EXECUTIVE SUMMARY

1. Background and Objectives

The extent of financial integration of the economies of the region and its relationship with the linkage of the real side of these economies has been an important question in this project. Is money merely a veil behind which the real economy operates in response to "real" stimuli, or does finance drive real behavior? Interest in these linkages was increased by the experience of the Global Financial Crisis (GFC). Yet, there is little theoretical consensus on this issue and also there is relatively little empirical analysis.

Out of our research emerges an interest in a 'grand trade off', concern about which has also been heightened since the GFC. This is the balance between financial integration and the benefits it confers, on the one hand, and the transmission of shocks from the rest of the world and associated threats to financial stability on the other. There is an interest in the direct channels of transmission of such shocks but also the indirect effects, for example, the ways in which financial integration might intensify the direct effects of the transmissions of shocks on the real side of these economies.

Papers prepared for this project explored these questions by examining both macroeconomic indicators on the behavior of the financial and real economies and also by reviewing the microeconomics of the channels of transmission of shocks and the processes of integration.

2. Findings and Conclusions

The study begins with chapters that address the measurement of regional integration compared with the engagement of regional economies with the global economy and how this relates to the aggregate behavior of the economies. This gives a picture of the potential for welfare gains from risk sharing and also the scale of possible costs from financial contagion in more open economies. We then turn to a consideration of the financial sector and the efficiency and performance of banking in the region. This allows a discussion of whether, in the current crisis, the banking sector was an important conduit of financial shock into real (trade and output) behavior. The final set of studies turns to the corporate sector and, using data on firms, examines what type of finance they use, what impact that has on their performance and whether foreign direct investment or ownership structures matter for productivity growth. These studies complete the analysis of both sides of the financial market (lending and borrowing) and give insight into several routes by which finance impacts on corporate behavior. Moreover, because they also include country and policy variables in their analysis it is possible to see where policy can be used to affect outcomes.

Overall the papers indicate there could be substantial gains from further financial market integration. The ability to smooth consumption and income could only grow with greater financial openness. Greater openness is likely to lead to greater regional integration. While the expectation is that integration may raise some risks, in terms of the transmission of shocks from the rest of the world, the work here points to significant scope for welfare gains. It also finds little evidence that financial contagion is a large risk.

The results of this research show that business cycles within the region are not highly correlated and, indeed, are more highly correlated with cycles outside the region. Since symmetric shocks, or symmetric response to shocks, are considered one pre-requisite for monetary union, the region does not seem to meet this criterion. At this stage, the bottom-up strategy appears to be even more important than top-down institution building, such as the creation of regional monetary unions or regional bond markets.

Alongside the results showing the underdeveloped level of risk sharing and insurance against consumption volatility, there is clear evidence of benefit from developing additional mechanisms to allow private agents to access a more diversified set of income sources. Improved openness of financial markets is one mechanism to achieve this. Creating structures from the top down, such as the efforts to develop regional bond markets, may simply be solving problems that are not of the “first-order” in this region.

Companies do not seem currently to demand greater access to bond finance. Their financing choices, while different from other regions, are not different in the way that was claimed as a rationale for building regional bond markets (that is, they are not overly bank financed). Nor do their choices seem to be distorted, in so far as that can be deduced from the finding that the drivers of corporate financing choices are broadly similar in this region to that in other groups of countries. Consumers are not yet even using the international capital markets that exist to smooth their consumption so there is little evidence that they need more such markets within the region.

The work also demonstrates that country-specific factors are generally significant in understanding the processes of integration and their consequences. These studies indicate that the country-level factors most likely to be important are those related to institutional quality. If so, work on institutional quality alongside efforts to open the financial sector might not only add to the degree of integration but also ameliorate the trade-off with the risks of transmission of significant shocks. These results point to the benefits of "bottom-up" work on integration and removing the impediments to integration.

3. Policy Recommendations

The problems that have been identified here – low levels of consumption smoothing, and business cycles that have been quite sensitive to movements outside the region – are better resolved at the economy level. If those problems were resolved and markets became more integrated as a result, then the transfers sought between economies and over time, through structures such as regional bond markets, might also be achieved.

The long-run consequences of the bottom-up approach may well be to shift the parameters of the economies of the region to provide support for new top-down institutions. But while that might be the long-run sequence, top-down institutional innovation is not the immediate priority from the work reported here.

Despite this skeptical finding about large-scale institution building related to financial markets at this stage of the region's development, there remains a rich agenda for regional cooperation.

Within the region, there are not only significant country differences in experiences, but also a wide range of experiences of various sorts of institutional structures in financial markets and their links with local corporate structures. These institutional differences are driving the observed country differences in processes and consequences. Our proposed future research program would exploit these differences in the region and identify more carefully the nature and contributions of country features. That analysis is a valuable input into the design of a capacity-building program for financial integration in this region and between this region and the rest of the world.

In terms of further work, the papers in this collection identify a number of empirical studies to clarify the questions that have emerged in the process of this research. This includes work on measures of integration, the indicators of business cycle movements, further work on the sources of corporate funding, and new indicators of bank efficiency, and others. One theme, however, is the value of identifying more carefully the specific institutional features which are contributing to the observed economy-level variations in results.