FINANCIAL INTEGRATION OF WESTERN BALKANS AND EUROPEAN UNION AND REGIONAL FINANCIAL COOPERATION IN WESTERN BALKANS

Assoc.Prof. Marijana ĆURAK
University of Split, Croatia

1. Introduction

Financial integration considered as a process of individual country's linkages to international financial markets, and financial globalization defined as a process through which international capital flows increase and financial markets in various economies converge in terms of equalization of prices and returns of financial instruments, have been one of the main characteristics of financial world during the last few decades. The process of financial integration has opportunity to affect financial development and growth of the economies. However, the benefits do not come without threats to the financial systems and the real economies. This was recently evident through the last financial crisis.

In order to get the opportunities for benefits of financial integration, the Balkan countries have made efforts in liberalization as important prerequisite of financial integration. Actually, financial liberalization is one of the key elements of financial reforms that have occurred during the last two decades, although the countries are at different stages of the processes. The efforts are mainly motivated by accession to the European Union. The main form of the financial integration is foreign direct investments of banks from the European Union, realized mainly through privatization of state-owned banks.

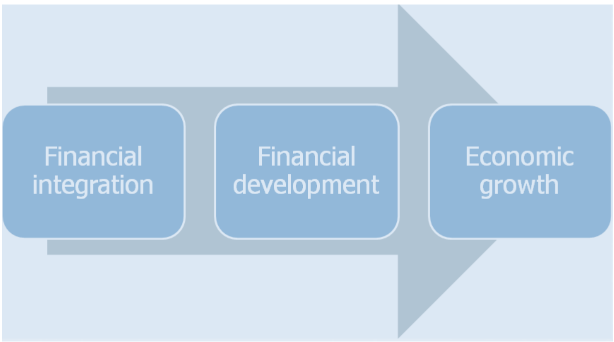
The aim of this paper is to provide key considerations on benefits and costs of financial integration for financial development and economic growth, and suggestions aimed at possible types of regional financial cooperation among Western Balkans.

The paper is structured as follows. The Section 2 deals with theoretical considerations of financial integration. Main characteristics of financial systems of Western Balkans countries are described in Section 3. Considerations of transmission of the EU crisis follow in Section 4 while Section 5 analyses possible forms of financial cooperation among Western Balkan countries. Section 6 concludes.

2. Theoretical Considerations of Financial Integration

Based on the theory, financial integration could produce positive effect on economic growth of recipient country, mainly through improved access to financing domestic investment. However, according to Kose et al. (2006) although the financial integration could produce direct effects on the economic growth, indirect benefits may be even more important. They include financial market development, institutional development, better governance and macroeconomic discipline. Based on empirical results of De Gregorio (1999) financial integration does not affect economic growth directly but indirectly, through fostering financial development. Consequently, this part of the work is focused on the effects of financial integration on growth through the channel of financial development (Figure 1).

Figure 1 Effects of financial integration



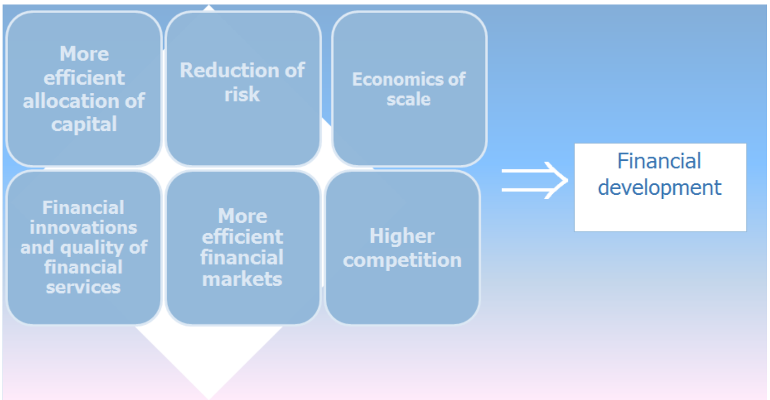
Recent theoretical and empirical literature confirms that financial intermediation promote economic growth. The explanation for the nexus between financial development and economic growth is based on the theory of financial intermediation and endogenous growth theory. The theory of financial intermediation adds specific frictions to models of resource allocation based on the perfect market. Precisely, according to the theory of financial intermediation the real-world market is characterized by frictions that include transaction costs (Gurley and Shaw, 1960) and asymmetric information that could result in adverse selection and moral hazard (Leland and Pyle, 1977; Diamond, 1984). Financial intermediaries are able to reduce both types of the frictions by providing the financial functions. According to Merton and Bodie (1995) the functions include clearing and settling payments, pooling resources and subdividing shares, transferring resources across time and space, managing risk (diversification, hedging and insurance), providing information, and dealing with incentive problems (adverse selection, moral hazard, and principal-agent problems).

