



## International financial integration of East Asia and Pacific



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### ABSTRACT

This paper provides a comprehensive analysis of how economies in the East Asia and Pacific (EAP) region have been integrating financially with the rest of the world since the 1990's, using bilateral data on portfolio investments, syndicated bank loans, mergers and acquisitions (M&As), and greenfield investments. Four main messages emerge from the analysis. First, the region is increasingly more connected with itself and with the rest of the world, even relative to GDP. Second, although economies in the North capture the bulk of the region's inward and outward investments, EAP's connectivity with the South has grown relatively faster. Third, EAP is relatively more connected through arm's length financing (portfolio investments and syndicated loans) with the more financially developed North, and through FDI (M&As and greenfield investments) with itself and the South. Fourth, more developed EAP economies have a larger role in EAP's arm's length investments than in the region's FDI.

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### 1. Introduction

The international financial integration of the East Asia and Pacific (EAP) region has captured significant attention in recent years. Part of this interest comes from the fact that EAP has been the region with the highest GDP growth in the world in the past decades, accounting for 29% of the world GDP in 2015, up from about 21% in 1990. As it captured a larger share of the world's income, became more developed, and deregulated its financial markets, EAP has been expected to play an increasingly larger role in international financial transactions along with the *North* (G7 members, excluding Japan, and 15 other Western European economies). But EAP is not alone. The increasing participation of EAP in the global economy is part of a broader trend that includes the *South* (non-EAP and non-North economies). Since the early 1990's, both

EAP and the South have been growing faster than the North and, by now, they account for an important fraction of the world's economic and financial activity (Hanson, 2012; World Bank, 2011, 2013, 2017; UNCTAD, 2013, 2015; United Nations, 2014; WTO, 2014; de la Torre et al., 2015; Broner et al., 2016).

As part of the interest in EAP's role in the world economy, one strand of the literature has concentrated on documenting the international financial integration patterns of the region. A natural way to do it is by analyzing the geographical composition of its investments, which requires cross-border bilateral data.<sup>1</sup> Several papers focus on the comparison of EAP's global and regional financial integration using gravity models (Eichengreen and Park, 2005a; Kim et al., 2008; Garcia-Herrero et al., 2009; Lee, 2010; Borenstein and Loungani, 2011; Pongsaparn and Unterberdoerster, 2011; Lee et al., 2013; Ananchotikul et al., 2015). This literature typically finds that EAP economies maintain stronger financial links with the rest of the world than with other economies within the EAP region. Some of these studies also benchmark EAP's intra-regional financial integration with that of Europe and Latin America and the

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<sup>1</sup> A number of papers have studied the EAP's financial integration process using other alternative measures, such as prices (Eichengreen and Park, 2005b; Chi et al., 2006; Yu et al., 2010; Hinojales and Park, 2011; Boubakri and Guillaumin, 2015), correlation between domestic savings and investment rates (Guillaumin, 2009), and the degree of consumption risk-sharing (Kim et al., 2006; Ng and Yarcia, 2014).

Caribbean (LAC), concluding that EAP lags behind Europe whereas it is comparable to LAC. Because this literature focuses on arm's length investments (either portfolio investments or bank claims), it does not examine the differences in investment patterns across financial instruments.<sup>2</sup>

A second strand of the literature discusses the financial integration of the EAP region in an indirect way, by analyzing the financing of the U.S. current account deficit. This literature examines how several developing economies, mainly Asian and oil exporter economies, have sustained large current account surpluses and have accumulated U.S. financial assets, leading to the so-called "global imbalances" (Bernanke, 2005; Clarida, 2005; Chinn and Ito, 2007; Gruber and Kamin, 2007; Caballero et al., 2008; Cooper, 2008; Adams and Park, 2009; Caballero and Krishnamurthy, 2009; Caballero, 2010; Forbes, 2010; Obstfeld, 2012). In related work, some authors argue that the sustainability of the large U.S. deficit is linked to the fact that the U.S. earns a higher return on its foreign assets than what it pays to foreigners on its liabilities. This return differential can be attributed to the composition of the U.S. external assets and liabilities (Gourinchas and Rey, 2007; Gourinchas et al., 2012). In particular, the U.S. holds foreign direct investment (FDI) and equity as assets, whereas it has low-yield riskless liabilities (Lane and Milesi-Ferretti, 2007, 2015; Mendoza et al., 2009; Milesi-Ferretti et al., 2010; Prasad, 2011; Kubelec and Sa, 2012).

