

## **Why Has There Been Less Financial Integration in East Asia Than in Europe?**

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In Europe, one of the most striking aspects of regional integration has been the growth and integration of securities markets. European bond markets have grown explosively, especially since the advent of the euro in 1999. Cross border transactions in government bonds have risen sharply with the emergence of the German bund as a benchmark asset. Bid-ask spreads in the government bond market have fallen to U.S. levels. Corporate bond issues have doubled in less than two years, and the growth of subinvestment bond issues has risen even faster than the total. The story in the commercial paper and unsecured money markets is similar: the volume of outstanding commercial paper rose by a third in the 12 months ending in October 1999 alone, while international banks have been able to book very large money-market deals on a cross-border basis at very fine bid-ask spreads (Eichengreen 2000). Securities markets are consolidating around London and Frankfurt, which are competing for the status of Europe’s dominant financial center. This rapid market integration has raised questions about the viability of Europe’s traditional model of bank-based financial intermediation, causing commercial and investment banks to respond with a wave of mergers and acquisitions, so far mainly within national but, increasingly, across them (as with the acquisition by Spanish banks of the leading Portuguese banking groups and by Swedish intermediaries of some leading Danish institutions).

In Asia, in contrast, regional integration has not had analogous effects in promoting financial integration. As documented in Park (2002), while regional initiatives have produced a substantial increase in intra-regional trade and foreign direct investment in Asia, there is surprisingly little progress toward regional financial integration. Cross border bank credit flows within Asia remain becalmed at low levels. There is no sign of the development of an integrated market in government and corporate bonds. Equity markets have not yet begun to consolidate. If anything, the countries of East Asia have developed stronger financial ties with the advanced economies of Western Europe and the United States rather than developing stronger financial links with one another. This conclusion obtains whether one analyzes the distribution of lead manager by nationality, the source of cross-border bank credit flows, or any one of a number of other indicators of financial integration.

Regional integration in Europe differs notoriously from regional integration in Asia. In Europe regionalism is motivated in part by a desire for political integration that has no counterpart in East Asia. Where Europe has built institutions of transnational governance (the Commission, the Parliament, the Court, and now the European Central Bank), Asian integration is “weakly institutionalized” – it is predicated not on transnational institutions but on intergovernmental agreements that above all respect the sovereignty of the participating states. Integration in Asia is not driven by an alliance of key nations like France and Germany or by a single hegemonic power (the role played by the United States in the Western Hemisphere); it is a more multi-polar process.

All of these are reasons why regionalism in Europe and Asia might take different forms. But none of them obviously explains why both regions have been relatively

successful at promoting the integration of trade and foreign-direct investment flows while, at the same time, their experiences with financial integration contrast so sharply.

This project will analyze the causes of these contrasting experiences and what they bode for the future financial development of the two regions. Is the contrast explicable in terms of the fact that Europe was earlier to begin the process of removing its controls on cross-border portfolio capital flows? Did Europe have better developed regional financial markets at the start of its regional monetary and financial integration project? Is deeper trade and factor market integration due to the Single Market project in Europe, compared to the still more partial and tentative moves toward regional trade integration in Asia? Does Europe's single currency make the key difference through the elimination of exchange risk?

The question of what accounts for the faster pace of regional financial integration in Europe than in East Asia has not been addressed by previous scholarship, to our knowledge. We are aware of the very considerable literatures that have grown up around the issues of financial-market development and integration in both Europe and Asia. But, so far as we know, there has been no systematic cross-regional comparative analysis of the Asian and European cases. (There have been comparisons of exchange rate-cum-monetary-policy options in the two regions – in, inter alia, Bank of France-Bank of Japan 2000 -- but that is a different topic.)

In addition to arranging a series of visits and seminars and a workshop on this topic, we envisage commissioning and undertaking systematic analysis of the direction of cross border financial flows, using Bank for International Settlements data, as a way of more systematically testing the aforementioned hypotheses. BIS data on bilateral flows

of bank credit can be the basis for estimating a modified gravity model of cross-border capital movements (as in Rose 2000, but of finance rather than trade), where flows depend on the size of the economies involved, the economic and physical distance between them, and institutional factors such as their financial development, the presence or absence of capital controls, the participation in a particular regional arrangement, and their choice of monetary-exchange rate regime. The results will have obvious implications for East Asian policies toward the development of financial markets going forward. If Asian policy makers wish to promote the integration of regional financial markets (as is their stated goal), it should be possible to say, on the basis of this research, whether domestic financial development, exchange rate stabilization, monetary unification, or the promotion of other product and factors flows within the region is likely to be the most effective stepping stone.

We think that the idea of a concrete research project, on which some of the core Berkeley faculty and outside faculty will collaborate, distinguishes our initiative from other collaborative projects. We envisage not just a series of seminars and workshops but in addition an ongoing project that promises output publishable in refereed journals.

Our two institutes are well positioned to undertake this collaboration. Their directors have written extensively on the European and Asian cases, respectively. (See Eichengreen 1997 and Pempel 1999.) Other Berkeley faculty from both Economics and Political Science have done research on these cases and can be enlisted in the project: Maurice Obstfeld (Economics) and Andrew Rose (Haas School) on European financial integration, Yingyi Qian (Economics) and Steve Vogel (Political Science) on structural changes in Asian financial markets. (Note that these are only examples of other core

faculty that we plan to involve in the project – along with Eichengreen and Pempel -- not an exclusive list.)

We plan to involve Berkeley graduate students as integral members of the project. Among the graduate students working under the project organizers' direction who will surely benefit from this activity are Julian di Giovanni (writing on mergers-and-acquisitions-related capital flows within Europe), Calvin Ho (writing on the impact of exchange-rate-cum-monetary relationships on the cost of external finance for various classes of European and Asian borrowers), Pipat Leungnareumitchai (writing on the impact of exchange rate changes on Asian financial markets), Russell Green (writing on the political economy of bank regulation in East Asia), and Intaek Han (writing on the politics of deposit insurance in Asia). We envisage a call for research proposals from dissertation students seeking limited levels of financial support for their projects, especially from those willing to add a cross-regional dimension to their research. We also plan to budget limited amounts of funding to pay graduate students at the pre-dissertation stage to work on the component of the program centering on the analysis of BIS data, in the hope of encouraging them to pursue dissertation research in this area.

Admittedly, not all the relevant expertise resides on the Berkeley campus. We therefore plan to involve a few key scholars on the European and Asian cases. On Asia, we have a commitment from Yung-Chul Park of Korea University, perhaps the leading expert on the subject of Asian financial integration. We envisage one or more short visits by Professor Park to the Berkeley campus and his ongoing collaboration on the research project. (Professor Eichengreen and Professor Park will take primary responsibility for and co-direct the empirical component of the project.) We also plan to bring in several

leading European academics working on the subject. These short-term visitors will present seminars jointly sponsored by the two Institutes, as well as speaking to the Economics or Political Science Department.

These visits will occur in Year 1 of the project, commencing in the fall semester of 2002. The research program agreed to in the course of Year 1 will then be completed in Year 2. The results will be presented at a research workshop organized collaboratively by the two Institutes, and suitably revised they will be published in the two Institutes' working paper series.

### **References**

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