Financial Integration in Asia
—Promoting Financial Stability and Regional Demand

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Summary

1. Moves toward regional economic and financial integration in Asia are accelerating. The ASEAN members have agreed to establish an ASEAN Community consisting of a political-security community, economic community and socio-cultural community by 2015. From the financial perspective, preparations for the creation of an economic community include a plan to integrate capital markets, primarily through the integration of stock markets within the region. ASEAN will also work toward the gradual liberalization of capital transactions. In addition, since the 1997 Asian financial crisis, the ASEAN+3 group has implemented a regional financial cooperation program based on (1) stronger economic surveillance within the region, (2) the establishment of a system to supply liquidity in emergencies, and (3) the development of Asian bond markets.

2. The onset of the global financial crisis has highlighted the need for the improvement of crisis response capabilities in Asian countries. At a time when flows of capital into Asia are conspicuously unstable, there is a growing need to reduce reliance on capital flows from outside of the region by deepening regional financial integration, and to improve the region's capacity to withstand external shocks. Asia also needs to expand intraregional demand, since it can no longer rely on demand from advanced countries, where growth rates are falling. Progress toward regional financial integration can be expected to strengthen the functions of financial systems in various ways and to increase the capacity to provide financial services to the real economy, thereby accelerating the transition to growth led by domestic demand.

3. A feature of Asian bond markets in recent years has been the conspicuous expansion of the corporate bond market. However, there is still considerable scope for further development. Also, an analysis of the balance of long-term bond investment in each country shows that the percentage of intraregional investment in Asia rose in 2010. Reasons for this appear to include progress toward regional economic integration and a growing preference for intraregional investment by Asian investors. Continued efforts to develop and open up national markets are crucial to the maintenance of this trend. Regional financial integration also appears to be mitigating the impact of the crisis, as indicated by the fact that banks within Asia are bridging the gap left by reductions in lending to Asia by European banks.

4. Asia is also being affected to some extent by the European debt crisis. In this situation, it will be necessary not only to strengthen regional financial integration, but also to develop a range of stronger measures to deal with crises. Specific priorities include, by using foreign exchange policies, fiscal and monetary policies, financial regulations and capital transaction regulations, to curb excessive capital inflows and outflows, and to implement countermeasures when such situations arise. Continued efforts to improve domestic financial systems are also essential.

5. China is implementing a yuan internationalization strategy, prompted mainly by declining confidence in the role of the U.S. dollar as a key currency since the global financial crisis. This is also significant from the viewpoint of regional financial integration, since it will cause a gradual shift away from the dollar over the long-term future. The Japanese government is supporting this shift because of the benefits that it will bring to the activities of Japanese businesses and financial institutions and to the Tokyo market. In July 2012, the Japanese cabinet adopted the "Japan Revitalization Strategy," the aims of which include the establishment of a presence in Asia for Japanese companies, financial institutions and markets through the creation of Asia's top exchange in Japan, and by making Japan the hub for domestic and international flows of funds. These various developments in countries and regions within Asia are expected to drive steady progress toward regional financial integration.

Introduction

There is an accelerating trend toward regional economic and financial integration in Asia. This article examines regional financial integration. There is no accepted definition of regional integration, but according to the *Asian Economic Integration Monitor* (AEIM) launched by the Asian Development Bank in July 2012, regional integration is a process leading to greater interdependence in such areas as trade, investment and finance. Integration affects people, goods and money. It is driven by market forces and policy-based efforts. The *AEIM* examines regional integration in relation to (1) production networks and trade, (2) financial integration, (3) macroeconomic interdependence, (4) international and regional transmigration, (5) infrastructure connectivity, (6) cooperation in trade policy, and (7) macroeconomic and financial cooperation. The specific indicators used in this analysis are intraregional trade, intraregional direct investment, intraregional equity and bond holdings, intraregional tourism flows, intraregional population migration, and national output correlations.

When discussing regional integration in Asia, we first need to deal with the question of scope. The analyses in *AEIM* refer to the entire region, which is defined as consisting of the 48 member countries of the Asian Development Bank (ADB). These are divided into Central Asia, East Asia, South Asia, Southeast Asia, the Pacific Islands and Oceania. Of course, there are various sub-regional frameworks in Asia, such as ASEAN, the East Asia Summit, APEC and the GMS. At present there is no generally accepted view on which areas should be the main focus.

The level of integration varies in each of the sub-regions but is relatively advanced in East Asia and Southeast Asia. ASEAN, or ASEAN+3, has become an important framework for regional financial integration, and this aspect will be the main focus of the analysis in this article.

A feature of integration in Asia is the fact that the process is being driven primarily by market forces. This is a major contrast with integration in Europe, which has been a policy-based process oriented toward political union. No institutional frameworks have been created in Asia with the aim of achieving integration, and the process has basically been characterized by gradual progress, and by openness to the rest of the world. In this context, moves to establish an ASEAN Community can be seen as a highly significant from the viewpoint of creating institutional structures.

If integration is moving forward under the impetus of market forces, what reasons are there to use policy tools to accelerate the process? This is the question that will be examined in this article. The reason emphasized in the *AEIM* is the fact that slower growth in industrialized countries since the onset of the global financial crisis means that Asia can no longer look to demand in those countries as the source of its growth. Asia already accounts for 36.6% of the world's GDP and 56.2% of its population. The region includes countries with extremely high income levels, and countries that are achieving dynamic growth. Reinforcement of regional integration seems to be a reasonable option for Asian countries wishing to secure growth under their own impetus. However, the fact that two-thirds of the world's poor live in Asia raises the question of how the benefits of integration will be distributed.

This article is structured as follows. In Part I we will consider the significance of policy-based moves toward regional financial integration through the creation of the ASEAN Economic Community and regional financial cooperation within the ASEAN+3 region. In Part II, after first looking at the current state of bond markets in Asia, we will use data to ascertain whether progress is being made toward regional integration of long-term bond investment, equity investment and bank lending. We will also look at issues affecting progress toward regional integration in the area of bond investment. In Part III, we will analyze the impact of the European debt crisis on Asia and consider how Asian countries should respond to instability in the international financial environment. We will also identify lessons that can be learned from the European debt crisis. In Part IV we will examine two factors that will influence regional financial integration: China's yuan internationalization strategy and financial cooperation between Japan and China, and Japan's efforts toward regional financial integration.

I. The Significance of Regional Financial Integration

1. Progress toward Capital Market Integration in ASEAN and Financial Cooperation in the ASEAN+3 Region

(1) Capital Market Integration in ASEAN

In this section, we will consider the significance of regional financial integration initiatives undertaken in the ASEAN and ASEAN+3 groups. We will look first at the current level of financial cooperation in each of these regions.

ASEAN aims to create an Economic Community by 2015. As a part of this effort, in addition to the Implementation Plan for ASEAN Capital Markets Integration, which focuses on regional stock market integration, ASEAN will also work toward the gradual liberalization of capital transactions. The Implementation Plan for ASEAN Capital Markets Integration recognizes the inadequate scale of capital markets in individual ASEAN countries. It consists of specific measures to harmonize market infrastructure in order to increase intraregional cross-border transactions in the region's securities exchanges. The main elements of the plan are the creation of a basic environment (① the establishment of a harmonization and mutual recognition framework), the creation of market infrastructure (② the establishment of an ASEAN exchange alliance and governance framework, ③ the development of new products, ④ the reinforcement of bond markets), the reinforcement of the implementation process (⑤ alignment of domestic capital market development plans, ⑥ reinforcement of structures within ASEAN). The plan is being promoted by the ASEAN Capital Markets Forum (ACMF), which was established in 2004 as a forum for discussion among securities regulatory authorities concerning the development of capital markets within the region.

A significant achievement in relation to market integration was the creation of the ASEAN and Plus Standards Scheme. Conceived by the ACMF, this is a set of disclosure standards to be applied to intraregional cross-border equity and bond offerings. The aim is to promote awareness of ASEAN as a single asset class by facilitating cross-border issues and enhancing the transparency of securities within the region.

Working alongside the ACMF are the Task Force on Regional Securities Market Linkages and the ASEAN 100 Task Force. While the ACMF consists of representatives of securities supervisory authorities, the other two task forces are made up of representatives of securities exchanges. The Task Force on Regional Securities Market Linkages is working toward the inter-linkage of the trading and settlement systems of securities exchanges within the region.

Launched in June 2012, the ASEAN Exchanges system connects seven exchanges within the region via an electronic network, allowing 210 representative issues to be traded. Other initiatives have focused on the simplification of procedures for the reciprocal listing of ASEAN companies on securities exchanges within the region, and on the assessment of the corporate governance of companies listed within the ASEAN region.

The ASEAN 100 Task Force aims to establish ASEAN as an asset class through the development of ASEAN stock indices and ETFs. In 2005, the FTSE/ASEAN180 and FTSE/ASEAN40 indices were developed in collaboration with the British FTSE Group.

As indicated by these initiatives, the main focus of regional financial integration in ASEAN has been the creation of a single asset class for ASEAN through market expansion.

(2) Regional Financial Cooperation in the ASEAN +3 Region

We will look next at recent moves toward financial cooperation within the ASEAN+3 region. In May 2012, the finance ministers and central bank governors of the ASEAN + 3 group issued a joint statement calling for the following steps to strengthen the Chiang Mai Initiative Multilateralization (CMIM), which is an emergency liquidity supply scheme. First, the overall scale of the scheme would be doubled from $120 billion to $240 billion (Table 1). Second, the IMF de-linked portion of the scheme would be increased from 20% to 30%, and to 40% in 2014 if conditions are suitable. Third, loan maturity and extension periods would be lengthened. Fourth, a crisis prevention facility known as the "CMIM Precautionary Line" (CMIM-PL) would be introduced.

To ensure the effective operation of CMIM, the ASEAN+3 Macroeconomic Research Office (AMRO) has been established in Singapore and has commenced surveillance activities. Specific activities will include the regular submission of economic reports at the regional and national levels, and consultation with individual countries.

The Asian Bond Markets Initiative (ABMI) launched in 2003 has produced many achievements. First, there was the recent creation of the Credit Guarantee and Investment Facility (CGIF). This institution guarantees corporate bonds issued in local currencies within the region. It was established as an Asian Development Bank trust fund with initial funding of $700 million. The establishment general meeting was held in November 2010, and a head office was opened in Manila. Guarantees will be provided to investment grade companies within the region (based on ratings issued by local rating agencies). The first guarantee is expected to be issued before the end of 2012.

Table 1 Contributions to CMIM

($100 million)

Country	Contribution	Loan multiplier
China (Notes)	768.00	0.5
Japan	768.00	0.5
South Korea	384.00	1
Indonesia	91.04	2.5
Malaysia	91.04	2.5
Singapore	91.04	2.5
Thailand	91.04	2.5
Philippines	91.04	2.5
Vietnam	20.00	5
Cambodia	2.40	5
Myanmar	1.20	5
Brunei	0.60	5
Laos	0.60	5
Total	2,400.00	-

Notes: Hong Kong will provide $8.4 billion of China's $76.8 billion contribution. Hong Kong is not an IMF member and will not receive support linked to IMF loans. For this reason, although its loan multiplier is 2.5, its loan ceiling will be 84 x 2.5 x 30%.

Source: Joint statement from 15th meeting of ASEAN+3 finance ministers and central bank governors (May 3, 2012)

Second, the ASEAN+3 Bond Markets Forum (ABMF) was established in 2010 to study approaches to regional market harmonization and integration and to consider the establishment of a private placement bond market for professionals as an international (offshore) bond market. After conducting detailed surveys of regulations, market infrastructure and other conditions in each country, the ABMF explored the potential for the introduction of harmonization and mutual recognition frameworks. It completed the "ASEAN+3 Bond Market Guide" in early 2012. It has now entered the second phase of its activities and is working toward the introduction of a standardized issuance program within the region—the Asian Multi-Currency Bond Issuance Program (AMBIP)—with the aim of creating bond markets for professionals in each of the region's countries.

The Joint Statement issued in May 2012 indicated that the existing roadmap had been revised, leading to the adoption of New Roadmap+, for which nine priorities were listed (Table 2). The Joint Statement called for the retention of the four existing task forces, but with changes to the items on which they would work.

The nine priorities are as follows.

(1) Critical ongoing priorities requiring further improvements to produce tangible outcomes (follow-up issues):
  ① Commencement of CGIF operations
  ② Development of infrastructure financing schemes
  ③ Creation of an investment-friendly environment for institutional investors, and the provision of information
  ④ Enhancement of ABMF activities
  ⑤ Initiatives leading to the establishment of a regional settlement institution (RSI)

(2) Additional issues that need to be addressed in order to strengthen the momentum of ABMI discussions

Table 2 New Roadmap+ (2012)

Task Force 1 (Chaired by China and Thailand) **Promoting issuance of local currency-denominated bonds** (1) Commencement of guarantee operations by Credit Guarantee and Investment Facility (CGIF) (F)...1st (2) Development of infrastructure financing schemes (F)...1st —including pilot projects in Laos and Thailand (3) Development of derivative/swap markets…2nd
Task Force 2 (Chaired by Japan and Singapore) **Facilitating the demand for local currency-denominated bonds** (1) Further development of government bond markets (A)…1st Development of repo market and security-based lending markets (2) Development of investment environment for institutional investors and information sharing with ABMI (F)…1st (3) Promotion of cross-border bond transactions...2nd
Task Force 3 (Chaired by Malaysia and Japan) **Improving regulatory framework** (1) Reinforcement of activities of ASEAN+3 Bond Market Forum (ABMF) (F)…1st —Common bond issuance program (2) Improvement of access to finance for individuals and SMEs (A)…1st (3) Improvement of bankruptcy procedures relating to bond transactions...2nd
Task Force 4 (Chaired by South Korea and the Philippines) **Improvement of bond market infrastructure** (1) Facilitation of activities in preparation for the establishment of a regional settlement institution (RSI) (F)…1st (2) Strengthening of infrastructure for regional rating systems (A)…1st (3) Improvement of financial knowledge and education (R)…2nd
Technical Assistance Coordination Team (TACT) (Chaired by Brunei, Laos and Vietnam) (1) Facilitation of technical assistance to ASEAN members with the aim of improving bond market development capabilities…1st

Notes 1: "(F)" denotes a follow-up task, "(A)" an additional task and (R) a related task.
Notes 2: "1st" and "2nd" indicate the level of priority allocated to each activity.
Source: The Joint Statement of the 15th ASEAN+3 Finance Ministers and Central Bank Governors' Meeting (May 3, 2012)

⑥ Further development of government bond markets
⑦ Enhancement of access to finance for consumers and SMEs
⑧ Strengthening the foundations for a regional credit rating system

(3) Issues requiring action because of changes in the international financial environment (relevant issues)
⑨ Improvement of financial knowledge

These items were selected after careful discussions based on awareness of the need to produce more tangible outcomes than in the past. They constitute a comprehensive list of key issues. They also reflect the view that regional financial integration will become an important focus for future efforts. Decisive action will need to be taken on each of these priorities, and the joint statement stipulates that each of the task forces should produce a work plan and make steady progress.

2. The Significance of Financial Integration to Financial Cooperation in the ASEAN+3 Group

(1) Prior to the Global Financial Crisis

We will next review the aims of moves toward financial cooperation within the ASEAN+3 group since the 1997 Asian financial crisis. Having concluded that the main cause of the financial crisis was double mismatching resulting from excessive reliance on overseas funds, especially short-term bank loans, countries in the group have since strengthened their financial systems through regional financial cooperation. A particular priority has been the development of domestic bond markets through the ABMI and other initiatives. The purpose of these moves is to replace financial systems that are heavily weighted toward the banking sector with more balanced systems that are capable of supplying long-term funds, and to strengthen financial intermediary functions so that domestic savings can be linked to investment. Financial cooperation was seen as a way of strengthening domestic financial systems and reducing reliance on borrowing from domestic and overseas banks.

