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A STUDY ON FINANCIAL INTEGRATION

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ABSTRACT

Well managed international financial integration promises important benefits. These benefits increase on Investment and the consumption. On the production, integration permits greater international specialisation and facilitates the allocation of scare resources to their most productive uses independent of location, thereby accelerating growth. On the other hand, the consumption, integration allows individuals to insure themselves against adverse developments in their home economy through international portfolio diversification and by tapping global capital markets to smooth temporary declines in income. Can integration permanently raise growth rates the opening economy, or even in the world economy? Any permanent growth effect must come through an increase in world saving rtes or faster productivity growth. There is little reason to believe that integration boost world saving rates. Indeed, a decline is more likely, since diversification of income risk and access to world capital markets to smooth out temporary income fluctuations reduce the need for precautionary savings. Any permanent gains from integration are thus more likely to come through the quality rather than the quality of investment.

Key Word:- Integration and Growth, Investment, Productivity, Financial System Spillovers, FDI Spillovers, Prospects for Private Capital Flows, Effects of integration on Domestic Financial systems, Cost of Banking Crises, etc.

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Introduction

Developing countries have become important sources of lending and investment to other developing countries. In years past, most of the capital exported from developing countries found its way to industrial countries, usually to help wealthy individuals safeguard their assets. During the past decade, however, developing countries have become a significant source of Foreign Direct Investment, Bank Lending, etc., for other developing countries. This expansion in South–South capital flows reflects developing countries' increasing integration into global financial markets. As developing countries' incomes rise and their banks and firms become increasingly sophisticated, it is natural that they should become more important sources of foreign lending and investment and that a portion of these flows should go to other developing countries. At the same time, South–South capital flows may have implications for developing-country recipients that differ from the implications of capital flows coming from rich countries. The purpose of this chapter is to present data on this growing trend and to evaluate its implications for development. The principal issues are (i) the forces that have propelled South–South financial integration, and (ii) the differences between South–South interactions and financial integration between developing and high-income countries.

Integration and Growth

Integration is a phenomenon in which financial markets in neighboring, regional and/or global economies are closely linked together. Various forms of actual financial integration include: Information sharing among financial institutions; sharing of best practices among financial institutions; sharing of cutting edge technologies (through licensing) among financial institutions; firms borrow and raise funds directly in the international capital markets; investors directly invest in the international capital markets; newly engineered financial products are domestically innovated and originated then sold and bought in the international capital markets; rapid adaption/copycat of newly engineered financial products among financial institutions in different economies; cross-border capital flows; and foreign participation in the domestic financial markets.

Because of financial market imperfections, financial integration in neighboring, regional and/or global economies is therefore imperfect. For example, the imperfect financial integration can stem from the inequality of the marginal rate of substitutions of different agents. In addition to financial market imperfections, legal restrictions can also hinder financial integration. Therefore, financial integration can also be achieved from the elimination of restrictions pertaining to cross-border financial operations to allow (a) financial institutions to operate freely, (b) permit businesses to directly raise funds or borrow and (c) equity and bond investors to invest across the state line with fewer [or without imposing any] restrictions.[1] However, it is important to note that many of the legal restrictions exist because of the market imperfections that hinder financial integration. Legal restrictions are sometimes second-best devices for dealing with the market imperfections that limit financial integration. Consequently, removing the legal restrictions can make the world economy become worse off. In addition, financial integration of neighboring, regional and/or global economies can take place through a formal international treaty which the governing bodies of these economies agree to cooperate to address regional and/or global financial disturbances through regulatory and policy responses. The extent to which financial integration is measured includes gross capital flows, stocks of foreign assets and liabilities, degree of co-movement of stock returns, degree of dispersion of worldwide real interest rates, and financial openness. Also there are views that not gross capital flows (capital inflow plus capital outflow), but bilateral capital flows determine financial integration of a country, which disregards capital surplus and capital deficit amounts. For instance, a county with only capital inflow and no capital outflow will be considered not financially integrated.

Investment

In a financially closed economy, investment must be funded by domestic savings. The two are matched by movements in the real interest rate the cost of borrowing and the return to savings. Without international capital flows, there can be no presumption that the returns to investment are equal across countries resulting in resource misallocation, on the margin, highly profitable investment projects in some countries may not be undertaken for lack of financing, although lower return projects are funded elsewhere. Financial integration, whether on the national or the international level, serves link between local savings and local investment, allowing savings to run as surely and instantly where it is most wanted and where there is most to be made of it, a water runs to find its levels. Investors are able to borrow and savers are able to lend internationally, thus the global rather than the national interest rate becomes the relevant cost of capital and return to savings. Of course, savings and investment must still match, but they now do so on a global rather than a national scale. Following integration, investment is, under ideal circumstances, reallocated toward the most rewarding projects, regardless of their location, financed by corresponding capital flows seeking the highest risk adjusted returns. World production increases, a gain partly accruing to savers I the less productive economies, who now receive higher returns and partly accruing to firms in the more productive economies, who now enjoy reduced cost of capital.

