THE IMPACT OF CAPITAL ACCOUNT LIBERALIZATION ON ROMANIAN FINANCIAL ACCOUNT

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1. Introduction

In the late 1980s developing countries from all over the world began easing restrictions on capital flows. A decade later many of the same nations experienced a string of financial crises, triggering a debate over the relative merits of capital account liberalization as a policy choice for developing countries. Critics claim that liberalization brings small benefits and large costs (Bhagwati, 1998; Rodrik, 1998; Stiglitz, 1999). Recent surveys document evidence to the contrary. Liberalization in developing countries reduces the cost of capital, temporarily increases investment, and permanently raises the level of gross domestic product (GDP) per capita (Henry, 2007; Obstfeld, 2007; Stulz, 2005).

Capital account liberalization remains one of the most controversial and least understood policies of our day. One reason is that different theoretical perspectives have different implications for the desirability of liberalizing capital flows. Another is that empirical analysis has failed to yield conclusive results. Figure 1 presents the linkages through government finances and policy choices on the one hand and through industrial and personal access to credit on the other.

Cobbam (2001) defines capital account liberalization as the process of removing restrictions from international transactions related to the movement of capital. It can involve the removal of controls on both domestic resident of international financial transactions and on investments in the home country by foreigners. Capital account liberalization, in broad terms, refers to easing restrictions on capital flows across a country's borders. This presumably results in a higher degree of financial integration with the global economy through higher volumes of capital inflows and outflows. Capital account restrictions can take different forms including: limiting domestic banks` foreign borrowing, controlling foreign capital that enter into the economy, limiting the industry sectors in which foreigners can invest, and restricting the ability of foreign investors to repatriate money earned from investments in the domestic economy.

The central point of capital account liberalization is that it moves developing countries from a steady state in which their ratios of capital to effective labor are lower (and rates of return to capital are higher) than in developed world, to a steady state in which capital-to-effective labor ratios and rates of return equal those in the developed world (Henry and Sasson; 2008).

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Capital account liberalization can improve economic growth, can have favorable effects on the domestic financial system and can support an efficient allocation of resources. These benefits can be obtained provided that capital account liberalization is carried out with an appropriate sequencing of reforms and supported by a sound and sustainable macroeconomic environment: improved international allocation of savings, technology transfer, efficiency and strength of the financial system; liquidity and smoothing of cycles, risk diversification and resilience to shocks, greater market orientation, higher domestic investment and higher growth, respectively lower waste of resources and corruption (Ishii and Habermeie, 2002).

Capital account liberalization involves some risks. It introduces additional risks specific to capital movements, respectively it affects financial sector stability much as domestic financial liberalization does. If capital account liberalization is not appropriately sequenced and coordinated with complementary policies and reforms, it is possible that risks may arise. These risks regard fields such as: capital flows and crisis, macroeconomic disturbance, structural factors, government involvement in the financial sector.

In theory, capital account liberalization should allow for more efficient global allocation of capital, from capital-rich industrial countries to capital-poor developing economies. This should have widespread benefits—by providing a higher rate of return on people's savings in industrial countries and by increasing growth, employment opportunities, and living standards in developing countries.

Access to capital markets should allow countries to "insure" themselves to some extent against fluctuations in their national incomes such that national consumption levels are relatively less volatile (Kose and Prasad; 2004). Since good and bad times are not synchronized across countries, capital flows can, to some extent, offset volatility in countries' own national incomes.

Capital account liberalization may also be interpreted as signaling a country's commitment to good economic policies. For a country with an open capital account, a perceived deterioration in its policy environment could be punished by domestic and foreign investors, who could suddenly take capital out of the country. This provides a strong incentive for policymakers to adopt and maintain sound policies, with obvious benefits in terms of long-term growth. Inflows stemming from liberalization should also facilitate the transfer of foreign technological and managerial know-how and encourage competition and financial development, thereby promoting growth.

The paper is structured as follows. Section 2 presents a brief survey focusing on capital account liberalization in Romania. It discusses about the process of liberalization, the main key vulnerabilities of Romanian economy associated to capital account liberalization, respectively the process stages. Section 3 outlines the estimation method. Section 4 describes the data and presents preliminary statistics for the data. Section 5 discusses the estimation results. Section 6 draws conclusions regarding the experience lived by Romania during capital account liberalization and a few proposals.