Another goal is to strengthen regional financial integration, specifically by expanding cross-border bond transactions. A particular focus for the ABMF at present is the creation of bond markets for professionals in each country, with harmonized regulations, in order to increase cross-border bond issues.

Regional financial integration has become a goal because of concern about the fact that although Asian countries have generally had substantial excess savings since the financial crisis, most of that money flowed into the financial and capital markets of advanced countries, such as the United States, rather than becoming a source of funds for capital investment and infrastructure development within the region. Mechanisms to channel Asian savings into Asian investment were seen as necessary in order to reduce this asymmetry in capital flows. The lesson of the financial crisis was that funds from outside of the region could not be relied upon. After the financial crisis, Asia shifted to a surplus liquidity situation resulting from its excess savings position and the accumulation of foreign currency reserves. For this reason, it was thought excessive reliance on foreign funds could be avoided more efficiently if funds were circulated within the region, rather than simply through efforts to reduce surplus savings within each country.

While this view is to some extent understandable in terms of the fundamental nature of regional integration, it is a very regionalist perspective. How different are the characteristics of outside money from those of regional money? Since regional money is not monolithic in nature, this is an important issue that needs to be verified.

When we consider regional financial integration in Asia, we need continuous verification of related factors, including the ways in which Asia's excess savings have changed, the shape of capital flows into Asia, and the differences between regional and non-regional funds.

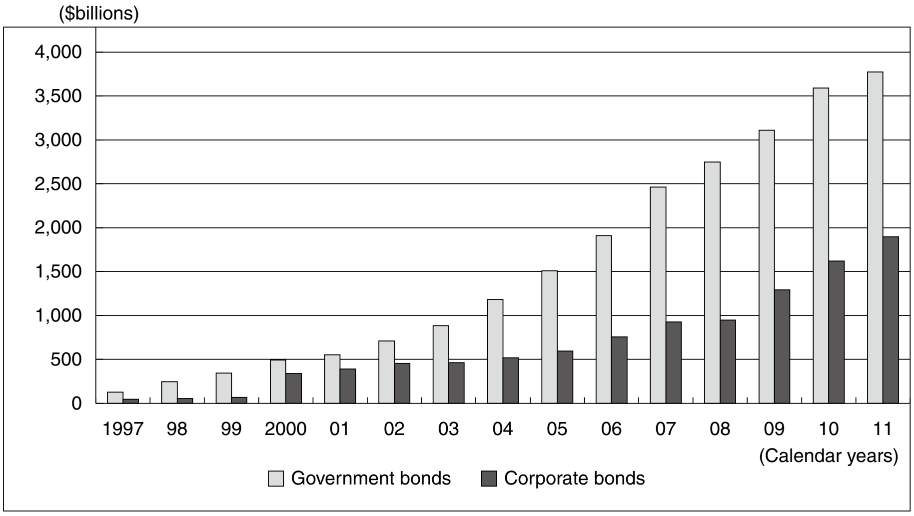
(2) After the Global Financial Crisis

①The Growing Importance of Crisis Countermeasures

The global financial crisis had major effects on the aims of regional financial integration. The first effect was to encourage efforts to strengthen crisis response measures. Asian financial systems were affected by the crisis in the following ways. (1) Capital inflows were dramatically reduced, causing currencies and share prices to fall. Foreign currency reserves were also depleted because of forex market intervention and other factors. (2) It became almost impossible to procure dollars overseas. Trade finance shrank rapidly, and spreads on dollar-denominated bonds expanded. Domestic liquidity was also affected, and in some countries short-term interest rates rose sharply. However, inter-bank markets continued to function. (3) Access to funds from domestic and overseas capital markets was reduced. This had a serious impact, especially on domestic stock markets. The effects were also felt in other areas, including securitization and issues of CP and low-rated corporate bonds. However, the decline in corporate bond issues was only temporary. The banking sector, which makes up a substantial part of financial systems, was not significantly affected.

This experience shows the importance of measures to contain the ripple effects of disruptions in international financial markets. Several approaches should be considered in this context. First, there is the reduction of reliance on capital flows, such as through the tightening of restrictions on capital inflows. Second, there is the reinforcement of supplies of liquidity, especially dollars. Possible ways to achieve this include the expansion of currency swaps with foreign central banks, the accumulation of foreign currency reserves, and the reinforcement of the regional currency swap network (CMIM). Third, there is the development of domestic financial and capital markets. It is important to maintain the functioning of domestic financial systems when international financial markets are affected by crises. Asian bond markets were comparatively successful in maintaining their normal functions during the global finan-

Fig. 1 Outstanding Issues in Asian Bond Markets



Notes: Totals for China, Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore, Thailand and Vietnam
Source: Asian Bonds Online

cial crisis (Fig. 1), and most financial institutions and major companies that became unable to raise funds overseas sought to return to domestic markets. This experience led to renewed recognition that excessive reliance on capital flows was problematic and that bond market development was an effective way of alleviating this problem.

Fourth, there is the reinforcement of financial regulation and supervision to maintain confidence in financial systems. The focus here is on the reinforcement of precautions against sudden outflows of capital. One approach is to impose restrictions on banks' foreign currency transactions in order to limit currency mismatching. Another priority is to prevent domestic credit from flowing into unproductive areas. Speculative investment by banks in stocks and real estate and related lending must be closely monitored and regulated. It is also important to improve the risk management capabilities of financial institutions to keep pace with the growing complexity of financial products and the diversification of financial services. To ensure effective regulatory supervision, the authorities also need to give priority to the establishment of training systems for their personnel and necessary institutional framework.

Another priority when developing regulatory systems is to apply the lessons learned through the global financial crisis. In particular, it is necessary to ensure that banks do not rely excessively on money procured from the markets, that the authorities are properly aware of advances in financial technology, including problems relating to securitization and credit ratings, and that trade finance is available. The issues surrounding securitization and credit ratings have profound implications for bond market development. The experience of the global financial crisis should also be taken into account when developing many bond market-related financial products and infrastructure, such as over-the-counter derivatives market.

One approach that is likely to gain renewed recognition as an important part of these crisis countermeasures is the reduction of reliance on external capital flows through the reinforcement of regional financial integration. During the crisis recovery process, monetary easing in advanced countries, expectations of growth in Asia and other factors have been reflected in a rapid increase in capital inflows and conspicuous instability in capital flows. This has strengthened the tendency to see regional financial integration as an important priority.

②The Need to Boost Intra-Regional Demand

Since the 1997 financial crisis, Asia has achieved export-driven economic growth led by manufacturing. However, it has become increasingly difficult to rely on demand from advanced countries, whose growth rates have fallen since the global financial crisis, which means that Asian countries now need to expand domestic demand and modify their export-led growth strategies. China needs to focus primarily on measures to boost consumption, while in other Asian countries the emphasis should be on investment promotion.

Asia's excess savings after the 1997 financial crisis resulted mainly from a decline in investment, and an investment recovery became a key priority. The inadequate level of investment is also an issue at present, especially the relative lack of growth in investment relating to domestic demand. The need for an investment recovery in areas that yield significant domestic demand expansion benefits appears to be greater than ever.

Domestic demand expansion in Asia would also be highly significant for Japan. To maintain its growth, Japan needs to deepen its economic relationships with Asian countries, and to focus on business areas targeted toward domestic demand in those countries. This process has heightened the need to procure finance in local currencies, leading to an increase in local bond issues by Japanese companies(1). Risk management in relation to local currencies has become a key priority for many companies. Various methods are used, such as foreign exchange swaps, bond issues and loans denominated in local currencies. In this sense, Japanese companies and financial institutions can be said to be playing a significant role in regional financial integration.

Increased domestic demand in Asian countries would also lead to the expansion of intra-regional trade in final products. Compared with the EU and NAFTA, the percentage of final goods exported to markets within the region is relatively low. Factors that will help to boost the trade in final goods include the expansion of FTAs and EPAs, and rising income levels in the countries concerned. Through this process, Asia is expected to provide the impetus for global economic growth not only as the world's workshop, but also as the world's consumer market. This could result not only in the accelerating reduction of reliance on exports to advanced countries, but also in further progress toward integration at the real economic level.

The strengthening of regional financial integration is seen as an effective way to drive the transition to domestic demand-led growth. This is because progress toward regional financial integration has the potential to strengthen financial systems in the following ways, thereby enhancing the capacity to provide financial services to the real economy.

First, greater openness would stimulate competition, which would strengthen the region's financial and capital markets and financial institutions. This would reduce financial limitations on individuals and enterprises, while transfers of financial expertise would lead to the development of new financial products. We can also expect the improvement of corporate governance and disclosure, and the reduction of price volatility in markets. Second, individuals and enterprises in the region would have access to new financial services. Third, capital would be distributed more efficiently within the region. Fourth, progress toward market integration would yield economies of scale and induce new investment, allowing the cost of funds to be reduced. There would also be a major improvement in market liquidity. The aforementioned concept of integration within an ASEAN Economic Community emphasizes this aspect.

If Asia can make progress toward integration at the real economic level, including the reduction of reliance on exports to advanced countries, there will be an increase in cross-border business activities, and in the need for finance to support those activities. This would lead in turn to further progress toward regional financial integration. In this way, financial integration and real economic integration within the region can each be expected to provide the impetus for the other.

(3) Summary

The main aims of regional financial integration are to reduce dependence on capital flows from outside of the region, and to support efforts to boost regional domestic demand by strengthening financial services within the region. The latter benefit would also be likely to reduce Asia's excess savings.

Numerous structural factors determine the savings-investment balance, including the demographic structure and growth rate of the population, income levels and growth, and the fiscal balance. However, many analyses have confirmed that the consumption, investment and saving behavior of individuals and enterprises are influenced by the availability of financial services. Pongsaparn and Unteroberdoerster [2011] used data from 105 countries to show that financial integration was a decisive factor in determining the savings-investment balance. Asian countries have generally responded to the increasing instability of the international financial situation by tightening restrictions on capital transactions. According to this analysis, economic health could be improved by stimulating domestic demand through accelerated financial integration. Their conclusion is that the long-term benefits of financial integration should not be overlooked. However, they do not examine the question of whether integration should be sought within the region or beyond (globally).

Table 3 examines saving and investment rates in Asian countries. When we compare 2007 and 2010, we find that all countries but South Korea reduced their excess savings, indicating that their growth may have been rebalanced for some reason. Governments have also made domestic demand expansion a priority. For example, China's efforts to make the transition to a domestic demand-led economy have produced a number of changes, including a rise in the qualitative level of consumption (increased expenditure on durable consumer goods and services) resulting from increased urbanization and higher income levels, as well as increased investment resulting from infrastructure development, especially in inland regions. Similarly, Malaysia has since 2010 been implementing the Economic Transformation Program, the main aim of which is stimulate investment in order to lift Malaysia out of the "middle income trap."

Table 4 traces trends in foreign currency reserves over the past few years. With the exception of year on year declines in Indonesia, South

Table 3 Savings and Investment Ratios (GDP Ratios)

(%)

		1995	1997	1999	2001	2003	2005	2007	2008	2009	2010
China	Savings ratio	39.6	39.0	38.0	39.0	43.0	46.4	50.5	51.5	51.0	53.0
	Investment ratio	41.9	37.9	36.7	36.3	41.2	42.1	41.7	44.0	48.3	48.2
	Savings excess	▲2.3	1.1	1.2	2.7	1.8	4.3	8.8	7.5	2.7	4.8
Hong Kong	Savings ratio	29.6	30.7	30.1	29.8	31.2	33.0	31.8	30.7	28.8	29.3
	Investment ratio	34.1	34.0	24.8	25.3	21.9	20.6	20.9	20.4	21.3	23.7
	Savings excess	▲4.4	▲3.4	5.3	4.5	9.2	12.4	10.8	10.3	7.5	5.6
South Korea	Savings ratio	36.5	35.0	35.1	31.3	32.2	32.3	30.9	30.0	29.9	32.2
	Investment ratio	36.9	35.4	28.9	29.2	29.9	29.7	29.4	31.2	26.3	29.2
	Savings excess	▲0.4	▲0.4	6.2	2.1	2.3	2.7	1.5	▲1.2	3.6	3.0
Taiwan	Savings ratio	28.6	27.2	27.5	25.3	27.2	27.3	29.6	27.3	25.8	29.7
	Investment ratio	26.7	25.1	25.0	19.8	19.9	22.7	22.1	22.4	17.7	22.6
	Savings excess	1.9	2.1	2.5	5.5	7.3	4.6	7.5	4.9	8.1	7.1
Indonesia	Savings ratio	30.6	31.5	19.5	30.0	23.7	27.5	28.1	31.0	31.7	34.2
	Investment ratio	31.9	31.8	11.4	22.5	25.6	25.1	24.9	27.8	31.0	32.5
	Savings excess	▲1.3	▲0.3	8.1	7.5	▲1.9	2.4	3.2	3.2	0.7	1.7
Malaysia	Savings ratio	39.7	43.9	47.4	41.8	42.5	42.8	42.1	42.5	36.0	39.2
	Investment ratio	43.6	43.0	22.4	24.4	22.8	20.0	21.6	19.3	14.4	21.4
	Savings excess	▲3.9	0.9	25.1	17.4	19.7	22.8	20.5	23.2	21.6	17.8
Philippines	Savings ratio	14.5	14.2	15.0	15.3	15.4	15.9	17.2	16.8	15.5	18.7
	Investment ratio	22.5	24.8	19.0	22.1	23.0	21.6	17.3	19.3	16.6	20.5
	Savings excess	▲7.9	▲10.6	▲4.0	▲6.8	▲7.6	▲5.7	▲0.1	▲2.5	▲1.1	▲1.8
Singapore	Savings ratio	50.0	n.a.	n.a.	n.a.	n.a.	49.4	53.3	51.1	50.0	51.9
	Investment ratio	33.3	n.a.	n.a.	n.a.	n.a.	20.0	21.1	30.2	26.4	23.8
	Savings excess	16.7	n.a.	n.a.	n.a.	n.a.	29.4	32.2	20.9	23.6	28.1
Thailand	Savings ratio	36.9	35.3	32.5	31.4	32.0	30.9	34.4	32.6	31.3	33.4
	Investment ratio	42.1	33.7	20.5	24.1	25.0	31.4	26.4	29.1	21.2	26.0
	Savings excess	▲5.2	1.6	12.0	7.3	7.1	▲0.6	8.0	3.5	10.1	7.4

Source: Asian Development Bank, *Key Indicators*

Table 4 Foreign Currency Reserves

(Unit: $100 million, %)

	1997	2007	2008	2009	2010	2011	GDP Ratio
China	1,399	15,282	19,460	23,992	28,473	31,811	43.6
Hong Kong	928	1,527	1,825	2,558	2,687	2,854	117.3
Indonesia	174	550	496	636	929	998	11.8
South Korea	204	2,622	2,011	2,699	2,915	3,042	27.3
Malaysia	210	1,007	915	968	1,066	1,333	47.8
Philippines	88	302	332	379	554	673	31.6
Singapore	713	1,630	1,742	1,878	2,258	2,377	91.5
Taiwan	835	2,703	2,917	3,482	3,820	3,855	82.6
Thailand	270	875	1,110	1,384	1,721	1,751	50.7
Total	4,821	26,498	30,808	37,976	44,423	48,694	44.0
Excluding China	3,422	11,216	11,348	13,984	15,950	16,883	44.8

Notes: GDP ratios refer to 2011.
Source: Statistics from each country

Korea and Malaysia as a result of capital outflows following the Lehman shock in 2008, all of the countries have recorded consistent upward trends. The main reason for this appears to have been a rapid increase in flows of capital into Asia. The total foreign currency reserves of the nine countries and regions shown in the table reached approximately $4.9 trillion (44% of GDP) at the end of 2011. China's importance continues to rise, as indicated by the fact that it accounted for $3.2 trillion, or 65.3%, of this total.

