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Non-linear growth effects of financial development: Does financial integration matter?

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Abstract

Using both macro- and industry-level data this paper analyses the non-linear effects of financial development and international financial integration on economic growth in Europe. Special attention is devoted to modeling threshold effects with respect to the depth of financial markets as a measure of economies' absorption capacity. Results reveal evidence of significant non-linear effects, with less developed European countries gaining more from financial development. In contrast, benefits of international financial integration become significant at higher levels of financial development. The data show that monetary integration in Europe significantly contributed to a higher degree of financial integration. Entry of new EU members to the European Monetary Union may thus be the mechanism ensuring a virtuous development circle, as the adoption of the Euro may allow the development of domestic financial markets and financial integration to go hand-in-hand.

JEL classification: F33; F36; G15

Keywords: Euro adoption; Financial integration; Financial development; Threshold effects; Economic growth

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1. Introduction

The aim of the paper is to analyze the likely effects of the process of euro adoption on financial development and growth in new EU member countries. About two decades ago the new EU members started the process of transition to market economies. This process led also to the creation of previously non-existent financial markets. Starting with Slovenia in 2007, it is now evident that the most advanced countries in the group will soon join the European Monetary Union. Because this process is and will be the strongest driving force of further financial integration of these countries with the rest of the EU, the likely economic consequences of this process represent a challenging subject of investigation.

Two decades of European monetary integration lead to a process of significant liberalization of capital flows and integration of financial markets. An additional impetus has been provided by the introduction of the euro (Baele et al., 2004). Progress in financial integration brought benefits also to new EU members. Indeed, it allowed them to run sizable current account deficits, facilitating faster growth and convergence of living standards. Large share of capital inflows in the form of FDI implies favorable risk sharing and transfer of technology that may represent one of the most important factors of catching up (Lane and Milesi-Ferretti, 2006b). It must be noted, however, that the process resulted in levels of negative foreign asset positions that are by international standards relatively high. As a consequence, future adjustments in the current account will be necessary for many countries (Lane and Milesi-Ferretti, 2006b). However, drawing from a recent experience of the ‘‘old’’ European countries and the stimulus that creation of the EMU gave to further financial integration (see Fig. 1 below), we may also expect an even increased dynamics in terms of financial integration as most of new EU members progress on their path of euro adoption. This may increase the sustainability of observed net foreign asset position on its own, and to the extent that it promotes further financial development also increase the ability to generate surpluses in the future. Investigating whether empirical evidence supports such theoretical predictions is in the centre of our analysis.

Significant effects of national financial development on growth are well documented in several empirical studies. In contrast, the evidence of the effect of financial integration is mixed. While it is generally acknowledged that higher degree of openness is associated with economic success, it is also very difficult to empirically confirm a positive effect of financial integration on growth. Recent studies argue that positive effects of financial integration on growth arise only when financial integration is combined with an appropriate institutional framework (Prasad et al., 2003). This implies that the empirical analysis of such phenomena should pay special attention to non-linearities and threshold effects.

We contribute to the literature along five lines. First, our analysis concentrates on the European countries. Because these countries are more homogenous in terms of institutional characteristics of their economies this makes our analysis less affected by other unobserved determinants of growth that may influence the results in studies using large cross-country panels. Moreover, because we focus on the likely contribution of the adoption of the Euro for the financial integration-growth nexus, our country sample includes the most comprehensive coverage of Central and Eastern European countries thus far used in the literature. We construct also an industry-level data set obtained from a large database of firm-level data, which includes as well two large formerly planned economies, Russia and Ukraine. Second, using macroeconomic data we analyze the growth effects of both the development of national financial markets