Bank Competition and International Financial Integration: Evidence Using a New Index

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Summary

In the debate on the benefits and costs of international financial integration recent literature has emphasized thresholds in the development of domestic markets as preconditions to benefitting from international integration. This paper offers an alternative view - that of development of competition in domestic markets as an aide to de-facto openness. Lack of competition in domestic financial systems may prevent countries from reaping the benefits of international integration simply because they prevent countries from being integrated in a meaningful way - that of price equalization. Using a new index of de facto financial openness, this paper explores the trends in and determinants of cross border integration of interbank markets. This index was introduced in Pasricha (2008)[1] and captures the size of deviations from covered interest parity as well as the speed of reversion to the no-arbitrage band. The index is constructed using a SETAR model on a yearly basis for 54 countries for an average of 13 years per country. The results indeed confirm a strong link between lack of financial sector competitiveness (banking and non-banking) and lack of price convergence, particularly for low and middle income countries. Capital controls explain only a small part of deviations from covered interest parity. Crisis periods and periods of greater volatility see lower de facto integration.

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[1] Gurnain Pasricha (2008), *Financial Integration in Emerging Market Economies*, Department of Economics, University of California at Santa Cruz Working Paper No. 641.