3. Specific Measures to Stimulate Regional Domestic Demand

Domestic demand expansion requires comprehensive policy packages, including measures to eliminate barriers to consumption and investment and change production mixes. Foreign exchange policies and improvements to financial systems form part of this process.

One foreign exchange-related measure is to allow the value of domestic currencies to rise in order to drive a shift in production resources from trade goods to non-trade goods, and to encourage consumption through increases in the purchasing power of consumers. A flexible foreign exchange policy also increases the degree of freedom available for the implementation of monetary policies. These measures have the potential to expand domestic demand. Furthermore, as intraregional trade expands, intraregional exchange rate stability becomes increasingly important, heightening the significance of foreign exchange policy coordination.

From the viewpoint of financial system development, financial intermediation functions play an essential role in efforts to stimulate consumption and investment. For example, various methods are being developed specifically for the utilization of bond markets, including the use of securitization to supply funds to small and medium enterprises, which play an important role in domestic demand expansion, and the expansion of bond issues relating to domestic demand and service industries, such as the securitization of housing loans and card receivables. If these financing methods can be combined with cross-border investment, regional financial integration will have the effect of accelerating domestic demand expansion.

Infrastructure development also plays an important role in the use of investment to accelerate economic growth through domestic demand expansion. Infrastructure development not only maintains the momentum of economic growth, but also helps to distribute the benefits of high growth to a greater number of people while reducing regional disparities. In addition to domestic infrastructure development, cross-border infrastructure development can also be expected to contribute to the improvement and integration of networks in such areas as transportation, energy and communications, thereby accelerating economic and financial integration.

Infrastructure development in Asia has not kept pace with economic growth, and current estimates indicate that investment of around $8.2 trillion, or $750 billion per year, will be needed between

Table 5 Amount of Infrastructure Development Investment Required in Asia (2010-2020)

(Billions of 2008 dollars)

Sector	East Asia and Southeast Asia	South Asia	Central Asia	Pacific	Total
Electric power	3,182.5	653.7	167.2	-	4,003.3
Transportation	1,593.9	1,196.1	104.5	4.4	2,898.9
Telecommunications	524.8	435.6	78.6	1.1	1,040.1
Water/sanitation	171.3	85.1	23.4	0.5	280.2
Total	5,472.3	2,370.5	373.7	6.0	8,222.5

Source: Asian Development Bank [2012b]

2010 and 2020 (Table 5). Asia's infrastructure has improved in recent years, but the level of development remains low compared with advanced countries.

Infrastructure development requires massive amounts of money. Because government budgets are limited, it will be necessary to expand the role of the private sector through the increased implementation of projects based on public-private partnerships (PPPs). The track record for private sector participation is limited, and most PPPs have been in the areas of telecommunications and energy. They have also been heavily concentrated in certain countries, such as China, India, Indonesia, Malaysia and the Philippines. To expand private sector investment, it will be necessary to deal with a number of issues, including the improvement of investment environments. One reason for the lack of growth in investment is the inadequate development of financial and capital markets. In addition to bank loans, greater use will need to be made of other methods, such as financing through infrastructure funds and capital markets. It will also be necessary to expand cross-border financing.

In May 2012, the ASEAN Infrastructure Fund (AIF) was established with capital provided by ASEAN members and the Asian Development Bank. Its mission is to expand infrastructure finance and facilitate regional cooperation on cross-border projects. Initially it will provide loans amounting to around $300 million each year, and its loan balance is expected to reach $2.1 billion in 2020 and $4.0 billion by 2026. The AIF will also be able to participate in PPPs as a public sector entity. Over the past 20 years, the Asian Development Bank has invested around $35 billion in infrastructure development and other projects designed to strengthen linkage and integration in the Asian region. The AIF can be characterized as a mechanism focusing on the financing aspects of these initiatives.

II. Regional Financial Integration—Current Situation and Issues

1. Level of Development of Asian Bond Markets

In this section we will analyze the current state of regional financial integration, beginning with a brief examination of the state of Asian bond markets. Table 6, which is based on the same data as Fig. 1, shows the balances of outstanding issues in Asian bond markets. The balance for corporate bonds at the end of 2011 shows a smaller increase compared with the position at the end of 2000 than that for government bonds, but a larger increase when compared with the level at end of 2007. Government bond markets have provided the impetus for the expansion of bond markets in Asia, but in recent years there has also been conspicuous growth in corporate bond markets. Corporate bond markets are expanding in many of the region's countries, and growth since the end of 2007 has been particularly conspicuous in China (5.4 times), Vietnam (4.7 times), the Philippines (2.8 times) and Indonesia (1.9 times). With the exception of China, however, the scale of the markets is small, and their contributions to the total outstanding issues are limited. Furthermore, as is apparent from the ratios of outstanding issues to GDP, there is considerable scope for the expan-

Table 6 Outstanding Issues in Asian Bond Markets

($billions, times)

	End of 2000 (A)	End of 2007 (B)	End of 2011 (C)	C/A	C/B
Government bonds	493.4	2,463.4	3,774.4	7.6	1.5
Corporate bonds	342.6	929.2	1,897.0	5.5	2.0
Total	836.0	3,392.6	5,671.4	6.8	1.7

Notes: Totals for China, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, Thailand and Vietnam
Source: Asian Bonds Online

Table 7 Ratios of Outstanding Bond Issues to GDP

(%)

	End of 2000			End of 2011		
	Government bonds	Corporate bonds	Total	Government bonds	Corporate bonds	Total
China	16.6	0.3	16.9	33.9	11.4	45.3
Hong Kong	8.2	27.6	35.8	37.1	31.9	69.0
Indonesia	35.4	1.4	36.8	11.4	2.0	13.4
Japan	84.3	25.4	109.7	175.4	17.5	192.8
South Korea	25.7	48.8	74.4	47.5	67.0	114.5
Malaysia	38.0	35.2	73.3	56.6	38.0	94.6
Philippines	31.1	0.2	31.3	30.3	4.5	34.8
Singapore	26.6	20.9	47.5	47.0	28.2	75.1
Thailand	22.8	4.5	27.4	54.5	13.0	67.5
Vietnam	0.3	0.0	0.3	12.7	1.7	14.4

Source: Asian Bonds Online

Table 8 Shares of World Total of Outstanding Bond Market Issues

(%, $billions)

	Dec. 1996	Sep. 2011
East Asia	2.1	8.1
China	0.2	4.8
South Korea	1.1	1.7
Indonesia	0.03	0.2
Malaysia	0.3	0.4
Philippines	0.1	0.1
Singapore	0.1	0.3
Thailand	0.1	0.3
Vietnam	-	0.03
Australia	1.0	1.5
Brazil	1.2	2.0
India	0.3	1.0
Russia	0.2	0.1
South Africa	0.3	0.3
U.S.A.	42.9	38.7
Japan	17.5	18.7
France	4.9	5.0
Germany	7.4	3.9
U.K.	2.7	2.6
Total	25,469	67,638

Source: Asian Development Bank [2012a]

sion of the relatively small corporate bond markets of these four countries (Table 7).

Outstanding issues in Asian bond markets have increased from 2.1% of the world total in 1996 to 8.1% in September 2011 (Table 8). If China is excluded, however, the increase is from just 1.9% to 3.3%, indicating that these markets are still very small.

Significant progress has been made toward the development of Asian bond markets over the past 10 years. This has resulted mainly from market development measures implemented by the authorities in each country, but regional financial cooperation initiatives, such as the ABMI, have also made a major contribution. Of particular importance is not only the expansion of market size, but also the heightened level of maturity(2).

On the other hand, as has been often stated, there is still substantial scope for market development. Asian bond markets have yet to reach the level of markets in advanced countries by many measures, including the ratio of outstanding bond issues to GDP, the liquidity of secondary markets, and the development of investors. In particular, the issuer base is weighted heavily toward government corporations, banks, infrastructure companies and other major corporations, and even the number of these issuers is generally limited. Corporate bonds should be used as an important source of funds for a wider range of enterprises.

The level of bond market development also varies according to the economic development stage and other factors. Bond markets scarcely exist in some countries, such as Cambodia, Laos and Myanmar. In view of the small overall scale of Asian bond markets, consideration should perhaps be given to some form of regional market integration. However, variation in the level of market development would be a major barrier to integration. Market development in relatively less developed countries and approaches to market integration will be extremely important questions.

In summary, the main priorities for bond market development in Asia are (1) the development of markets in less developed countries and the reduction of gaps in market development stages, (2) the expansion of corporate bond markets and the improvement of secondary market liquidity in each country, and (3) the expansion of cross-border transactions(3).

2. The Current State of Regional Financial Integration

(1) Bond and Stock Investment: Analysis Based on CPIS

We will next use data from the Coordinated Portfolio Investment Survey (CPIS) conducted by the IMF to analyze intraregional investment. According to Pongsaparn and Unteroberdoerster [2011], securities investment assets in Asian countries amount to around 20-30% of GDP. While this is far higher than the ratios for Latin America and Eastern Europe, it is low compared with the 120% ratio for the Euro-zone. The same is true of the assets and liabilities of BIS reporting banks. This is indicative of major differences between the scale of financial systems in advanced countries and developing countries. The small balances of investment assets and liabilities in securities are a sign that there is considerable scope for the development of bond markets and institutional investors in Asia.

Table 9-1 shows the level of bond investment from eight countries and regions to 10 countries and regions. The total balance of investment from the eight countries and regions as a percentage of the world total for outstanding securities investment has moved from 17.7% to 11.8%, 12.8% and 14.2%. These figures reflect the late emergence of growth in the balance of total investment from Japan. Table 9-2 shows that the balance of investment by countries and regions other than Japan remained almost unchanged at around 2% of the world total. Returning to Table 9-1, we find that the percentage of intraregional investment has moved from 3.3% to 3.5%, 3.7% and 4.3%. Most of the growth, especially since the global financial crisis, has been in the ratios for ASEAN countries (Malaysia, the Philippines, Singapore and Thailand), whose investments have been toward ASEAN and South Korea. Investment in China and Japan has also increased. The main contributor here is Hong Kong.

However, the only countries/regions to invest more than $10 billion in the region are Hong Kong, Singapore and Japan. It is significant that investment from Hong Kong and Singapore is mostly handled by asset management companies in Europe and North America.

Japan's total investment balance is far higher than those of other countries/regions, with the result that the intraregional investment ratio without Japan increases from 12.0% to 15.3%, 16.7% and 20.4%, as shown in Table 9-2. The corresponding ratios in Table 9-3, which relates only to the ASEAN members, are 6.5%, 10.2%, 9.4% and 14.4%.

Because there has been little increase in Japan's intraregional investment ratio, the over all intraregional investment ratio shows minimal growth when Japan is included. When Japan is excluded, the trend toward regional integration becomes apparent. The large changes that occurred between 2009 and 2010 point to the possibility that the integration process is accelerating. This can be attributed to the development and expansion of national markets within the region.

A more detailed analysis of each country's intraregional investment ratios and investment recipients reveals that there is a strong tendency among ASEAN members to direct investment toward countries within ASEAN. Capital flows involving advanced countries play a key role in Hong Kong, Japan and South Korea, and the emphasis on intraregional investment is relatively weak. In 2010, there was an increase in the percentage of intraregional investment into Japan, but this was mostly attributable to investment from Hong Kong and South Korea, and there was little investment into Japan from ASEAN members.

In each of the tables, the figures immediately to the right of the intraregional investment ratios represent investment into Asia as percentages of total investment by investors worldwide. These figures are indicative of a clear regional bias among investors within the region. In Table 9-3, for example, investment in ASEAN accounted for just 0.7% of total investment by investors worldwide, while the intraregional investment ratio was far higher at 14.4%.

Table 9-1 Balance of Cross-Border Investment in Long-Term Bonds in East Asia

2001 ($millions)

Recipient of Investment	Source of Investment: Hong Kong	Indonesia	Japan	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment	Percentage of intraregional inward investment
China	1,776	--	880	118	--	--	325	--	3,099	5,504	56.3
Hong Kong	--	95	1,254	288	28	25	920	47	2,657	15,625	17.0
Indonesia	--	--	106	40	8	3	260	--	418	1,613	25.9
Japan	4,980	1	--	75	15	5	3,606	--	8,682	169,196	5.1
South Korea	2,680	--	5,435	--	3	7	1,670	--	9,794	22,389	43.7
Malaysia	1,766	--	2,197	295	--	9	1,392	--	5,660	9,263	61.1
Philippines	1,152	--	1,347	89	41	--	577	--	3,207	8,843	36.3
Singapore	1,225	35	928	141	7	59	--	9	2,404	13,227	18.2
Thailand	530	--	748	159	21	--	500	--	1,958	3,613	54.2
Vietnam	--	--	30	15	--	--	--	--	45	101	44.6
Total	14,109	131	12,925	1,221	122	108	9,251	56	37,924	249,374	15.2
Total investment balance	85,877	687	1,004,878	5,284	551	1,641	41,960	327	1,141,205	6,430,125	17.7
Intraregional investment (%)	16.4	19.1	1.3	23.1	22.2	6.6	22.0	17.1	3.3	3.9	

2007 ($millions)

Recipient of Investment	Source of Investment: Hong Kong	Indonesia	Japan	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment	Percentage of intraregional inward investment
China	5,440	--	458	202	6	--	907	15	7,028	13,313	52.8
Hong Kong	--	66	849	1,768	68	155	3,399	42	6,347	17,276	36.7
Indonesia	--	--	604	191	111	--	4,048	1	4,954	15,558	31.8
Japan	2,835	--	--	540	20	12	2,421	47	5,875	232,505	2.5
South Korea	13,125	9	8,117	--	295	169	10,468	278	32,462	82,963	39.1
Malaysia	3,613	3	2,031	240	--	--	4,153	39	10,080	28,632	35.2
Philippines	592	2	1,635	14	44	--	874	2	3,163	20,593	15.4
Singapore	2,834	177	3,872	346	89	497	--	54	7,869	35,913	21.9
Thailand	442	--	289	115	9	33	1,119	--	2,008	4,044	49.7
Vietnam	724	--	64	6	--	--	638	29	1,460	2,157	67.7
Total	29,605	256	17,919	3,423	642	867	28,027	508	81,246	452,954	17.9
Total investment balance	205,319	1,576	1,924,829	53,256	3,405	4,792	103,120	4,368	2,300,664	19,441,450	11.8
Intraregional investment (%)	14.4	16.3	0.9	6.4	18.8	18.1	27.2	11.6	3.5	2.3	

2009 ($millions)

Recipient of Investment	Source of Investment: Hong Kong	Indonesia	Japan	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment	Percentage of intraregional inward investment
China	8,271	--	521	141	--	--	1,390	--	10,324	15,962	64.7
Hong Kong	--	73	1,390	378	100	69	3,694	185	5,890	11,421	51.6
Indonesia	203	--	1,792	163	48	--	5,575	8	7,790	24,738	31.5
Japan	3,742	--	--	686	--	7	1,488	90	6,013	216,051	2.8
South Korea	10,671	11	8,440	--	1,296	153	14,319	8,362	43,251	98,391	44.0
Malaysia	2,987	6	2,509	130	--	56	4,528	201	10,418	27,733	37.6
Philippines	651	4	1,477	55	196	--	1,273	29	3,685	17,398	21.2
Singapore	2,896	214	3,595	100	605	--	--	10	7,422	27,131	27.4
Thailand	173	--	684	73	104	18	1,238	--	2,291	5,551	41.3
Vietnam	96	--	33	2	2	--	120	--	253	1,363	18.6
Total	29,691	309	20,443	1,729	2,352	303	33,626	8,885	97,338	445,739	21.8
Total investment balance	244,908	2,212	2,224,756	26,492	6,493	3,861	126,317	12,989	2,648,029	20,640,109	12.8
Intraregional investment (%)	12.1	14.0	0.9	6.5	36.2	7.9	26.6	68.4	3.7	2.2	

