ABSTRACT

Financial integration is the procedure through which financial markets of an economy are linked with financial markets of other economies or with the rest of the world. In the middle of 1980's financial markets are deregulated which had facilitated huge flow of capital to the Asian countries. This opening of financial markets globally by Asian countries could result in market mechanism which enhances the efficiency of financial markets and invites foreign capital, possibly expanding the integration of financial markets. South Asia is a distinctive and diverse region consisting of countries large as well as small, ruled by different political beliefs. The countries in this area are economically different and at different level of economic development.

Policymakers in all countries, as well as countries that produce large capital movements, should take into consideration how their policies may alter global economic and financial steadiness. Macroeconomic policies like monetary policy and fiscal policy play important role in financial stability during inflow surges.

In this study, monetary policy and fiscal policy are observed among macroeconomic policies. The effect of financial integration on monetary policy and fiscal policy is measured separately. For this purpose, panel data is taken from secondary data sources for the South Asian Countries (Pakistan, India, Bangladesh and Srilanka. The sample data is taken for the period of 2000 to 2013 and IV technique is applied. For the measurement of monetary policy, money supply (M2) is taken as proxy variable whereas inflation is the outcome variable which is dependent variable. Whereas for fiscal policy, government expenditure and government revenue is employed for measuring it and its outcome variable is fiscal deficit which is also dependent variable.

The results depict that, in case of monetary policy, financial integration has negative effect on inflation. It shows that financial integration persuade the countries to implement the monetary policy which result in reduction in inflation. For fiscal policy, with the increase in capital flows, government spending increases along with government revenues but overall the fiscal deficit is improvised because revenues are more than the expenditures. It reinforces that financial integration has disciplining effect on the fiscal deficits through reduction in expenditures as compared to the revenues.