The two strands of the literature mentioned above claim that the relative financial underdevelopment of Asian economies plays an important role in their integration patterns.<sup>3</sup> The first strand argues that Asian economies prefer to invest globally rather than regionally due to their inadequate financial and legal structure, lack of liquidity, low auditing and accounting standards, low transparency, and weak corporate governance. The second strand argues that Asian economies lack enough "safe" assets in which to allocate their excess savings and, therefore, invest in assets from developed economies. But financial underdevelopment can manifest in other forms too, with implications for the geographical composition of a country's external balance sheet. In particular, the higher degree of financial development of the North affects not only its availability of financial instruments for both domestic and foreign savers, but also the sophistication and depth of its financial markets and institutions that are able to invest abroad and diversify risk internationally. Therefore, given these disparities in the development of financial markets, we expect different integration patterns of the EAP region with the North, the South, and itself across the different investment types. Specifically, EAP can be expected to be more connected through arm's length financing with the North, and in relative terms more connected through FDI with the South and itself.

This paper contributes to the discussions in the literature by providing a comprehensive analysis of how EAP economies have been financially integrating across borders using different types of financial investments in an integrated framework. To do so, we assemble a novel dataset encompassing bilateral cross-border portfolio investments, syndicated loans, mergers and acquisitions

(M&As), and greenfield investments (the latter two jointly known as FDI) between 1990 and 2014. We then analyze EAP's connections with itself, the North, and the South. This helps us complement our understanding of where EAP stands in its financial integration process across all types of commonly used cross-border financial investments, taking into account all regions of the world. The bilateral dimension of our dataset allows us to analyze the financial integration process along the intensive margin (value of cross-border bilateral investments) and the extensive margin (number of connections/partners), as well as contrast EAP's connectivity with the North vis-à-vis the South. It also helps us shed light on whether financial development (and economic development more generally) might explain the broader patterns of EAP's integration.

Although the paper contains several facts about EAP's international financial integration, four main related messages emerge from the analysis and can be summarized as follows. First, the EAP region is increasingly more connected with itself and with the rest of the world in terms of portfolio investments, syndicated loans, and M&As, even relative to GDP. Moreover, the gravity model estimates indicate that the degree of EAP's financial integration is typically greater than that of South regions along both the intensive and extensive margins.

Second, EAP's connections with the South have grown relatively faster than those with the North, due to expansions in both the intensive and the extensive margins. Nevertheless, the North remains by far the main source and destination of EAP's investments to and from the rest of the world (EAP's inter-regional investments). The EAP's intra-regional investments are of considerable size, too. In fact, they are larger than those with the South, and for some investment types they are as large as those with the North.

Third, in relative terms, EAP economies are more connected intra-regionally and with the South in FDI, whereas they are more connected with the North in arm's length investments. The differences in EAP's financial integration patterns across investment types can be related to the relatively less developed EAP's and South's financial markets vis-à-vis those of the North.

Fourth, more developed EAP economies (as measured by their GDP per capita) account for the bulk of the value of EAP's intra- and inter-regional investments, though their dominance in the process of EAP's financial integration is more subdued along the extensive margin. They also have a larger role in the region's arm's length investments (resembling integration patterns of North economies), whereas less developed EAP economies have a larger participation in the region's FDI (integrating in a way similar to that of South economies).

Taken together, our findings expand the literature on EAP's international financial integration in several ways. First, although we find that the EAP region is more financially integrated with global markets (North and South together) than with regional ones (consistent with previous research), the results change when we analyze EAP's integration with the North and the South separately. EAP's intra-regional investments are actually larger than those with the South for all investment types, whereas they are smaller than those with the North in arm's length investments but equal or greater in FDI. Second, we confirm that EAP is more intra-regionally integrated (both in terms of value and connectivity) than LAC, but we also find that this result can be generalized to the rest of South regions. Third, the heterogeneity in the level of financial development across EAP economies has important implications on the region's integration patterns. We find that the more developed EAP economies have a larger participation in EAP's arm's length investments than in EAP's FDI, whereas less developed EAP economies are more important when considering the region's FDI. Overall, our findings across types of investments, across regions, and across economies are consistent with the arguments in the

<sup>2</sup> Although a couple of studies examine different financial instruments, they present only graphical evidence and do not explore for instance if the different intra-regional integration patterns across investment types are also observed in EAP's inter-regional investments (Pongsaparn and Unterberdoerster, 2011; Ananchotikul et al., 2015).

<sup>3</sup> Financial markets in the EAP region are typically less developed than those in the North, whereas they are more developed than those in the South. For example, the share of domestic credit to the private sector over GDP was 101% for the average North economy during 1990 and 2014, whereas it was 70% and 29% for the average EAP and South economy, respectively. The share of nonbank financial institutions' assets over GDP was 88%, 27%, and 10%, for the average North, EAP, and South economy, respectively.

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