Financial intermediaries' functions are linked to economic growth through the models of endogenous growth theory. According to the models, financial intermediation could affect economic growth through four channels: changing the marginal productivity of capital, proportion of saving funnelled to investment, saving rate (Pagano, 1993) and technological innovations (Schumpeterian growth models).

Among drivers of financial development, financial integration could have an important role. Precisely, financial integration could lead to more efficient allocation of capital, diversification of investment and reduction of risk, exploitation of economics of scale in providing financial services, financial innovations and increased quality of financial services, improvements in consumers' choice, more efficient financial markets and higher competition in financial sector (Figure 2). Participation of the foreign banks in financial sectors, as an important form of financial integration in developing countries, may enhance access to finance, decrease the costs of financial intermediation, lower the problems of adverse selection and moral hazard, provide transfer of technology and management experience especially in the field of risk management, improve the skills of the banks' labor, and improve governance of financial institutions, supervision and regulation.

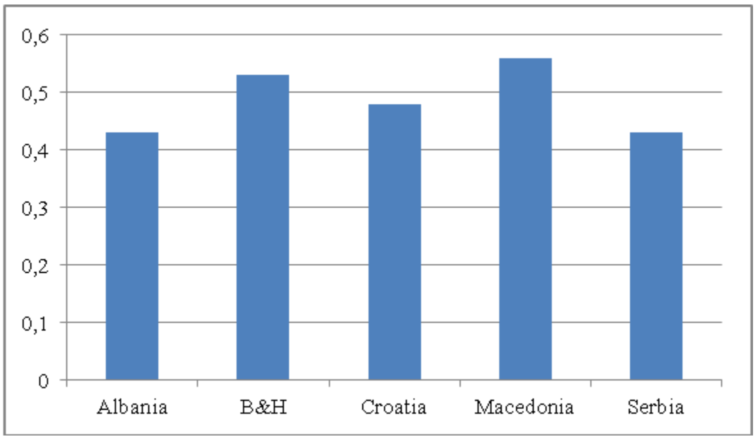
However, based on Mishkin and Eakins (2012) if financial openness is mismanaged it could negatively affect financial system and economic growth. Financial liberalization can stimulate banks to increase lending (credit boom) in the short run. The problem could arise especially in case of misallocation of capital – using the resources to finance low-productive investments (Agénor, 2001). Particularly, small and medium-size firms could have limited access to finance. Losses on loans and credit rationing may occur. Thus, in the situation of the financial crisis, financial institutions become unable to channel funds efficiently from savers to deficit units with productive investment opportunities. The result is decreasing economic activity.

Figure 2 Effects of financial integration on financial development



Beside the problems related to allocation of capital, financial integration could produce additional costs or risks. They encompass risk of cross-border contagion, risk of sudden stops in capital flows and risk of financial and macroeconomic stability. The contagion and capital flow volatility may be related to currency speculations, bad economic prospects, and the movement of interest rates (Agénor, 2001). The capital flow volatility may be associated with herding behavior of the investors, as well. To the extent that foreign financial institutions are exposed to losses of assets and problems of liquidity and access to finance, they may suddenly stop capital flows in host countries with negative effects on financing and economic growth of the countries. Based on Agénor (2001) risk of financial and macroeconomic stability is related to increased capital flows that may result in monetary expansion, inflationary pressure, exchange rate problems and increasing current account deficit. Considering foreign banks in developing countries, they may ration loans to small firms, create problems related to market concentration and "to-big-to-fail" and associated problem of moral hazard, and, as mentioned above, to suddenly cut lending (Agénor, 2001).

