

Tomfort, André

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## The role of the European Union for the financial integration of Eastern Europe

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## Working Papers

# The Role of the European Union for the Financial Integration of Eastern Europe

Author: André Tomfort

Section: Economics, Law and Political Sciences  
Paper No. 26, 06/2006

### Editors

Prof. Dr. Gert Bruche  
Prof. Dr. Hansjörg Herr  
Prof. Dr. Sven Ripsas

# **The Role of the European Union for the Financial Integration of Eastern Europe**

**André Tomfort**

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the Institute of Management Berlin at the  
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Editors:  
Prof. Dr. Gert Bruche  
Prof. Dr. Hansjörg Herr  
Prof. Dr. Sven Ripsas

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*Dr. André Tomfort is Professor for Financial Analysis and Management at the Berlin School of Economics (FHW-Berlin).*

## **Abstract:**

The **objective** of this paper was to investigate the integration of Eastern European financial markets into the EU and world markets. Financial integration has been measured by international investment positions and financial liberalisation measures.

**Results:** Both analysis methods supported the thesis that a dynamic integration process has happened. The major driving forces are the EU accession and EMU participation expectations, economic integration, legal and institutional harmonisation efforts to international standards. However, the current state of the financial integration process still leaves a lot of room for more integration to come in the future. The economic net benefits of financial integration for Eastern Europe seem to be more positive than for many other Emerging Market economies.

**Text structure:** In the first section of this paper the integration stimulus from the EU and EMU accession process has been analysed. The importance of the institutional transformation process for financial integration that was closely linked to the EU accession was highlighted in section 2. The third part of this paper is focusing on the role of trade as a driving force for financial integration. The fourth section is analysing the development of the international investment position of three of the core countries of Eastern Europe to gain empirical insights into the financial integration process and to assess the impact from different kinds of financial markets. In the last section the development of current account restrictions was shown to assess whether cross-border financial transactions may still be negatively affected by governmental hurdles. At the end of this paper the degree and potential of further financial integration has been assessed as well as the resulting impact for the economic development of Eastern European countries.

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## Introduction

International financial integration is increasing rapidly in world financial markets. More and more foreign asset and liability positions can be observed and international capital transfers are on a rising trend. This development is based on a number of factors. Capital account restrictions have been lifted in many countries, other barriers to investing abroad are also being dismantled and cross-border transaction costs are declining. More efficient and new financial instruments are available that make investing abroad much easier. The investor's awareness of higher return and better diversification potentials in foreign and newly emerging markets is rising. Financial integration and corresponding rising capital flows can play a fundamental role in increasing growth and welfare in many recipient countries. Typically, developing economies can profit from international capital flows since they can solve their inter-temporal saving-investment gap. However, financial integration leads also to a growing dependence from foreign events that often occurred as exogenous shocks with corresponding financial, currency, and banking crisis. Central and Eastern Europe was a particular case in this context. It was somewhat less crisis-prone than Asia or Latin America because it profited from the accession towards the European Union. This accession process gave the financial integration of Central and Eastern Europe a unique characteristic that could become a guidance for other regions in world that aim to be more economically and financially integrated with industrialized countries. Therefore, the accession towards EU was described in this paper with a particular focus towards its impact on financial integration. The economical and institutional transformation process and the way it influenced financial integration was also analyzed and again – the accession towards the EU played an important role. Other driving forces for financial integration such as economic integration were taken into consideration as well. Another important feature of this work was to measure empirically the degree of financial integration of Central and Eastern European (CEE) countries. Three different kinds of measures have been used that are independent of each other so that a reliable overview was achieved. These measures are the international investment position of three CEE core countries, the extent of capital account restrictions and other measures for financial market developments, and the cointegration of CEE financial market returns with Western European market returns. The latter statistical analysis should give an indication to what extent international investors regard CEE markets as an investment alternative.

