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Measuring financial and economic integration with equity prices in emerging markets

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Abstract

This paper examines real and financial links simultaneously at the regional and global level for a group of Pacific-Basin countries by analysing the covariance of excess returns on national stock markets over the period 1980–1998. We find overwhelming evidence at the regional and global level and for all sub-periods that financial integration is accompanied by economic integration. This seems to suggest that economic integration provides a channel for financial integration, which explains, at least partly, the high degree of financial integration found in this study and in other studies for this region even in the presence of foreign exchange controls. This result has important implications for the use of restrictions to isolate capital markets from world influences.
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1. Introduction

The recent emergence of new capital markets and the relaxation of foreign capital controls, which has opened the possibility of international investment and portfolio diversification, have increased the interest of academics and practitioners in studying the degree of financial integration of these markets. In this paper, the analysis is

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focused on the Pacific-Basin region, which constitutes an important part of emerging capital markets. The countries in our sample are: Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand. In 1998, these markets constituted 43 percent of emerging markets capitalisation, while in 1999 this figure had risen to 47 percent.[1]

Financial integration is measured by testing the law of one price to financial assets with the same risk. For our selected group of countries work has concentrated on testing the international parity conditions. For example, Bhoocha-Oom and Stansell (1990) look at interest rates (adjusted and unadjusted for exchange rates changes) between Hong Kong and Singapore versus US. Faruquee (1992) examines the uncovered interest rate differential between Singapore, Korea and Thailand versus the Japanese LIBOR—taken to represent the world rate of interest. Dooley and Mathieson (1994) look at seven Pacific Basin countries versus US using an analytical framework for interest rate determination, where the prevailing interest rate represents a weighted average of open (US interest rate adjusted for the change in the exchange rate) and closed economy rates that would have existed otherwise. Reisen and Yeches (1993) using the same framework examine Korea and Taiwan by applying the Kalmar Filter technique to capture changes in the degree of integration over time.

The results of these studies support the view that there is substantial integration between domestic and international financial markets in Hong Kong, Singapore, Malaysia, Philippines and Indonesia, while the views are divided for Korea and Thailand. In Taiwan capital market integration with world financial markets was found to be limited. Using, however, a different method of measuring capital mobility based on a portfolio balance model, Chinn and Maloney (1998) found evidence of a greater degree of openness in Taiwan since early 1989. The extensive capital market integration in the Pacific Basin Region has also been supported by Phylaktis (1999), when in addition to looking at long-run comovements of real interest rates, another indicator of the degree of capital market integration was used, namely the speed of adjustment of real interest rates to long-run equilibrium following a shock in one of the markets. Thus, even in countries like Taiwan and to a lesser extent Korea, where controls were substantial in both countries, extensive linkages have been found with world capital markets.

Similar conclusions have been found in studies, which have looked at stock markets and tested whether stocks with the same risk i.e. exposure to a common world factor, have identical expected returns irrespective of the market. In the case when a market is segmented from the rest of the world however, its covariance with a common world factor will not be able to explain its expected return. Bekaert and Harvey (1995) allowed conditionally expected returns in a country to be affected by their covariance with a world benchmark portfolio when the market is perfectly

[1] See "Emerging Stock Market Fact Book", (1998,1999) published by the International Finance Corporation. Excluding Hong Kong and Singapore, which might not be considered as emerging markets, the figures still remain high at 30 percent and 32 percent in 1998 and 1999, respectively.

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