Figure 3 Rule of Law – Regulatory enforcement



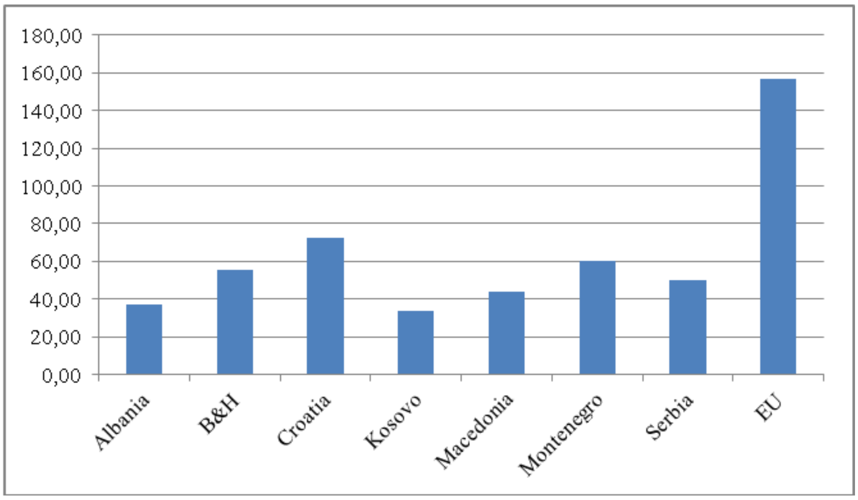
Source: The world justice project
1 signifies the highest score and 0 signifies the lowest score.

The risks of financial integration are especially pronounced in countries with the absence of a strong institutional environment in which contracts can be enforced and property rights can be established, as is the case in Balkan countries (Figure 3). Although financial integration may provide benefits of regulation improvements, it requires certain regulation base in order to deliver positive effects on economic growth. However, financial openness in a weakly regulated system may make financial system unable to perform effectively its role of capital allocation (de Gregorio, 1999).

3. Structure and Performance of the Western Balkans' Financial Systems

The financial sectors of the Western Balkans are at different level of development. Figure 4 shows private credit by deposit money banks to GDP. This is one of the main indicators of financial development which shows lagging far behind the EU average and heterogeneity among Balkan countries. However, there are some similarities among financial systems, especially related to their financial structure. The financial systems are bank-oriented, with banks accounting for over 90 percent of financial institutions asset in most of the countries, while institutional investors (insurance companies, investment funds and pension funds) and capital markets are at low level of development.

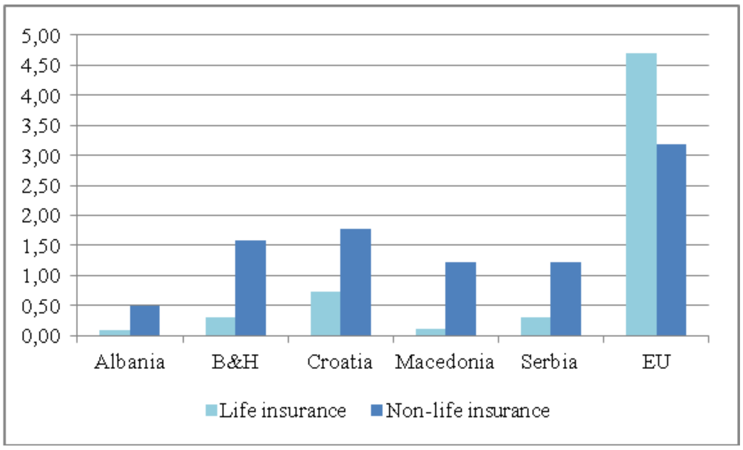
Figure 4 Private credit by deposit money banks to GDP (%)



Source: Financial structure database

Both, life and non-life penetration (gross insurance premiums to GDP ratio) that show the importance of insurance sector in economy, are at very low level (Figure 5). Concerning the structure of insurance product, as opposite to the EU insurance market, there is dominance of non-life insurance. The most important type of insurance is obligatory the motor third party liability insurance. Penetration of foreign ownership in insurance industry happens slower compared to banking sector. The foreign insurance companies have higher share in life insurance than in non-life insurance business. Reform of pension insurance occurs in part of the countries. Bosnia and Herzegovina and Montenegro still have not introduced private pension funds.

