Distinguishing Between Financial Openness and True Financial Integration: Results from a Multi-Country Study

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Abstract. The concept *financial openness* is differentiated from that of *financial integration* with a survey of literature, and with reference to country experiences. A ranking is made of different developed and developing countries in terms of various definitions of financial integration, including the Feldstein-Horioka coefficient. It is seen that the ranking is not – by any means – identical for different measures of financial integration. Evidently, mere opening up to capital flows will not bring about financial integration, which will be reflected in interest rate premiums. Tests are conducted for the dependence of the degree of integration on country-specific characteristics such as the degree of decentralization, credit market restrictions, degree of indebtedness, size, and the like.

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1. Introduction

The economic mantra of the 1990s, taught by leading economists and institutions alike, was financial openness and capital account convertibility. The echoes are now dying out after the East Asian crisis and the popular approach prevailing is to go in for a kind of tempered financial liberalization where the flood ports are thrown open only after the domestic economy has been put through the paces of internal financial reforms and judicial prudential regulations.

The point being held aloft is that there are benefits, but also costs associated with financial globalization, and that the costs for the individual economy diminish if the ground is well-prepared prior to opening up.

Put in other words, financial integration is beneficial, just as trade liberalization is, if the sequencing is right – and then it is not just a question of the sequencing of trade and financial reforms. The inference is that financial integration does not mean merely opening up for capital in- and out-flows. Such a distinction between financial 'openness' and 'integration' is strongly made in Le (2000). He argues, in the context of the crises of the 1990s that unstable capital market developments occur when there is a mismatch between financial openness and financial integration. A stable equilibrium can be re-attained if this gap is removed, which can be achieved in quite different ways. Malaysia tackled such a problem of financial imbalance by placing restraints on capital movements so that the degree of financial openness was cut down towards the level of financial integration. On the other hand, Thailand and Korea took the harder alternative of undertaking reforms and increasing the level of financial integration to remove the imbalance.

The foregoing discussion implies that a country may find itself at different positions on an international comparison of the extent of financial liberalization depending on which of these two measures of financial liberalization is used. An estimate of financial openness can be obtained by looking at the growth in direct investment and financial flows, and the changes in the regulations – and the barriers – associated with these flows. A measure of financial integration is clearly a more involved one, requiring more information. *This paper makes an attempt to develop and compare indices of financial openness and integration of some 17 emerging or newly industrialized countries.*

It may be noted that even between countries with avowed intentions of a speedy process of financial liberalization, there are considerable differences in actual achievement in this regard. Verdier (1998) makes an enquiry into the characteristics of OECD countries, which have embraced financial globalization most enthusiastically. Some of his results may seem counter-intuitive, but are rigorously derived, and it may be of interest to see whether they are applicable to countries outside the OECD group. This study seeks to distinguish the factors determining the ***degree*** of financial integration in emerging markets. Variables representing the basic economic structure and chosen development paths, as well as characteristics often reflecting political choices or the influence of dominant pressure groups, are tried out. Such a choice of a broad spectrum of variables is especially crucial in a study involving Asian countries among which inter-country differences reign far more than is the case within the OECD family.

The scheme of the study is as follows: The next section makes a comparison of the indices of financial openness and integration, highlighting the fact that the concepts are quite different. This section 2 also includes a brief, but fairly comprehensive survey of earlier work on tests of financial integration. The subsequent sections 3 and 4 conduct tests for the factors that influence the ***extent*** or degree of financial integration, using a sample of 17 emerging economies, working with data for the 1990s. The final section brings together the conclusions and suggestions for further research.