The new pattern of capital flows depends on the relative return to investment across countries. Extensive research over the last decade has established a by-now-familiar set of characteristics of successful economies, including sound macroeconomic policies and god microeconomic fundamentals. The point is important: it is the relative return rather than the relative development level that drives capital flows; In consequence, financial integration has primarily resulted in capital flows to countries already enjoying high domestic investment levels. Integration thus raises the payoff for establishing good fundamentals; it does not substitute for fundamentals. In consequence, the trend toward integration may, at least temporarily, widen the gap between high and the low growth developing economics, although in the long term this very widening raises the benefits of improving the fundamentals in low growth group.

Can integration permanently raise growth rates I the opening economy, or even in the world economy? Any permanent growth effect must come through an increase in world saving rtes or faster productivity growth. There is little reason to believe that integration boost world saving rates. Indeed, a decline is more likely, since diversification of income risk and access to world capital markets to smooth out temporary income fluctuations reduce the need for precautionary savings. Any permanent gains form integration are thus more likely to come through the quality rather than the quality of investment.

Productivity

Integration my boost productivity growth by shifting the investment mix toward projects with higher expected returns, a shift brought about by an improved ability to reduce and to diversify the higher risk typically entailed in higher return projects. The risk of any particular investment can conceptually be divided into four parts: a global component, a national component, a sector component and a component specific to the particular investment. The sector and the project specific risks can be diversified domestically, resulting in sizable benefits from the national financial integration typically preceding international integration. Global risks by their nature cannot be diversified away. This leaves national risk, which cannot be diversified within a country but can be diversified internationally.

If national shocks are a quantitatively important part of the overall risk of investment projects, the diversification benefits obtained by adding another domestic investment project to a portfolio of other domestic projects are lower that the benefits of adding the same project to a portfolio of internationally diversified projects. In consequence, a foreign investor can pursue projects with higher project risks and returns while keeping portfolio risk to an acceptable level. A move from a system of closed national economies to an integrated world economy thus permits a global switch toward projects with higher expected returns, thereby increasing the average world growth rate. The effect is reinforced if integration also permits a reduction in project risk.

The quantitative significance of a switch to higher return investments in the wake of integration depends on three factors, the technological lag of a particular country, risk aversion, and the speed with which existing capital can be reallocated. Very large magnitude of gains reflects the magic of compound interest even small increases in growth rates have first order level effect over time. For the economies lagging farthest behind current best practice the gains comprise both catch up and the global efficiency gain, while the leading economies benefit from only a latter change. Yet even for these economies the benefits of higher output, and hence consumption growth rates, are very significant a well managed integration is a win win situation.

The equalization of returns across countries and the higher growth rate resulting from a globally more productive capital stock provide the long term benefits of integration proper. In addition provides more immediate benefits through knowledge spillovers, particularly in financial markets and via FDI. While these benefits are not strictly dependent on financial integration, integration tend at least to accelerate the knowledge transfer.

Financial System Spillovers

The cost of capital to the end borrower consists of four components, the real interest rate on minimum risk liquid assets, the risk premium imposed by the financial intermediary for financing particular ventures, the cost structure of the financial system and the profit margin charged. Integration affects all four components. Integration replaces the local with the world interest rate and reduces the risk premium to the extent that foreign lenders can better diversify the country risk. The other components the cost structure of the financial system and the profit margin are also affected if integration enhances the depth of the financial system or its competitiveness.

Beyond the effect on the cost of capital, a deepening of the domestic financial system in the wake of integration also aids growth through a more efficient allocation of resources, in turn leading to further financial deepening. This positive feedback lop between financial and real development is well established. International integration a likely to augment the feedback. Foreign financial institutions will introduce or create access to new financial investments, while participation of foreigners in domestic securities markets enhances liquidity, in turn facilitating long term maturity transformation.

FDI Spillovers

International financial integration also opens the door to both inward and outward FDI, which may influence growth through three channels. First, FDI may increase the total volume of investment in the recipient economy, second, even if it substitutes for rather than augments domestic investment, it may be more productive than the capital it replaces. Third, it may generate spillover effects that raise the productivity of exiting domestic capital.