## **1. Integration stimulus from the EU accession and possible EMU participation**

In 2004, Poland, the Czech Republic, Hungary, Slovenia and the Baltic states joined the European Union (EU). Before the membership into the EU happened, a long political and economical adjustment process took place. Just after the end of the cold war in 1989, the European Union started to intensify diplomatic and economic relationships with CEE countries. The EU removed import quotas and released the so-called Phare program to support financially the transmission process towards market economies. At a later stage, bilateral association treaties between the EU and individual Eastern European countries were concluded which deepened the trade links and formed a legal basis for economic relationships. As a consequence of all these measures, trade between both regions started to increase sharply and within a few years, the EU became the most important trading partner for Central and Eastern Europe. In 1993, the European Council decided that Central and some Eastern European countries could become EU members if they fulfill a series of political, legal and economic criteria, aiming the transformation towards democracies, constitutional states and market economies. In 2000, the negotiations were extended to Bulgaria, Latvia, Lithuania, Romania, and the Slovakia. Finally in 2004, the mentioned countries became EU members.<sup>1</sup> The described accession towards the EU has caused a strong stimulus for financial integration through convergence expectations. Economic convergence can be expected if CEE economies will develop towards EU levels because intensified trade with the EU as well as legal harmonization should benefit economic growth, labor income, employment, tax payments and social stability<sup>2</sup>. The entire process will be supported by foreign direct investment inflows that usually follow corresponding trade linkages. Foreign direct investment creates employment, has valuable technological and organizational spillover effects, forces local governments to improve the infrastructure and thereby improves the efficiency of the overall economy.<sup>3</sup> Such a convergence in the real economy will also cause a convergence of corporate cash flows, financial market risk premiums and overall capital costs, resulting in a higher integration of financial markets.

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<sup>1</sup> Kommission der Europäischen Union, "Die EU-Erweiterung – Eine historische Gelegenheit, 2000: 6-26.

<sup>2</sup> International Monetary Fund, "International Financial Integration and Developing Countries," World Economic Outlook, 2001: 152-162.

<sup>3</sup> Lane, P.R., "An Empirical Analysis of International Financial Integration," Draft, Trinity College, 2001:11-12.

The formal integration into the European Monetary Union (EMU) may be possible from 2007 on. While not all of the candidate countries are likely to fulfill the Maastricht Criteria for an EMU participation, their chances seem to be fairly good. All countries can be expected to remain below the 60% government debt level. Some countries show inflation rate far above the critical participation level. However, they have the option to bring inflation rates down through administrative measures such as lowering indirect taxes or government fees. The negative impact of these measures on the budget deficit can be outweighed to a significant extent by their positive impact on economic growth and a decline in government debt costs once financial markets believe in the EMU participation so that bond yields converge to EMU levels. Similar developments could have been observed for Southern European countries when the first EMU participation round took place. Also the exchange rate criterion can be easily fulfilled if investors bet on an EMU participation of these countries because the corresponding capital inflows will lead to a strong support for these currencies. Countries which hurt the budget deficit criterion can increase direct taxes as well as government fees, and reinforce their privatisation efforts to raise their incomes. Furthermore, governments can lower spending to improve the expenditure side. Only countries such as Slovakia and Hungary that suffer from a combination of high inflation rates and a failure of the budget deficit criterion may face some trouble to join the EMU in coming years. But they have still the fact in their favour that some of the core member countries such as Germany and France are not able to keep their budget deficit below 3% for several years so that a loosening of the stability pact or at least a looser interpretation will support them in their efforts to join EMU. The only country from the table below that still is considerably failing the EMU criteria and where participation is quite unlikely for the foreseeable future is Romania.<sup>4</sup>

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<sup>4</sup> For a detailed discussion, read Deutsche Bank Research: EU-Monitor, Frankfurt, 6-36, April 2004



Table 1.1: Emerging Europe: Macroeconomic Convergence State  
Forecasts for 2005 and 2006 are DB Research, IMF and own Estimates

	Real GDP				Consumer Prices				Current Account Balance (as % of GDP)			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Emerging Europe	4,6	6,2	4,5	4,5	9,5	6,7	5,4	3,8	-4,3	-4,9	-4,6	-4,1
Poland	3,8	5,4	4	4	0,8	3,5	2,5	2,5	-1,9	-1,5	-1,6	-2
Czech Republic	3,7	4	4,1	4,1	0,1	2,8	1,5	2,8	-6,2	-5,2	-4,8	-3,5
Hungary	2,9	4	3	4	4,7	6,8	3,8	3,5	-9	-8,9	-8,2	-5,6
Eurozone	0,8	1,8	1,2	2	2,2	2,1	1,9	1,7	-0,6	0,1	0	0,2
OECD	2,2	3,6	2,9	3,1	1,8	2	2	1,9	-0,2	-0,1	-0,2	0,1

