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REGIONAL FINANCIAL INTEGRATION - A SOLUTION TO STREAMLINE THE FINANCIAL SYSTEM OF THE REPUBLIC OF MOLDOVA

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Abstract: The financial system in the Republic of Moldova does not have the potential to generate economies of scale. Consequently, the financial products and services provided are characterized by limited diversification, insufficient volume and high costs. Under these circumstances, one of the solutions that can help to overcome this impediment is Moldova's financial integration at regional level. In the context of this research the authors have set the following objectives: to define the concept of regional financial integration; to identify and argue the benefits and negative effects of the process of international financial integration; to develop the methodological framework for measuring financial integration; to assess the level of financial integration of the Republic of Moldova; to develop the mechanism of transmission of the potential effects of financial integration on the performance indicators of the financial system of the Republic of Moldova; to formulate solutions for the extension of financial integration of the Republic of Moldova at the regional level in terms of financial system efficiency. The authors of this paper used the following research techniques and methods: economic analysis, synthesis, analogy, modeling, induction, deduction, mathematization and formalization in the field of international finance knowledge and others. The originality and value of the research lies in developing the conceptual and methodological framework associated with regional financial integration in order to increase the efficiency of the financial system of the Republic of Moldova.

Keywords: financial integration, financial liberalization, international finance, sustainability.

JEL Classification: F36, F38, F55, G2, Q01.

Introduction

Regional integration can bring substantial economic benefits. In particular, emerging countries are potential winners from regional integration (Viner, 1950). In this context, according to the IMF classification, the Republic of Moldova is an emerging economy (IMF, 2022; World Economic Outlook Database, 2022). At the same time, according to the World Bank, the Republic of Moldova is a small upper-middle-income country (World Bank Country and Lending Groups). Therefore, the Republic of Moldova, through regional integration, can:

- improve the efficiency of its markets;
- conduct a joint policy process and have an anchor in the process of promoting reforms;
- share the costs of public goods or large infrastructure projects;
- have a basis for global integration;
- to obtain other non-economic benefits (security, peace, etc.).

At the same time, the emerging character of the country suggests that regional integration entails certain risks, the most pronounced of which concern (Te Velde, n.d.):

- the sustainability of a country's development may be affected by the fact that, especially domestically, regional integration creates winners and losers. There is therefore a need for policies and institutions at national level to ensure that social, environmental and governance risks are properly managed and that regional integration is inclusive;
- the preferences that countries may have when identifying and selecting priorities to be achieved in the process of regional integration. To a large extent, these preferences are conditioned by economic geography, connectivity gaps; preferences for preserving sovereignty in certain areas;
- shortcomings in assessing the impact of regional integration on growth processes, trade and investment flows, income distribution.

Over the last three decades, several regional blocs representing economic associations have been set up in Europe, Asia, Africa and Latin America. We mention in this context the Southern African Development Community (1992), the West African and West African Economic and Monetary Union (1994), Association of South East Asian Nations (1997), Central African Economic and Monetary Community (1998), Euro Area (1999), East African Community (2000), Union of South American Nations (2008), Pacific Alliance (2011) (World Bank Country and Lending Groups, n.d.)

Considering the benefits of regional economic integration, the Republic of Moldova signed the EU-Moldova Association Agreement in 2014, which provides for a deep and comprehensive free trade area, among other things. This agreement lays the foundations for deeper economic integration between the EU and Moldova.

Developing the concept of regional financial integration

In the authors' view, regional economic integration is a complex, multi-sided process whereby two or more states in a given geographical area raise a number of trade barriers in order to achieve certain economic objectives that otherwise either could not be achieved or could be achieved only to a lesser extent.

Financial integration is a component part of economic integration. In fact, financial integration follows the other components of economic integration.

By regional financial integration the authors mean the process of establishing interdependencies and aligning financial systems, including their components (markets, institutions and regulations) with the aim of facilitating the flow of capital, investment and financial services across national borders and within national economies that have decided to cooperate at the regional level.

Regional financial integration expresses the extent or level to which financial markets, institutions and services operate and/or are available according to the same rules and under the same conditions in the countries of the region concerned. In a well-integrated financial system within a region, assets with the same risk and return characteristics have the same cost, irrespective of the country (which is part of the region) in which they are traded.

