Économie internationale 111 (2007), p. 5-8.

ÉCONOMIE INTERNATIONALE

MONETARY AND FINANCIAL INTEGRATION IN ASIA: INTRODUCTION

Agnès Bénassy-Quéré[1] & Valérie Mignon[2]

Surging growth and rising interdependence of East-Asian economies during the last two decades have heightened interest in monetary and financial integration. From 1985 to 2005, the share of intra-regional trade in total trade for the South-East and East Asian region (including Japan) grew from 28% to 34%. Around the middle of this period, in 1997, the rapid propagation of the Thai currency crisis over South-East Asia lent urgency to accompanying economic integration with steps toward monetary and financial integration and for jointly improving the quality of financial supervision in the region.

More recently, the sudden drop in Mainland China's stock markets on February 27, 2007 (–8.8%, Shanghai Composite) that was followed by drops on European (–3.0%, Stoxx 600) and US (–3.5%, S&P 500) markets, suggests that China has become a key player in the international financial landscape. On the other hand, when the China market fell 21% over a four day period in early June 2007, it made hardly any waves in these other markets perhaps because a domestic policy measure, an increase in the stock transfer tax to "cool" stock speculation in China, was widely seen as the trigger. Nevertheless, the novelty is that, while Wall Street still exerts an important influence on the other stock markets, asset price fluctuations in emerging economies can now spread to the US market. This illustrates the still growing international financial integration between markets and the important role of East-Asian markets, such as China's.

Meanwhile, governments in the region have recognized the need to develop a regional capital market in order both to reach a critical size fostering lower costs and to reduce financial vulnerability through reduced reliance on extra-regional financial intermediaries. The "Asian Bond Markets Initiative" launched in December 2001 by the ASEAN+3 group[3] exemplifies this orientation. On the academic side, there has been intensive research on these issues. Several papers were presented during the international conference on "*Opening and innova-*

1. Agnès BÉNASSY-QUÉRÉ, Director of CEPII (agnes.benassy@cepii.fr).
2. Valérie MIGNON, Professor, University of Paris X, EconomiX-CNRS, and CEPII (valerie.mignon@cepii.fr).
3. ASEAN + China, Japan and South Korea.

tion on financial emerging markets" that took place in Beijing (China) in March 27-28, 2007.[4] *Économie internationale* is pleased to publish a selection of five papers on this topic.

Concerned by the evolution of the Chinese exchange rate regime, Patrick ARTUS aims at answering the following question: can a *de facto* currency board or a hard peg become unstable in China? A currency board is supposed to ensure the stability of the exchange-rate regime. However some features of the Chinese economy seem to contradict this scheme. Indeed, while the Chinese exchange-rate regime is very similar to a currency board[5], its instability is high, in particular regarding the accumulation of foreign exchange reserves. To explain this instability, Patrick Artus proposes a theoretical model in which some factors play a central role: rigidity of interest rates on credits, insufficient reaction of goods supply to variations in real interest rates, lack of international capital mobility and stickiness of prices. Patrick Artus concludes that it is the lack of financial liberalization – due to capital controls and to the rigidity of interest rates – that mainly explains the absence of the stabilizing role of the currency board in China. However, according to him, this does not imply that more liberalization would be better for China: indeed, while Chinese authorities tend to move towards more liberalization, this goes along with an appreciation of the yuan and a rise in asset prices that encourage Chinese people to invest on domestic markets, thereby reinforcing the pressure on the exchange rate.

Moving from money to financial markets, Michel AGLIETTA and Pierre MAAREK investigate the development of the Chinese bond market. First, a broad and deep government bond market is the benchmark for the development of domestic capital markets and therefore for the financial opening of the country. This stage of financial reform will make monetary policy more effective *via* more straightforward transmission mechanisms. Second, the priority for social welfare embedded in the new line of economic reform will spur the expansion of fiscal expenditures, leading to the growth of a still modest public debt. Third, the high domestic saving (46% of GDP) will benefit from a more diversified asset allocation. Therefore, the domestic bond market will play a key role both in financing productive investment and channeling household wealth accumulation, a process that will lead later to more broadly-based consumption. Meanwhile the saving rate will likely decline, especially since population is aging. To investigate the path to an older society, the authors rely on *Ingenue 2* model, which is a worldwide overlapping computable general equilibrium model aiming at simulating the economic consequences of aging. They simulate the impact of pension reform as announced by the National Security Council and show that the saving rate should gently

