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To cite this article: Ahmad Zubaidi Baharumshah , Chan Tze Haw , A. Mansur M. Masih & Evan Lau (2011) Financial integration of East Asian economies: evidence from real interest parity, Applied Economics, 43:16, 1979-1990, DOI: [10.1080/00036840902902243](https://doi.org/10.1080/00036840902902243)

To link to this article: <https://doi.org/10.1080/00036840902902243>



Published online: 22 Oct 2009.



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# Financial integration of East Asian economies: evidence from real interest parity

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In this article, we investigate the financial linkages between the East Asian economies with Japan and the United States. We test for long-run Real Interest-rate Parity (RIP) using an array of panel-data techniques, including recent techniques developed by Breuer *et al.* (2002) and Carrion-i-Silvestre *et al.* (2005). This study offers two important results: first, the failure to account for structural breaks in the industrialized countries and Asian emerging economies is likely to provide evidence of nonstationary series that are stationary. Second, we found strong evidence that the parity condition holds in all the Asian countries. The failure of earlier studies to confirm mean reversion of Real Interest-rate Differential (RID) may reflect the choice of estimation/testing procedure rather than any inherent deficiency in the RIP.

## I. Introduction

The extent to which rates of real interest are connected across countries, and how these linkages have progressed over time, especially in the last two decades, have gained considerable attention in the literature (Fraser and Taylor, 1990; Anoruo *et al.*, 2002; Holmes, 2002; Pipatchaipoom and Norrbin, 2008; to name a few). Real Interest-rate Parity (RIP) requires good and financial market arbitrage and its confirmation is viewed as an indication of macro-economic convergence (Frankel, 1991). There are a number of different measures of financial integration

besides RIP. In this article, the price based measure is employed to check for financial integration. For quantity based measures, we need to look at net capital flows from one country to another. The argument here is that for financial integration, there ought to be a sustained evidence of sizeable cross border transactions in financial assets (measured by the ratio of capital flows to Gross Domestic Product (GDP)).

From the perspective of the East Asian countries, the interest has been fueled by the emerging consensus that joint development agreements are best served through close economic cooperation

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