Assessment of Moldova's financial integration

In order to measure the level of international financial integration of the Republic of Moldova (IFint), the authors determined the ratio of the sum of the stock of foreign assets and liabilities to gross domestic product (GDP). This indicator is recommended for application in order to calculate international financial integration by Lane and Milesi-Ferretti researchers (Bénétrix, 2008; Hoffmann et al., 2019; Lane and Milesi-Ferretti, 2007).

$$\mathrm{IFint} = \frac{(\text{Stock of foreign assets} + \text{Stock of foreign liabilities})\text{x}100\%}{\text{Gross domestic product}} \quad (1)$$

For the purpose of determining this indicator, the *International Investment Position of the Republic of Moldova* is explored as a source of information, in particular the financial account.

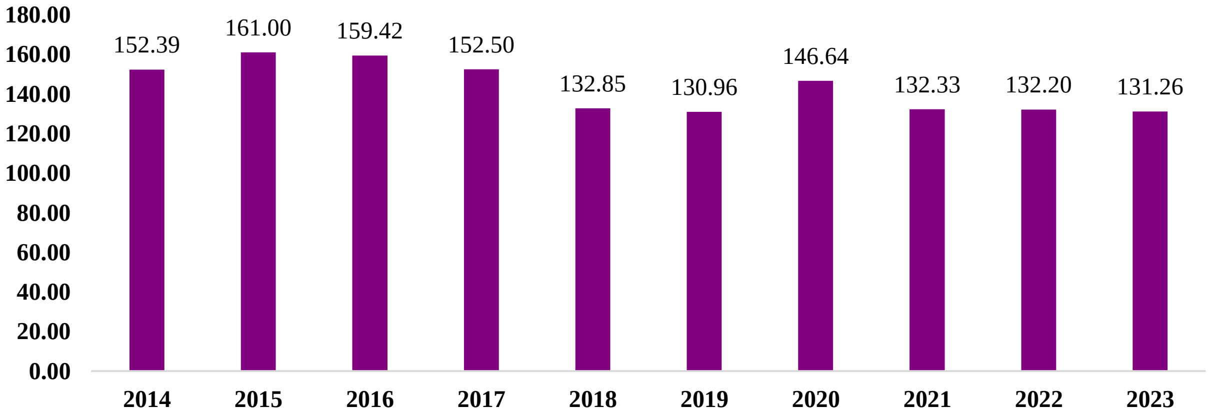

Figure 1. Evolution of the level of international integration of the Republic of Moldova, annually, as of December 31, in %.

Source: developed by the authors on the basis of NBM information on International Accounts of the Republic of Moldova. Available on (NBM,2022).

As shown in Figure 1, the level of international financial integration of the Republic of Moldova between 2014 and 2023 shows a fluctuating evolution: a continuous decrease between 2015 and 2019 and a relative stabilization between 2021 and 2023 after the increase in 2020. These developments are largely determined by fluctuations in the exchange rates of the original currencies against the US dollar, changes in the prices of financial instruments and other changes.

Figure 2 explains, from a structural point of view, the evolution of Moldova's level of international integration.

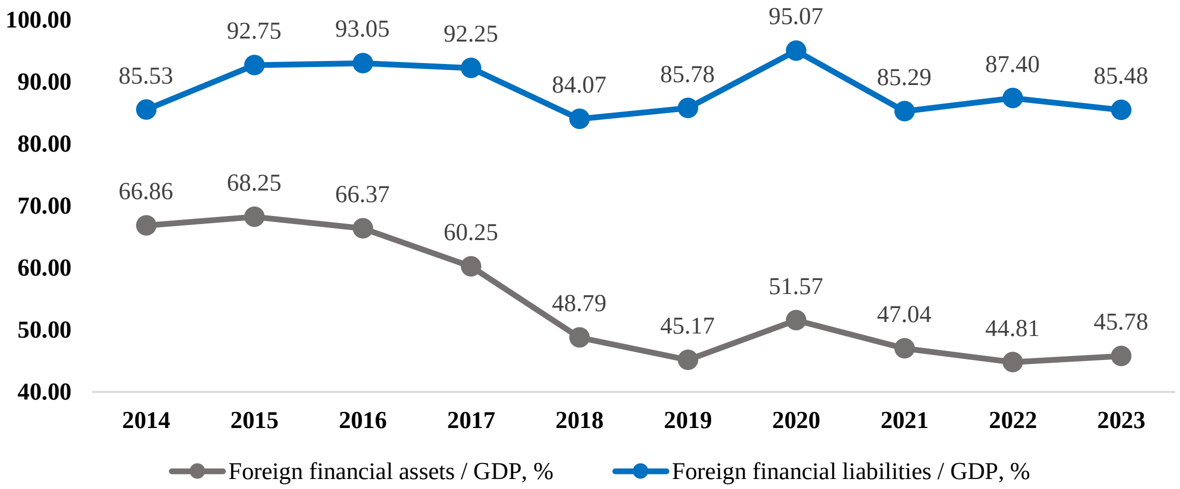

Figure 2. Evolution of the ratio of financial assets to GDP and of the ratio of financial liabilities to GDP, in %.