2. The process of capital account liberalization in Romania

In the perspective of the European Union, Romania has pledged to liberalize capital flows in accordance with Article 56 of the European Community Treaty; this article prohibits any restriction on capital movements between Member States or between Member States and third countries. Liberalization of capital flows in the

European Union was achieved mainly as a result of applying the Treaty of Maastricht (1992) that provides complete liberalization of capital flows as a precondition for the introduction of euro currency.

Although the liberalization of capital flows in Romania started in 1991 with the adoption of Foreign Investment Law (No. 35/1991) which allows foreign investments in Romania, providing guarantees and incentives for foreign investors, the liberalization stage of capital flows was made in 2001 in the context of EU accession preparation.

An important step in the liberalization process was conducted in March 1998 when Romania assumed the obligations stipulated in Article VIII of the International Monetary Fund regarding the operations of current account convertibility. According to international practices and taking into account the concrete situation of Romania, the approach of capital flows liberalization is a gradual one.

The main objective is to complete the liberalization process until the EU accession date, except for the transition period required. Romania has fully accepted the acquis communautaire that regards Chapter 4 – Free movement of capital and has undertaken towards the European Union that it will remove all restrictions on capital flows by accession date.

The essential conditions required for the liberalization of capital transactions are: the existence of a macroeconomic framework conducive to sustained growth, eliminating major structural imbalances and the functioning of a solid financial system in an operational and settlement framework. The main key vulnerabilities of Romanian economy associated to capital account liberalization were:

-High inflation;

-The low level of monetization and financial intermediation;

-High volatility of short-term capital flows;

-Insufficient restructuring of the real sector;

-Poor corporate governance;

-Weak enforcement of law in the financial sector;

-The state of capital markets, insurance and derivatives and their supervisory mechanisms that are not tested;

-Profitability sources and low efficiency of banks.

To cope with the pressures mentioned above, banks may be tempted to short-term external borrowing, using government securities as collateral. The situation from 2002, when banks were the primary dealers of government securities and short-term guarantees were liberalized from January 1, 2003 and no provisions to specify what assets may be used as collateral to foreign borrowing, has spurred the call to such a risky approach as an alternative to internal restructuring. This raises the risk of a "mismatch" of maturities (long-term assets and short-term liabilities). In addition, if the returns of government securities continue the downward trend and short-term borrowing costs in foreign currency remains unchanged, the interest rate differential is likely to become negative, forcing banks to borrow more on short term. Such a risk has materialized in Turkey after capital account liberalization, and contributed to the severe financial crisis that occurred there in 2000 year (Daianu et al., 2002).

In Romania, capital account liberalization was accomplished with relative delay behind other countries in Central and Eastern Europe. Deferral of capital account liberalization has been justified by several grounds. First, the gradual approach regarding structural reforms and macroeconomic stabilization programs of the '90s was reflected in rising inflation and interest rates compared to other countries in the region and EU Member States. Second, it was

deferred capital account liberalization until the restructuring of the banking system, when the financial sector became robust enough to cope with capital flows increased potential reversibility. Third, the central bank was necessary to achieve a satisfactory level of international reserves; this objective is achieved in the first half of the past decade.

The process of capital account liberalization in Romania includes three stages (Altar et al.; 2006):

First stage 2001 -2002: Liberalization of direct investments and real estate of abroad residents as well as personal capital flows and other capital flows (such as admission of national value titles to the cote on the external market, mortgages from the part of the foreigners applied to the residents, credits on a medium or long term for the commercial transactions or the services offered by the residents to the nonresidents);

Second stage 2002 – 2005: Liberalization of capital movements related to the performance of insurance contracts and other capital flows with significant influence on the real economy (which means: capital transfers for the execution of insurance contracts, transactions in foreign currency made by residents, loans with a maturity of less than a year offered by foreigners to residents, financial loans and credits offered by residents to foreigners, mortgages made by residents to foreigners, admission of the foreign assets on the Romanian capital market);

Third stage 2005 – 2006: Liberalization of capital transactions with impact on the balance of payments (this includes: free access of non-residents to bank deposits in national currency, to open current bank accounts in the national financial institutions by non-residents, operations with obligations and other instruments on the open market by non-residents, the right of residents to open bank accounts abroad, entire conversion of the national currency).

