Comments on
“Financial Integration in
Emerging Market Economies”

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Main points

- Very nice paper on an important topic
- Very nice application of the data
- More work welcomed in different directions
Main points

- Clarify analysis, findings, and contribution
  - Compare integration with other estimates
- Give additional twist to the analysis
  - Some comparison of integration that gives an edge
    - More integration now than before?
    - Comparison with developed countries then and now?
  - More detail on factors that affect integration
  - Identify factors more clearly for testable implications
    - Crises
    - Capital controls
    - Default risk
    - Currency risk
- Some examples of these points follow
Rest of the comments

- Highlight what measure the paper studies
- Type of analysis that could be done in more detail
- Some of the issues in need of more clarifications
Rest of the comments

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What measure the paper studies

Forward discount (fd)

\[ \delta_t = P \left( \frac{F_{t+k} - S_t}{S_t} \right) \underbrace{\delta \ + \ \{ i_{t+k}^\epsilon - i_{US}^\epsilon \}}_{\text{Foreign - US}} = 0 \]

\[ i_{t+k}^\epsilon = i_{US} - P \left( \frac{F_{t+k} - S_t}{S_t} \right) \]

\[ \delta 0: \text{Expected appr.} \]

\[ \delta 0: \text{Exp. depr.} \]
What measure the paper studies

- “Broad” CIP

\[
\left( i_{t+k}^P, Arg - i_t^{Doll, US} \right) = \left( i_{t+k}^P, Arg - i_t^{Doll, Arg} \right) + \left( i_{t+k}^{Doll, Arg} - i_t^{Doll, US} \right)
\]

Curr. risk

Country risk

\[
-P \left( \frac{F_{t+k} - S_t}{S_t} \right) \neq \left( i_{t+k}^P, Arg - i_t^{Doll, Arg} \right) + \left( i_{t+k}^{Doll, Arg} - i_t^{Doll, US} \right)
\]

\[ \neq 0: \text{Exp. depr.} \]

Curr. risk

Country risk
What measure the paper studies

Paper tests failure of CIP

Factors

- Transaction costs - spreads
- Capital controls (existing or anticipated)
- Reserve requirements

Many more factors

- Default risk (issuer risk)
- Confiscation risk (jurisdiction risk)
- Dual agency problems
- Forward contracts in both markets
- Liquidity
- Who does the arbitrage
What measure the paper studies

- Paper uses different instruments involved in CIP
- Has problems to capture financial integration
- Using same assets like bonds or equity has some advantages
  - Identical assets, identical risks
- But some drawbacks in terms of data coverage
Rest of the comments

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FD and arbitrage bands

Argentina: CIP as crisis approached

Case 3: \[
\left( \frac{i_{t,k}^{\text{borrowing-offshore}} - i_{t,k}^{\text{deposit.*}}}{i_{t,k}^{\text{deposit-offshore}} - i_{t,k}^{\text{lending.*}}} \right) \leq fd_{t,k} \leq \left( \frac{i_{t,k}^{\text{deposit-offshore}} - i_{t,k}^{\text{lending.*}}}{i_{t,k}^{\text{borrowing-offshore}} - i_{t,k}^{\text{deposit.*}}} \right)
\]

upper band \quad lower band

[Graph showing NDF discount from 9/9/1998 to 9/9/2001]
Argentina: controls on outflows and inflows

Prem-fit = 2.28** return + 5.38*** control_out - 0.89*** control_in + 12.73 control_out*return - 2.22 control_in*return

(2.39) (0.05)
Korea: quantitative controls on inflows

ADR Cross-market premium
Chile: tax on capital inflows

ADR cross-market premium
Russia: crisis

ADR cross-market premium
Rest of the comments

- Highlight what measure the paper studies
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More clarifications

- Better clarify analysis and substantiate some of the statements
- Links to the literature on both developed and developing countries
- What data are exactly used?
- Why are bandwidths so different for 1-month and 3-month rates?
More clarifications

Measure of financial integration

- What is the benefit of using a combined measure that has several indicators?
  - Bandwidth
  - Percent out
  - Median deviation
  - Continuous runs outside
- Is this what the literature does?
- These measures are related
- What about speed of convergence?
- What about using only one aspect like the bandwidth?
  - The rankings do not seem to be always the same
More clarifications

Correlations with indexes of financial integration
- What is expected?
- More correlation with de-facto or de-jure measures?
- What type of measures are the relevant ones?
  - LMF?

Controls: why only affect one band?
- Case of capital inflows: tax paid when entering country
- Expected appreciation not priced in (i* not low enough)
  - Foreign investors don’t come in because of the tax
- Expected depreciation (i* not high enough)
  - Foreign investors don’t come in
  - Domestic do not necessarily leave if they pay tax upon return
More clarifications

- Use of AR vs. TAR
  - How powerful and valid are the non-linearity tests?

- Crises
  - “Crisis period:”
    - Is definition optimal?
    - What is the beginning and end?
  - Effect?
  - Why not test effect?
  - Why considering only non-crisis periods?
  - Relation to spreads (in equity markets)
Evolution of Bid-Ask Spreads - SM crisis

\[ \mu = 0.017 \]

\[ \mu = 0.026 \]
Thank you