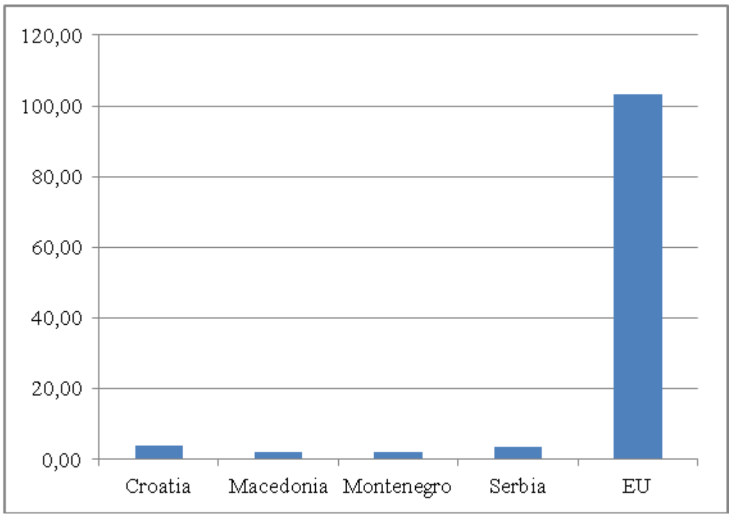
Figure 5 Life and non-life insurance penetration (% of GDP) in 2011



Source: Financial structure database and Swiss Re

Stock market turnover ratio expressed as a percentage of stock market capitalization as an indicator of capital market development lags significantly behind the same indicator for EU (Figure 6). As mentioned earlier, financial structure of Balkans is bank-oriented and direct finance through issuance of securities plays minor role. Although in part of the stock exchanges there are numerous listed companies, most of them are not actively traded. The capital markets suffer from high degree of illiquidity.

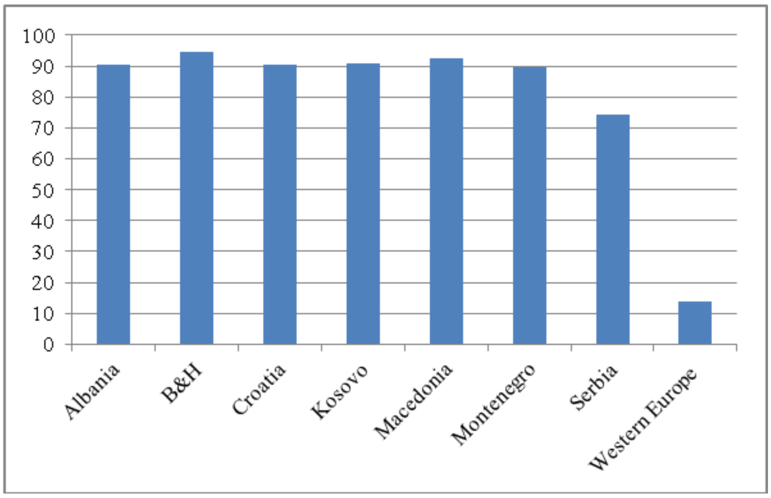
Figure 6 Stock market turnover ratio (% of stock market capitalization) in 2011



Source: Financial structure database

Additional commonality of Balkan's financial system is large presence of foreign owned banks. Precisely, foreign owners account for about 90 percent of total assets of banking sector, as it is shown on Figure 7. Most of the foreign banks come from European Union, mainly from Austria, Italy, France, and Greece.

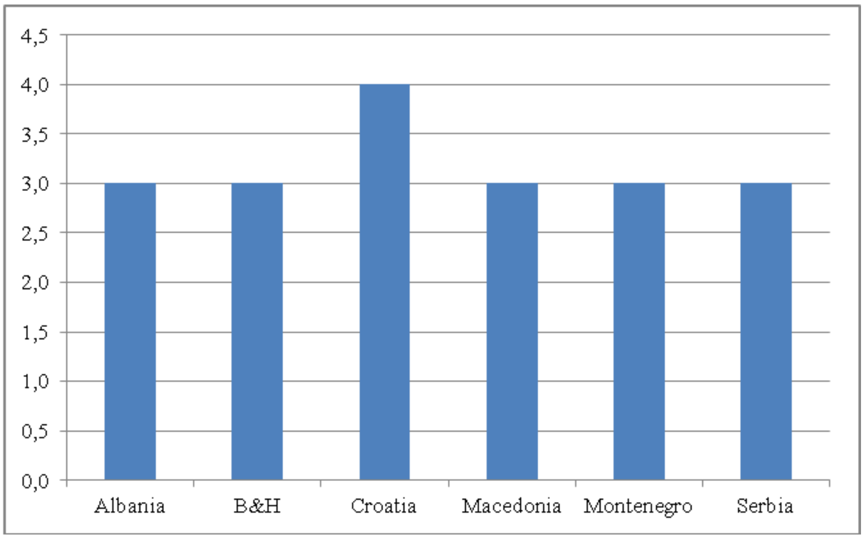
Figure 7 Share of foreign owned banks in total assets of banking sector (%) in 2011



