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International equity market integration: Theory, evidence and implications

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Abstract

We survey the literature on international equity market integration. In doing so, we examine the theory of integration, the burgeoning literature on empirical evidence, and the implications. It is clear from our review that significant methodological advances in recent years have provided a new perspective on the degree of such integration. Among the most important implications of the rapidly amassing evidence of substantial integration among both the developed and the emerging markets is the need for international investors to carefully monitor the risk associated with varying benefits of diversification.

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Keywords: International integration; Equity markets

1. Introduction

The world's economic and financial systems are becoming increasingly integrated due to the rapid expansion of international trade in commodities, services, and financial assets. The commodities and services trade linkage arises from the fact that increasing proportions of domestic production are exported to foreign countries, while increasing proportions of domestic consumption and investment use commodities and services that are produced overseas and are imported. At the same time, as this real international integration is occurring, however, both the level and pace of international financial integration have increased. The financial assets linkage arises because national and overseas residents,

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whether households, corporations, or financial institutions, can increasingly decide whether to hold domestic assets such as bills, bonds, equity, or other assets in foreign countries. Although the so-called home bias still persists for households (whereby the share of domestic financial assets is above that which portfolio theory suggests would be optimal), this bias is decreasing over time for financial institutions. The actions of international investors who seek the best risk-return profiles in an increasingly integrated international financial system have fundamental effects on the ability of governments to pursue independent policy objectives. In particular, they impact directly and forcefully on the determination of exchange rates, they influence the levels of national income and employment, and they may eventually curtail the potential benefits of international diversification.

In this paper, we review the theory, evidence, and implications of international equity market integration. The literature is sufficiently vast that we cannot be fully inclusive of all articles published on the topic. Indeed, the task is even more daunting when one considers that equity market integration is but one facet of capital market integration, itself a subset of economic integration. Instead, we focus here on the seminal and most influential papers that have been written on the issue of equity market integration among the world's developed markets. This makes sense in the context of a Special Issue of the *International Review of Financial Analysis* on international equity market integration for two reasons. First, the seminal and influential articles on defining, measuring, and drawing the implications of equity market integration among the developed markets have frequently served as the intellectual base for numerous studies of integration among the developing and emerging equity markets, and between these and the developed markets. Second, the range of papers in this Special Issue covers many of the important developing and emerging market regions including Asia, Central Europe, and Latin America. In addition, while these papers provide reviews of the relevant literature on integration among the developing and emerging markets, no one paper contextualises all the findings presented in this Special Issue. We therefore encourage the reader to seek out the papers in this Special Issue, which provide more comprehensive reviews. In Section 2, we provide a brief description of the common definitions of international financial integration. Section 3 turns the focus of attention to the challenges in measuring the degree of integration among the world's developed equity markets. Section 4 examines the implications of international equity market integration. The final section introduces the papers in this Special Issue.

2. Defining international financial integration

International financial markets have developed rapidly throughout the last four decades. Watson et al. (1988) document this development in terms of internationalisation, securitisation, and liberalisation. In terms of internationalisation, the pace of activity in financial markets has grown faster than real output in the major industrial countries, but this has been accompanied by even faster growth in offshore financial market activity. Concerning securitisation, there has been a move away from indirect finance, through intermediaries, to direct finance through international bond markets. Liberalisation has resulted in the removal of domestic quantity and price restrictions, greater international