Applying the principles above, full capital account liberalization was completed in 2006, before Romania's EU accession, and was overlapped on the adoption of inflation targeting strategy. This strategy was implemented in 2005, after being considered for the first time in 2001, when it was mentioned in the Pre-Accession Economic Program of the Central Bank as a major option.

In Romania, control over capital operations was necessary to avoid some shocks that could appear on the market. Developing countries are exposed to large flows of speculative capital from two main reasons: the political and economical instability of these countries provide greater opportunities to win from short-term capital flows, respectively monetary policies of developing countries have more limited effects on capital movements (Beju; 2007).

3. Methodology

The literature on capital account liberalization is very fast. Studies provide some mixed results on the effects of liberalization.

One of the earliest studies in this area by Alesina, Grilli and Milesi-Ferretti (1994), finds no significant effect of openness on growth. Their results are based on a study of 20 industrial countries during the period 1950 - 1990. They find that the effect on growth was small. Their study was followed by a study by Grilli and Milesi-Ferretti (1995), who also found the same negative effect of openness on growth, by using a larger sample of 61 countries. This study was extended by Rodrik (1998) to a larger sample of countries. Also, they obtain the same results of no effect.

There are similarly a number of studies that show that liberalization has significant effects on the cost of capital, investment, and economic growth. Quinn’s (1997) study showed positive

results. However Quinn developed a more complex measure of capital account liberalization. He made a scale that ranged from zero to eight. Quinn considered the impact of both capital account openness and a change in openness and found a positive association to growth. His study thus suggests that the evidence of negative or no effect may have been a result of the measure of openness used. Edwards (2001) dealt with this issue, where he used lagged values of capital account openness, along with other variables as instruments, to overcome the problem of endogeneity. He still found positive results for the effect of capital account openness on growth but this is limited to high-income countries. Edison et al. (2002) find that this relation is stronger in emerging markets, especially Asia. Prasad et al. (2003) conclude that "…an objective reading of the vast research effort to date suggests that there is no strong, robust, and uniform support for the theoretical argument that financial globalization per se delivers a higher rate of economic growth."

Klein and Olivei (2008) study the impact of capital account liberalization on financial depth and economic growth in a cross-section of developed and developing countries over the periods 1986-1995, respectively 1976-1995. They found that countries with open capital accounts in the majority of these periods enjoyed a significantly greater increase in financial depth than countries in which capital account restrictions still exist.

In this study, we propose to analyze the impact of the liberalization process, exchange rates, inflation and interest rate on financial account (three of the main key vulnerabilities of Romanian economy associated to capital account liberalization). In the absence of a theoretical model that offers a clear explanation of these determinants, we construct the following regression that includes these elements::

$$CF=\alpha+\beta_1*CS+\beta_2*I+\beta_3*RD+\beta_4*LIB+\varepsilon_i.$$

where, FA is financial account, FC- foreign currency, I – inflation, IR- interest rate, LIB- a dummy variable that takes a value of one when the capital account is liberalized, and zero otherwise.

LIB is included in the regression in order to examine the effect of liberalization process on financial account. The main focus of the estimation is on the coefficient estimate of LIB with a significant negative (positive) coefficient indicating a decrease (increase) in financial account evolution following liberalization.

