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From Various Degrees of Trade to Various Degrees of Financial Integration: What Do Interest Rates Have to Say?

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NON-TECHNICAL SUMMARY

The second half of the 20th century has been characterized by the rise of regional trade agreements (RTAs) along with the worldwide trend of removing trade barriers within the General Agreement on Trade and Tariffs (GATT) negotiations. The trade creating (within the considered trade unions) and trade diverting (with the rest of the world) effects associated with regional trade agreements, have been extensively studied in the literature, relying on the wellknown gravity equation.

Alongside with this literature, another strand of research emphasizes that trade integration goes along with financial integration. As stressed in Eichengreen and Park (2005), it seems indeed that "finance follows trade".

To our best knowledge however, it has never been tried to investigate the impact of this parallel integration in trade and financial flows on asset returns. This seems especially important in the sense that RTAs are characterized by various degrees of trade integration and consequently, of financial integration. These differences should be reflected in the returns of financial assets and primarily in interest rates.

In this paper, we propose a systematic study of the degree of financial integration following the degree of trade integration according to Balassa's (1961) classification, from preferential trading area to complete economic integration. To this end, we exploit all the information contained in interest rates and rely on the expectations hypothesis of the term structure of interest rates (EHTS) and real interest rate parity (RIP). These two conditions are empirically investigated on various regional trade agreements, using cointegration techniques by paying a special attention to potential breaks.

Our results show that customs unions, corresponding to step 3 of the Balassa's classification, seem to be a decisive threshold after which financial integration robustly takes place. Indeed, while EHTS and RIP are not clearly evidenced for preferential trading and free trade areas (such as ASEAN+3, LAIA, and EFTA), both conditions are verified for customs unions such as

ANDEAN, CACM, MERCOSUR and the European Union. On the whole, our results are consistent with Eichengreen and Park's (2005) intuition that "finance follows trade" only after a certain degree of trade integration.

J.E.L. Classification: C22, E43, F15.
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