Historical Data from DB Research<sup>5</sup>

Table 1.2: Emerging Europe: Detailed EMU Convergence State

	Inflation	Interest Rates	Fiscal balance (% of GDP)	Public Debt (% of GDP)	Exchange Rate against Parity	Currency Regime
	2004	last	2004	2004	Max. 2 Y	
Reference Value	2,5	5,5	-3	60	-15,00%	
Poland	3,5	4,8	-4,8	50,6	-13,5	Float
Czech Republic	2,8	3,3	-3	40,3	-6,3	Managed Float
Hungary	6,8	6,4	-5,3	57,5	-9,3	Target Zone
Estonia	3	2,4	1,1	5,9	-0,4	Currency Board
Latavia	6,2	2,3	-1,2	16	-7,6	Peg
Lithuania	1,2	6,4	-2,5	22	-0,3	Currency Board
Slovakia	7,5	3,6	-3,3	44,5	-3,9	Managed Float
Slovenia	3,6	4,1	-1,9	26,4	-5,4	Managed Float
Bulgaria	6,1	3,2	1,8	44,3	-3,8	Currency Board
Croatia	2,1	3,1	-4,9	54	-6,8	Managed Float
Romania	11,9	7,2	-1,2	26,6	-14,4	Crawling Peg

Historical Data from DB Research<sup>5</sup>

The main effect of the possible EMU membership is that as long as financial markets believe in it, capital exports into these countries will help them to keep interest rate sufficiently low to reach the interest rate and budget deficit criterion, to keep the exchange rate sufficiently strong and to support local governments in their fight for lower inflation rates. This has been the experience in the first EMU entrance round. If one believes in this scenario than a second important conclusion can be derived: The prospect of an EMU membership is a strong supportive factor for the integration of CEE financial markets because it causes significant cross-border transactions.<sup>6</sup>

<sup>5</sup> Deutsche Bank Research: EU-Monitor, 27, Frankfurt, June 2005 & International Monetary Fund: International Financial Statistics Yearbook, 269-271; 529-531, 356-359, Washington 2004

<sup>6</sup> A detailed discussion with regard to the credit market can be found in: FRBSF Economic Letter, "Monetary and Financial Integration: Evidence from the EMU," 2004: 1-3. & G. Roland, "After enlargement: Institutional achievements and prospects in the New Member States," proceedings of the third ECB conference "The New member States: Convergence and Stability," 2005: 40

## **2. The institutional transformation process as a basis for financial integration**

After focusing on macroeconomic stabilization and market liberalization policies, more attention has been given on structural reform and institutional development in the course of the transition process of the CEE countries.<sup>6</sup> Empirical studies show that structural reforms and the development of institutions are important keystones for economic and financial performance.<sup>7</sup> For example, institutional quality such as the reliability of governmental institutions or the transparency of the legal system can have a long-term impact on capital inflows and financial integration because they influence the willingness of foreign investors to place capital in the specific country. This is particularly true for foreign direct investment with respect to the protection of intellectual and other property rights.

Analyzing the current development state of institutions in CEE countries, one can distinguish between legislative, administrative and judicative matters. Legislative institutions focus on issues related to the political process and have to ensure political, civil, and human rights. These issues have been tightly controlled by the EU and have improved significantly. Administrative institutions have to be judged by the quality of public administration, by their legal accountability and the institutional framework required for economic activities in the private sector. Here, a lot of progress could have been observed but not all requirements are fulfilled by now. Judicative institutions should ensure trust in the police and the courts, the quality of contract enforcement, and the extent of corruption. Also with respect to judicative institutions, the transformation process has progressed significantly but a lot of work still has to be done.<sup>8</sup> Liberalization policies often go along with corruption and criminal activity predating on private economic activity. Corruption is very likely to have a negative impact on foreign direct investment and on portfolio flows. In this context it is important to highlight the importance of law enforcement as one of the key success factors. Again, the EU played a very supporting role through its capital transfers that enabled the building of an effective legal and control system. Furthermore, the prospect of an EU membership and stricter law enforcement in the

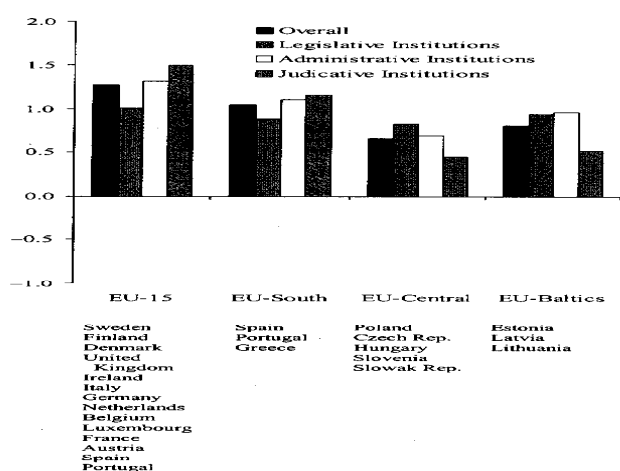
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<sup>7</sup> H. Edison, „Testing the links: How strong are the links between institutional quality and economic performance, Finance & Development 40(2), 2003: 35-37

future gave a strong incentive for many economic agents to choose to be rather producers in the economy than predators. While criminal activity and corruption in many Central European countries is certainly still a problem it is at a considerable lower level than in Eastern European countries that still are outside of the EU.<sup>9</sup>

