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DISCUSSING THE EFFECTS OF FINANCIAL OPENNESS IN THE CEECs

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Abstract: *This paper is aimed at analyzing the macroeconomic benefits and drawbacks of financial globalization in the CEE area. First, the literature on financial openness and its impact on consumption, economic growth and poverty are examined, in order to see whether the empirical findings are consistent or rather divergent. Then, the paper analyzes the necessity and consequences of the financial integration in the CEE area, with a focus on the challenges imposed by the global financial crisis.*

Key words: *financial openness, CEECs, financial crisis.*

1. Introduction

Financial globalization has become a hot debated concept over the last decade, involving a broad area of meanings, benefits and costs. Until the start of the financial crisis in 2007, financial liberalization was very often invoked as being a stimulus for economic growth for developing/ emerging countries. But the fast expansion and propagation of financial crisis from the US to other continents has been undoubtedly associated with the financial openness. This has raised questions about the real impact that the financial openness carries at both national and global level, and it has also shown that additional empirical work is needed to address these questions.

In the context of the growing merchandise trade, the autarchic development is no longer possible. The trade openness is a stimulus for financial openness, which is sometimes seen as a pre-requisite of financial development. The Importation of foreign best practice, expanding diversification opportunities and efficiency-enhancing competitive effects are examples of how the financial openness can improve the domestic financial system.

In literature, there is little systematic evidence that financial opening has positive effects on economic growth and poverty alleviation. The experience of the last global financial crisis has indicated that financial openness might increase the frequency and severity of economic crisis. Despite this negative perspective on financial openness, the developing countries continue to undertake measures towards this direction. In this paper, we aim at examining the positive implications, risks and costs involved by financial globalization, with a focus on the CEECs.

2. Literature Review

In the early 1990s, the IMF encouraged developing countries to liberalize their capital accounts in order to take part in financial globalization. Despite the risks

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associated to the liberalization of capital movements, the IMF researchers (Fisher, 1997; Dornbush, 1998) supported this idea from a theoretical perspective and in the absence of empirical demonstrations. At that time, economists thought the benefits of free capital movement will occur over time, and will prove to be higher than the costs and risks, exactly as it was the case of trade liberalization.

A considerable number of empirical studies applied on emerging economies have been conducted in the field of financial integration. They basically look at finding a relationship between the financial integration and consumption volatility, on the one hand, and between financial integration and economic growth, on the other hand. The results are sometimes divergent or not significant. For instance, Kose, Prasad and Terrones (2003a) find that the ratio of consumption volatility to income increased in the case of financially integrated emerging economies, in the 1990s. In another study (2003b), they demonstrate that consumption correlations across countries remained almost stable in the 1990s, despite the deepening of financial integration in that period of time. Buch, Doepke and Pierdzioch (2005), as well as Prasad and others (2003), and Fujiki and Terada-H. (2007) find that increased financial integration is not associated with consumption volatility on the long term.

When it is measured as a rise in the international capital mobility, financial integration leads to restrictive and disciplinary monetary policies, because the substitutability of international financial assets reduces the effectiveness of expansive monetary policies. Thus, the inflationary pressures are reduced and the monetary policy becomes able to target inflation.

The causal relation between financial openness and economic growth is controversial because the question is whether the economic growth determines financial development or the financial development is caused by growth. When considering a long period of time, the relation between them is like a spiral. Nevertheless, the effects of financial globalization on economic growth cannot be analyzed as a direct relationship because the benefits of financial globalization are visible only on the long term, and even so, it is difficult to measure the exclusive explanatory power of the financial openness variable itself. Anyway, when empirically studying those relations, the results are inconclusive and not robust (Kose and others, 2006). The benefits are hard to be detected with macroeconomic data and techniques.

Another relation investigated in the literature is that financial openness-poverty. The financial opening can accelerate the rate of economic growth and this is independent of the poverty rate. The poverty rate can remain the same, because the economic growth could increase the social inequality. In the past, most of the studies found a positive association between financial development and poverty reduction (Aghion and Bolton, 1997; Honohan, 2004). Out of theoretical considerations, financial development facilitates the access of the poor to credits, but their access is more restrained than the access of the rich to credits (Aghion and Bolton, 1997). In this light, financial development leads to poverty reduction, but increases social inequality.

