ASEAN Financial and Capital Markets
—Policies and Prospects of Regional Integration—

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Summary

1. Asia is moving toward increasing economic integration in the run-up to the establishment of the ASEAN Economic Community at the end of 2015. This process includes the acceleration of intraregional financial integration through the liberalization of capital transactions. There has been considerable progress toward the development of financial and capital markets in ASEAN. However, the markets are still relatively small and vulnerable to external shocks. Moreover, this situation has been responsible for the continuing existence of restrictions on capital transactions, which have impeded progress toward regional financial integration. That is why regional financial integration has moved forward more slowly than integration at the real economic level. From this perspective, efforts to move toward regional financial integration as a way of creating an integrated and functionally efficient regional financial system are centering primarily on the liberalization of financial services and capital transactions, the development of settlement systems, and the development and integration of capital markets.

2. There is wide variation in the both types of financial systems in ASEAN countries and also in their level of development. To achieve regional integration, member countries will therefore need to strengthen the competitiveness of their domestic financial and capital markets and financial institutions, and to improve their financial regulations and other systems. As far as banks are concerned, the specific areas in which efforts are needed include the improvement of operating efficiency, the development of new business, human resource development, and the facilitation of inter-bank mergers. Stock and bond markets will also require improvements, including increases in the numbers of issuers and investors, human resource development, the development of financial products, the development of market infrastructure, systems and regulations, and the improvement of liquidity in secondary markets. The expansion of domestic investors will also be extremely important from the perspective of coping with capital flows. Growth in the numbers of issuers and investors involved in cross-border transactions can also be expected to accelerate market expansion and development.

3. A key requirement when developing financial systems is to ensure that systems contribute to economic development. Funds need to be allocated to productive purposes, and a particular priority within the ASEAN region at present is infrastructure finance. To accelerate intraregional financial integration, it will be necessary not only to strengthen each country’s markets, but also to implement measures to facilitate integration, such as the development of cross-border investment products, the modification and harmonization of regulations and systems, and the liberalization of capital transactions.

4. Intraregional financial integration also leads to escalating competition and is unlikely to bring benefits to all participants. The adjustment of national interests within the region and support for less developed countries will therefore be important priorities. To minimize the risks of intraregional financial integration, sound macro-level policy management and the development of domestic financial and capital markets, as well as the creation of crisis management systems, must be treated as prerequisites for the liberalization of capital transactions. The most important priority in the immediate future will be to raise the standard of financial systems in each country. This will facilitate intraregional financial integration and ensure that markets are ready to absorb capital flows from outside of the region. There is strong demand for funds in ASEAN countries, especially for infrastructure development, and the region will inevitably remain reliant on external funds to some extent.

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Introduction

Capital flows into developing countries in Asia and other regions have expanded rapidly in recent years. In addition to the benefits that these capital flows have brought, there have also been significant negative consequences, including increased public and private sector debt, and greater volatility in capital flows. In May 2013, indications that the United States was about to change its quantitative easing policy triggered a shift in capital inflows into developing countries, which had previously been expanding rapidly. There are no indications that developing countries are likely to face a crisis situation in the foreseeable future. However, there is a renewed awareness of the need to be prepared for risks.

This situation requires a multifaceted response from developing countries. First, they need to strengthen their liquidity support systems for emergencies, mainly by accumulating foreign currency reserves and expanding bilateral and multilateral currency swap agreements. Second, they must to ensure appropriate macroeconomic policy management. Third, they need to improve their domestic financial systems.

All of these measures are used in response to increases in capital inflows, but restrictions on capital transactions also merit consideration as a way of curbing inflows. In Asia, however, efforts are focusing on the achievement of ASEAN financial integration with the establishment of the ASEAN Economic Community at the end of 2015. For this reason, the best strategy would be to accelerate regional financial integration by moving forward with the liberalization of capital transactions, while working to reduce reliance on capital from advanced countries and build robust markets.

In this article we will examine the current state of financial systems in ASEAN countries and analyzes some of the challenges that confront them as they move toward regional integration. Part 1 provides a detailed analysis of the content of regional financial integration in ASEAN. Part 2 looks first at the strategies needed to achieve regional financial integration. This is followed by an examination of the situation in the banking sector, stock markets and bond markets, and the outlook for integration in each of these areas, as well as some of the issues that exist at present. Part 3 describes approaches that could contribute to economic development and facilitate regional financial integration by describing specific examples, such as infrastructure finance and funds passport schemes. Part 4 begins with a retrospective analysis of Europe’s experience of financial integration and the lessons that can be learned from it. This is followed by some important approaches to regional financial integration.

Financial systems in ASEAN countries are small by international standards, and there is also considerable variation among countries within the region. Progress toward regional financial integration would bring many benefits, including the reduction of reliance on external funds because of the increased circulation of funds within the region, an enhanced presence for the region resulting from economies of scale, and improvements in the standard of regional financial systems and the quality of financial services. However, the achievement of integration in the ASEAN region is likely to take considerable time because of the need to reconcile national interests, and reduce disparity within the region by assisting relatively less developed countries with financial technology.