FDI thus effects growth in two ways, by contributing to the volume of investment and by helping to improve efficiency. The primary growth impact comes through improved efficiency rather than an increased quantity of investment. In this context, however, three caveats must be kept in mind. First, the quality effects are self eliminating, as domestic practices are adjusted, the scope for additional spillover benefits decreases. Second, the evidence strongly suggests the FDI follows rather than initiates growth. The benefits from FDI, much like the financial market benefits to integration, are thus more likely to butters existing virtuous cycles than to originate new ones, integration magnifies the benefits of good fundamentals, it does not substitute for them. Third, the net effect of FDI on growth will differ across recipients. In highly distorted economies, FDI may primarily exploit domestic rent extracting opportunities, in economies with functioning markets, relative returns are more likely to channel FDI to bottlenecks, with substantially greater benefits.

As a result, the financial integration of developing countries is expected to deepen and broaden over the coming decade, against a backdrop of increasing global financial integration. Indeed, given the changes that are taking place at the international level in particular, the rapid advances in technology, communication s and financial innovation and the growing economic complexity in developing countries, the progressive financial integration of the latter in world financial markets appears inevitable. Gross private capital flows may therefore be expected to raise substantially, with capital flowing not only from industrial to developing countries, but increasingly, among developing countries themselves and from developing to industrial countries.

Aggregate net private capital flows to developing countries are likely to be sustained in the short to medium term because of the continuing decline in creditworthiness risks and other investment risks, the higher expected rates of return in developing countries and the fact that these countries are underweighted in the portfolios of institutional investors. The rate of growth, though, and eventually the levels will inevitably decline. There will probably also be considerable variation among countries, depending on the pace and depth of improvements in macroeconomic performance and creditworthiness. In fact, in countries where economic and policy fundamentals are quite weak, the initial manifestation of growing financial integration may take the form of net outflows of private capital.

In the international environment, three factors in particular are seen as having the potential for creating significant volatility in private capital flows to developing countries.

1. Movements in international interest rates and other asset returns especially movements in industrial country stock markets. Private capital flows to emerging markets are considered to be

particularly affected by changes in these factors because investors regard these markets as marginal.

2. Investor herding behaviour. The new investor base in developing countries dominated by institutional investor is widely thought to be prone (flat) to herding behaviour, arising from its incentive structure and the relatively limited information available on developing country investments.

3. Contagion or spillover effects, which arises when events in one emerging market causes investors to change their investment decisions in other emerging markets. The likelihood of contagion is also seen to be high in the current international environment, in part because of institutional features in the current investor base.

The structural forces driving private capital flows to developing countries

The structural trends now evident in private capital flows is being driven to two primary forces, higher long term expected rates of return in developing countries and the opportunity for risk diversification.

High expected rates of return

Standard economic theory predicts that if the level of capital stock is relatively low, then other things being equal the marginal product of capital will be high. If not constrained by the availability of skilled labour, infrastructure and other factors that are complements to capiotal in the product process, therefore, the rate of return to investment will be relatively high in countries with low levels of capital stock.

For the foreign investor, country creditworthiness, or a country's ability to make resources available for external payments is also a vary important determinant of the overall rate of return to investment. In the mid 1980's the macroeconomic performance and creditworthiness of many developing countries started to improve again and this trend accelerated in the early 1990's. Developing countries that have been the major recipients of private capital have seen decline in inflation, higher growth of output and exports, and higher and more productive investment. The more stable domestic macroeconomic environment has in turn, improved prospective rates of return to investment in general, while the growth in earning capacity and reduction in the stock of external liabilities in many of the heavily indebted middle income countries has reduced country risks for the foreign investors. Many of these countries have also seen a significant growth in the skilled labour force and improvements in supporting infrastructure over the past decade.

Opportunity for Risk Diversification

Te second force behind the structural tend in private capital flows is investors' desire for portfolio risk diversification. Investors can benefit from holding emerging market equities because return in emerging markets tend to exhibit low correlations with industrial country return that is they tend not to move in tandem with those of industrial countries. In general, by holding an asset whose returns are not correlated with the return of another asset, investor can raise the overall return on their portfolio without commensurate increase in risk.

The opportunity for portfolio diversification offered by emerging markets is a relatively recent phenomenon, associated with the 1990's that has developed as capital markets in these countries have depended and broadened.

The Changing enabling environment in industrial countries

The strong response of private capital flows stemmed from changes in the enabling environment in both industrial and developing countries during the 1980s and 1990s. Industrial countries have seen changes in two broad areas. First, in the real sector, increasing competition and rising costs at home, combined with falling transport and communication costs, have heighted firms' responsiveness to opportunities to increase efficiency and reduce costs by locating investments abroad. This is leading to the progressive globalization of production and has spurred the growth of "efficiency seeking" FDI. Second, in financial markets, a self reinforcing process of competition, deregulation technological advances and financial innovations have increased the responsiveness of investors to international investment opportunities. This process is rapidly leading to the linking of domestic markets into one global market.

