International Review of Economics and Finance 25 (2013) 291–309

Contents lists available at SciVerse ScienceDirect

International Review of Economics and Finance

journal homepage: www.elsevier.com/locate/iref

Growth, productivity and capital accumulation: The effects of financial liberalization in the case of European integration

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ARTICLE INFO

Article history:
Received 8 March 2012
Received in revised form 25 July 2012
Accepted 26 July 2012
Available online 9 August 2012

JEL classifications:
F41
F36
F43

Keywords:
Financial integration
Economic growth
Productivity
Capital accumulation
European integration

ABSTRACT

In the present contribution, I concentrate on the process of financial liberalization in a specific context of European economic and monetary integration. I implement *de facto* and *de jure* measures of financial liberalization and find that formal aspects of financial openness generate a strongly positive impact on economic growth and its sources, productivity growth and capital accumulation. Moreover, there is evidence of a positive contribution to the process stemming from the EU membership, while no substantial effect comes from the euro adoption. Finally, I investigate the effects from financial integration on country groups within the EU.

1. Introduction

The process of financial liberalization of the last few decades dramatically changed the economic architecture worldwide.[1] In the investigation concerning the influence of the progressive financial opening, authors were mostly focusing on positive and negative growth effects. Most of the theoretical discussion on the growth effects coming from financial liberalization suggests that, through an improved allocation of capital, economic growth should be higher. In the standard neoclassical model, the liberalization of financial transactions leads to intensified flows of capital from capital-abundant towards capital-scarce regions. As an important consequence for the latter, the reduction of capital costs follows, thereby motivating higher investment and, finally, positively – even though temporary – influencing growth (Barro, Mankiw, & Sala-i-Martin, 1995; Gourinchas & Jeanne, 2006).

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[1] I follow this part (being a great majority) of economic community that clearly distinguishes between financial liberalization and financial development. In the present study, I adopt the concepts of financial liberalization, financial integration and financial openness as synonyms. They refer both to the global and the narrower European context. Nevertheless, when I use financial globalization, I refer exclusively to the international context.

1059-0560/$ – see front matter
http://dx.doi.org/10.1016/j.iref.2012.07.015

The results of the empirical studies in this field were rather inconclusive, with some authors finding strong support for the growth-enhancing hypothesis and some other contributions showing only weak or mixed evidence of positive growth.[2] In particular, negative influence of financial globalization has been found in enhanced financial instability (Bhagwati, 1998; Neumann, Penl, & Tanku, 2009; Rodrik, 1998; Stiglitz, 2004) and increased volatility of industrial production (Levchenko, Rancière, & Thoenig, 2009).[3] Moreover, due to increased volatility and riskiness, financial liberalization has been made responsible for having offered the main contribution to past financial and economic crisis (Joyce, 2011; Kaminsky & Reinhart, 1999; Stiglitz, 2000).[4]

In a more elaborated context, positive growth effects may be generated also indirectly, by improved factor productivity. In this sense, financial openness may produce a positive impact on productivity via better, more efficient allocation of resources (Kose, Prasad, & Terrones, 2009; Mishkin, 2006), as well as easier access to investment opportunities (Giannetti, Guiso, Jappelli, Padula, & Pagano, 2002). Moreover, financial integration may result in a reduction or even complete elimination of capital constraints, permitting the economy to engage in a more productive investment (Acemoglu, Aghion, & Zilibotti, 2006; Acemoglu & Zilibotti, 1997). Additionally, capital account release may spur financial development (Baltagi, Demetriades, & Law, 2009; Klein & Olivei, 1999), as well as it contributes to more efficient business activities (Rajan and Zingales, 2003). On the top of that, an expectation is that more freedom in financial transactions contributes to a better risk diversification, thus, enhancing foreign investors to shift at least a part of their investments from safe and low-yield to risky but more profitable locations (Obstfeld, 1994; Sandri, 2010). Moreover, a more efficient risk diversification could induce also domestic agents to undertake more risk in innovative activities (Obstfeld, 1994; Saint-Paul, 1992).[5] In this context, it has been argued that the investigation of the effects of financial integration on productivity and investment proved to have important implications in terms of welfare analysis (Bonfiglioli, 2008; Gourinchas & Jeanne, 2006; Kose, Prasad, Rogoff, & Wei, 2009).