Financial integration in ASEAN basically means the expansion of local banks into other countries in the region, and an increase in cross-border securities transactions. These changes would require the liberalization of capital transactions and the adjustment and harmonization of financial regulations, systems and market infrastructure. This opening up would also entail risks, and sound macro-level policy management and the development of domestic financial and capital markets are prerequisites for the liberalization of capital transactions. To minimize the risks, it would also be necessary to develop and harmonize financial regulatory and supervisory structures, a process that would require sustained efforts at the regional level. This balancing of integration and risk management would be a key priority.

One of the most important requirements is to
ensure that as many participants as possible can benefit from regional financial integration. This requires deeper debate among participants about how integration should be approached. The most important priority at present is likely to be measures to raise the level of financial systems in member countries. Attention to this aspect will enhance the achievability of ASEAN financial integration, which is a major policy goal, while also helping to build robust financial systems and develop structures to accommodate capital inflows from outside of the region. ASEAN countries have a voracious demand for funds, especially for infrastructure development, and they will inevitably continue to rely on funds from outside of the region to some extent.

1. Moves toward the Establishment of the ASEAN Economic Community and ASEAN Financial Integration

(1) Creating the ASEAN Economic Community

In this section we will examine policy moves toward the formation of the ASEAN Economic Community and ASEAN financial integration. We will begin with an overview of the ASEAN Economic Community.

ASEAN was formed in 1967 by Indonesia, Malaysia, the Philippines, Singapore, and Thailand. These five original members were subsequently joined by Brunei in 1984, Vietnam in 1995, Laos in 1997, Myanmar in 1997, and Cambodia in 1999. While continuing to achieve economic growth, ASEAN members have sought to strengthen ASEAN as a group by working actively to overcome a variety of conflicts of interest, and by moving toward economic integration. The benefits of economic integration are likely to include improved international competitiveness and enhanced attractiveness to investors outside of the region.

Enthusiasm for integration has gradually intensified, and in October 2003 agreement was reached at the 9th ASEAN Summit in Bali to establish an ASEAN Community by 2020. It was decided that the three core components of this community would be the Political-Security Community, the ASEAN Economic Community (AEC) and the Socio-Cultural Community.

At the 13th ASEAN Summit, which was held in Singapore in November 2007, members decided to bring forward the creation of the ASEAN Community to 2015. This decision resulted from growing awareness of several factors, including a rapid rise in economic interdependence within and beyond ASEAN, and the increased urgency of efforts to reduce economic disparity within ASEAN through the establishment of the AEC. It was at this time that ASEAN adopted the AEC Blueprint as its roadmap for regional integration. In December 2008 ASEAN was given legal status with the adoption of the ASEAN Charter.

The AEC Blueprint identifies ① a single market and production base, ② a highly competitive economic region, ③ equitable economic development, and ④ full integration into the global economy as the four key characteristics of the AEC. These four characteristics are broken down into 17 core elements and 176 targets (Fig. 1). It was further decided that 2009, 2011, 2013 and 2015 should be the milestone years for measuring progress in each of these areas.

Unlike the EU’s single market, the AEC will be neither a tariff union nor a full common market. However, the creation of a single market and production base will bring a number of benefits, including economies of scale and more efficient production networks. Countries at varying stages of economic development will be included in the AEC, and those countries will be able to play different roles within production networks. Market and production base integration will lead to the expansion of intraregional trade and investment (Fig. 2). ASEAN’s giant consumer market will also be attractive to investors.

While the establishment of the AEC will bring major benefits, however, it will also require changes, including the removal of barriers to investment and the trade in goods and services, and...
the harmonization of numerous regulations. Other essential prerequisites include the development of enhanced infrastructure to improve the efficiency of trade, and competitive financial services. The ASEAN countries will need to work very hard to achieve the many targets listed in the AEC Blueprint.

According to the scorecards used to monitor progress under the Blueprint, ASEAN is moving forward steadily toward the achievement of these goals. However, ASEAN has no central organization, and scorecard monitoring is based on declarations by individual countries. Nor are there any compulsory mechanisms or penalties to ensure that targets are reached.

Despite these issues, ASEAN seems to be making gradual progress toward the creation of the AEC. However, differences in legal and regulatory systems and the processes used to establish laws and regulations are causing bottlenecks in the AEC formation process. Progress toward the liberalization of service transactions and achievement of free flows of skilled labor appears to be slow at present. Furthermore, the scorecard items are not specific, and the scores achieved may not fully reflect the actual progress made.

While the establishment of the AEC at the end of 2015 will be an epochal event, it can also be seen as simply a milestone on a longer journey. ASEAN’s current targets after almost 50 years of history are macroeconomic stability, the reinforcement of international competitiveness, the reduction of disparity, environmental protection and the maintenance of centrality. Having introduced a single currency, the EU is now working ultimately toward political union through a top-down process. In contrast, ASEAN has adopted a Blueprint that calls for development through a bottom-up process. While there is continuing debate about the appropriateness of the contents of the Blueprint, what is clear is that ASEAN needs to deepen its integration in order to cope with escalating competition from developing countries, especially China and India.
domestic financial services and capital transactions, and the harmonization of regulations. In other words, ASEAN aims to achieve integration through liberalization and harmonization. Financial and capital markets in individual ASEAN are small, and this approach will allow them to achieve economies of scale. In addition, competition among markets within the region will help to strengthen financial systems and financial institutions. This will in turn improve the efficiency with which funds are allocated and ensure that appropriate financial services are available for a wide range of domestic and cross-border economic activities. With these achievements, the aim of regional financial integration is to reduce dependence on external capital and financial systems and to allocate regional savings to regional investment.