Source: EBRD and national central banks

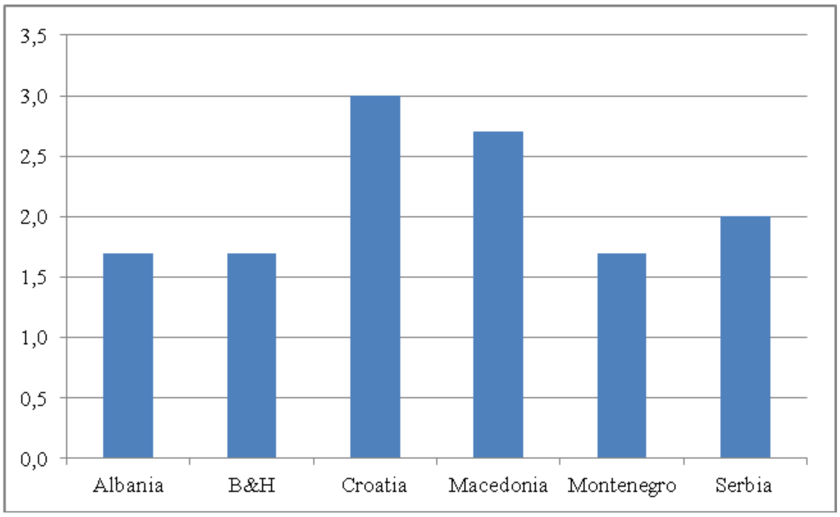
Financial sector restructuring as well as regulatory improvements and strengthening financial supervision, increased governance standards, improvements in risk management, financial innovations, lowering of costs of financing, and technological and knowledge spillovers have occurred during the last two decades. The scores of banking and non-banking sector reforms are presented on Figures 8 and 9. Reforms in banking sector precede those in non-banking part of financial system. Among the countries, Croatia has reached the highest scores.

Figure 8 EBRD index of banking sector reform



Source: EBRD, Ranging from minimum 1 = no or little progress to maximum 4+ = standards of advanced industrial economies.

Figure 9 EBRD index of non-banking sector reform



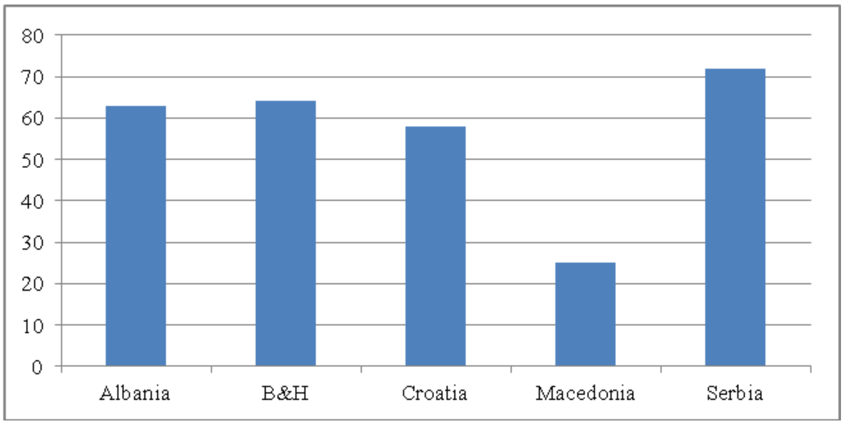
Source: EBRD, Ranging from minimum 1 = no or little progress to maximum 4+ = standards of advanced industrial economies.

The improvements in banking and non-banking sectors were mainly held by foreign parent financial institutions. Thus, the financial integration supported financial development of host countries and their economic growth. Until the last financial crisis the benefits of foreign bank entry were not doubted. However, the costs of the integration became evident shortly after the financial and economic crisis in EU started.

4. Transmission of the EU Crisis

With the entry of foreign banks, the region faced with a fast increase in loans to the private sector. Based on Ćetković (2011) this was the consequence of high profitability potential (high interest margins) in the banking sectors of the Balkans and increasing profit-orientation of EU banks. The bank lending particularly focused to the households. Especially small and medium-sized companies suffered from limited access to bank loans.