In general, political institutions often had problems sustaining public support for their institutional reform programs and were faced with negative voter reactions. In this context, the EU became an important “outside anchor” to the reform process in Central and Eastern Europe. Domestic political fights became subordinated to the overriding goal of EU membership. This subordination can be explained by the expected benefits - directly received via EU financial transfers and indirectly via the hope of economic convergence towards EU standards, improved political security, and a public sense of “belonging to Europe.” Without this anchor function of the EU, the structural and institutional reform process would have been much slower and economic and financial integration would have not reached the level we can observe today.<sup>10</sup>

Graph 2.1: Institutional development in groups of European countries (2004)



F. Hammermann, R. Schweickert, “EU Enlargement and Institutional Development: How far are the EU’s Balkan and Black Sea Neighbours?”, 2004: 18

<sup>8</sup> F. Hammermann, R. Schweickert, “EU Enlargement and Institutional Development: How far away are the EU’s Balkan and Black Sea Neighbours?”, 2005: 5-18. A detailed discussion of the administrative and judicative institutions with respect to the financial sector will be done at a later stage

<sup>9</sup> G. Roland, T. Verdier: Law enforcement and transition, European Economic Review, 2003: 3-5

<sup>10</sup> E. Berglöf, G. Roland, “The EU as an “outside anchor” for transition reforms, 1997: 1-17

### 3. International trade as a driving force for financial integration

Looking at other driving forces behind financial integration, the first obvious issue is international trade in goods and services. Goods trade may be important for several reasons. Firstly, goods trade directly entails corresponding financial transactions such as trade credit and export insurance. Secondly, goods trade and financial positions are sometimes jointly determined such as in the case of FDI and intra-firm trade. Finally, openness in goods market may make a country more transparent to foreigners so that their willingness to conduct financial investments in this country will increase.<sup>11</sup>

Table 3.1: Poland: Economic Integration based on the international trade position  
 Based on IMF (2004): "International Financial Statistics Yearbook," and own Calculations

Date	Exports in Mio. USD	Imports in Mio. USD	Real Econ. Integrat.
1994	18355	18930	0,205
1995	25041	26687	0,214
1996	27557	34844	0,395
1997	30731	40553	0,489
1998	32467	45303	0,461
1999	30060	45132	0,491
2000	35902	48209	0,469
2001	41663	49324	0,421
2002	46742	53991	0,448
2003	61007	66732	0,507

Table 3.2: Czech Republic: Economic Integration based on the international trade position

Date	Exports in Mio. USD	Imports in Mio. USD	Real Econ. Integrat.
1993	14231	14748	0,851
1994	15964	17372	0,791
1995	21477	25162	0,898
1996	21950	27656	0,865
1997	22319	27257	1,022
1998	25886	28532	0,883
1999	26259	28161	1,029
2000	29019	32114	1,077
2001	33404	36482	1,091
2002	38480	40720	0,991
2003	48736	51242	1,064

Based on IMF (2004): "International Financial Statistics Yearbook," and own Calculations

<sup>11</sup> P.R. Lane, "An Empirical Analysis of International Financial Integration," 2001: 16-19.

Table 3.3: Hungary: Economic Integration based on the international trade position

Date	Exports in Mio. USD	Imports in Mio. USD	Real Econ. Integrat.
1992	10097	10108	0,577
1993	8119	12140	0,575
1994	7648	11364	0,482
1995	14619	16078	0,763
1996	15966	17640	0,804
1997	19284	20611	0,951
1998	23698	25583	1,070
1999	25608	27778	1,183
2000	28762	31675	1,306
2001	31080	33318	1,210
2002	34792	36911	0,964
2003	43229	46594	1,005

Based on IMF (2004): "International Financial Statistics Yearbook," and own Calculations

In all three countries that are taken as an example for Central Europe, an increasing economic integration with the rest of the world can be observed. The real economic integration can be calculated by adding exports and imports and then divides the sum by GDP. As described in the previous section, the political integration into the EU was of great importance for the dynamic of CEE trade relationships and the extent of economic integration.