4. The conference was organized jointly by the following institutions: Centre d'Economie et de Finances Internationales (CEFI), Centre d'Etudes Prospectives et d'Informations Internationales (CEPII), groupe Caisse d'Epargne Paris (CNCE), IXIS Corporate and Investment Bank, Réseau Inter-Universitaire de Recherche en Macroéconomie Financière (MACROFI), TX Investment Consulting Co Ltd Beijing and the French Embassy in Beijing.
5. This similarity of the Chinese exchange-rate regime to a currency board comes from the strong link between foreign exchange reserves and money supply.

decline to 2050, together with a decrease in the real long-run interest rate. Overall, according to Michel Aglietta and Pierre Maarek, well-organized bond markets will become the fulcrum of financial integration in East Asia.

Reconsidering what we know about the link between financial development and the structure of growth by manufacturing industry sector, George von FURSTENBERG and Ulf von KALCKREUTH first derive representative measures for manufacturing sectors' dependence on external finance (DEF). One original feature of their work is that it taps into a rich government database of aggregate US industry-level data not previously used for financial analysis. These data allow derivation of annual DEF values for 21 manufacturing sectors for each of 21 years that can be compared with DEF measures obtained by Rajan and Zingales (RZ) in their seminal 1998 *American Economic Review* paper. RZ report the median of the decadal values of DEF constructed for exchange-listed US firms in each sector. Their paper was very influential in the literature: Its methodology has been adopted in numerous studies of developing countries in order to evaluate the influence of their domestic financial development on the distribution of growth over manufacturing sectors, depending on how much they rely on external finance. However, it turns out that the values reported by RZ for the median US firm do not correlate well with the cyclically-adjusted aggregate estimates by sector. More importantly, differences in measures of DEF both within and between sectors can not conclusively be associated with structural-technological factors that would allow the US distribution of DEF values to be interpreted as sufficiently fundamental for application to other countries.

Based on the widespread idea according to which interdependencies and integration intensify during crises, Carlos C. BAUTISTA and Samuel MAVEYRAUD-TRICOIRE investigate the links between various East Asian economies before and after the 1997 crisis. More specifically, they study the potential effects of the crisis on the degree of financial integration between East-Asian countries. To this end, they retain the Feldstein-Horioka framework which considers a measure of financial integration based on the relation between domestic saving and domestic investment. The underlying idea is straightforward: in the case of perfect financial integration, there should be no relationship between domestic saving and investment. In other words, when regressing the domestic investment rate on the domestic saving rate, the slope coefficient should be equal to zero for perfect financial integration. Along this line, a large number of studies have attempted to investigate the relationship between investment and saving; many of them finding a high correlation between the two domestic variables despite the presence of international capital mobility. This result is known as the Feldstein-Horioka puzzle. Carlos C. Bautista and Samuel Maveyraud-Tricoire attempt to solve this puzzle by allowing the presence of structural shifts in the relationship between the two variables. Using Markov-switching models for various East Asian countries, they show that periods with relatively low estimates, *i.e.* with high capital mobility, are associated with current account surpluses. Hence, the switches from one state to the other are interpreted as movements of saving and investment to satisfy the intertemporal budget constraint by each country.

In the last contribution of this volume, Stéphanie PRAT investigates the impact of currency mismatches on changes in emerging sovereign bond spreads. She controls for standard macroeconomic and external variables that are found relevant in the literature on emerging bond spreads. Using a rich database, she derives a set of indicators of currency mismatches, both at the aggregate level and for the banking sector. Twenty-five emerging countries are considered over the 1993-2005 period. By including her currency mismatch indicators in the standard models of emerging yield spreads, Stéphanie Prat puts forward their key role. Indeed, the analysis indicates that these indicators play a significant role in the determination of emerging sovereign bond spreads, showing that (*i*) banking sector currency mismatch indicators are significant in determining country risk premium and (*ii*) the debt structure of the banking sector is of a great importance. Overall, the conclusion is that currency mismatch indicators have to be considered when studying the vulnerability of emerging markets in order to derive robust results.

A. B.-Q. & V. M.