Figure 10 Foreign currency loans (% of total loans) in 2012

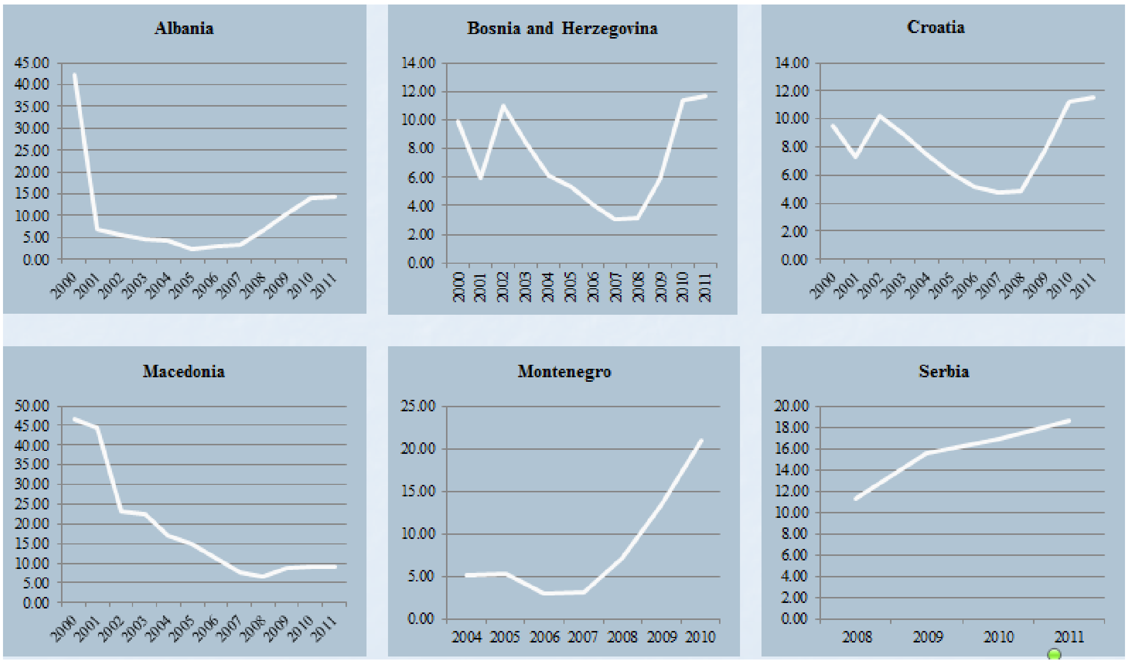


Source: Central banks and World Bank (2012)
Official statistics classify MKD loans indexed to foreign currency as domestic currency loans
(underestimation of foreign currency loans).

High level of borrowing increased regional countries' dependence upon foreign fund flows what made Balkans to become vulnerable to external shock. With the crisis, problems of funding parent banks affected funding of their subsidiaries. Additionally, high degree of eurozation resulted in high exposure to foreign currency loans which dominated in total loans (Figure 10).

When the crisis began the foreign funding and credit demand decreased. The process of deleveraging followed. There were runs on deposits in Bosnia and Herzegovina, Montenegro, and Serbia (World Bank, 2012). Banking sectors in Balkans have experienced high growth of non-performing loans. In part of the countries the ratio of non-performing loans in total loans even doubled in the period from 2009 to 2011 (Figure 11)

Figure 11 Non-performing loans to total loans (%)

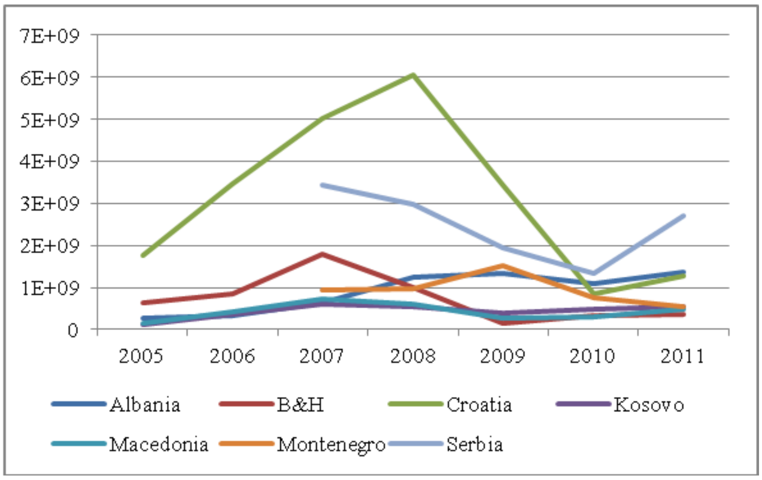


Source: Ćurak, Pepur, Poposki 2013

The empirical research of Ćurak et al. (2013) of determinants of non-performing loans in South-Eastern European countries shows that the main drivers of bad loans are economic growth, inflation, real interest rate, bank size, solvency and bank performance.