#### 4. Financial Integration according to the international investment position

One direct approach is to measure the level of financial integration by the amount of a country's portfolio of external assets and liabilities. This portfolio is describing the international investment position (IIP).<sup>12</sup> The larger the international investment position is the more the country is financially linked with the rest of the world. The data in the table below summarizes total holdings by domestic residents of financial claims on the rest of the world and non-residents claims on the domestic economy. The data methodology is based on the IMF Balance of Payments manual. According to this methodology liabilities are divided into five categories: Foreign direct investment (FDI), portfolio equity investment, portfolio debt investment, other investment and derivatives. Assets are classified into the same five categories as liabilities, plus official reserves.

<sup>12</sup> P.R. Lane, G.M. Milesi-Ferretti, "International Financial Integration," 2003: 84-86.

Table 4.1: Poland: International Investment Position (in Mio. USD)

Date	Assets	FDI	Equity	Debt	Other	Liabilities	FDI (Stock)	Equity	Debt	Other	(A&L)/GDP
1994	23506	461			15727	53075	3789	443	7988	40855	0,829
1995	31966	539			14527	59304	7843	663	8712	42086	0,731
1996	28746	735			8454	58515	11463	2279	7869	36904	0,647
1997	31908	678	2	837	8988	62439	14587	2672	8653	36527	0,703
1998	36399	1165	9	1084	7866	80205	22479	4969	8689	44068	0,751
1999	40101	1024	28	1115	10619	89257	26075	4980	9637	48565	0,838
2000	44672	1018	47	1528	14615	99999	34227	5360	12707	47715	0,840
2001	49299	1156	108	1203	20275	107128	41247	4301	14594	46986	0,830
2002	51016	1453	245	1930	17604	123542	47900	4398	19367	51877	0,869
2003											

Based on IMF (2004): "International Financial Statistics Yearbook," and own Calculations

Table 4.2: Czech Republic: International Investment Position (in Mio. USD)

Date	Assets	FDI	Equity	Debt	Other	Liabilities	FDI (Stock)	Equity	Debt	Other	(A&L)/GDP
1993	17950	181	264	12	13621	14123	3423	1101	855	8744	0,942
1994	20471	300	334	99	13494	18088	4547	1331	1579	10631	0,914
1995	29396	345	693	62	14273	27182	7350	2642	2054	15136	1,090
1996	30629	498	748	624	16323	33151	8572	3398	1900	19280	1,112
1997	29779	548	417	615	18425	32863	9234	3028	1853	18749	1,292
1998	36426	804	449	752	21804	40361	14375	3793	1771	20422	1,247
1999	37465	698	1843	1057	21042	40548	17552	2724	1878	18394	1,475
2000	38304	738	2439	2333	19488	43378	21664	3059	1294	17242	1,439
2001	42609	1136	1894	3212	21469	49340	27092	3551	1423	16957	1,435
2002	52419	1473	2869	6233	17098	65598	38669	4250	2423	19504	1,477
2003	59550	1912	1845	11558	16337	83549	47527	6469	3229	25566	1,523

Based on IMF (2004): "International Financial Statistics Yearbook," and own Calculations

Table 4.3: Hungary: International Investment Position (in Mio. USD)

Date	Assets	FDI	Equity	Debt	Other	Liabilities	FDI (Stock)	Equity	Debt	Other	(A&L)/GDP
1992											
1993											
1994											
1995											
1996											
1997	15139	898	32	139	5634	41432	16325	2582	9914	12161	1,348
1998	17422	1301	87	206	6472	45881	18811	2317	12217	1254	1,375
1999	20384	1524	73	294	6629	50134	19542	4335	12599	13494	1,563
2000	20261	1976	221	447	5542	50177	20009	3014	11825	15053	1,523
2001	23314	2260	271	543	8320	54434	23099	2935	12786	15132	1,461
2002	24653	2745	363	573	9680	66496	28717	3825	17118	16212	1,226
2003	32386	3921	424	602	13055	97221	42915	5310	22189	24808	1,451

Based on IMF (2004): "International Financial Statistics Yearbook," and own Calculations

