ASSESSING THE FINANCIAL INTEGRATION OF CENTRAL AND EASTERN EUROPEAN COUNTRIES WITH THE EURO AREA: EVIDENCE FROM PANEL DATA COINTEGRATION TESTS

Salem Boubakri*, Cécile Couharde**, Cyriac Guillaumin***

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ABSTRACT. The aim of this paper is to assess the financial integration degree of the Central and Eastern European Countries (CEECs) with the euro area in the prospect of their integration in the Economic and Monetary Union (EMU). To this end, we test the Feldstein-Horioka regression for a non-stationary and heterogeneous panel of 10 CEECs and the euro area. In order to overcome some empirical shortcomings of this approach, we employ the recently developed panel data unit root tests and cointegration techniques. The empirical findings reveal that the financial integration process of the CEECs with the euro area is not yet complete. Another contribution of this paper is to show that this process is linked to the institutional monetary arrangement of these countries.

JEL Classification: C23; F31; F41.
Keywords: CEECs; Feldstein–Horioka Approach; Financial Integration; Panel Data Cointegration.

RÉSUMÉ. L'objectif de ce papier est d'évaluer le niveau d'intégration financière des pays d’Europe Centrale et Orientale (PECO) vis-à-vis de la zone euro dans la perspective de leur intégration au sein de l’Union économique et monétaire (UEM). Nous retenons l’approche développée par Feldstein-Horioka en estimant le coefficient de corrélation entre taux d’épargne et taux d’investissement sur un panel non-stationnaire et hétérogène composé des 10 PECO et de la zone euro. Afin de pallier certains problèmes empiriques soulevés par cette approche, nous utilisons les techniques économétriques les plus récentes de cointégration en panel. Nos résultats montrent que le processus d’intégration financière des PECO au sein de la zone euro n’est pas encore achevé et qu’il est étroitement lié au régime monétaire suivi par ces différents pays.

Classification JEL : C23 ; F31 ; F41.
Mots-clefs: PECO ; approche de Feldstein-Horioka ; intégration financière ; cointégration en données de panel.
1. Introduction

Between 2004 and 2007, 10 Central and Eastern European Countries (Poland, Hungary, Czech Republic, Estonia, Lithuania, Latvia, Slovenia, Slovakia, Bulgaria and Romania) joined the European Union. In the same time, these countries have expressed their wish to rapidly integrate the euro area. 1

The conditions for adopting the euro have been spelled out by the Maastricht Treaty. In addition to the requirements of containing inflation, ensuring stability of long-term interest rates, imposing limits on public debt and budget deficits, these criteria also call for achieving exchange rate stability. The prescribed vehicle for meeting this latter criterion is the Exchange Rate Mechanism II (ERM II) in which the prospective euro entrants must participate at least two years prior to the European currency adoption. However, beyond the Maastricht criteria, financial integration has been also highlighted as a factor making the integration in a monetary union easier. Following Mundell (1973) and Mckinnon (2002), a very large literature tries to justify the opportunity of a currency union, drawing attention to the financial integration process. The importance of assessing the degree of financial integration across the euro area has also been stressed by the European Central Bank (Baele et al., 2004). Indeed, financial markets integration plays a key role in the transmission of the common monetary policy. With high financial market integration, common shocks tend to dominate and a common monetary policy is then more effective to react to such shocks. On the other hand, in the case of weak financial market integration, local (country-specific) shocks prevail, which diminishes the effectiveness of a common monetary policy (Asdrubali et al., 1996; Kalemli-Ozcan et al., 2009). For the CEECs, it is thus essential to analyze the integration of their financial markets especially with the euro area’s ones.

The aim of this paper is to assess the financial integration degree of the CEECs with the euro area. To this end, we estimate the saving-investment coefficient, following the approach developed by Feldstein and Horioka (1980). In our view, this approach provides the best methodology to estimate a country’s integration with regional financial markets. 2 Indeed, as the saving-investment coefficient measures the allocation of saving between countries, its assessment can be particularly relevant for countries that wish to integrate a monetary union. However, as this measure is also difficult to interpret and to operationalize, we implement a framework that tries to overcome some of its empirical shortcomings, by using recent panel data econometric techniques. Moreover, instead of treating separately euro area countries and CEECs (Maurel, 2004), we first estimate the saving-investment relationship for euro area countries and then add CEECs in the panel in order to analyse the consequences of this inclusion on the value of the Feldstein-Horioka coefficient.

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1. Slovenia, Slovakia and Estonia already belong to the euro area since, respectively, 2007, 2009 and 2011.
2. Different methods have been used to measure financial integration. For a survey on these various methods, see Kose et al. (2006).
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