The crisis in EU resulted in decline in foreign direct investments (Figure 12), most of which come from the EU. The foreign direct investment recovered in 2011 but did not reach the pre-crisis levels.

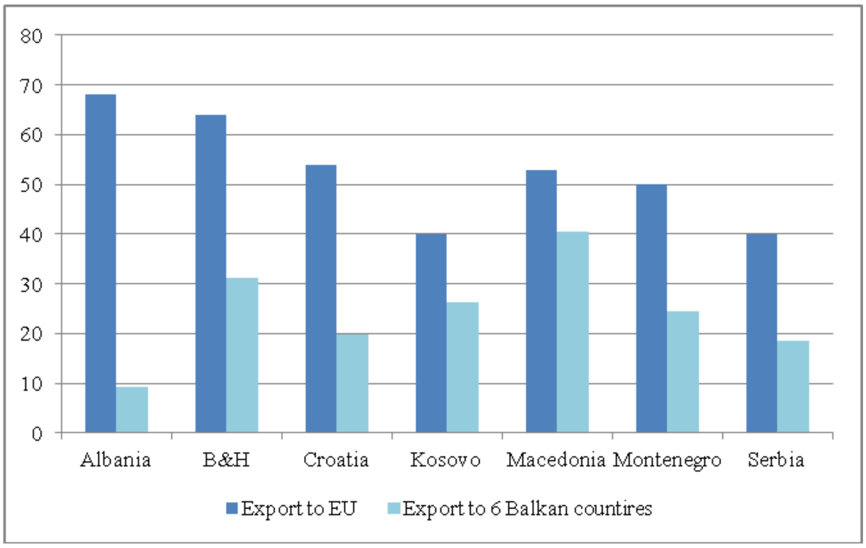
Figure 12 FDI net inflows (US $)



Source: World Development indicators

In addition to lending from EU and FDI, the crisis affected the export and remittances. Namely, besides finance, the Western Balkans is significantly integrated with European Union through trade and labour. According to the data shown on Figure 13, export of Balkan countries to EU has the highest share in total export of the countries. Especially high trade dependence on EU holds for Albania and Bosnia and Herzegovina. Although there are trade linkages among the Balkans, they are significantly lower in comparison to those with EU. Demand for the export from Balkans countries reduced in 2009.

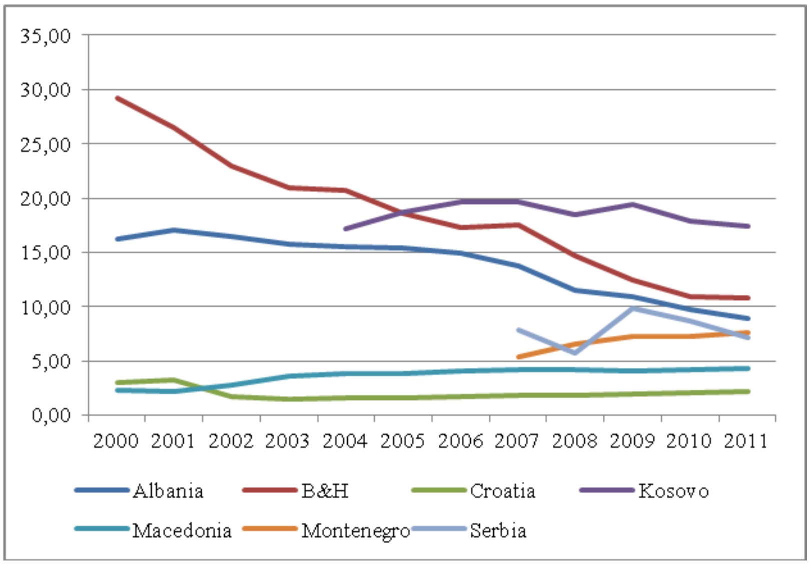
Figure 13 Export to EU and to 6 Balkan countries (% of total export)



Source: National Bank Statistics of 7 countries. Bureaus of Statistics Data of 7 countries

Since most of the remittances come from the European Union (Burgess and Körner, 2012), the crisis affected remittances, too. As the remittances are important sources of saving in Balkans, they are of significance for financial system. This is especially true for high migration countries such as Kosovo, Bosnia and Herzegovina, and Albania (Figure 14).