2010 ($millions)

Recipient of Investment	Source of Investment: Hong Kong	Indonesia	Japan	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment	Percentage of intraregional inward investment
China	12,763	13	494	146	9	--	1,721	1	15,147	22,348	67.8
Hong Kong	--	83	1,443	405	234	210	4,570	215	7,161	20,026	35.8
Indonesia	116	--	2,646	74	253	695	8,054	42	11,880	35,735	33.2
Japan	11,025	--	--	1,220	65	12	1,240	63	13,624	295,049	4.6
South Korea	13,528	102	11,650	--	2,427	--	13,775	7,906	49,387	131,081	37.7
Malaysia	3,173	12	2,773	186	--	18	6,468	125	12,755	39,662	32.2
Philippines	931	--	2,908	219	512	--	1,687	46	6,303	25,113	25.1
Singapore	3,561	622	4,664	149	1,967	96	--	23	11,081	34,831	31.8
Thailand	164	--	851	83	165	--	2,280	--	3,543	10,186	34.8
Vietnam	75	--	38	21	--	--	91	--	225	2,633	8.6
Total	45,336	833	27,467	2,503	5,631	1,032	39,886	8,421	131,107	616,664	21.3
Total investment balance	251,417	4,432	2,636,112	29,889	10,770	5,266	126,746	13,311	3,077,943	21,735,503	14.2
Intraregional investment (%)	18.0	18.8	1.0	8.4	52.3	19.6	31.5	63.3	4.3	2.8	

Notes 1: China and Vietnam are not included among sources of investment because no data are available.
Notes 2: The figures in the lower right of each table represent world totals of outstanding investment.
Source: IMF, *Coordinated Portfolio Investment Survey*

Table 9-2 Outstanding Cross-Border Investment in Long-Term Bonds in East Asia (Excluding Japan)

(Percentages of intraregional investment)

	Hong Kong	Indonesia	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment
2001	10.6	19.0	21.7	19.5	6.3	13.5	17.1	12.0	1.2
2007	13.0	16.3	5.4	18.3	17.8	24.8	10.6	15.3	1.1
2009	10.6	14.0	3.9	36.2	7.7	25.4	67.7	16.7	1.1
2010	13.6	18.8	4.3	51.7	19.4	30.5	62.8	20.4	1.5

Notes: Calculated by excluding Japan from Table 9-1. "Total balance of inward investment" denotes investment in East Asia (excluding Japan) as a percentage of total world investment.
Source: IMF, *Coordinated Portfolio Investment Survey*

Table 9-3 Outstanding Cross-Border Investment in Long-Term Bonds in East Asia (ASEAN Region)

(Percentages of intraregional investment)

	Indonesia	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment
2001	5.1	13.9	4.3	6.5	2.8	6.5	0.6
2007	11.5	7.4	11.1	10.5	2.9	10.2	0.5
2009	10.2	14.7	1.9	10.1	1.9	9.4	0.5
2010	14.3	26.9	15.4	14.7	1.8	14.4	0.7

Notes: Calculated by excluding Hong Kong and South Korea from Table 9-2. "Total balance of inward investment" denotes investment in East Asia (ASEAN region) as a percentage of total world investment.
Source: IMF, *Coordinated Portfolio Investment Survey*

We will now apply a similar analysis to stocks (Table 10-1 through 10-3). In these tables, intraregional investment ratios move from 9.7% to 24.7%, 21.6% and 20.9%, from 17.9% to 33.0%, 30.1% and 28.1%, and from 24.9% to 10.5%, 8.6% and 11.0% respectively.

These figures contrast with the upward tendency in the ratios for bond market investment. Between 2001 and 2007, intraregional stock investment by Hong Kong, Japan and South Korea increased, but the ratios for Hong Kong and South Korea subsequently declined, as did the ratio for East Asia as a whole. The level of intraregional investment by Japan is low and has not changed significantly since 2007. According to the AEIM, this decline in the intraregional investment ratio for East Asia reflects the fact that Asia stock markets suffered larger price falls than markets in advanced countries after the Lehman shock.

The intraregional investment ratio for ASEAN members either fell or remained static between 2001 and 2007 and has followed a similar pattern since then. Despite a regional bias among investors in ASEAN countries, the intraregional investment ratio has not risen.

Among ASEAN members, Malaysia has increased its intraregional investment ratios for both bonds and stocks in recent years. It is possible that Malaysia will emerge as a new driving force for regional financial integration.

The total balance of intraregional bond investment by the seven countries/regions other than Japan in 2010 was 5.5 times higher than the 2001 level and 1.6 times higher than the figure for 2007. However, the ratio for stocks has peaked out at 10.9 times the 2001 level but only 0.9 times than the 2007 figure. Also of interest is the fact that the intraregional investment ratio for bonds within the ASEAN region is higher than that for stocks.

We will conclude this analysis by looking at Table 11, which compares regional trends in investment by investors worldwide in 2005 and 2010. East Asian investors reduced their investment in European bonds between 2005 and 2010 and diverted their funds into investment within Asia or in other regions. There was also a decline in investment in European and U.S. stocks, accompanied by an increase in stock investment within Asia or in other regions. This pattern was more pronounced than in the case of bonds.

Table 10-1 Balance of Cross-Border Investment in East Asian Stocks

2001 ($millions)

Recipient of Investment	Hong Kong	Indonesia	Japan	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment	Percentage of intraregional inward investment
	Source of Investment										
China	5,449	--	789	15	8	--	1,035	4	7,301	13,298	54.9
Hong Kong	--	11	4,848	100	47	--	3,125	6	8,138	79,869	10.2
Indonesia	--	--	50	13	44	--	307	15	428	3,590	11.9
Japan	2,145	2	--	101	7	--	1,536	1	3,793	332,338	1.1
South Korea	1,311	--	381	--	8	--	1,034	--	2,735	51,869	5.3
Malaysia	604	--	339	124	--	--	5,295	--	6,361	12,882	49.4
Philippines	60	--	213	3	61	--	420	1	758	3,447	22.0
Singapore	1,403	2	924	1	461	2	--	8	2,801	36,185	7.7
Thailand	488	--	290	20	15	1	1,520	--	2,334	7,791	30.0
Vietnam	--	--	1	6	10	--	25	3	46	85	53.7
Total	11,460	16	7,834	385	661	4	14,298	38	34,695	541,354	6.4
Total investment balance	94,615	17	227,343	1,300	1,332	111	31,319	82	356,118	5,196,431	6.9
Intraregional investment (%)	12.1	95.0	3.4	29.6	49.6	3.2	45.7	46.3	9.7	10.4	

2007 ($millions)

Recipient of Investment	Hong Kong	Indonesia	Japan	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment	Percentage of intraregional inward investment
	Source of Investment										
China	152,976	--	15,043	23,066	100	--	12,807	8	204,000	409,119	49.9
Hong Kong	--	351	17,501	15,302	1,832	--	16,206	104	51,296	315,692	16.2
Indonesia	468	--	800	561	212	--	3,556	18	5,615	39,684	14.2
Japan	8,540	3	--	4,813	200	--	13,256	14	26,827	1,057,999	2.5
South Korea	3,574	--	5,618	--	666	--	7,609	8	17,476	263,551	6.6
Malaysia	1,964	1	1,158	701	--	--	8,798	4	12,626	53,319	23.7
Philippines	389	--	318	105	37	--	800	1	1,650	18,886	8.7
Singapore	4,285	6	6,457	1,264	2,110	3	--	256	14,382	127,683	11.3
Thailand	1,123	23	1,444	325	120	2	3,525	--	6,562	45,883	14.3
Vietnam	122	--	6	1,201	1	--	469	4	1,803	3,726	48.4
Total	173,441	385	48,346	47,338	5,279	5	67,026	417	342,235	2,335,543	14.7
Total investment balance	514,511	866	573,469	104,858	9,422	186	176,803	3,300	1,383,415	17,121,471	8.1
Intraregional investment (%)	33.7	44.4	8.4	45.1	56.0	2.8	37.9	12.6	24.7	13.6	

2009 ($millions)

Recipient of Investment	Hong Kong	Indonesia	Japan	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment	Percentage of intraregional inward investment
	Source of Investment										
China	134,867	--	12,600	12,428	240	--	31,502	58	191,696	415,491	46.1
Hong Kong	--	9	15,055	6,721	2,246	--	7,156	121	31,308	234,169	13.4
Indonesia	193	--	663	243	482	--	2,361	19	3,959	45,195	8.8
Japan	5,771	1	--	2,548	110	--	13,812	12	22,252	702,792	3.2
South Korea	1,860	--	4,508	--	540	--	7,599	1	14,507	192,400	7.5
Malaysia	965	2	587	206	--	--	7,283	8	9,050	38,800	23.3
Philippines	215	--	163	71	16	--	597	2	1,063	11,706	9.1
Singapore	5,674	7	6,061	657	2,251	--	--	244	14,894	106,664	14.0
Thailand	608	39	1,054	179	230	2	2,103	--	4,214	43,117	9.8
Vietnam	43	--	22	516	685	--	447	11	1,724	2,774	62.1
Total	150,194	57	40,713	23,568	6,800	2	72,859	476	294,669	1,793,108	16.4
Total investment balance	498,708	852	594,069	75,230	20,150	26	170,432	3,299	1,362,765	13,712,846	9.9
Intraregional investment (%)	30.1	6.7	6.9	31.3	33.7	6.4	42.7	14.4	21.6	13.1	

2010 ($millions)

Recipient of Investment	Hong Kong	Indonesia	Japan	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment	Percentage of intraregional inward investment
	Source of Investment										
China	140,155	13	13,481	10,639	347	--	34,217	102	198,953	432,706	46.0
Hong Kong	--	3	16,554	6,134	2,599	--	8,192	206	33,687	300,919	11.2
Indonesia	1,871	--	3,341	416	766	--	2,877	21	9,292	60,971	15.2
Japan	5,771	--	--	4,459	147	--	14,713	16	25,105	817,187	3.1
South Korea	1,765	--	5,816	--	403	--	8,385	1	16,370	261,193	6.3
Malaysia	1,007	--	1,851	319	--	--	8,613	12	11,803	55,467	21.3
Philippines	142	--	271	116	28	--	974	2	1,532	17,089	9.0
Singapore	6,604	22	8,427	859	7,196	5	--	585	23,698	132,728	17.9
Thailand	898	--	1,605	321	320	--	2,978	--	6,123	55,443	11.0
Vietnam	140	--	222	480	31	--	395	12	1,281	2,698	47.5
Total	158,354	37	51,568	23,742	11,837	5	81,343	956	327,843	2,136,401	15.3
Total investment balance	581,704	948	678,481	86,697	25,050	19	194,121	5,035	1,572,055	15,503,684	10.1
Intraregional investment (%)	27.2	4.0	7.6	27.4	47.3	26.1	41.9	19.0	20.9	13.8	

Notes 1: China and Vietnam are not included among sources of investment because no data are available.
Notes 2: The figures in the lower right of each table represent world totals of outstanding investment.
Source: IMF, *Coordinated Portfolio Investment Survey*

Table 10-2 Outstanding Cross-Border Investment in East Asian Stocks (Excluding Japan)

(Percentages of intraregional investment)

	Hong Kong	Indonesia	South Korea	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment
2001	9.8	81.7	21.8	49.1	2.7	40.7	45.1	17.9	4.0
2007	32.1	44.0	40.6	53.9	2.7	30.4	12.2	33.0	7.5
2009	29.0	6.7	27.9	33.2	6.4	34.6	14.1	30.1	8.0
2010	26.2	4.0	22.2	46.7	26.1	34.3	18.7	28.1	8.5

Notes: Calculated by excluding Japan from Table 10-1. "Total balance of inward investment" denotes investment in East Asia (excluding Japan) as a percentage of total world investment.
Source: IMF, *Coordinated Portfolio Investment Survey*

Table 10-3 Outstanding Cross-Border Investment in East Asian Stocks (ASEAN Region)

(Percentages of intraregional investment)

	Indonesia	Malaysia	Philippines	Singapore	Thailand	Total	Total balance of inward investment
2001	13.3	44.3	2.7	24.2	32.9	24.9	1.2
2007	3.5	26.3	2.7	9.7	8.6	10.5	1.7
2009	5.5	18.2	6.4	7.5	8.6	8.6	1.8
2010	2.3	33.3	24.6	8.2	12.5	11.0	2.1

Notes: Calculated by excluding Hong Kong and South Korea from Table 10-2. "Total balance of inward investment" denotes investment in East Asia (ASEAN region) as a percentage of total world investment.
Source: IMF, *Coordinated Portfolio Investment Survey*

Table 11 World Balance of Outstanding Cross-Border Investment

Long-term bonds—End of 2005 ($billions)

	Source of Investment									
	NAFTA		EU15		East Asia		Others		Total	
Recipient	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share
NAFTA	244	22.4	1,100	14.8	669	33.9	1,432	48.9	3,444	25.7
EU15	441	40.4	5,008	67.5	717	36.4	1,041	35.5	7,207	53.7
East Asia	58	5.3	151	2.0	51	2.6	73	2.5	332	2.5
Others	348	31.9	1,157	15.6	536	27.2	386	13.2	2,427	18.1
Total	1,091	100.0	7,415	100.0	1,972	100.0	2,931	100.0	13,409	100.0

Long-term bonds—End of 2010

	Source of Investment									
	NAFTA		EU27		East Asia		Others		Total	
Recipient	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share
NAFTA	399	21.5	1,829	16.2	1,030	33.5	2,559	46.5	5,817	26.8
EU27	731	39.4	7,600	67.3	992	32.2	2,018	36.6	11,341	52.2
East Asia	100	5.4	232	2.1	131	4.3	154	2.8	617	2.8
Others	627	33.8	1,632	14.5	925	30.1	777	14.1	3,961	18.2
Total	1,857	100.0	11,293	100.0	3,078	100.0	5,508	100.0	21,736	100.0

Stocks—End of 2005

	Source of Investment									
	NAFTA		EU15		East Asia		Others		Total	
Recipient	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share
NAFTA	499	13.5	1,027	21.0	226	31.3	284	25.1	2,036	19.5
EU15	1,449	39.3	2,584	52.7	197	27.3	464	41.0	4,694	45.0
East Asia	769	20.9	510	10.4	106	14.7	73	6.4	1,458	14.0
Others	967	26.2	780	15.9	193	26.8	311	27.4	2,250	21.6
Total	3,684	100.0	4,901	100.0	721	100.0	1,133	100.0	10,439	100.0

Stocks—End of 2010

	Source of Investment									
	NAFTA		EU27		East Asia		Others		Total	
Recipient	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share
NAFTA	776	14.8	1,290	19.4	380	24.2	542	26.6	2,988	19.3
EU27	1,707	32.7	3,390	50.9	287	18.3	767	37.6	6,151	39.7
East Asia	1,006	19.2	662	9.9	328	20.9	140	6.9	2,136	13.8
Others	1,738	33.3	1,323	19.8	577	36.7	591	29.0	4,229	27.3
Total	5,227	100.0	6,665	100.0	1,572	100.0	2,040	100.0	15,504	100.0

Notes: East Asia consists of 10 economies (China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Thailand and Vietnam). Because there are no data for China and Vietnam as sources of investment, there are only eight East Asian sources of investment.
Source: IMF, *Coordinated Portfolio Investment Survey*

The intraregional investment ratios for NAFTA, Europe and East Asia in 2010 were 21.5%, 67.3% and 4.3% respectively for bonds, and 14.8%, 50.9% and 20.9% respectively for stocks. East Asia's ratio for stocks was higher than that of NAFTA. However, there was a major gap between East Asia and Europe in relation to bonds. As we have already seen, the ratios for bonds significantly rise if we exclude Japan, and the gap is also expected to narrow as the pace of regional integration accelerates.