The empirical evidence about financial globalization is based not only on macroeconomic data, but also on microeconomic ones. For instance, the microeconomic analyses can describe the variation within a country, across sectors, controlling for common shocks or reforms. The underlying idea is that the elimination of capital controls enhances efficiency, mainly by reducing the supply of capital.

3. Experience of the CEECs. Theoretical and Empirical Insights

The financial openness helps emergent countries develop, therefore representing a need at a certain point in their economic trajectory. The first reason is that foreign direct investments, in particular, and foreign capital, in general, are factors of economic growth and domestic investment. In the absence of investment funds from abroad and also in the context of low domestic savings and weak domestic financial markets, the economic growth and development are seriously constrained. But foreign capital inflows are risky in the sense that they must be accompanied by effective and appropriate macroeconomic policies and prudential regulations.

But foreign funds are not always really necessary for economic development because, first of all, the investment demand in that country could be very weak (due to low social returns, for instance). Also, the real appreciation of national currency could discourage private investments. Therefore, the effects of capital inflows on growth and consumption could be indeterminate.

In the CEECs, the liberalization of capital accounts was accomplished through domestic macroeconomic policies, at the initiative of national governments, but with the consultative support of the IMF. The integration of these countries in the European Union has generated positive effects for their economy, such as the increase of the FDI volume and capital inflows. But the financial openness has also exposed them to a greater volatility to external shocks. As long as their financial markets are underdeveloped, as compared to the rest of the EU, the output volatility will remain higher in the CEECs than in the EU. The risk of a greater openness is that the monetary policy will lose flexibility and the fiscal policy will become the only additional instrument to deal with conflicting and external priorities.

In 2008, the global financial crisis raised a big question about the transitional growth model adopted by the CEECs, particularly about the trade and financial openness and their consequences. However, despite the negative predictions, the financial systems did not collapse. Nevertheless, there is a strong demand now for recalibrating their growth model, instead of replacing it with a new one.

An interesting peculiarity of the CEECs regards the ownership of commercial banks. In the CEECs, most of the commercial banks have been sold to big finance houses from developed EU countries. This carried both positive and negative implications for these economies. First, during the economic boom, financial integration stimulated economic growth in the CEE area, which was not the case of all emerging countries. Later, during the financial crisis, West European banks did not withdraw all funding from their CEE subsidiaries overnight and therefore there were no big banking crisis in the Eastern Europe. The „Vienna Initiative" also helped the CEECs to prevent a run of the foreign finance houses for the exit. Overall, even though the foreign banks fuelled unsustainable credit booms, the EBRD claims that countries with a higher share of foreign bank ownership did relatively better in the crisis than those with shaky local institutions that relied on short-term liquidity from abroad.

A particular feature of the CEECs economies right before and after the crisis was the high volatility of exchange rates. From 2008 to 2009 the zloty depreciated by over 50% against the euro, the forint by almost 40%, the Czech koruna by almost 30% and the Romanian leu by 25%. This has raised the cost and risk of credit. But, since March 2009, the regional currencies have appreciated again.

4. Conclusions

The participation of the CEECs to the financial globalization is strongly related to their participation into the EU, but also to the prospects of becoming a part of the European Monetary Union. The CEECs financial integration is thus a historical inevitability and will not change in the next year. Now, the most important objective in the CEE area is the achievement of the nominal convergence criteria in order to facilitate the Euro area enlargement. One condition is to join the ERM 2 exchange rate system two years before moving to EMU. The severe consequences of the financial crisis make the achievement of nominal criteria more difficult now than in the past. At present, the limit imposed for the budgetary deficit seems to be impossible to reach by most of EU countries. A new strategy for the EMU enlargement is therefore strongly needed, one solution being the relaxation or change of the actual nominal convergence criteria.

The financial crisis shows that the financial globalization must be sustained by home country supervision and especially by stronger cross-border regulation. For instance, Austria and Sweden did not act prudentially when their banks were getting up to Latvia or Hungary. In addition, the CEE host countries must strengthen local capital markets.

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