THE IMPACT OF FINANCIAL LIBERALIZATION ON ROMANIAN BANKING SYSTEM EFFICIENCY

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Abstract: *In the last three decades, many emerging countries have moved away from a system of restrictive monetary and financial controls to a more liberalized financial sector. The restrictive imposed policies were expected to contribute to industrialization of the economy and to the stability of the banking sector. However, financial liberalization had big costs on the banking system's competitiveness and efficiency. Financial liberalization has a different impact on banking markets. Thus, there is no size that fits all policies concerning banking liberalization process. For highly efficient banks, competition is improving their efficiency standard, while less efficient banks can`t compete with foreign banks and further are decreasing in efficiency or are driven out of the market. Overall, the average efficiency of domestic banking markets should be an important variable in deciding to open up their banking market. Banks that are operating close to the frontier, in general are improving their efficiency following financial liberalization process. Banks that are operating in a further distance can`t manage to compete with foreign market entrants, so, they are losing from liberalization process. In this article we propose to measure the impact of financial liberalization process on Romanian banking system. We used the panel regression to study the informational efficiency of three Romanian banks during 2004 - 2012. The dependent variable of the model was the price of stock bank, and the independent variables were the financial indicators (return on equity, return on assets, net profit margin). In the second regression we introduce a dummy variable for crisis period. Our results show that the financial indicators choose do not affect the efficiency of Romanian bank, but the crisis had a negative impact on them. International context, credit risk, the implementation of Basel III and reducing exposures in the absence of investment alternatives remains key challenges to the Romanian banking system in future.*

Keywords: *financial liberalization; bank; return on equity; return on assets; net profit margin*

Jel classification: *O16; G21; G23*

1.Introduction

One of the most important decisions taken by national authorities during the last three decades was the liberalization of financial systems. This process was developed in many emerging market economies from Europe, Latin America, Asia and Africa. The financial deregulation aimed, essentially, to sustain the economic growth, through the smooth progress of financial development.

The measure of financial liberalization were meant to eradicate financial restrictions, by making the central bank more responsible in implementation of monetary policy, restructuration and privatization of financial institutions, eradication of credit control, liberalization of interest rate, removal the obstacle on capital flows, elimination of barriers on competition among financial players, and liberalization of equity markets.
Financial liberalization has a positive impact on financial development, according to the finding of several research studies. Financial deregulation leads to better financial evolutions by improved risk sharing between the domestic and foreign intermediaries (Henry 2000a). Better risk sharing can reduce the cost of capital tempting additional investment and growing the level of investment (Henry 2000b, Bekaert and Harvey, 2000), but can also conduce to investments in riskier higher expected return projects (Bekaert, Harvey and Lundblad, 2005). So, financial liberalization is associated with financial flexibility – the efficiency in which capital can be reallocated and supervised.
Improved financial intermediation is frequently associated with a higher economic growth. There are a large literature suggesting that financial development contributes to economic growth, by decreasing the investment costs and pooling capital more efficiently (Lucas, 2005; King and Levine, 1993; Beck, Levine and Loayza, 2000), although a few studies indicate the contrary (Devereux and Smith, 1994).
In many economies, the banking system is the most important component of financial sector, having an essential role in promoting of the economic growth. This is the reason for why the financial deregulation process referred in a large extends to the banking system liberalization. The banking reforms consist in the abolition of the credit control, liberalization of interest rate, privatization of state-owned banks and elimination of barriers in capital flows. The liberalization in banking system seek to improve the efficiency of the banks, to acquire a better allocation of credits, to encourage savings and, consequently, to achieve a higher economic growth.
Difficult economic context has influenced the Romanian banking system, both in the savings, and lending. The biggest challenge for banks was credit risk, given that non-performing loans have increased and are expected to increase further due to financial crisis.
In the context of unpredictable economy and volatile financial markets, the Romanian banking system is facing one of its toughest tests. In addition, the financial position of many banks became more difficult, some of them being forced to absorb significant losses in sovereign debt crisis. Now banks have to regain the confidence of markets and the public, to absorb new regulatory requirements, reduce costs, focus on core activities and increase lending, while ensuring a balance between risk and reward.
In this paper we analyze the impact of financial liberalization on Romanian banking system efficiency. The paper is structured as follows. In section 2 we reviewed the prior literature on the impact of financial liberalization on banking system. Section 3 presents the empirical methodology we have applied to measure the impact of financial liberalization on banking system. In section 4 we showed the results of our empirical investigation and discussed it. Section 5 comprises the most important conclusions of our analysis.

2.Literature review

The theory of financial liberalization process is based on McKinnon (1973) and Shaw (1973) works, which is focused on the economic benefits of liberalization.
Denizer, Dinc and Tarimcilar (2000) examine the bank efficiency in pre and post-financial liberalization period in the Turkey during 1970-1994. Their empirical results show that financial liberalization reforms were followed by a decline in bank efficiency.
Bonaccorsi di Patti and Hardy (2005) analyzed the impact of banking system reform on the productivity and cost productivity in Pakistan and on the efficiency of groups of banks (state-owned, foreign, private domestic and privatized). Their result show that the first wave of liberalization in 1991-1992 generates a higher profitability due to the increase in revenues more than the costs, but during 1998-2002 profitability recorded a decline due to a negative contribution from business conditions that more than offset an increase in profit productivity after the second wave of reforms. Efficiency by groups of banks recorded various levels: state owned banks are least efficient, the privatized banks improved their efficiency immediately after their privatization, and the new private domestic banks are among the most efficient and sometimes out-performed the foreign banks. As a result, banking liberalization led to a higher banking performance, especially between 1993 and 1997. A similar research is the empirical study of Abbas (2010) who analyzes the impact of financial liberalization and deregulation on the bank performance in Pakistan, finding that the banks efficiency has improved during 1990-2006. Regarding the group banks' efficiency the more efficient are foreign banks, followed by private banks, nationalized commercial banks and privatized banks.
Studying the relationship between financial liberalization and bank performance in India between 1991 and 2001, Koeva (2003) find that industry concentration, profitability and bank spreads in bank industy have decrease during the period of liberalization. Ghosh, Harding and Phani (2008) examined the impact of foreign banks entry liberalization on agency costs in India, finding that the gains of private banks were almost double than those of national banks after liberalization. They also find a significant relationship between firm-specific abnormal returns and factors usually associated with a bank's potential for takeover. They conclude that the expected gains from the reduction of agency costs represent one reason of the valuation gains associated with banking liberalization.
Williams and Nguyen (2005) examine the impact of financial liberalization on banking performance in South East Asia during 1990-2003. Their findings indicate that bank privatization reform increases bank efficiency performance more than other types of liberalization reforms. Hermes and Nhunq (2008) study the impact of financial liberalization on bank efficiency in ten emerging countries from Latin America and Asia during 1991-2000, finding that financial liberalization has a positive impact on bank efficiency.
Maudos and Solis (2011) analyzed the evolution of banking competition in Mexico between 1993-2005, a period characterized by deregulation, liberalization and consolidation of banking system. They found a diminishing in competitive rivalry in the deposit market and a boost in the loan market. The banking reform increased the risk aversion of banks, causing a discouragement to finance private activities which were more profitable, preferring to finance only the less risky which low return. They