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International Financial Integration

Brian M. Lucey

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Special Issue

International Financial Integration

Editorial

Institutions and institutional structures are boundary conditions for finance. Since the pioneering work of La Porta et al. (1998), economics and finance have begun to rediscover the importance of considering not just what the markets are doing but the settings within which these markets operate. At a macro-level we see increasing evidence of the importance of the design of institutions and in the wake of the 2007-8 crash a renewed interest in the importance of institutional capture and independence. At a more micro-level the same crash has refocused discussion of whether or not some institutionally imposed “speed bumps” on the free operation of the markets may be beneficial in the longer term.

The seven papers in this special issue of the Journal provide readers with a tour of the horizon and boundaries of these issues. Three strands can be elaborated from these papers; the examination of high frequency integration, the importance of institutions in mediating the integration experience, and the role of ownership in an integrating world. The papers here were selected from among the 150 presented at the 6th INFINITI conference on international financial integration, held in June 2008 at Trinity College Dublin.

Akram et al. and Logoarde examine how we conceive of integration when we consider high frequencies. Much of the extant research on integration concerns itself with longer runs of lower frequency data and it is still somewhat unusual to find high frequency studies. Akram et al. examine the law of one price, a fundamental condition of integration modelling, in the context of a very large sample of tick level currency swap data, several millions of observations over the spring and summer of 2004. They examine one-way arbitrage, which implies a restriction due to financing requirements, as opposed to the more conventional round trip arbitrage. Examining these one way deviations from the law of one price in the currency markets they find persistent opportunities for economically meaningful profits. Analysis of these indicates that market institutional features are most probable causes of these deviations. Logoarde focuses on daily data, but in the context of 28 emerging markets. Using a variety of liquidity measures and efficiency measures, he shows that volatility and efficiency drastically fall in times of crisis, the falls being higher than found in developed markets. In addition, the crucial import of institutions is reiterated, with internal market developments to deepen and make more transparent market making having a beneficial effect, reducing transactions costs. In particular, the enforcement of insider trading and improved automation act to improve efficiency but perhaps at the cost of higher volatility. Sequencing of particular reforms is important.

The second set of papers takes a broader canvas, looking at institutions per se, the determinants of banking entry and the potential role of currency unions. Aggarwal and Goodell look at the direct and indirect effect of institutions. In particular, they examine the determinants of national preferences for styles of intermediation, markets versus institutions. Looking at how structural, cultural, governance and regional variables

interact, they find that regulatory quality and political stability are strongly impactful of choices for market based systems, while countries that have cultures where uncertainty avoidance is high are associated with bank and institutional based systems. The use of a wider range of institutional measures as well as more recent and more inclusive measures results in their finding that legal origin is not important, a finding that is becoming common when institutional measures are used. Lehner approaches the issue of institutional quality via an examination of the decision to make greenfield or other forms of market entry for banks. The finding is that the less developed and smaller the entry market the more likely the MNC bank is to enter via a non-greenfield approach, such as cross border lending or acquisition. It is important to note that the paper is theoretical, but generates several testable hypotheses that should prove fruitful. Qin examines the potential for a supranational institution, a currency union, in the ASEAN region. Using simulations and analyses the finding is again indicative of the importance of institutions, a currency union. The proposed currency union would, it is claimed, reduce intraregional shock transmission and volatility while strengthening trade.

The papers by Knyazeva et al. and Dow form a third set, where the interrelated issues of ownership, control and effects of globalisation are examined. Knyazeva et al. examine this in the context of the privatisation of telecom companies globally, while Dow approaches it from the perspective of how different forms of *keiretsu* in Japan fare across the international business cycle. Dow finds that in periods of international economic weakness *keiretsu* members act in a manner where stronger members prop up weaker, but that while this acts to overcome capital controls it is at the expense of future profit tunnelling. The authors suggest that the evidence is indicative of intertemporal tradeoffs where in times of economic crisis present profitability is smoothed between the members at the expense of greater volatility in more expansionary times. Knyazeva et al. follow a significant body of literature in looking at privatisation and find results that are in general in line with the body of knowledge. However, they find that while ownership changes are beneficial at a firm level in terms of increased profitability and productivity, these are dominated by institutional and regulatory elements at country level. This finding of the importance of institutions of course resonates throughout the papers here.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R.W., 1998. Law and finance. *Journal of Political Economy* 106 (6), 1113-1115.

Brian M. Lucey
School of Business Studies
Trinity College
College Green, Dublin 2
Ireland
brianmlucey@gmail.com