As this analysis shows, there is a trend toward regional integration in relation to bonds, but there has been no clearly defined trend in relation to stocks. This difference may have resulted from the existence of the ABMI(4).

Data concerning cross-border bond issues in the main currencies (dollar, euro, yen) by Asian issuers are available from Asian Bonds Online, but it is difficult to obtain data about cross-border issues in national markets within the region, and it is hoped that data resources will be improved in this area.

(2) Bank Lending

①Intraregional Banking Flows

It is difficult to build a detailed picture of intraregional banking flows in Asia. Table 12 traces trends in borrowing by the ASEAN+3 countries and Hong Kong from BIS reporting banks according to the nationality of the banks. The BIS reporting banks referred to in this table are located in 30 countries, and most of them are important countries. The totals in Table 9B obviously include Finland, Hong Kong, India, Luxembourg, Norway and Singapore, but data for individual countries are not disclosed.

The ratio for Europe fell from 52.4% in December 2001 to 46.1% in June 2011 and 42.6% in March 2012, while that for the United States rose from 10.9% to 18.6% and 18.4% over the same period. There was little change in Japan's ratio, which stood at 9.1%, 8.5% and 8.5% respectively.

The figures for "Others" were also largely unchanged at 26.4%, 23.8% and 27.4% respectively. Asian countries and regions, especially Hong Kong and Singapore, account for an estimated 20% of them. The scale of lending by Asian banks can be estimated from the locational banking statistics in Table 2A (External assets of banks as of March 2012), which includes figures of $3,049.3 billion for Japan, $955.3 billion for Hong Kong, $883.9 billion for Singapore, $225.8 billion for Taiwan, $129.4 billion for South Korea, and $54.2 billion for Malaysia. There appears to be no substantial lending to Asia from regions other than Europe and the United States. Based on data published by the financial authorities in Hong Kong and Singapore, lending from this region/country to ASEAN+3 is estimated to account for around 40% of total lending. On this basis, we can conclude that Hong Kong and Singapore each account for about 10% of lending toward the region, and that the shares of South Korea and Malaysia (not included in the data for reporting banks in Table 9B) are substantially smaller than this.

This means that intraregional flows make up over 30% of banking flows (based on the total for Hong Kong, Singapore, Japan, Taiwan, etc.). The fact that this ratio has not changed significantly over the past 10 years suggests that banks from the countries and regions concerned are maintaining a stable presence in the region. However, the discussion so far has not included Chinese banks. If China's rapidly expanding banks were included,

Table 12 Sources of Funds Borrowed by Banks in ASEAN+3 and Hong Kong (Amounts Outstanding)

($millions, %)

	Total lending	Nationality of Lending Banks						
		Europe	Australia	Canada	Taiwan	Japan	U.S.A.	Others
Dec. 2001	1,244,242	52.4	n.a.	1.2	n.a.	9.1	10.9	26.4
Jun. 2011	3,549,297	46.1	1.1	0.5	1.4	8.5	18.6	23.8
Mar. 2012	3,709,327	42.6	1.1	0.3	1.7	8.5	18.4	27.4

Source: BIS, Table 9B: Consolidated foreign claims of reporting banks-immediate borrower basis the percentage of intraregional lending could increase.

In the preceding analysis, we looked at the nationalities of the reporting banks that provide loans in countries within the region, but we did not consider the methods used by reporting banks to procure their funds. If reporting banks procure some of their funds from outside of the region, we must assume that the percentage of intraregional lending would be proportionately lower.

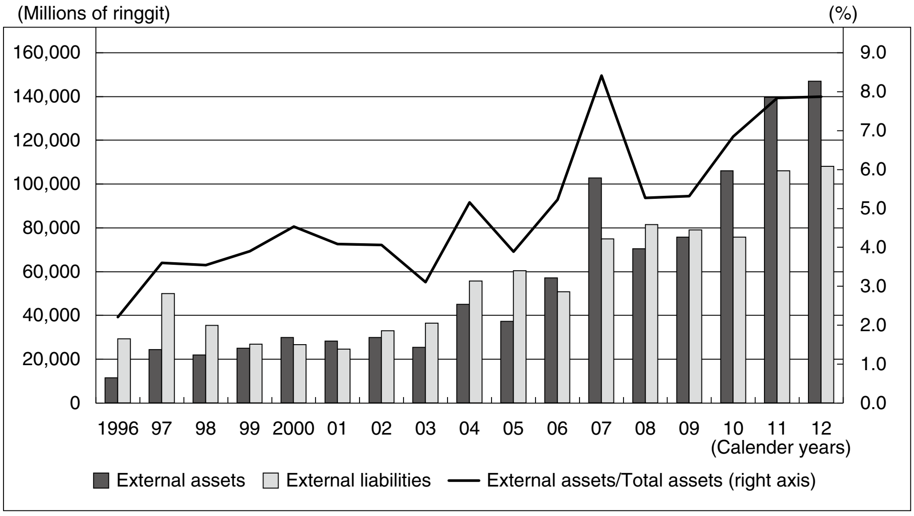
②Recent Changes

An analysis of changes in the ratios between June 2011 and March 2012 shows that the ratio for European banks fell from 46.1% to 42.6%, and that the only ratio to rise was that of Taiwan (27.8% increase in the balance of loans outstanding). The ratio for "Others" rose from 23.8% to 27.4%, apparently because of contributions from Hong Kong and Singapore. This means that banks within the region, including those in Taiwan, Hong Kong and Singapore, are offsetting the reduction of lending by European banks. The balance of loans outstanding provided by "Others" increased by 20.3% during this period. The balance of loans outstanding provided by the big three Singaporean banking groups (DBS, OCBC, UOB) amounted to S$500 billion (¥31.5 trillion) at the end of June 2012, a year on year increase of 17%. It is estimated that a constant percentage of their loans was channeled into the Asian region.

Top-ranked Malaysian banks are also expanding their business in the region, although these are not included in the statistics. As shown in Fig. 2, there has been a gradual upward trend in the external assets of the Malaysian banking sector as a percentage of total assets, and the main borrowers of these external liabilities appear to be foreign banks. The fact that Asia accounted for 56.4% of the external assets of the Malaysian banking sector at the end of 2011 indicates that the neighboring countries are the main focus of overseas business (Fig. 3).

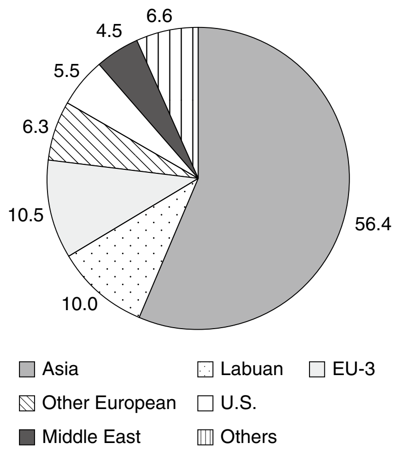
Overseas expansion has become an important strategy for Malaysian banks, some of which regard themselves as ASEAN regional banks. Malaysian companies are expanding their overseas investment, especially in the areas of energy, construction, plantation and services, and banks are also expanding overseas to support these companies. Banks have also started to build a cross-border involvement in consumer business, such as credit cards. In addition, overseas expansion by local banks is contributing to the economic development of the countries in which their overseas operations are located.

Fig. 2 External Assets and Liabilities of the Malaysian Banking Sector



Notes: The 2012 figures are as of the end of June.
Source: Bank Negara Malaysia, *Monthly Statistical Bulletin* June 2012

Fig. 3 External Assets of the Malaysian Banking Sector (Region, %)



Source: Bank Negara Malaysia, *Financial Stability and Payment Systems Report* 2011

At the end of 2011, six of Malaysia's eight banking groups had over 50 offices in 19 countries. As Malaysia's neighbor, Singapore was traditionally the main focus of overseas expansion. However, in recent years, Indonesia has also become an important target.

As shown in Table 12, Australian and Japanese banks have also maintained their shares of lending and are playing an important role in the supply of funds to Asia. The balance of credit provided to Asia by Japanese banks increased by 24% year on year in 2011 and reached a new record of $210 billion (approximately ¥17.2 trillion) at the end of that year. Japanese banks are harvesting the buoyant demand for funds for such areas as infrastructure development and resource development, and are increasing their share in areas in which European banks excel, notably trade finance and project finance. In 2012 (up to mid-September), the three mega-banks also lifted their rankings in the area of co-financing in the Asia-Pacific region. This accelerated move into Asia has heightened the reliance of major enterprises in the region on Japanese banks.

③Expectations toward the Regional Banking Sector

The expansion of cross-border activities by the banking sector not only supports the cross-border activities of businesses but also leads to the growth of financial sector within the region. Likely benefits from this process include a rise in the level of growth rates within the region, as well as the potential for greater financial stability. Malaysian and Singaporean banks, which are among the most highly developed in the region, are expected to act as drivers for regional financial integration in the future.

The banking sector also contributes to economic growth in each country by stimulating domestic demand. Most large corporations have the credit ratings needed to allow them to issue bonds, but there are many areas in which the banking sector must provide appropriate financial services, including lending to SMEs and the consumer banking business. Priorities from the viewpoint of facilitating lending in these areas include the establishment of credit risk information data bases and the reinforcement of credit guarantee systems. In the consumer banking business, consumer protection measures need to be strengthened and appropriate regulations introduced because of the risk of excessive borrowing.

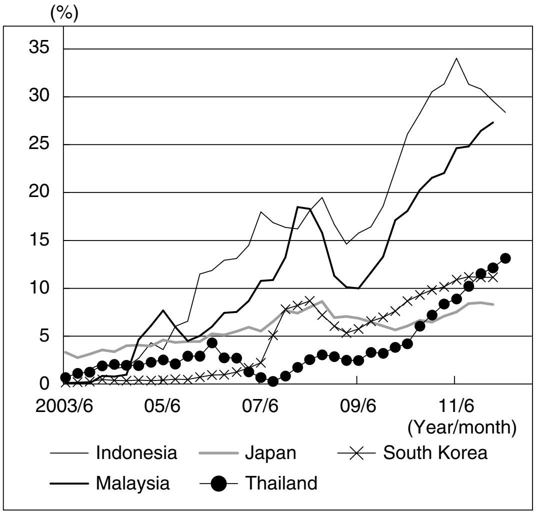
Another priority when economic structures are changing is the provision of diversified financial services. Specific examples include pension-related financial products, services for the wealthy, the provision of credit for the establishment of new businesses, finance for infrastructure projects, micro-finance, and Islamic finance. Participation in banking transactions is still low in many Asian countries, and measures to facilitate financial inclusion, such as the development of bank branch networks in rural areas and the expansion of micro-finance, have become important priorities from the viewpoint of reducing income disparity.

3. Priorities for Regional Financial Integration

(1) Reasons for the Expansion of Cross-Border Transactions

Investors are becoming increasingly interested in Asian bond markets, and foreign investors'

Fig. 4 Overseas Investor Ratios of GB Markets



Source: Asian Bonds Online

holding rates in government bond markets are rising (Fig. 4). There are a number of reasons for this trend. First, the expansion and development of bond markets and domestic institutional investors is accelerating, and there are expanding opportunities for even individual investors to invest through investment trusts. Second, investors feel more confident thanks to the efforts of individual countries to improve their markets, as well as regional financial cooperation through the ABMI and other mechanisms. Third, foreign investors are being encouraged to participate through regulatory changes, such as the easing of restrictions on capital transactions. Fourth, the trend toward investment in Asia has accelerated because of the recovery of Asian economies after the global financial crisis and their subsequent strong performance, and the improvement of the sovereign ratings of Asian countries.

In addition, from the investor's viewpoint, Asian bonds are a tool for international investment diversification. Other reasons include the fact that nominal interest rates are relatively high even though fiscal conditions are better than in most advanced countries, and the fact that interest rates can be expected to fall and currency values to rise gradually in step with economic development. Rates of return on investment in Asian bond markets have been excellent since 2000(5).

In summary, the incentives for the expansion of cross-border transactions come from the synergistic effects of the development and opening up of markets in each country through government and private sector efforts, the reduction of investment risk, especially through the changes of credit ratings, and the benefits in terms of investment returns. Furthermore, reasons for the rising percentage of intraregional investment are likely to include integration at the real economic level, which appears to be accelerating, and the relative attractiveness of intraregional investment to investors within the region compared with investment in the markets of advanced European and North American countries because of poor economic performance in those countries(6).

(2) What Needs to be Done to Increase Cross-Border Transactions?

However, market development is still far from complete, and much still remains to be done in order to expand cross-border transactions (Table 13). The missions of the four ABMI task forces are divided into issuance expansion, demand expansion, regulation and market infrastructure. A similar approach to the expansion of cross-border transactions should be possible (Items 1-4 in Table 13). The use of issues by international institutions is still likely to be an effective approach to Item 1. The ABMF regards the development of a common bond issuance systems as the most important of the tasks listed in Item 4. In addition, action on differences in credit rating systems in each country, including the methods used and the actual content, is an important priority from the viewpoint of encouraging cross-border investment, and this aspect is being discussed by an ASEAN+3 research group in Fiscal 2012. Rating agencies within the region will need to be strengthened, since investors within and beyond the region currently use ratings provided by international rating agencies as a standard for deciding whether or not to invest.

In addition to these tasks, Item 5 also listed priorities specific to cross-border transactions, in-

Table 13 Steps toward the Expansion of Cross-Border Transactions

1. Expansion of issuer base: Securitization and credit guarantees should be utilized to complement the creditworthiness of issuers.
2. Expansion of investor base: Institutional investors should be developed within the region, and information-sharing and information provision activities for investors should be undertaken.
3. Product development: Cross-border products (securitization products, Asian corporate bond funds, investment trusts, etc.) should be developed and used as catalysts.
4. Modification and harmonization of regulations and systems: Systems and market infrastructure (capital transaction regulations, taxation systems, market-related laws and regulations, ratings and other forms of credit risk data, accounting and audit standards, settlement systems, etc.) should be modified and harmonized.
5. Others:
(1) Differences in market development stages should be reduced through the development of bond markets in each country (including the expansion of issuer scale, the improvement of creditworthiness, the improvement of secondary market liquidity, and the development of risk hedging tools and settlement systems).
(2) Currently-related problems should be overcome through the development of foreign exchange markets, the liberalization of capital transactions, internationalization of currencies in the region and foreign exchange policy coordination.
(3) Debate on approaches to and the costs and benefits of economic and financial integration within and beyond the region should be intensified.
(4) Official institutions should engage in cross-border transactions, including reciprocal holding of government bonds.

Source: Compiled by the author

cluding the development of markets in each country, and action in various currency-related issues. Priorities for market development in each country include the improvement of secondary market liquidity, the development of risk hedging tools, and the improvement of settlement systems. It should also be remembered that a properly developed government bond market is essential to corporate bond market expansion.

III. The Unstable International Financial Situation and the Asian Financial Sector

1. The Impact of the European Debt Crisis

In Part III we will look at the relationship between the international financial situation and the Asian financial sector. Asian economies recovered quickly after the Lehman shock. However, the growing seriousness of the European debt crisis has started to impact on Asian exports, and in many countries economic growth rates peaked out in the first half of 2010 and have since started to fall.