Source: developed by the authors on the basis of NBM information on International Accounts of the Republic of Moldova. Available on (NBM, 2022).

To a large extent, the reduction in the level of international financial integration of the Republic of Moldova is determined by the reduction in the ratio of external financial assets to GDP in the context of a relatively constant evolution of the ratio of external financial liabilities to GDP. Thus, the graph shows that the dynamics of the ratio of external financial assets to gross domestic product (GDP) follows a gradually declining trend: from 68.3% - the level recorded in 2015 to 44.8% - the level recorded in 2022. The ratio of external financial liabilities to GDP has followed a relatively constant downward trend, with a peak of 95.1% in 2000.

Developed countries are characterized by a higher level of financial integration. To illustrate this, Figure 3 shows the evolution of Israel's level of financial integration. Israel is considered the most advanced country in West Asia and the Middle East in terms of economic and industrial development. In April 2024, the IMF estimated Israel's GDP at 530.7 billion dollars and Israel's GDP per capita at 53.4 thousand (13th place in the world) (Lane și Milesi-Ferretti, 2007). At the same time, Israel ranks 15th for foreign direct investment from 2022 onwards (UNCTD, 2024).

As Figure 3 suggests, overall, Israel's level of financial integration has fluctuated. Thus, in the time segment between 2018-2021, the level of financial integration experienced a period of growth. In 2021 this indicator decreased and resumed its growth in 2022.

Comparative analysis of Figures 2 and 3 helps to draw a conclusion about the level of financial integration registered by the Republic of Moldova far below that registered by Israel.

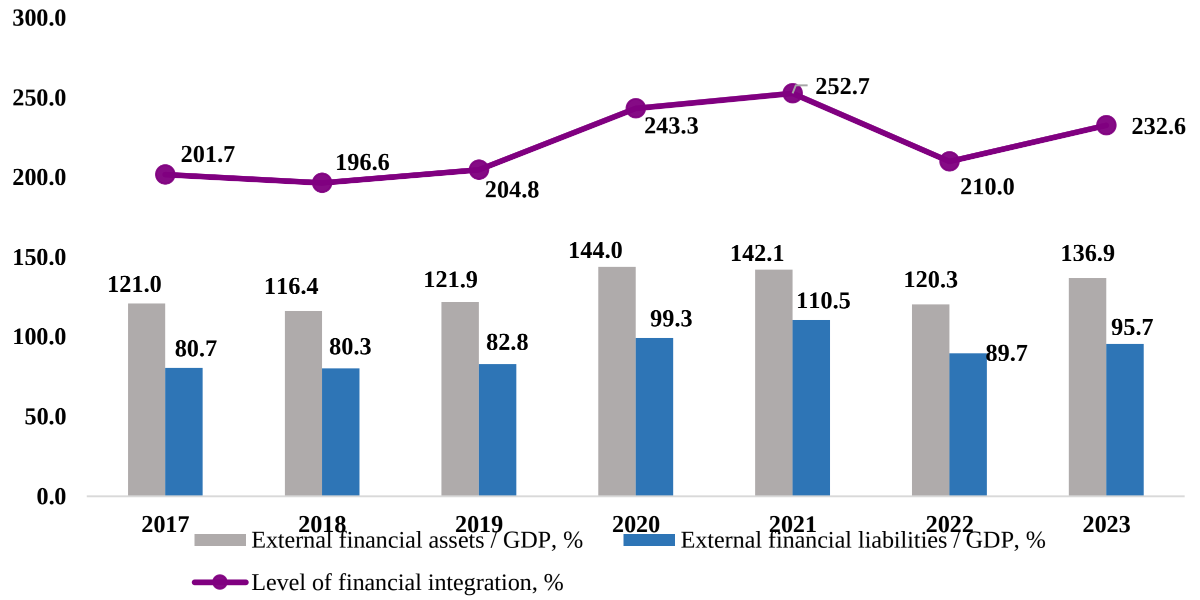

Figure 3. Evolution of the level of financial integration, the ratio of financial assets to GDP and the ratio of financial liabilities to GDP recorded by the State of Israel, in %.

Source: developed by the authors on the basis of information from the Bank of Israel on Israel's International Investment Position (IIP). Available on Bank of Israel.