The changing enabling environment in developing countries

Changes in the enabling environment of industrial countries have meant that economic agents in these countries both firms and portfolio investors have become more responsive to opportunities to earn higher rates of return or diversify risks through international investment. And developing countries have begun to offer investment opportunities as their creditworthiness and rates of return have improved. Concomitant changes in the enabling environment of developing counties have enable these forces to be translated into actual investments.

The most important enabling factors are simply whether private capital is permitted to flow into a country and whether the restrictions on the repatriation of profits and capital are prohibitive. Along with the sharp decline in expropriation risks, the 1980s and 1990s have witnessed a progressive dismantling of barriers to capital account mobility in developing countries. Whereas previously most national investment codes and bilateral investment treaties imposed few restrictions on the recipient countries with respect to market entry, recent laws and agreements have emphasized the free flow of investment. Many of the recent laws and agreements also contain provisions for the settlement of disputes, usually providing for several different mechanisms for their resolute ranging from direct negotiations between the disputing parties to arbitration(negotiation) proceedings in which investors and host states may participate on an equal footing.

The effects of integration on domestic financial systems

The banking system plays a leading role in the process of financial integration nd is one of the main channels through which the benefits of integration materialize. This is so because banks dominate financial intermediation in developing countries and therefore they end up directly or indirectly intermediating a large proportion of private flows. Since and increasing share of private flows is being used by the private as opposed to the public sector in recipient countries, banks are increasingly responsible for its allocation. In addition, in the medium and long term, banks in developing counties can benefits from financial integration by adopting more advanced financial technologies, achieving greater diversification in their portfolios, having access to a larger supply of funds, and realizing efficiency gains derived from economies scale and scope and a higher degree of market competition.

However, the transition toward greater financial integration also involves risks for the economy in general and the baking sector in particular. During the process of financial integration banks will be adversely affected by increased macroeconomic volatility and by structural changes in banking. The main structural changes affecting the banking sector that result from integration are an increase in competition which can erode banks worth, and exposure to new sources of risk that banks may not be prepared to mange properly. Because conditions can change more swiftly and markets can react faster and with increased amounts of funds, the room for maneuver available to policy makers is significantly reduced in an integrated environment. The weaker the initial conditions in the banking sector and in the macroeconomic are in integrating economies, the grater the challenge for policymakers. One of these challenges arise because during integration banks are given easier access to funds and are therefore able to expand lending much more quickly, so they can finance a lionger lasting boom in expenditures and asset prices. If initial conditions in the banking sector are weak, banks are likely to extend credit in excess and more risky sectors.

The process of financial integration is usually accompanied in its early stages by a surge in private flows that may increase bank lending and exacerbate macroeconomic and financial sector vulnerability. The surge in private inflows is partly due to improved economic prospects in the recipient country, which, in turn, will increase economic agents expectations. The inflows also often finance a rapid expansion in bank lending and aggregate expenditures, accelerating economic growth and validating agents expectations and cause an increase in asset prices. These effects can reinforce one another, leading to additional borrowing, higher expectations and output growth, and increased levels of expenditures and asset prices. In developing countries with weak infrastructure and regulatory institutions in banking a common condition in many emerging economies the surge in bank lending and the rise in asset prices will be associated with a deterioration in banks portfolios. Poorly managed and supervised banks will tend to invest in highly profitable although risky activities.

An integrating economy is more likely that an autarkic one to experience a boom bust cycle in bank lending and the potential cost associated with such a course higher. This is so because in an integrated environment banks can expand lending more quickly and in larger amounts, circumstances can change more swiftly and markets react faster. All these factors can lead to sift changes in market sentiment and cause large reversals of flows, creating significant macroeconomic and financial sector distress and carrying high economic and social costs. In addition to the direct costs of bailing out failed bank, the sudden loss of liquidity in the banking sector which is more difficult to contain in an integrated environment, can amplify economic downturns. Such distress can set back economic reforms severely. An important challenge therefore, is for a country to maintain or improve the health of the banking system.

CONCLUSION

The aim of this paper was to describe the concept of financial integration, compare the benefits and risks of financial integration and summarize the progress in financial integration. The existing literature offers a variety of definitions of financial integration. However, all of them emphasize that financial integration is the process through which financial systems and financial markets in an economy become more closely integrated with those in other economies or with those in the rest of the world. In particular, we distinguish more opportunities for risk sharing and risk diversification, better allocation of capital among investment opportunities, and potential for higher economic growth. Some economists also consider financial development as a positive effect of financial integration. The financial development reduces asymmetric information, increases the completeness of markets, reduces transaction costs, increases competition and, hence, positively affects the economic growth of countries involved in the integration process.

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