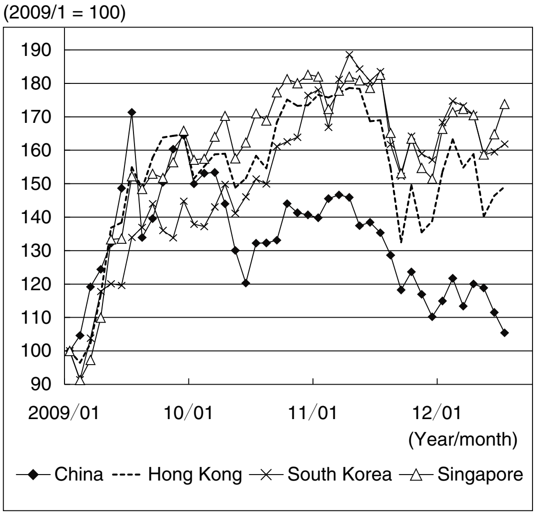
From a financial perspective, rapid inflows of capital into Asia in 2009 and 2010 resulted in closer integration with advanced countries' markets and increased exposure to the influence of those markets. Money flows into Asia are driven by the relatively strong performance of Asian economies, the increased availability of investment funds due to monetary easing in advanced countries, and expanding interest rate gaps. On the other hand, the risk stances of investors in advanced countries shift very often in response to changes in the European situation or other factors, with the result that the volatility of these inflows of money has increased.

After rising in step in economic recovery, stock prices in China plummeted in August 2009 and are still following a downward trend punctuated by occasional upward movements (Fig. 5-1). Stock prices in Hong Kong, South Korea and Singapore also began to drop in the second half of 2011 and have since gone through a series of rises and falls. However, stock prices in ASEAN countries have remained firm, in part because of relatively strong real GDP growth rates (Fig. 5-2).

After generally gaining value against the dollar from 2009 onwards, most Asian countries' currencies shifted to a downward trend in mid-2011 (Fig. 6-1, 6-2). This has also halted the accumulation of foreign currency reserves (Fig. 7-1, 7-2). The reserves of Thailand and Indonesia in particular are significantly lower, possibility as a result of intervention to support domestic currencies.

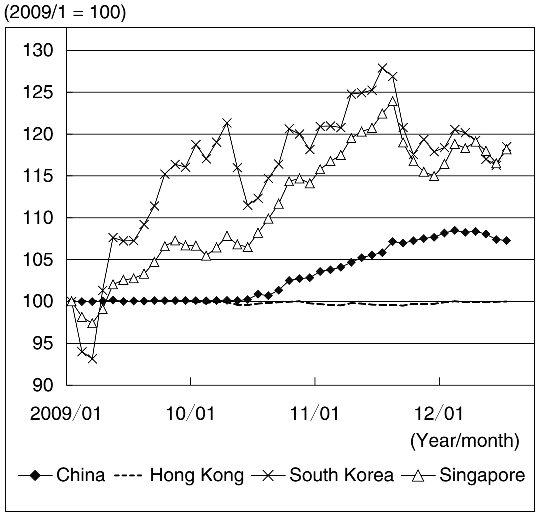
While the situation is not serious, these trends

Fig. 5-1 Stock Prices



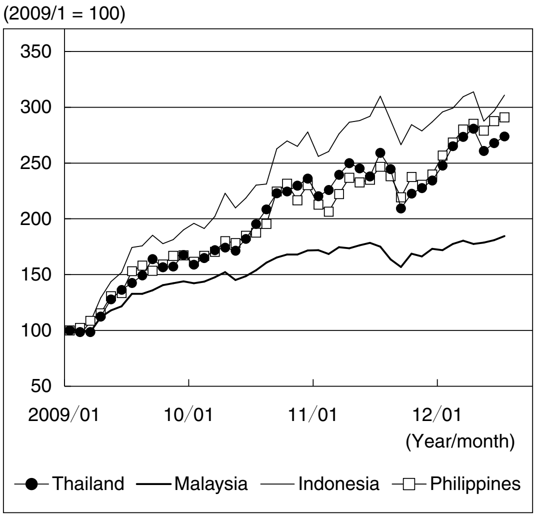
Source: Data from each country

Fig. 6-1 Nominal Dollar Exchange Rates



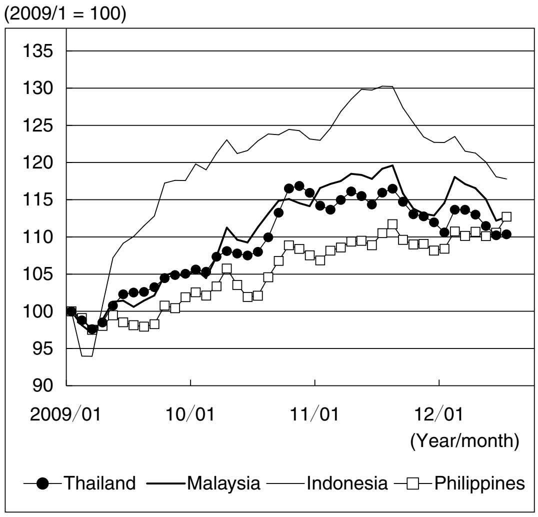
Source: Data from each country

Fig. 5-2 Stock Prices



Source: Data from each country

Fig. 6-2 Nominal Dollar Exchange Rates



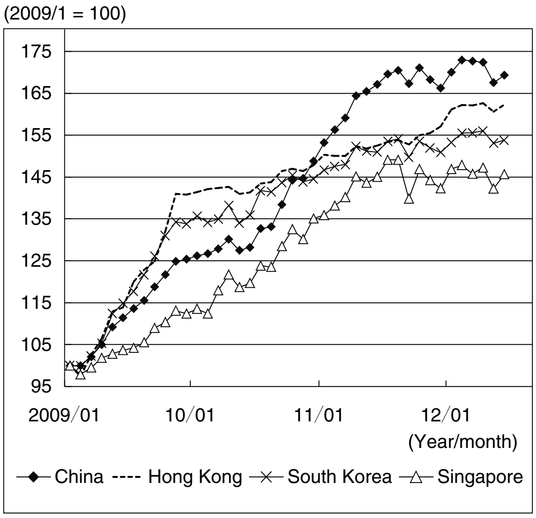
Source: Data from each country

show that the European debt crisis is also impacting on Asian economies and financial and capital markets.

An analysis of balance of payments positions in 2011 reveals that inflows of portfolio investment (gross) have declined compared with the previous year in all of the countries surveyed. In Fig. 4, we see a conspicuous decline in the foreign investor ratio for the Indonesian government bond market since mid-2011, indicating that funds are flowing out of the bond market. Table 11 shows that the percentage of European investors investing in East Asian bonds and stocks fell from 45.5% in 2005 to 37.6% in 2010 in the case of bonds, and from 35.0% to 31.0% in the case of stocks. This is also likely to be a result of the European debt crisis.

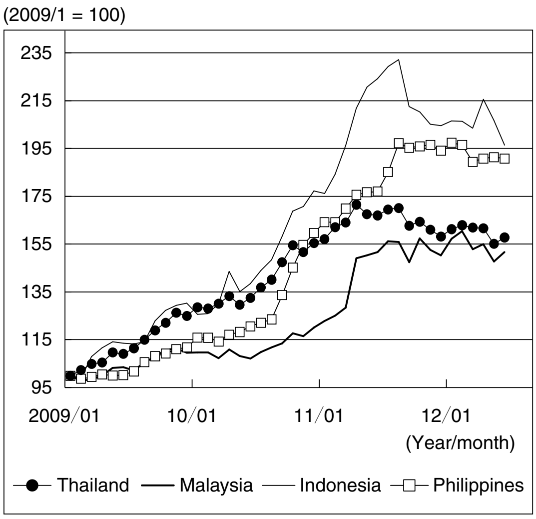
As shown in Table 12, banks within the region have taken up the slack left by the accelerating reduction of lending (deleveraging) by European banks. It appears from this that the crisis within the advanced countries is driving regional financial integration in Asia.

Fig. 7-1 Foreign Currency Reserves



Source: Data from each country

Fig. 7-2 Foreign Currency Reserves



Source: Data from each country

While Asia has been affected to some extent by the European debt crisis, the region has so far been able to cope with the situation. However, Europe's problems are likely to persist for a considerable period, and Asia could also face an increasingly serious situation if capital outflows expand. Crisis countermeasures will need to be strengthened against this contingency.

2. Asian Countries' Response to an Unstable International Financial Situation

In responding to the current international economic and financial situation, Asian countries will need to focus not only on regional financial integration, but also on the following factors.

(1) Groundwork for the Liberalization of Capital Transactions

One possible way to contain the ripple effects of turmoil in international financial markets would be to reduce reliance on capital flows by tightening restrictions on capital inflows. While Hong Kong and Singapore have made progress toward the liberalization of capital transactions, other Asian countries still maintain relatively stringent restrictions, and many are using sterilized intervention to curb increases in currency values while maintaining a degree of freedom for monetary policies. There is a tendency to restrict outflows more stringently than inflows, in part because of the experience of the Asian financial crisis. After the crisis, many countries also strengthened measures designed to restrict capital transactions and deinternationalize their currencies. These restrictions have been gradually eased since then, but there are now moves to tighten controls over capital flows again because of the experience of the global financial crisis, and because of a desire to curb rapid increases in capital inflows into Asia(7).

The volatility of net capital inflows into Asia has risen in recent years, and there has also been a significant increase of risk exposure related to capital flows, shown for example by the upward trend of the foreign investor ratio of government bond markets. Moves to restrict capital inflows are perhaps inevitable. However, liberalization of capital transactions is prerequisite for regional financial integration. The best approach, therefore, is to move toward liberalization while taking appropriate precautions against the risks associated with capital flows. Progress toward regional financial integration is also being hindered by the limited scale of foreign exchange transactions involving

Asian currencies, and the fact that those currencies are not internationalized. After liberalizing capital transactions, Asian countries should also aim to internationalize their currencies.

It is well known that sound macroeconomic policy management and the improvement of domestic financial systems are prerequisites for the liberalization of capital transactions. This is known as the "integrated approach." Macroeconomic policies include a flexible foreign exchange policy to provide freedom for monetary policy, and fiscal and monetary policies that ensure appropriate responses to capital inflows and outflows. The most effective approach to the other prerequisite, the improvement of domestic financial systems, is the development of financial and capital markets, accompanied by the strengthening of regulatory supervision over markets and market participants. Since foreign exchange transactions will increase rapidly in step with increases in capital flows, there is also likely to be a need for measures to strengthen foreign exchange markets, including increased flexibility (reduced intervention) in relation to exchange rates, and the development of currency derivative markets.

The easing of restrictions on capital outflows is likely to be a more effective approach to reduction of net capital inflows than the tightening of restrictions on inflows. In recent years, this approach has been adopted by several countries, including China, South Korea, Malaysia and Thailand. With the improvement of the capacity to manage risks associated with overseas investment, it is required to encourage companies and institutional investors to internationalize their activities.

Of course, regional financial integration must not result in a financial crisis. To stabilize capital inflows, it is necessary to use foreign exchange policies, fiscal and monetary policies, financial regulations and restrictions on capital transactions to curb excessive inflows and outflows and implement countermeasures when these situations occur. Another requirement is the continuing improvement of domestic financial systems.

Restrictions on capital transactions have been the subject of extensive debate. In developing countries, including those in Asia, full deregulation must be seen a long-term goal.

(2) Developing Domestic Bond Markets

As has been stated repeatedly, the development of domestic financial systems is essential. When we consider the importance of bond markets in relation to crises, it becomes apparent first of all that while bond market improvements are unlikely to reduce capital inflows during normal times, they can be expected to influence the composition of inflows. In other words, bond markets can function as a substitution mechanism for inflows of higher-risk capital. Second, if bond markets have been developed they can be expected to provide the means to complement capital flows when inflows shrink rapidly or outflows increase.

To provide these functions, it is necessary to develop robust bond markets. In particular, it is important to diversify the investor base by bringing in various characters of foreign investors and developing domestic investors, and to stabilize market prices and improve secondary market liquidity. These improvements will help to curb sudden one-way shifts in market prices.

In the past, the main cross-border investors were hedge funds. With the inclusion of bonds from developing countries in global indexes, however, there has been a gradual increase in the presence of real money investors, such as pension funds. This trend can be expected to bring greater stability to overseas funds.

However, foreign funds will inevitably flee when crises occur. That is why the development of domestic investors is also essential. At present, local banks hold large amounts of government bonds, but they are not especially active in trading. By increasing the number of institutional investors, such as pension funds and investment trusts, it should be possible to diversify investment methods and improve liquidity.

There are other requirements in relation to the improvement of liquidity. For example, it is essential to establish benchmark interest rates, improve the transparency of transaction prices, strengthen market maker functions, and develop markets for bond and interest derivatives. One of the weaknesses of Asian bond markets is the inadequate development of derivative markets. Given that over-the-counter derivative markets are regarded as high-risk markets, the best approach would probably be to create bond futures markets based on securities exchanges(8).

Measures implemented during crises have also included the easing of conditions for the acceptance of bonds as loan collateral, and the temporary easing of regulations concerning the market valuation of bonds. While these measures are effective, their implementation needs to be based on a proper awareness of the functioning of market mechanisms.

(3) Introduction and Expansion of Islamic Finance

Islamic finance has characteristics that help to enhance financial sector stability. Shariah governance based on Shariah principles contributes to the improvement of governance in the financial sector. Strong Shariah governance systems ensure that funds are allocated for productive purposes and are always backed by real assets. Speculation is prohibited in Islamic finance, and there are no speculative transactions such as derivatives transactions or foreign exchange dealings. These features are in tune with the values of ethical investment and financing, including socially responsible investment (SRI), the growth of which has been particularly conspicuous since the global financial crisis.

Islamic finance appears to have the potential to contribute to global financial stability and the stability of national financial markets. Asian countries should give positive consideration to the expansion of this type of finance.

(4) Reinforcement of Financial Regulation

Since the global financial crisis, there has been growing international debate about the need to strengthen financial regulation. The Lehman shock also impacted on Asia through reduced exports and capital inflows, shrinking liquidity, and a decline in issues of high-risk financial products. All of these phenomena resulted from ripple effects from advanced countries, and the soundness of domestic financial systems was maintained. However, the Asian financial sector is part of the international financial system and cannot be isolated from the debate over the reform of international financial regulation. At present the debate is focusing mainly on the following points(9).

First, there is the reinforcement of microprudential supervision, which means monitoring of individual financial institutions. This process is being introduced basically through a review of the Basel rules. Key points of debate include the reinforcement of capital adequacy, the improvement of liquidity, and the limitation of leveraging. Examples of this type of regulation include the Volcker Rule, which separates the commercial banking business from other types of high-risk business.

Second, there is the reinforcement of macroprudential supervision, which focuses on monitoring systemic risk. This function has not always worked effectively in the past. Monitoring needs to start before risks have been identified in individual financial institutions, so that attention can be drawn to market trends that could jeopardize systemic stability. The aim of monitoring is to prevent generalized crisis of the financial system. One of the techniques used for this purpose is to tighten regulation of globally systemically important financial institutions.

Third, there is the reduction of procyclicality. Many aspects of financial and accounting systems, including the framework of Basel 2, have a tendency toward procyclicality. In the area of financial regulation, for example, it is possible to introduce counter-cyclical mechanisms, such as progressive increases in bad loan reserves in proportion to increases in the amount of lending. This type of regulation is already in use in many Asian countries.