In the case of Israel, the level of financial integration on the assets side exceeds the level of financial integration on the liabilities side. This development suggests that Israel's balance of payments current account is in surplus. Thus, in April 2024, the IMF estimated Israel's current account balance to be equal to 29.7 billion US dollars, and the current account share in GDP - equal to 5.6% (World Bank, 2023; Te Velde, n.d.)

In order to deepen the assessment of the degree of international integration of the financial sector of the Republic of Moldova, the authors have resorted to the processing of the information reflected in the International Investment Position of the Republic of Moldova. The results of this analysis are presented in Figure 4 and Figure 5.

Figure 4 represents the institutional structure of Moldova's international financial assets. Thus, the largest share of international financial assets are held by the National Bank of Moldova. Moreover, while in 2014 the NBM held 34.3% of the total international financial assets, in 2023 this share reached 72%. In the structure of international financial assets held by the NBM, reserve assets hold 100%.

The continuous upward trend in the share of international financial assets held by the NBM is accompanied by the decreasing position of non-financial corporations, households and non-profit institutions in the service of households (from 56% in 2014 to 18% in 2023). In the structure of international financial assets held by these economic agents, the main asset categories are direct and other investments (cash and deposits, loans, trade credits). Portfolio investments are negligible.

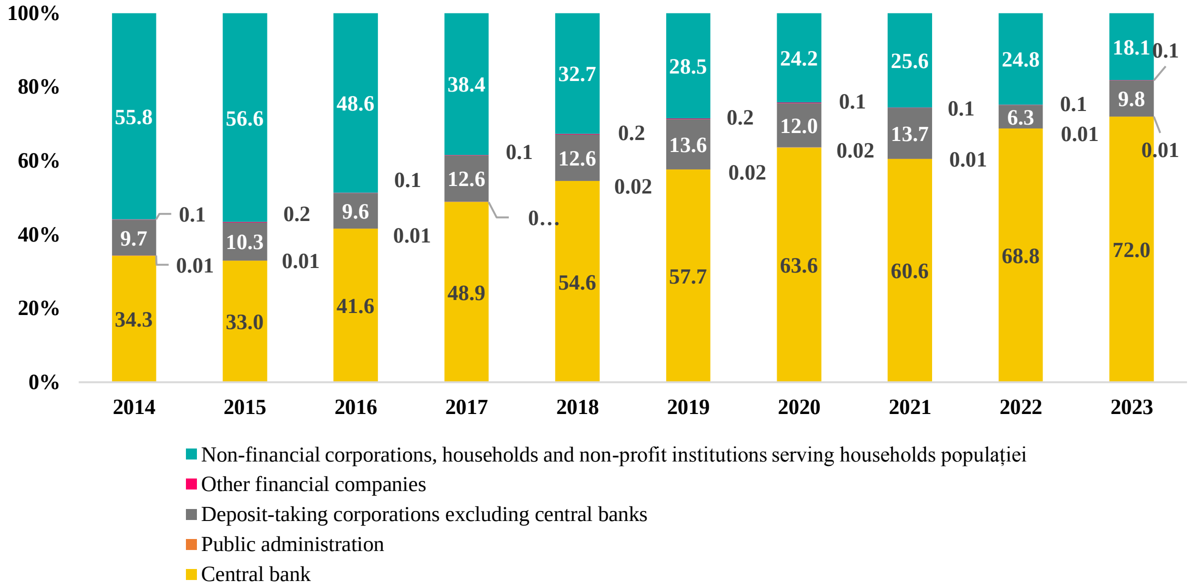

Figure 4. Structure of external financial assets, by sector, in %.

Source: developed by the authors on the basis of the NBM information on the International Investment Position (BPM6) according to the analytical presentation. Available on NBM.

The relatively modest role played by Moldovan commercial banks and other deposit-taking financial institutions in holding international financial assets should be noted. In this context, these institutions show a general downward trend: from 14% recorded in 2019 and 2021 to 6.3% in 2022 and 9.8% in 2023). The main categories of assets held by this category of economic agents are other investments (cash and deposits, loans), with portfolio investments modest by volume.

Figure 5 represents the institutional structure of Moldova's international financial liabilities. Thus, the largest share of international financial liabilities (about 70%) is held by non-financial corporations, households and non-profit institutions serving households. In the structure of international financial liabilities, the following categories of liabilities have larger shares: direct investment and other investment (loans, trade credits and advances). Portfolio investment plays a minor role for this category of economic agents.