The data in the tables 4 to 6 shows that in all the three cases of Poland, the Czech Republic and Hungary the amount of assets and liabilities has risen considerably. In Poland and Hungary, the IIP more than doubled in the regarded time period while in the Czech Republic it even more than tripled. However, to receive a reasonable assessment on the development of the IIP it is necessary to relate it to the gross

domestic product (GDP). This has been done in the row (A&L)/GDP according to the formula: (Assets + Liabilities)/GDP. This measure delivers a somewhat different picture. While the Czech Republic still shows a significant increase in financial integration this is only partially true for Poland and Hungary. The differences between these countries are not dramatic with regard to FDI. But in equity and mainly in debt markets growth in the Czech Republic was considerably more dynamic than in the other two countries. This stands in contrast to the results of economic integration, where Poland and Hungary have been somewhat more integrated than the Czech Republic. So, obviously, by deepening their debt and equity markets, Poland and Hungary could reach a much higher level of financial integration. This conclusion is basically true for the whole region of Eastern Europe. Economically, well developed financial markets provide more longer-term finance, help to improve corporate governance, lead to a better diversification of risk and a sounder local financial system. So far, banks have become the main source of financing for the economy while securities markets have grown at a more moderate pace. Most of the capital markets are still in their infancy. Particularly the smaller markets in Eastern Europe are still very illiquid and difficult to access for international investors. Also the larger and more advanced markets still have a lot of leeway for improving market depth and liquidity, as well as regulations and institutions. The fixed income markets tend to be more developed than the stock markets. After the Russian crisis bond issues have declined significantly but are on a strong recovery trend since then. While most of the issuers are still government related and corporate and bank issuers still play a very minor role, the length of maturities in local markets has increased recently with a sizeable increase of paper with maturities of 2 to 5 years. Stock markets in the region have reached a level of development that corresponds to the size of its population and the economy. Market capitalisation in terms of GDP has been the largest in Hungary and in the Czech Republic with around 20 % while the average in the region is below 15% in the year 2002. In Latin America market capitalisation is around 30% of GDP, in East Asia it is around 50% and in western industrialised countries it is usually above 100%.<sup>13</sup>

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<sup>13</sup> Lemierre, J.: Eastern Europe – regional developments in the securities markets; in: The Handbook of World Stock, Derivative & Commodity Exchanges, 1-5, London 2002

## 4.1 Importance and Development of the banking sector

The size and the quality of the domestic financial sector facilitates international asset trade in several ways. Domestic financial intermediaries deliver a platform for the distribution of international assets so that local investors can easier gain foreign asset exposure. This was especially the case for German but also other European banks that very aggressively provided Eastern European investment vehicles for their clients in their home countries. But also the Eastern European financial sector has progressed significantly so that local investors do have easier access to financial markets in the EU and the US. In this context, one has to stress the impact from foreign direct investment in the local Eastern European banking industry. Due to significant deregulation measures from local governments and the prospect of Eastern European countries to join the EU, a lot of foreign direct investment in the local banking sector could have been observed. After the deregulation of the banking sector the former dominating state banks lost large market shares to smaller emerging private banks. The number of smaller banks rose sharply as well as competition in the banking sector so that a consolidation in banking sector became unavoidable. Foreign banks began to buy into this consolidation process by accumulating easily accessible market shares. In many Eastern European banking industries foreign market shares have risen to above 50%. This deregulation and consolidation process has a very positive impact on financial market integration. It did not only helped to create a platform for international asset trades but also raised transparency and banking quality for foreign investors and has led to a much better credit risk and deposit diversification compared to the former monopolistic structures.<sup>14</sup>

In addition, significant institutional and legal progresses have been made in the financial market sector such as the establishment of formal exchanges, the development of legal frameworks and regulatory institutions, the establishment of internationally compatible accounting standards, and improvements in transparency and corporate governance. Despite these progresses, more structural improvements are necessary. Particularly the implementation and enforcement of established laws

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<sup>14</sup> Gelos, G.; Roldós, J.: Consolidation and Market Structure in Emerging Market Banking Systems, in: IMF Working Paper 02/186, 11-12, 20, Washington 2002 and Lane, P.R.; Milesi-Ferretti, G.M.: International Financial Integration, in: IMF Staff Papers, 84-86, Vol. 50, 93-94, Washington 2003



and regulations is a problematic issue. Often regulatory institutions lack sufficient empowerment, judges hesitate to apply newly introduced laws, and important information is not widely distributed. On balance, the legal protection of investors has been more effective on paper than in reality. Mentioning this, of course one has to distinguish between the more and less advanced financial markets in the region. Solving these problems is one of the key challenges to deepen financial integration with the EU and the rest of the world further.

