# Financial Integration

It's a phenomenon where financial markets in neighboring, regional or global economies are closely linked together - for example, through cross-border capital flows, foreign participation in the domestic financial markets, and information sharing among financial institutions. Legal restrictions can sometimes hinder financial integration.

## Types of Financial Integration

Financial market integration manifests itself in three major formats: functional, regional, and international.

**(a) Functional financial integration** has lessened the operational identities among those financial institutions with formerly distinct product lines, such as commercial versus investment banks, savings and loan associations, insurance companies, postal offices, and consumer credit companies. Policies towards despecialization and diversification of financial services and products which banks and other financial institutions are allowed to offer, were generally more important in countries with historically more segmented financial systems than in countries with more open and homogeneous systems.

**(b) Regional or geographical financial integration** has also been accelerated by the technological progress in the financial system. Widespread installation of automated teller machines (ATMs) provides a powerful weapon for commercial banks to overcome any barriers to interstate branching. Technological breakthroughs in computers and telecommunication make it possible for a financial institution to more easily gain access to the previously blocked market regions. Furthermore, the "regional branch networks" have been increasingly adopted in the United States whereby neighboring states collectively allow branching by each other's commercial banks on a reciprocal basis. Thus, banks in Virginia, Maryland and the District of Columbia can now establish banking establishments freely within the tri-state region. The same is true for the banks in the New England states as well as in the South Eastern states of Florida, Georgia, South and North Carolinas, etc. In some developing countries such as Indonesia and Pakistan, commercial banks are more freely allowed to open branches nationwide outside their traditional banking markets, thus accelerating the trend toward geographical integration in financial services.

**(c) International or cross-border financial integration** is perhaps the most significant financial integration. In fact, among the most noteworthy financial market developments during the recent decades has been the trend toward internationalization, financial innovation, and securitization. While all these three developments interact among each other, internationalization has been instrumental in providing a fertile ground for financial innovation and securitization. The degree of international financial integration can be seen by various measures to facilitate a free flow of capital and financial services across national boundaries.

## Adverse effects

Financial integration can also have adverse effects. For example, a higher degree of financial integration can generate a severe financial contagion in neighboring, regional and/or global economies. In addition, Boyd and Smith (1992) argue that capital outflows can journey from capital-poor countries with weak institutions and policies to capital-rich countries with higher institutional quality and sound policies. Consequently, financial integration actually hurts capital-scarce countries with poor institutional quality and lousy policies.

## Recent Development

During the past two decades, there has been a significant increase in financial integration; this increased financial integration generates a great deal of cross-border capital flows among industrial nations and between industrial and developing countries. In addition, this increase in financial integration pulls global financial markets closer together and escalates the presence of foreign financial institutions across the globe. With rapid capital flows around the world, the currency and financial crises in the late 1980s and 1990s were inevitable. Consequently, developing countries that welcomed excessive capital flows were more vulnerable to these financial disturbances than industrial nations. It is widely believed that these developing economies were much more adversely impacted as well. Because of these recent financial crises, there has been a heated debate among both academics and practitioners concerning the costs and benefits of financial integration.