The next largest international financial liabilities are held by general government. General government predominantly holds liabilities in the "other investment" category (borrowing, including loans and loans with the IMF).

Commercial banks and other deposit-taking financial institutions have a decreasing share over the time segment examined (2014-2023). The main categories of liabilities held by these institutions are other investment (cash and deposits, loans) and portfolio investment.

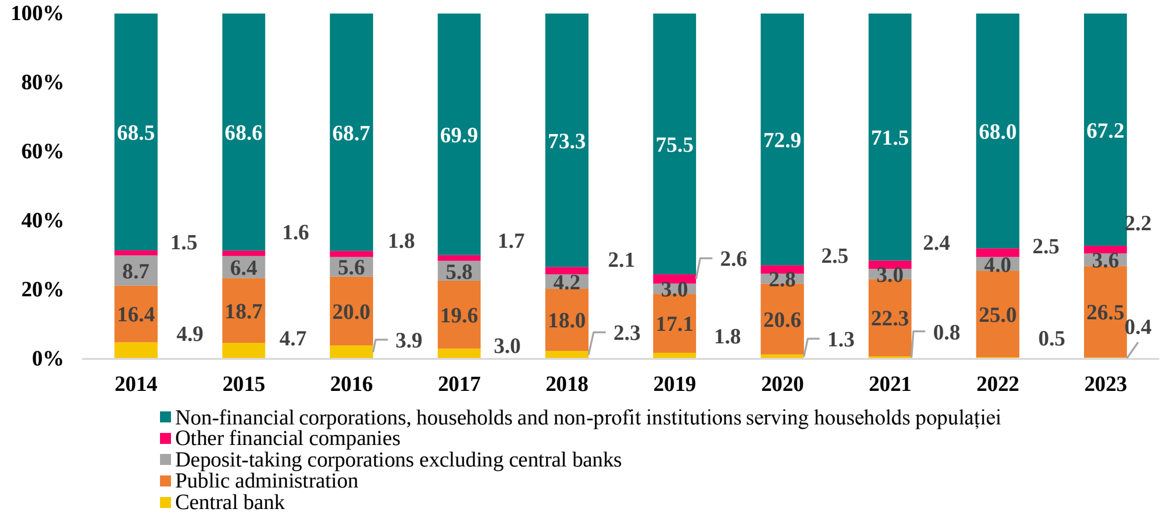

Figure 5. Structure of external financial liabilities, by sector, in %.

Source: developed by the authors on the basis of the NBM information on the International Investment Position (BPM6) according to the analytical presentation. Available on NBM.

Rationalizing Moldova's regional financial integration

According to the authors, the financial system is a complex concept that has several dimensions: the institutional dimension, the instrumental dimension and the regulatory dimension.

The institutional dimension consists of all the institutions that make up the financial system: banks, insurance companies, stock exchanges, etc.

The instrumental dimension is represented by all financial instruments, which are assets that can be traded or exchanged (shares, bonds, certificates of deposit, exchange-traded funds, loans, mutual funds, derivative contracts).

The regulatory dimension is the set of regulations, rules and practices that borrowers and lenders use to decide which projects are financed, who finances the projects and the terms of financial transactions.

As a consequence of the interaction of these dimensions, various financial flows are generated: flows of financial assets and flows of financial liabilities.

Financial integration of the Republic of Moldova refers to the process of connecting and harmonizing the financial systems on each of these dimensions.

Depending on the dimension considered (institutional, instrumental and regulatory), the financial system of the Republic of Moldova will derive the following benefits from increased financial integration:

- improved access to capital: individuals and legal entities will be able to access more diversified sources of funding;
- risk diversification: investors will be able to diversify their portfolios across asset classes and countries:
- more efficient allocation of resources;
- financial systems and markets will be more efficient, competitive and transparent;
- expanding cross-border transfer of knowledge, technology and experience. Exchange of knowledge and experience will develop the financial sector, regulatory framework and risk management methodology.

Conclusions

International financial integration has a crucial role to play in facilitating Moldova's economic growth and development by promoting the cross-border flow of capital, investment and financial services.

At the same time, the authors' analysis shows that the Republic of Moldova has a low level of international financial integration. Moreover, the level of international financial integration is tending to decrease over time.

At the same time, foreign experience in the field of international financial integration shows that emerging countries which open their financial accounts directly without taking preparatory measures to this end risk facing deep financial crises. To avoid such unfavorable developments and jeopardize the potential benefits of international financial integration, countries need to liberalize in a step-by-step manner, strengthening their efforts to promote and consistently implement domestic economic and financial reforms.

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