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Stock market integration in ASEAN after the Asian financial crisis☆

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Abstract

This paper considers the degree to which the five stock markets in the original Association of Southeast Asian Nations countries (ASEAN-5) are correlated as a way to assess the feasibility of policy initiatives to enhance ASEAN stock market integration and the implications for portfolio investors. In particular, this paper considers whether the ASEAN-5 markets are integrated or segmented using the time series technique of cointegration to extract long-run relations. The empirical results suggest that the ASEAN-5 stock markets are cointegrated and are thus not completely segmented by national borders. However, there is only one cointegrating vector, leaving four common trends among the five variables. We therefore conclude that ASEAN-5 stock markets are integrated in the economic sense, but that integration is far from complete. On a policy level, initiatives to further integrate the stock markets are feasible, and in fact desirable. From the perspective of the international portfolio investor, benefits of international portfolio diversification across the five markets are reduced but not eliminated.
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1. Introduction

This paper examines stock market integration in Indonesia, Malaysia, the Philippines, Singapore, and Thailand in the aftermath of the Asian financial crisis. These five countries are the original members of the Association of Southeast Asian Nations (ASEAN), which now also includes Brunei Darussalam, Cambodia, Laos, Myanmar, and Vietnam. Over the past few years, ASEAN member countries have made tremendous progress in forming a free trade area and investment zone—witness the ASEAN Free Trade Area (AFTA) and the ASEAN Investment Area (AIA). The region is now examining the possibility of capital market integration for national bond markets and stock markets alike. ASEAN countries, in fact, are beginning to discuss the feasibility of a currency union as well, which suggests that the countries are interested in multilateral approaches to many regional economic and financial issues. The five original ASEAN countries (the ASEAN-5) are the most likely candidates to undertake integrative measures first, and therefore provide the focus for this paper.

Integration in the ASEAN capital markets may include initiatives to coordinate the five national capital markets that already exit, or at an extreme may involve the creation of supranational regional bond and stock exchanges.[1] The issue is integration as opposed to capital market development more generally, although one motivation for integration is typically to foster development of the market. ASEAN policymakers are weighing the benefits of financial market integration in the same way as European Union policymakers prior to monetary unification. With respect to unification in Europe, Kleimeier and Sander (2000) point out that there are really two kinds of benefits: first, benefits of regional integration of the type studied in the Cecchini Report (Cecchini, 1988); and second, benefits of integrating the region with global financial markets. Although Kleimeier and Sander (2000) examine banking, the point is generalizable to stock and bond markets as well. ASEAN policy makers are naturally wondering what gains might be available to their region.

Interest in stock market integration arises primarily because financial theory suggests that an integrated regional stock market is more efficient than segmented national capital markets. Capital market efficiency in Southeast Asia has become even more important after the Asian financial crisis of 1997–1998, so we focus on the post-crisis period to-date, using high-frequency data. Southeast Asian countries are specifically seeking to reduce the traditional dependence of firms on bank loans rather than bond and stock issuances, and at the same time are seeking new capital from outside the region.

With an integrated regional stock market, investors from all member countries will be able to allocate capital to the locations in the region where it is the most productive. With more cross-border flows of funds, additional trading in individual securities will improve the liquidity of the stock markets, which will in turn lower the cost of capital for firms seeking capital and lower the transaction costs investors incur. These suggest a more efficient allocation of capital within the region.

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[1] A separate paper (Plummer & Click, 2003) examines the bond markets (and see the references therein). This paper uniquely focuses on stock markets.

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