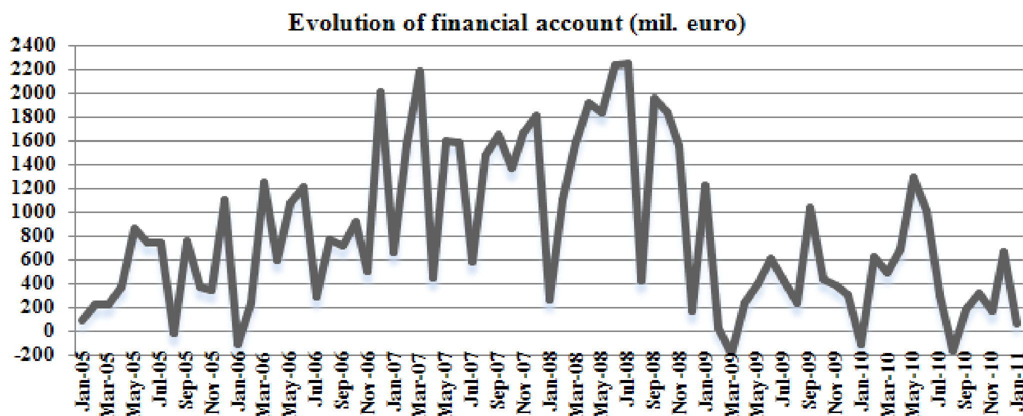
4. Data

Date agreed with the European Union to liberalize the capital account was April 11, 2005 when non-residents had access to short-term deposits in RON. The process of liberalization ended in September 2006, when foreigners had access to government securities.

In this study, we choose the period April 2005 – January 2011. Taking in account the financial crisis, we share the period in two samples: April 2005 – April 2008, respectively April 2005 – January 2011. The first sample has 37 observations, and the second sample 70 observations.

All data are monthly. Financial account is expressed in million euro (chart 1); the foreign currency is the exchange rate of RON/EUR, inflation is monthly rate (annual rate of change), and for interest rate we use ROBOR.

Chart 1: Evolution of Romanian financial account during January,2005 - January, 2011



Source: BNR

Romanian financial account refers to foreign direct investment, portfolio investment, financial derivates, other capital investment and reserve assets of National Bank of Romania (the net values) (table 1). ROBOR is the Romanian Interbank Offer Rate. Data for financial account, exchange rate and interest rate are taken from the interactive database of National Bank of Romania (NBR), and the data for inflation is taken from the Eurostat database.

Table 1: Evolution of Romanian financial account elements in 2005-2010 (mil. Euro))

	2005	2006	2007	2008	2009	2010
Financial account	5891	9555	16652	17206	5236	5549
Direct investment	5238	8725	7049	9310	3554	2552
Portfolio investment	777	-195	483	-563	513	1135
Financial derivatives	-19	-85	-298	-294	-51	2
Other capital investment	5330	6272	13924	8717	2347	5346
NBR`s reserve assets, net	-5433	-5157	-4502	39	-1123	-3488

Source: Author`s calculations

5. Empirical results

In this section we provide evidence of the impact of liberalization process, foreign currency, inflation and interest rate on financial account.

Liberalization process has a negative and insignificant impact on Romanian financial account in both samples. The other three variables have different impact on financial account (table 2). In the first sample, the euro currency has a negative, but insignificant impact on financial account, while the inflation and interest rate have a positive impact, the last one is significant at the 10%. In the second sample, the situation has changed. This difference may be due to the appearance of the financial crisis. This time, all the three variables have a positive, but insignificant impact on Romanian financial account

Table 2: Empirical results

Sample	2005M04 - 2008M04	2005M04 - 2011M01
C	-0.01278 (-0.903702)	-0.00736 (-0.927508)
FC	-56.39789 (-0.741062)	15.9473 (0.432454)
I	10.77625 (0.662022)	4.35578 (0.598879)
IR	47.54061 (1.797167)***	8.24985 (1.082397)
LIB=1	-0.01059 (-0.736805)	-0.00709 (-0.906407)

Source: Author`s results
Notes: *, ** and *** denote rejection of the null hypothesis at the 1%, 5% and 10% respectively. In parentheses are the t-Student values.

6. Conclusion

Capital account liberalization was initially seen as an inevitable step for poor countries economic development. This liberalization allows financial flows from capital abundant countries (where the expected returns are low) to countries with small capital (where the expected returns are high). Resource flows of liberalized countries would reduce their cost of capital, respectively will increase their investments. The main political question was not how to realize capital account liberalization, but when, before or after the adoption of macroeconomic reforms: trade liberalization and inflation stability.

Romania's case shows that capital account liberalization, if it is done before all the preconditions are fully accomplished, it will involve substantial risks and significantly complicate monetary policy. The experience lived by Romania illustrates that the use of administrative decisions, such as the debt / income ratio for households, might be efficient on short term to allow other policies to intervene in time for the correction of existent imbalances. But on long-term markets and private agents will learn how to avoid such administrative restrictions.

We propose to study in our further research if the crisis had an impact on Romanian financial account, in order to justify the differences that appear in our samples, respectively the impact of capital account liberalization on Romanian gross domestic product.

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