Building on such a theoretical fundament, growing although still insufficient attention has been dedicated to the empirical investigation of the main channels through which financial integration influences economic development. Here, the results obtained by Bonfiglioli (2008), Kose, Prasad, and Terrones (2009) – using country level data – and Bekaert, Harvey, and Lundblad (2011) – in an industry-level investigation – seem to communicate an important message, namely, that it is mainly productivity growth that is positively influenced by intensified financial activities and contributes in that way to increased economic growth. However, Levchenko et al. (2009), in a study based on industry-level data, could not confirm any effect of the progressive financial openness on productivity and the growth effects appeared temporary.

Contributing to both strands of the literature, the present study aims to disentangle the effects of financial integration on growth in general, as well as on its direct (capital accumulation) and indirect (productivity improvements) sources. However, whereas the past studies build upon investigations in a generalized global framework,[6] there was only limited effort to single out the impact of financial liberalization specifically on the European economy. In this sense, the most important innovation of the paper is to concentrate on the process of financial integration and its effects observable in the specific context of the ongoing process of economic and monetary integration in Europe. In particular, an important question is whether the efforts to establish the common European market under the institutional design both of the European Union (EU) and later on of the European Monetary Union (EMU) contributed in a significant way to the general process of financial globalization. Moreover, given that the members of the EU were and still are characterized by considerable structural divergences as well as by different degrees of development of their financial markets, one could expect that the pattern of influence coming from the process was dissimilar in different country groups within the EU.

The literature measuring the growth effects of financial integration in the EU is essentially missing. The only rigorous analysis till now has been offered by Guiso, Jappelli, Padulla, and Pagano (2004) and by Masten, Coricelli, and Masten (2008). The first study is an empirical investigation trying to assess the 'growth dividend' in Europe coming as a result of more intensive financial integration. They implement the Rajan and Zingales (1998) methodology to international industry-level panel and find that financial development spurs the industry growth. The second contribution implements both macro and industry-level data to detect the effects of financial development and international financial integration on economic growth in Europe. Their main finding predicts that the adoption of the euro by the new EU member states may lead to the establishment of a virtuous development circle, mainly thanks to a positive dynamics in the domestic financial markets and further financial integration. Both studies investigate effects of financial integration on economic growth in general, disregarding the effects on its main sources, investment and productivity and treating the EU as a whole, without distinguishing between different groupings within the EU.

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[2] Bekaert, Harvey, and Lundblad (2005), and Quinn and Toyoda (2008) document strong support for growth enhancing financial liberalization, while Rodrik (1998) and Edison, Levine, Ricci, and Sløk (2002) find only weak growth effect. Moreover, Prasad, Rajan, and Sumramanian (2007) in a study including a sample of developing countries between 1970 and 2004, show that countries running current account surpluses experienced a positive and not – as neoclassical model predicts – negative impact on growth. As an implication, countries relying on foreign financing experienced lower growth than countries financing their activity prevalently with domestic sources. In this same spirit, Gourinchas and Jeanne (2007) call this negative correlation between foreign capital flows and domestic growth in developing countries 'allocation puzzle'. Given the contradictory evidence of the past studies, Kose, Prasad, Rogoff, et al. (2009) speak about mixed effects of financial openness on growth.

[3] Regarding more specifically developing countries, an extended literature emerged on the so called 'capital flight', referring to an extensive accumulation of foreign assets by the private sector. It is argued that this effect, by moving scarce capital away from less developed economies, might contribute to adverse effects on investment, and finally on economic growth (Yalta & Yalta, 2012).

[4] For a comprehensive survey on the effects of financial liberalization on growth and volatility, see Kose, Prasad, Rogoff, et al. (2009).

[5] In a recent theoretical contribution, Cakici (2012) demonstrates that intensifying financial openness contributes to a more considerable impact of positive, temporary technology shocks on a series of economic variables (output, investment, consumption, labor supply and net exports).

[6] A great majority of past studies concentrate on samples including at the same time a number of developing and industrialized countries. Those studies aim at providing an overall evaluation on the effects of financial globalization on economic development. However, in doing that they sometimes exclude subgroups of countries, like for instance, Rodrik and Sumramanian (2009) do not include European countries, while Gourinchas and Jeanne (2007) do not consider the group of Central and Eastern European (CEE) countries. Consequently, the exclusion of some country groups might lead to mixed and inconclusive results of apparently comparable analyses.