## **5. Development of current account restrictions**

Opening financial markets to the outside world is a long-drawn process that involves lifting restrictions on portfolio capital flows and foreign direct investment. Such restrictions discriminate according to citizenship or residency and/or inhibit cross-border transactions. Restrictions in this context can vary from a complete prohibition for certain transactions or instruments (derivatives f.e.), to quantity limitations, or taxes on such transactions or information requirements to local financial supervisory authorities. Obviously, a reduction in such restrictions allows for more international financial transactions and a deeper financial integration with foreign capital markets.<sup>15</sup> By measuring the historical development of restrictions or liberalisation efforts one can receive a further indication for financial integration progress of the researched countries. Such measurements, however, are not easily done and cause a lot of problems. As described, these restrictions can have many different forms for a wide array of financial assets. There are large differences in the intensity and effectiveness of such restrictions with respect to cross-border capital flows. Furthermore, particularly the ratings for the first years of economic transition have to be regarded with some caution because the quality of information in this period was still limited. Consequently, there are significant gaps between the ideal set of indicators and the measures that are available in practice.<sup>16</sup> One of the most formal empirical measurements for Eastern Europe is conducted by the European Bank for Reconstruction and Development (EBRD).<sup>17</sup> This liberalisation measure is published in transition reports for Eastern Europe. It measures price liberalisation, trade and foreign exchange liberalisation, privatisations, governance and enterprise reform,

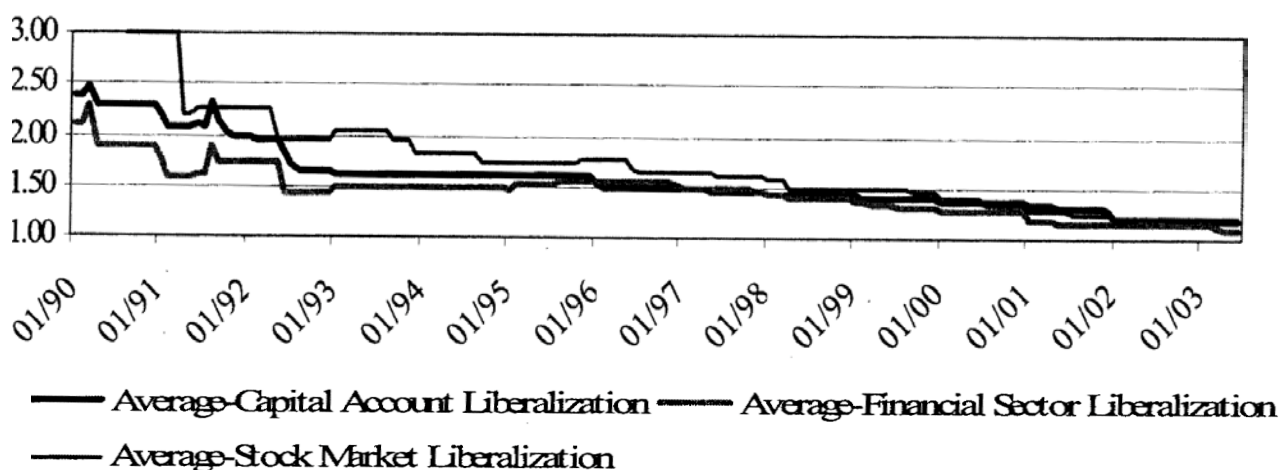
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<sup>15</sup> Buiter, W.; Taci, A.: Capital Account Liberalisation and Financial sector Development in Transition Countries, in: NBER Working Paper, 3-5, Cambridge Ma. 2002

<sup>16</sup> International Monetary Fund: Chapter IV: International Financial Integration and Developing Countries, in: World Economic Outlook, 146, Washington, October 2001

competition policy, banking reform, interest rate liberalisation, and reforms for non-bank financial institutions. The IMF is providing a detailed description of current account restriction in the Annual Report on Exchange Arrangements and Exchange Restrictions.<sup>18</sup> Despite the described inaccuracies, the historical development of such restriction or liberalisation measures is giving a reasonable indication about legal and structural efforts to integrate Eastern European financial markets with EU and world financial markets. Souza has constructed a historical index and several subindexes from the mentioned data sources to measure the liberalisation efforts of Eastern European countries.<sup>19</sup> Souza's index is based on the criteria of the liberalisation index (see attachment) developed by Kaminsky and Schmukler.

