquidity, which would provide more financing for exports. Hence, the higher financial market development would become a major determinant of the CEEC export growth. Second, this study explores the role of CEEC factor endowments in facilitating their trade flows. Due to the massive foreign direct investment (FDI) inflows from the EU countries, the CEEC have substantially improved the quality of their human capital and infrastructures so that they can further boost their high-technology exports. The labor education and knowledge transfer can significantly affect the CEEC export growth over the long run.

This study would contribute to the literature in two aspects. First, this is the first study to examine the financial development effect on the CEEC-EU trade flows. The earlier studies have narrowly focused on the EU membership effect on their bilateral trade flows. The EU effect has proven to be small because of the free trade agreement implementation long before the EU membership. These studies have overlooked the other important trade determinants. This study tries to determine whether the CEEC financial market development would play a crucial role in facilitating their trade flows. The CEEC membership to the EMU would accelerate their stock market and bank development as they become more integrated with the eurozone financial markets. This would enhance their access to the supply of market-based financing for exports. This study would contribute to the literature on the relationship between the financial development and the CEEC-EU trade flows. Second, this study explores the role of CEEC factor endowments in facilitating their trade flows. Most of the similar studies have primarily relied on the basic gravity variables to estimate the CEEC trade. However, their transformation from the planned to capitalist economies since the 1990s has accelerated their economic growth. The huge improvement in human capital and infrastructures has led to their growing emphasis on high-technology exports. Most of the CEEC have highly educated labor force for conducting advanced research. Thus, the upgrade in their production facilities due to the FDI inflows has increased their production efficiency in high-technology exports. This study would contribute to the literature on the relationship between the factor endowments and the CEEC-EU trade flows.

The remainder of the paper is organized as follows. [Section 2](#) presents the literature review on the CEEC and EU trade flows. [Section 3](#) describes the empirical specification. [Section 4](#) presents the results and discusses their significance. [Section 5](#) describes their implications for the CEEC-EU trade patterns. [Section 6](#) concludes.

2. Literature review

A number of empirical studies have examined the financial development effect on the trade flows. First, the higher financial development through capital flow liberalization can boost the trade flows through the increase in financing. [Beck \(2003\)](#) finds that the countries with better-developed financial markets have the higher exports, especially the export industries that rely more on external finance. They have to bear substantial upfront costs that cannot be financed solely by retained earnings or internal cash flows from operations. The fixed outlays include research and development (R&D), product development, and marketing research expenditures. The financial markets can provide more external financing to the export-oriented firms to overcome their liquidity constraint. The lower cost of obtaining external finance would allow these firms to further specialize and exploit the economies of scale. They would have a comparative advantage in the industries that show the high scale economies. These countries often have higher share of manufactured exports in their gross domestic product (GDP) and in total merchandise exports ([Beck, 2002](#)).

The more efficient bank institutions can provide the necessary credits for the firms to finance their global activities. In the case of obtaining sufficient trade finance, it is easier for exporters to build the closer banking relationships at home than abroad ([Manova, 2013](#)). The massive bank liberalization can attract more foreign bank FDI inflows. This would facilitate the local bank expansion. The additional financing provided by the larger banks would contribute to the higher export growth. Moreover, the deeper stock market liberalization such as the equity market liberalization can increase exports disproportionately more in financially vulnerable sectors that require more external finance. The positive stock market effect is stronger in economies with initially less active stock markets. The higher foreign equity inflows may substitute for the equity flows at the domestic financial markets. The equity market liberalization effect is also larger in the presence of higher trade costs caused by restrictive trade policies ([Manova, 2008](#)). It is important to pursue the financial market liberalization to finance the growing exports over the long run. Finally, there is positive relationship between financial market development and liberal trade policies. The development of domestic asset markets and the integration on financial markets across the borders have substantial effect on trade openness ([Svaleryda, & Vlachos, 2002](#)). This provides support for the argument that one of the long-term trade policies should emphasize the financial market liberalization.

The previous studies have tried to use the human capital endowments to explain the trade flows. The labor education would strongly boost trade as countries with more educated labor force would be the net exporters of skill-intensive goods. The better quality of human capital endowments would allow these countries to gain high skill-intensive export

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