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The determinants of international financial integration

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Abstract

It is generally accepted that there has been an increase in the degree of international financial integration over the last two decades. As a result, international financial integration has become a topical area of research for many financial economists. To enrich the literature in this area, our paper provides an empirical investigation into identifying the potential "drivers" of international financial integration including policy on capital controls, the level of economic and educational development, economic growth, institutional and legal environment, trade openness, financial development and tax policy. Overall, the results provide strong evidence in support of our choice of drivers of international financial integration.
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1. Introduction

It is generally agreed by many financial economists and practitioners that there has been an increase in the degree of international financial integration (international financial integration) over the last two decades (Agenor, 2003; Lane & Milesi-Ferretti, 2003; Morrison & White, 2004; Vo, 2005b). Countries are trying to remove the restrictions on cross-border capital movement, deregulate domestic financial markets and become proactive in offering competitive investment environments to encourage international investment. The use of capital controls in the OECD countries has now reached the lowest point in over fifty years (Epstein & Schor, 1992). Not only the OECD but also developing countries' financial linkages with the global economy have

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recorded notable increases in recent years (Prasad, Rogoff, Wei, & Kose, 2003). In addition, there has been a rapid increase in the size of capital flows in an environment where national financial markets are deregulated and international capital flows are liberalized. Recent evidence in a study by Lane (2003) suggests that as the current explosive growth in cross-border asset trade has significant impacts on key open-economy macroeconomics variables such as trade balance and the real exchange rate that are critically important for policy analysis.

To recognize the importance of a clear understanding of international financial integration, there has been an increasing interest amongst financial economists concerning this research area. Many recent research consider the concept of international financial integration and provide an array of indicators to proxy for international financial integration even though none of those definitions can be generally accepted or considered as a benchmark (Edison, Levine, Ricci, & Sløk, 2002; Prasad et al., 2003; Vo, 2005b; Von Furstenberg, 1998). These studies clearly differentiate definitions of international financial integration and different types of indicators: *de jure* indicators to proxy for the prerequisites or causes of international financial integration and *de facto* indicators for the consequences or results of international financial integration. In addition, Vo (2005b) also discusses other international financial integration concepts where its measures involving testing correlations between different macroeconomic variables.

The concept of international financial integration is integral to international finance and it is natural that the degree of international financial integration changes with economic conditions. The main purpose of this paper is to empirically investigate the determinants of international financial integration. Firstly, it is important to identify suitable quantitative variables to proxy for international financial integration.[2] Vo (2005b) constructs several international financial integration indicators using data from the International Financial Statistics (IFS) of the International Monetary Fund (IMF). In this study, we use the following indicators to represent the degree of international financial integration: the aggregate stock of assets and liabilities as a share of GDP (IFI01), the stock of liabilities as a share of GDP (IFI02), the aggregate stock of foreign direct investment (FDI) and portfolio investment (PI) as a share of GDP (IFI03), the stock of FDI and PI inflows as a share of GDP (IFI04), the aggregate flows of equity as a share of GDP (IFIEF), the inflows of equity as a share of GDP (IFIEFI), the aggregate stock of equity as a share of GDP (IFIES) and the stock of equity inflows as a share of GDP (IFIESI). The rationale for the inclusion of the equity measures is that equity flows might be driven by a different mechanism (Lane & Milesi-Ferretti, 2003). The decision to include both stock measures and flow measures to proxy for international financial integration is justified by the fact that flow measures are subject to short-term fluctuations while stock measures are not. In addition, it is contended that *de facto* measures of international financial integration which are also considered as volume-based capital account openness measures should cover not only the ability of foreign investors investing domestically but also the ability of residents in the host country to invest abroad. Secondly, a number of control variables need to be identified to serve as candidates to represent determinants of international financial integration.

Some previous empirical research examines the determinants of international financial integration in which capital controls are considered as measures of international financial integration (Alesina, Grilli, & Milesi-Ferretti, 1994; Epstein & Schor, 1992; Lemmen & Eijffinger, 1996; Milesi-Ferretti, 1995). However, capital controls are considered as prerequisites (*de jure* measures) for international financial integration (Vo, 2005b). Hence, for the purpose of

[2] See Vo (2005b) for a detailed discussion of the advantages and disadvantages of international financial integration indicators.

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