Graph 5.1: Current Account Liberalisations



Kaminsky, G.; Schmukler, S.: Short-Run Pain, Long-Run Gain: The Effects of Financial Liberalisation, in: IMF Working Papers, WP/03/34, IMF, Washington 2003

As the graphs show, capital markets have been liberalised consistently in Eastern Europe, supporting cross-over transactions and financial integration with EU financial markets and the rest of the world. All three indexes for capital account liberalisation, financial sector liberalisation and stock market liberalisation point into the same direction. Of course, progress was the strongest in the early phase of economic

<sup>17</sup> European Bank for Reconstruction and Development (EBRD), Transition Report, several issues London

<sup>18</sup> International Monetary Fund: Annual Report on Exchange Arrangements and Exchange Restrictions, Washington 2004

<sup>19</sup> Souza de, L.V.: Financial Liberalisation and Business Cycles: The Experience of Future EU Member States in the Baltics and Central Eastern Europe, Working Paper, Kiel Institute for World Economics, 12-15, Kiel, March 2004

transition because it was relatively easy to achieve. In recent year, the liberalisation indexes have flattened but not stopped. Still, the liberalisation is far from being finished and more efforts are needed to pave the way for a continuation of financial integration. With respect to individual countries, three groups can be distinguished: Rapid liberalizers that followed an early “big bang” approach (Bulgaria, Estonia, Latvia, Lithuania); consistent liberalisers that followed a more delayed path (Czech Republic, Hungary, Poland) and finally the cautious liberalisers where the liberalisation process happened much slower and in a less consistent way (Romania, Slovakia, Slovenia).<sup>20</sup>

## **6. Conclusions and outlook**

Financial integration in Eastern Europe has taken place with European and world markets. Measurements for financial integration such as the international investment positions of three Eastern European core countries or the described financial market liberalisation measure support the thesis that a dynamic financial integration process of Eastern European Markets with EU and world markets has happened. The major driving forces behind that development are likely to EU accession, EMU participation expectations, economic integration and corresponding policy efforts, legal liberalisation of local financial markets and legal harmonisation efforts to international standards as well as the willingness of international investors to broaden their investment base to newly Emerging Markets due to attractive return opportunities. The current state of the financial integration process leaves still a lot of room for more integration to come in the future. With respect to different country groups, Central Eastern European countries have reached a higher level of financial integration compared to South Eastern European countries.<sup>21</sup> The consequences of financial integration have been widely discussed in academic literature. To summarize the discussion with respect to Eastern Europe one could expect that capital will become easier available in these countries which will be supportive for economic growth in these countries.<sup>22</sup> Furthermore, financial integration will help local financial markets to deepen in terms of the investor base as well as in terms of financial instruments.

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<sup>20</sup> Souza de, L.V.: Financial Liberalisation and Business Cycles: The Experience of Future EU Member States in the Baltics and Central Eastern Europe, Working Paper, Kiel Institute for World Economics, 15, Kiel, March 2004

<sup>21</sup> Buitier, W.; Taci, A.: Capital Account Liberalisation and Financial sector Development in Transition Countries, in: NBER Working Paper, 5-10, Cambridge Ma. 2002

As statistical investigations have found out, a successful financial integration will benefit investors in these markets<sup>23</sup> which should also be positive for the economic climate in these countries. On the negative side, financial integration will lead to a larger dependency from developments abroad. New risk factors emerge. A wrong exchange rate policy or inadequate financial supervisions could lead to disastrous economic and financial crisis results that have happened in several emerging market economies in the past. Eastern Europe, however, has been remarkably stable in this context and has overcome global crisis events and financial contagion relatively well. One reason for that has been the EU and EMU participation prospective. That prospective has caused continuous and relatively stable FDI and portfolio investment inflows.<sup>24</sup> Another reason for that stability can be found in the adjustment process towards the EU's financial and economic legal system. That adjustment is likely to have had a positive impact on local transparency and supervision. Last but not least, a lot of Eastern European countries are conducting relatively flexible exchange rate regimes (at least in an emerging market context) so that disastrous exchange rate policies mistakes are unlikely to happen in the future. On balance, many aspects are supporting the view that Eastern Europe will rather profit from financial integration and can avoid the biggest drawbacks other emerging markets have suffered from. Looking into the future, more efforts have to be done to integrate and develop Eastern European markets further. Financial market and banking supervision and regulation has to be strengthened, the legal framework has to become more effective and the transparency of financial activity has to be improved. Risk management tools in the local financial industry have to be implemented in a more advanced manner to stabilise the financial system. The latter is particularly important to withstand the risks associated with international capital flows.

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<sup>22</sup> International Monetary Fund: Chapter IV: International Financial Integration and Developing Countries, in: World Economic Outlook, 152-161, Washington, October 2001

<sup>23</sup> Martin, P.; Rey, H.: Financial Integration and Asset Returns, in: CEPR Discussion Paper, No. 2282, 12-14, Nov. 1999

<sup>24</sup> Tomfort, A.: Risiko- und Ertragsanalyse von Emerging Market Anleihen aus Sicht eines Schweizer Anlegers; in: Finanzmarkt und Portfolio Management, 278, St. Gallen 2000

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