Fourth, there is the reinforcement of regulations targeting specific financial products and businesses. It is important to prevent the use of complex securitization mechanisms and the exclusion of those securities from balance sheets, which were the main causes of the subprime mortgage problem in the United States. Products of this type did not exist in Asia in the past, and it is hoped that securitization will continue to follow a healthy growth trend in the future. The keys are product standardization and measures to ensure the transparency of transactions, such as through the use of exchanges. Another form of regulation targeting specific products and businesses is the restriction of "shadow banking," an offshoot of the subprime mortgage problem whereby banks engage in banking-related activities in ways that circumvent the banking regulations.

We will look next at credit rating agencies, whose reputations have been affected by the global financial crisis. This has led to the introduction of new regulations, including registration systems. International rating agencies have not been especially active in Asia, while local agencies are not yet fully developed. Although this situation has prevented rating-related problems, it also reflects the difficulty of rating Asian securities, and it will be necessary to strengthen Asian rating agencies under a new regulatory framework based on international standards.

It has been suggested that the transparency of over-the-counter derivative transactions should be improved through bulk settlement using a central counterparty. Regulatory changes are also being considered with the aim of improving the transparency of repo transactions through the clarification of costs and the types of securities accepted.

Fifth, there is the reinforcement of crisis response frameworks. It is important not only to identify problem banks and implement early intervention measures, but also to establish frameworks for the resolution of banks. Exceptional treatment based on the "too big to fail" concept should be avoided wherever possible. Because crisis resolution methods vary from country to country, the relevant authorities need to cooperate closely in order to contain crises quickly and resolve problems.

The key priorities in these areas are to ensure that the authorities have the powers and capabilities needed to move forward steadily with regulatory reform, and to ensure that regulations do not become a barrier to economic growth.

3. Lessons from the European Debt Crisis

The European debt crisis, which began with the Greek crisis in November 2009, can be seen as the result of inconsistencies caused by currency union, which were exposed by the global financial crisis(10). The environment that formed as a result of currency union was conducive to the expansion of private and public debt in the member countries, in part because of the convergence of government bond interest rates within the eurozone. With the onset of the global financial crisis, governments came under pressure to implement stimulatory measures and deal with an increasingly serious banking crisis. The result was a vicious circle of sovereign debt crises and banking crises.

Asia has two lessons to learn from the European debt crisis. First, rapid monetary union entails major risks. After monetary union, member countries become unable to maintain their competitiveness by reducing the value of their currencies. Unless the domestic economy can be effectively adjusted, this situation can easily cause the current account deficit to expand, triggering a crisis.

For monetary union to succeed, the participating countries need to achieve a certain level of economic and political uniformity. The European debt crisis proves that it is difficult to realize a scenario in which monetary union facilitates regional economic uniformity.

Asia has even wider gaps between countries in terms of economic development stages than Europe, and it would be impossible to achieve strong regional financial integration such as monetary union rapidly. The reduction of gaps in development stages through the economic development and the improvement of financial systems of less developed countries will therefore be an important prerequisite for integration. It is especially important to recognize that foreign exchange policy coordination requires a cautious approach, including implementation in stages, since it reduces the freedom with which individual countries can implement macroeconomic policies. The region needs to look for a gradualist approach based on reference to regional currency basket and other concepts.

Integration in Europe was driven by political factors and internal factors, while the prospect of accelerating integration in Asia is linked to economic factors and external factors, including the development of intraregional divisions of labor and economic stagnation in advanced countries. For this reason, Asia is moving toward loose integration that will to some extent result in greater openness beyond the region as well. This situation is likely to remain the basis for future progress toward integration.

Second, moves toward regional financial integration must be accompanied by adequate precautions against financial crises. Regional financial integration not only stimulates intraregional domestic demand and supports economic growth, but also improves the capacity to withstand financial crises and other external shocks(11). Given the present international financial situation, however, the importance of crisis countermeasures is likely to increase, and it will be necessary to focus on responses to capital flows, as described in the previous section, on the gradual liberalization of capital transactions, on the development of domestic bond markets, and on the reinforcement of financial regulations.

Regional financial cooperation frameworks should be used for these purposes(12). Monitoring of capital flows is likely to be especially important. In view of the increasingly serious banking crisis associated with the European debt crisis, the prevention of systemic risks through the development of frameworks for macroprudential supervision will be an essential requirement. Other essential preparations include the development of mechanisms for bank bail-outs.

The steps that are currently being taken to strengthen the CMIM framework and expand the activities of AMRO are also an essential part of crisis countermeasures. Many aspects need to be debated in relation to regional financial cooperation, including the development of financial and capital markets, responses to capital flows, regional financial integration, and crisis management. In 2008, Asian Development Bank President Haruhiko Kuroda proposed the Asian Financial Stability Dialogue (AFSD) as an organization for this purpose. The Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) has also stepped up its activities in relation to regional cooperation in such areas as responses to international financial regulatory reform.

There will need to be debate concerning the best organizational response on this issue. Furthermore, since none of the existing organizations have the power to force countries in the region to adopt regulatory changes and other measures, careful consideration will be necessary to the focus of initiatives and methods to make them effective.

IV. Outlook for Regional Financial Integration

1. The Influence of China: Internationalizing the Yuan and Japan-China Financial Cooperation

(1) Internationalizing the Yuan—Current Situation

In this section we will examine trends in Japan and China, which will play an important role in regional financial integration. We will look first at the internationalization of the yuan.

Since the global financial crisis, China has been implementing a yuan internationalization strategy. This is motivated basically by a loss of confidence in the U.S. dollar as the key currency. Currency internationalization generally means free interchangeability with other currencies as the basis for a dramatic increase in the use of the currency in trade and capital transactions (including overseas bank loans and bond issues). The only international currencies in Asia are the Japanese yen, the Hong Kong dollar and the Singaporean dollar. If the yuan becomes an international currency, it will have a major influence on the future shape of foreign exchange policies in Asia, including the potential for policy coordination.

The first core component of the strategy is the expansion of yuan settlements for the trade in goods. In December 2008, China began to use yuan settlements on a trial basis for the trade in goods with specific countries and regions. Yuan-based settlements began in earnest in July 2009. Initially the People's Bank imposed restrictions concerning the domestic regions involved in the trial, as well as the export markets involved and participating companies. However, these limitations have gradually been eased. In June 2010, the scheme was expanded to include all export markets, and the scope of transactions to include all current transactions. In August 2011, the trial program within China was extended to include the entire country, and in March 2012, all companies with trade licenses were included in the scheme.

Yuan-denominated settlements reached 3.58 billion yuan in 2009, 506.34 billion yuan in 2010, and 2,080 billion yuan in 2011[13]. The percentage of trade settled in yuan has been around 10% since mid-2011.

Most yuan-denominated settlements involve Hong Kong. Initially the purpose of yuan settlements was to reduce currency risk of exporting companies. However, the value of the yuan is tending to rise, and over 80% of the transactions are in fact import settlements. This situation is leading to a rapid increase in the balance of yuan-denominated deposits in Hong Kong (Fig. 8).

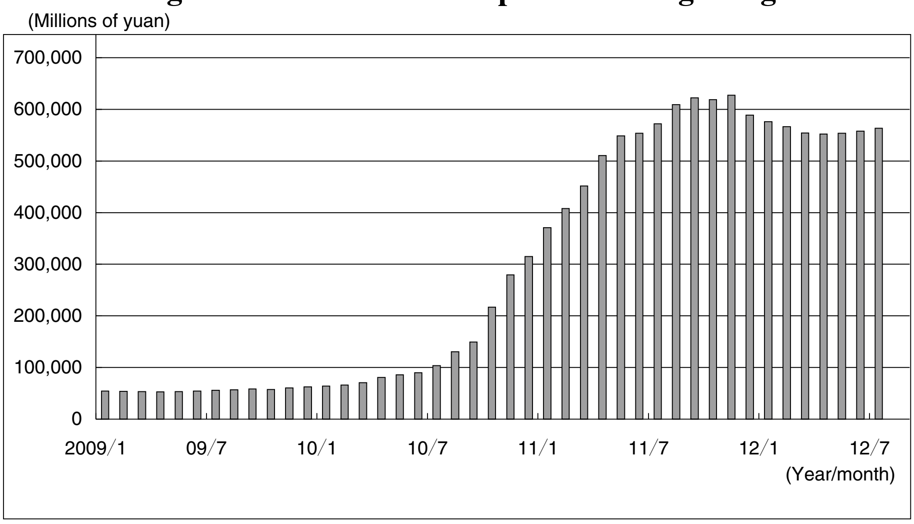
The second core component of the strategy is the easing of restrictions on yuan-denominated capital transactions. In relation to outward direct investment, companies located in regions selected for the yuan-denominated trade settlement trial have been allowed to carry out investments on a trial basis since January 2011. In addition, approval was given for yuan-denominated lending to companies targeted for direct investment. In addition, companies based in Shanghai were allowed to obtain yuan-denominated overseas loans for purposes other than trade-related overseas debt.

In October 2011, approval was given for overseas investors to use yuan acquired by legal means (yuan-denominated bond issues, trade settlements, dividend payments received) for direct investment in China.

In relation to inward portfolio investment, overseas banks that handle yuan-denominated trade settlements have been allowed to invest yuan funds in the domestic interbank bond market since August 2010, although the banks concerned need to obtain licenses and investment quotas. Furthermore, in December 2011, the government announced regulations providing for a trial program involving investment in domestic securities by "renminbi qualified foreign institutional investors" (RQFIIs), such as fund management companies and securities companies. Participating companies were allowed to use yuan solicited from Hong Kong investors for investment within China.

This left investment in overseas securities as

Fig. 8 Balance of Yuan Deposits in Hong Kong



Source: Hong Kong Monetary Authority

the only type of current or capital transaction for which yuan-denominated settlements were still not permitted. Of course, approval was given for each item on a limited basis.

The third core component of the strategy was the signing of currency swap agreements with foreign central banks. China has been signing agreements providing for swaps between the yuan and other countries since December 2008, not only to support short-term liquidity, but also in the expectation that companies in the other countries would use yuan to pay for imports from China. By March 2012, swap quota agreements amounting to approximately 1,650 billion yuan had been signed with 17 countries.

The fourth core component is the expansion of the yuan-denominated bond issues and the expansion of the Hong Kong offshore market. The Asian Development Bank and the International Finance Corporation issued yuan-denominated Panda bonds in Mainland China in 2005. Approval was given for issues by foreign-owned companies (resident in China) in 2009, and a subsidiary of the Bank of Tokyo-Mitsubishi UFJ, Ltd. issued bonds in November of that year. China has subsequently allowed issues of this type a little at a time.

In 2007 approval was given for yuan-denominated bond issues in Hong Kong by Mainland Chinese banks. In 2009, issues by subsidiaries established in Mainland China by foreign banks were approved and implemented. In October 2009, the Chinese government began to issue government bonds in Hong Kong. An initial issue worth 6 billion yuan was followed by issues worth 8 billion in yuan in November 2010, 20 billion yuan in August 2011 and 23 billion in June 2012.

Yuan-denominated bond issues by issuers regarded as non-residents from a mainland perspective have been allowed since July 2010, with the aim of increasing yuan-denominated financial products in Hong Kong. Bonds of this type are known as “dim sum bonds.”

The Hong Kong yuan offshore market began to operate on a significant scale as a result of this change, which also led to the formation of a market for the Hong Kong yuan (CNH), distinct from the Mainland Chinese yuan (CNY) market. Previously foreign exchange transactions had been limited to NDF transactions, but now there is also a foreign exchange market for the yuan in Hong Kong. In contrast with the tightly regulated domestic foreign exchange market, in which non-residents cannot participate, there are few restrictions in the Hong Kong market. Because the CNH used in trades between non-residents is a floating currency, its value can diverge from that of the CNY. This means that China is in effect operating a dual exchange rate system.

As a result of the easing of restrictions in July 2010, it became possible to develop and sell a variety of yuan-denominated financial products in Hong Kong. Japanese companies can now issue yuan-denominated corporate bonds in Hong Kong, and investment from Japan in Hong Kong yuan-denominated bonds is also possible.[(14)]

Yuan-denominated bonds worth approximately 200 billion yuan were issued in Hong Kong between 2007 and mid-2012[(15)]. There were four issues totaling 15 billion yuan in 2009, 16 totaling 35.8 billion yuan in 2010, and 87 totaling 106 billion yuan in 2011. The 2011 figure reflects the expansion of the scope of issuers to include mainland general business corporations in August of that year. At 67.2 billion, bond issues during the first six months of 2012 were 52% higher than the total for the same period in 2011. The issuer base has also expanded to include issuers not only from Mainland China but also from Europe, the Middle East and other regions.

Other phenomena that are indicative of progress toward the internationalization of the yuan include the debate over the inclusion of the yuan in the basket for IMF special drawing rights (SDRs), moves by some countries to add the yuan to their foreign currency reserves, the establishment of a banking forum as a framework for cooperation between the Hong Kong Monetary Authority (HKMA) and the U.K. Treasury concerning offshore yuan operations, and a statement by the U.K. Chancellor of the Exchequer calling for the establishment of an offshore yuan market in London.

(2) The Outlook for the Internationalization of the Yuan

Murase [2012] uses the term "managed internationalization" to describe the internationalization of the yuan in an environment in which the mainland and Hong Kong markets are still separated by restrictions on capital transactions(16). Overseas funds are allowed to move freely in and out of the Hong Kong market, which is used for the investment of hot money that previously flowed in and out of domestic markets in ways that circumvented regulations. Dual interest rates and exchange rates have formed in the two markets, but Chinese trade companies with offices in Hong Kong are able to use whichever of the CNH or CNY rates is the more advantageous, and a certain amount of arbitrage will occur between the two markets. This market environment is attributable to the formation an offshore market while maintaining restrictions on capital transactions, and it cannot be regarded as a natural situation. Other issues highlighted in Murase [2012] include higher transaction management costs due to the continuing policy of domestic-overseas separation, and the strong possibility that the liberalization of mainland interest rates and financial and capital market reforms will be delayed.

There is likely to be a significant need for yuan transactions because of the expanding presence of the Chinese economy. If the Chinese government so wishes, therefore, it is likely that internationalization will move forward at a reasonable steady pace. As discussed later in this article, yuan-denominated transactions are in fact also expanding in the Tokyo market.

However, the essential requirements for an international currency are not only unrestricted currency and capital transactions and the development of domestic financial, capital and foreign exchange markets, but also the establishment of confidence in the value of the currency. Capital market liberalization requires the application of market principles to capital flows through steps that include the development of financial and capital markets, the liberalization of interest rates, the adoption of a flexible foreign exchange policy, and the development of monetary policy tools. Because of the many obstacles that exist in these areas, China's progress toward the liberalization of capital transactions will inevitably be gradual(17). It would be impractical to move ahead with just the internationalization of the yuan in this environment. Yu [2012] states that rather than hastening to internationalize the yuan, China will focus on the establishment of the conditions required for the liberalization of capital transactions. In reality, the only way to internationalize the yuan while keeping risks to a minimum is through the accelerated development of domestic financial systems, including improvements at the macro level(18).

(3) Progress toward Japan-China Financial Cooperation

Japan has adopted a clearly defined cooperative stance toward China's yuan internationalization strategy. During a Japan-China summit meeting on December 25, 2011, the leaders agreed to increase reciprocal cooperation toward the development of financial market in both countries. The main areas of cooperation are (1) promotion of the use of the yen and yuan in cross-border transactions between Japan and China (promotion of yen- and yuan-denominated trade settlements, yuan-denominated Japanese direct investment in mainland China), (2) support for the development of a market in which the yen and yuan can be directly exchanged, (3) support for the sound development of yen- and yuan-denominated bond markets (yuan-denominated bond issues by Japanese companies in the Tokyo market and other overseas markets, yuan-denominated bond issues in the mainland market by the Japan Bank for International Cooperation, investment in Chinese government bonds by the Japanese authorities), (4) encouragement for the development of yen- and yuan-denominated financial products and services in overseas markets by the private sector, and (5) the establishment of a joint working group on the development of financial markets in Japan and China.