Figure 14 Remittances (% of GDP)



Source: Financial structure database

Credit boom and growing consumption in the pre-crisis period were followed by increasing current account deficit and private sector debt. With the crisis, the rates of economic growth turned to be negative and problems with the budget deficits, public and external debts increased.

The crisis reminds on risks of financial integration through presence of foreign banks and suggests some ways to reduce them. According to EBRD (2012) they encompass avoiding foreign banks control over a bulk of assets of banking system and dependence of foreign funding but more reliance on domestic sources of finance as well as preventing credit boom.

The crisis makes a new challenge for the region which fosters the need for continuation of the financial, economic and institutional reforms. On the way of the processes, the cooperation among the countries could be helpful.

5. Forms Of Cooperation

Regional cooperation is one of the aims of Stabilization and Association Process. However, efforts towards cooperation should not be observed as a fulfilment of the EU membership requirements only but also as a factor contributing to reforms on the way to sound business environment. Regional financial and economic cooperation is important prerequisite of political cooperation and thus, factor of stability and prosperity of Balkan countries. Some similarities among the countries related to mutual aims towards European integration, harmonization of legislation as well as common heritage related to market, regulations and languages among most of the countries (Network of Parliamentary Committees for Economy and Finance of the Western Balkan countries, 2013) make achievement of cooperation easier.

There are many forms of the possible financial cooperation among the countries:

- Cooperation in the context of improvement of regulatory and legal systems in financial area (example: Regional Network of Committees (Regional Network of Parliamentary Committees for Economy and Finance of the Western Balkan countries)). According to La Porta et al. (1996), one of the main prerequisite of the financial development is efficiency of the legal system. The data on the enforcement of legal rights show very low level of development of the legal systems in Balkan countries. Cooperation could contribute to the improvements in the legal systems. The same could contribute to lowering the level of corruption.

- Cooperation and sharing of information between regulators of financial sectors is important for supervision and control of regulatory arbitrage between jurisdictions (Kathuria, 2008).

- Cooperation on sharing knowledge and experience in the field of finance (example: EU financial aid under the instrument for pre-accession assistance (IPA)). Experience of those more advanced would be beneficial for other countries – educational and training programs.

- Cooperation between banks – educational and training programs, staff exchanges.

- Cooperation between stock exchanges – harmonization of listing rules, connectivity between trading platforms (in order to achieve scale economics), cross-border listing, product development, training and staff exchanges.

- Cooperation among regulators of financial sectors and agencies for law enforcements on fight against frauds in financial system and money laundering. The money laundering often takes form of cross-border transactions, implying the importance of collaboration among the countries in order to prevent or detect it.

- Cooperation among education institutions and between the institutions and financial sectors in developing study programmes closer to the financial institutions' needs, and organizing regional professional associations.

- Forums on regional financial/economic cooperation.

6. Conclusion

All the countries in the region are in the process of European integration although with different stage. The fulfilment of the EU membership requirements is the main driver of the reforms. The economies are highly dependent on EU through financial and economic linkages. Financial integration provides benefits but expose the Balkan countries to the risks. This has been evident recently through transmission of the crisis from EU. Financial integration, through enabling source of financing, was viewed as one of the main factors of economic growth of the region in pre-crisis period. However, high dependence of foreign funding in unprepared Balkan countries in context of EU crisis and reduction in foreign lending were observed as important causes of decline in the economic activity in the region.

Since the countries are going to integrate their financial institutions and markets into European financial system, on the way on harmonizing national legislations with European one and preparing the financial systems for the integration, there is a need for the cooperation among financial intermediaries and markets of Balkans. The cooperation could take various forms from political, financial sector's regulatory and supervisory level to the level of financial institutions, stock exchanges and educational institutions.

However, cooperation should not only be viewed as an element in meeting the prerequisites of the region's integration in EU but also as a factor of legal and economic/financial improvements that are important prerequisites of political and social stability in the region.

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