This agreement is seen as an initiative to support the expanding economic and financial relationships between Japan and China. There are specific benefits for Japan. First, Japanese companies engaged in business activities with China will benefit from lower transaction costs and currency risks and an expanded range of options for financing and investment. Second, the presence of the Tokyo market and Japanese financial institutions will be expanded due to the improved usability of the yen and the diversification of financial products and services. On both levels, the aim is to harness growth in Asia, especially China, as a source of vitality for the Japanese economy.

In the Tokyo market, financial institutions are increasingly offering yuan-based financial products and services, including the acceptance of yuan deposits from individuals and Japanese companies, and the provision of yuan-denominated loans. Japanese banks are also stepping up their efforts to support yuan-denominated direct investment by Japanese companies(19).

There has also been progress toward the establishment of a market for the direct exchange of the yen and yuan. Direct exchange between the yen and the yuan (offshore yuan) began in the Tokyo foreign exchange market on June 1. On the same date, direct yen-yuan exchange transactions began in the Shanghai center of the China Foreign Exchange Trading System (CFETS), following the establishment of a new market maker system. Ten banks, including local subsidiaries of Japanese banks, were designated as market makers.

Direct trading lowers transaction costs, reduces the Herstatt risk (settlement risk resulting from the fact that settlements occur in different time zones for each currency) and improves the usability of both countries' currencies. It is also expected to revitalize the Tokyo market. Direct transactions in the Shanghai market have increased dramatically since June 1, and trading spreads are shrinking. The yen's share of spot currency transactions in the Shanghai market rose from 0.1% in the January-March quarter of 2012 to 1.4% (equivalent to $12 billion) in the April-June quarter.

In the longer-term future, these changes will result in a gradual shift away from the dollar. They will also be highly significant from the perspective of regional financial integration. Efforts to move away from the dollar are not limited to Japan and China. For example, in September 2012, China and Taiwan reached agreement on the introduction of direct trading between the yuan and the Taiwanese dollar. In addition, seven ASEAN countries have agreed to link their ATM systems and settle foreign currency transactions through these systems directly in local currencies(20). Of course, it will take a considerable period of time for a general shift away from the dollar to permeate throughout Asia. In the immediate future, it is likely that the private sector will use the yen and yuan as levers to drive regional financial integration. It is also hoped that synergy benefits will arise between Japan-China financial cooperation and ASEAN+3 financial cooperation.

2. Regional Financial Integration and Japan

(1) Market Development Initiatives in Japan

Our final topic is Japan's involvement in regional financial integration. There are two aspects to this. First, there is attraction of Asian economic entities (general business corporations, financial institutions, institutional investors and individual investors) into Japanese financial and capital markets. Second, there is the fact that Japanese economic entities will be involved in some way in Asian financial and capital markets.

Japan is playing a major role in regional financial cooperation, but the development of domestic bond markets and the encouragement of Asian issuers and investors to use those bond markets is also a major priority. Japan has undertaken various initiatives in this area. First, there is the creation of frameworks—the Market Access Support Facility (MASF) and the Guarantee and Acquisition toward Tokyo market Enhancement (GATE) system—within the Japan Bank for International Cooperation to provide partial guarantees for Samurai bonds issued by foreign governments, and to acquire part of those issues. Reasons for the establishment of these systems include the expansion of the foreign issuer base, the expansion of investment opportunities for domestic investors, and the revitalization of the Tokyo market.

Second, in July 2009, the Japan Securities Dealers Association established the Study Group to Vitalize the Corporate Bond Market. In June 2010 this group released a report entitled "Toward Vitalization of the Corporate Bond Market." In July 2012 a sub-group report on initiatives to revitalize the corporate bond market was published.

Third, in May 2011, the Tokyo Pro-Bond Market was established as a bond market for professionals. This became possible after the enforcement of the Act for Amendment of the Financial Instruments and Exchange Act in December 2008. Disclosure and screening procedures for this market have been simplified, and information disclosure in English and program listing can be carried out. In March 2012, the ING Bank of the Netherlands used the market to list a ¥200 billion program requiring issuance within one year, and in April bonds worth ¥50.7 billion were issued. The Asian Development Bank is also considering a pilot issue.

Criteria applied by bond issuers and investors when choosing markets include issuance costs, rates of return on investment, and convenience in terms of market infrastructure and regulations. It is hoped that market development efforts will result in the formation of a market that will be attractive to overseas issuers and investors. Market competition in Asia is intensifying, and publicity activities concerning Japanese markets need to be stepped up in order to attract bond issues and stock listings by Asian companies. Other priorities include the provision of incentives for investment by foreign investors.

Because of the increasing instability of financial systems in Europe and the United States, confidence in the Japanese market is relatively high. For example, samurai bond issues by South Korean business corporations and financial institutions, for which overseas financing is difficult, doubled year on year to around ¥370 billion in 2011. As a result, the percentage of foreign bond issues denominated in dollars fell from 67% in the previous year to 55%, while the percentage denominated in yen rose from 11% to 19%. Furthermore, outstanding Japanese government bonds held by foreign investors increased by around 20% year on year and reached a record high of ¥81.6 trillion at the end of June 2012. The percentage of government bonds held by foreign investors has also reached an all-time high of 8.7%.

(2) Government Strategies

The basic aim of the New Growth Strategy adopted by Japan's cabinet in June 2010 is to accelerate Japan's growth by harnessing the growth of Asian economies. Financial strategies based on this policy include the establishment of Asian bond markets, the development of primary and secondary corporate bond markets for professionals, the revitalization of the samurai bond market, the creation of an integrated exchange, and the opening up of Asian financial and capital markets. In January 2011, the cabinet adopted "Realizing the New Growth Strategy 2011" as a follow-up policy for the New Growth Strategy.

Based on these developments, on December 24, 2010 the Financial Services Agency completed an action plan for the revitalization of financial and capital markets and the financial industry. A key focus of this action plan is the role of the financial sector as a bridge between Asia and Japan. The priorities identified in this context are the establishment of a position for the Japanese market as the main market in Asia, and the expansion of the activities of Japanese financial institutions in Asia. Specific policies for the realization of the latter goal include the promotion of policy cooperation with Asian countries in relation to financial and capital markets. The development of Asian bond markets is seen to be linked to the expansion of the activities of Japanese financial institutions.

In July 2012, the Japanese cabinet adopted "Rebirth of Japan: A Comprehensive Strategy." A key element in this strategy regarding finance is the achievement of an enhanced presence for Japanese companies, financial institutions and markets in Asia. Specific strategies identified for this purpose include (1) the improvement of the competitiveness of Japanese financial and capital markets and financial institutions with the aim of making Japan the financial center for Asia (law changes to allow the creation of an integrated exchange, improvement of the competitiveness of Japanese financial institutions and markets, the reinforcement of the growth potential and competitiveness of insurance companies, the development and opening up of Asian financial and capital markets through Japanese initiatives, the promotion of global regulatory reforms), (2) support for the improvement of the international competitiveness of Japanese companies (the reinforcement of systems to supply funds for overseas expansion, the formulation of measures to promote urban development projects, especially in Asian emerging economies, the facilitation of strategic business restructuring by business corporations).

Through these strategies, Japan aims to build the top exchange in Asia, and to become a hub for the circulation of money within and beyond Japan. Clearly the goal of the policy is to promote regional financial integration in Asia, including Japan. Benefits are expected to emerge as this strategy is put into effect.

In addition, Financial System Council, Working Group on the Medium- and Long-Term Modalities of the Japanese Financial Industry [2012] identifies "outward globalization" (global expansion of the financial industry) and "inward globalization" (improvement of domestic markets) as components of the strategy. In relation to outward globalization, the Working Group proposes that the Japanese government should call on overseas authorities to reform their regulations, including restrictions on market participation by foreign banks, that domestic regulatory obstacles to the free activities of financial institutions should be eased, and that there should be collaboration and risk sharing between private sector financial institutions and public financial institutions. Because changes to restrictions on market participation by foreign banks involve the sovereignty of the countries concerned, it would be necessary to spend time exploring various possibilities.

As far as inward globalization is concerned, the aim should be to create dynamic markets in which players from emerging economies in Asia and elsewhere can participate, and which allow free inflows and outflows of funds. The Working Group states that this will require continued efforts to develop highly transparent and internationally compatible market rules, efficient and reliable exchanges, and settlement and clearing systems.

A deeper understanding of Asian financial and capital markets and the behavior of economic entities is essential to the achievement of the goals of financial globalization. Furthermore, if care is taken to maintain a synergistic approach to real economic integration and financial integration, support for integration at the real economic level will also facilitate financial integration.

Conclusions

Policy initiatives toward regional financial integration have taken various forms, including the establishment of the ASEAN Economic Community, financial cooperation within the ASEAN+3 group, financial cooperation between Japan and China, and the Rebirth of Japan strategy. Moves toward regional integration at the real economic level are accelerating, as evidenced by the fact that the 16 members of the ASEAN+6 group agreed to commence negotiations on a wide-area free trade agreement in August 2012. Regional financial integration is also expected to move forward steadily in step with this process. Regional economic integration and financial integration are also likely to provide impetus for each other. There has already been progress toward the regional integration of long-term bond investment and bank lending.

Regional financial integration is being driven forward as a way of supporting economic growth by strengthening the functions of the financial sector and accelerating the expansion of domestic demand. It is also seen as a way of reducing reliance on external funds and improving the ability to withstand external shocks such as financial crises. For example, moves by banks within the region to bridge the gap left by reductions in lending to Asia by European banks are the perfect illustration of how regional financial integration can limit the ripple effects of crises.

Even so, the international financial situation remains unstable, and it will still be necessary to strengthen various crisis countermeasures. To cope with sudden capital inflows or outflows, measures will be needed in various areas, including foreign exchange policies, fiscal and monetary policies, financial regulation and capital transaction regulation. Continued efforts to develop domestic financial systems are also essential. Regional financial cooperation frameworks should be used for these purposes. Regional financial cooperation should also be used as opportunity to debate various issues, such as financial and capital market development, responses to capital flows, regional financial integration and crisis management.

Japan will need to focus on the development of domestic financial and capital markets, while also enhancing their usability for Asian economic entities. It will also need to do everything possible to strengthen financial integration in Asia, including Japan, by providing support for the development of financial and capital markets in the region's countries. These efforts will have a direct bearing on the interests of all economic entities, including Japanese companies, Japanese financial institutions, institutional investors and private investors.

End Notes

1. Yuan-denominated corporate bond issues amounted to 3.4 billion yuan (approximately ¥40 billion) in the first eight months of 2012. This is around 50% higher than the total for the whole of the previous year. Lease companies are also issuing baht-denominated and won-denominated bonds.

2. For example, see Felman et al. [2011].

3. Refer to Bhattacharyay [2011] for a discussion of factors determining bond market development.

4. The regional preferences of investors in the nine Asian countries/regions are verified in Asian Development Bank [2012a] ("Intraregional Portfolio Debt Investment," Pp41-51), which calculates the percentages of their investment in home markets, Asian markets and the markets of advanced countries in 2001, 2009 and 2010. (The results of these calculations are shown in Table 13 on Page 44.) The figures for 2001 clearly indicate a strong tendency to invest in home markets (home bias) compared with investment in Asia or advanced countries, and a clear tendency to invest more in advanced countries than in Asian markets (global bias). While there was still a home bias in 2009, there was no significant difference between the ratios for investment in Asia or advanced countries, indicating that the global bias had disappeared. The results for 2010 follow exactly the same pattern, but it is interesting that the home bias is stronger than in 2009 when compared with the ratios for investment in advanced countries.

5. Turner [2012] identifies a number of trends based on an analysis of rates of return on Asia bonds in the 2000s. First, there is no arbitrage between advanced and developing countries, and in some cases excess returns have been gained through hedged investment in bonds in developing countries. Second, while there is significant fluctuation in rates of return in developing countries, the Sharpe ratio (rate of return/volatility) is higher than advanced countries. The volatility of returns on investment in the bonds of developing countries increased during the global financial crisis, but this was mainly the result of exchange rate fluctuations, and movements in rates of return were relatively small in local currency terms.

6. Asian Development Bank [2012a] ("Intraregional Portfolio Debt Investment,"Pp41-51) includes two analyses concerning the determinants for cross-border transactions. First, the factors that determine cross-border asset holdings among the eight countries and regions in Asia were analyzed using a gravity model. The results show many overlaps with the factors identified in this article as reasons for the expansion of cross-border transactions. Second, the following factors were identified through a survey of investors in China, Hong Kong, India, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore and Thailand. (1) The expansion of cross-border investment is impeded by the fact that Asian investors are basically conservative and have a strong home bias. (2) Since the main factors limiting investment are a lack of liquidity and barriers to transactions, it will be necessary to improve market liquidity and ease restrictions on capital transactions. The point that is emphasized in this article is that the development and opening up of markets in each country will lead to the expansion of cross-border transactions.

7. For details, see IMF, Asia and Pacific Department [2011].

8. According to Turner [2012]

9. The author referred to Mayes and Morgan [2012] and Kodres and Narain [2012].

10. The author referred to Volz [2012].

11. Based on Mayes and Morgan [2012]

12. Central banks in ASEAN members are establishing frameworks for high-level cooperation and working to improve the capabilities of banks and develop regulatory frameworks so that banks in ASEAN can provide the driving force for regional economic and financial integration. Central banks in the region are also introducing cross-border collateral systems in the form of bilateral contracts. This approach is based on reciprocal contracts under which banks from one country that are active in the other country are allowed to use government bonds and central bank bonds denominated in the currency of their own country as collaterals when adjusting their liquidity in the host country. The Malaysian central bank has already exchanged a memorandum of understanding with the MAS in Singapore and the Thai central bank and plans to add more partner countries in 2012.

13. According to Ba [2012]

14. Since 2011, dim sum bonds have been issued in Hong Kong by various Japanese companies, including leasing companies, banking groups and trading companies.

15. Based on Ba [2012]

16. According to Murase [2011] and Murase [2012], China has three basic principles for the implementation its currency policy: independence, manageability and gradualism. The establishment of an offshore market resulted from China's compromise between its need to manage and regulate the domestic yuan market and the need to internationalize the yuan. If China liberalizes capital transactions to the same extent as Western countries, the offshore market will become redundant.
    China aims to achieve full managed exchangeability of the yuan by 2020 with a view to making it a key currency. Foreign exchange transactions are not restricted in normal times, but there is a separate monitoring of real demand transactions and speculative transactions, and the latter are restricted. This means that exchangeability will not be achieved for all market transactions, but only for those transactions deemed to be normal by the currency authorities.
    China wants to monitor and manage yuan transactions worldwide through the information management systems of the People's Bank within China, and through Chinese-owned yuan settlement and clearing banks overseas. Murase [2011] also expresses doubt that the effectiveness of this structure can be maintained under full liberalization. China's attempt to create a managed international (exchangeable) currency can be seen an experiment that runs counter to the accepted wisdom of international finance that an international currency is one that is freely traded.

17. In February 2012, the People's Bank produced a report calling for the liberalization of the main types of capital transactions in three stages under a 10-year plan.

18. On April 16, 2012, the daily fluctuation range for the yuan-dollar rate was increased from 0.5% to 1%. In its quarterly report on the implementation of monetary policy published in May, the People's Bank stated in relation to future foreign exchange policy that the frequency of intervention would be reduced.

19. In fiscal 2011, the yuan-denominated transactions of the three megabanks appear to have expanded to ¥150 billion, a five-fold increase over the previous year's total.

20. Based on Tsuyuguchi [2012]

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