However, the achievement of financial integration in Europe has taken over 50 years, and basically there appears to be no reason why Asia should approach the process in a hasty and slipshod way. Because of the variation in the economic and financial development stages of Asian countries, ASEAN’s position is that priority must be given to national sovereignty and preparations to deal with the risks that will result from integration, and that variation in the pace of integration in different countries is acceptable, especially between the original five members and Brunei, Cambodia, Laos, Myanmar and Vietnam (BCLMV).

Financial systems in ASEAN countries are generally small, and the level of development varies from country to country. Approaches to regional financial integration will need to take these characteristics into account.

The ASEAN financial integration initiative is based on the Roadmap for Monetary and Financial Integration (RIA-Fin), which was endorsed at the 2003 ASEAN Finance Ministers Meeting (Fig. 4). The plan outlined in the AEC Blueprint on this basis is described below. These items have been identified as steps required for the creation of a single market and production base. The goal is to create an integrated regional financial system capable of functioning efficiently.

First, financial services liberalization (FSL) will
be achieved after the development and stabilization of the financial sector. Countries can liberalize as soon as their preparations are complete, and the liberalization process will be based on respect for each country’s policy goals and level of economic and financial development. The specific action required is the achievement of some degree of liberalization by 2015. The ultimate target year is 2020, by which time countries should have achieved large-scale deregulation regarding all of their financial service sectors. This process is to be based on a liberalization plan consisting of a list of “pre-agreed flexibilities.” The lists that make up the plan have been compiled in stages covering the periods to 2015 and 2020 and from 2020 onwards. This means that full liberalization may not be achieved by 2020. Moreover, the definition of “full liberalization” is not entirely clear.

Second, the following targets have been set concerning capital market development and integration (CMD) in the period to 2015: ① facilitation of harmonization of rules concerning bond issuance, information disclosure and sales of securities, ② mutual recognition of qualifications, education and experience of market professionals, ③ increased flexibility with regard to language use and enabling laws for securities issuance, ④ reassessment of withholding tax systems relating to bonds, and ⑤ market efforts toward the linkage of securities exchanges and bond markets, including cross-border issuance. It is not entirely clear what steps need to be carried out before these goals can be deemed to have been achieved.

Third, as with financial services liberalization, ASEAN will proceed cautiously with capital account liberalization (CAL). The plan emphasizes the need to avoid the risks of liberalization while ensuring that all member countries share the benefits. The plan calls specifically for liberalization in areas that will help to promote direct investment and capital market development. However, progress under the plan is likely to be extremely gradual, since the goal for all items is to “progressively liberalize, where appropriate and possible.”

The ASEAN Secretariat is monitoring progress toward financial integration using a scorecard system. It has also commissioned the Economic Research Institute for ASEAN and East Asia (ERIA) to assess the plan. According to ERIA, the key components of financial integration should be implemented from 2015 onwards. However, the establishment of the AEC at the end of 2015 is certain to provide a strong impetus for progress toward financial integration.

2 Liberalization of Finance Services

In April 2011, the central bank governors of ASEAN countries formulated the ASEAN Financial Integration Framework (AFIF). This framework provides an overall picture of ASEAN’s approach to financial liberalization and integration as it works toward the establishment of the AEC. The aim is to create a semi-integrated financial and capital markets by 2020.
Financial services liberalization will allow banks, insurance companies and investment companies in ASEAN countries to provide services in other countries of the region. The aim is to create an environment in which Qualified ASEAN Banks (QABs) that have reached a certain standard in terms of competitiveness and other factors will be treated on an equal footing with local banks. The ASEAN Banking Integration Framework (ABIF) was created, together with the AFIF (see above), as a structure within which QABs can be recognized.

Asian Development Bank [2013] explains financial services liberalization in terms of three elements. First, the QAB framework will allow banks from ASEAN countries to operate in other countries in the region. To eliminate the concerns of host countries, QABs will be required to meet rigorous standards of soundness. Not many banks in the region will be able to qualify under these standards, which will function both as targets toward which banks in ASEAN countries should aspire, and also as guidelines for the establishment of prudential regulations by the banking authorities.

Second, it will be necessary to treat banks moving into markets on an equal footing with local banks. Third, to ensure the proper functioning of this framework, it will be necessary to move toward the harmonization of banking regulations in member countries. It will also be necessary to develop financial infrastructure in each country, including rating agencies, credit guarantee facilities and inter-bank markets. Capacity development will be a priority for countries that have not yet developed this infrastructure, and those countries will not be able to accept QABs until after this has been achieved. This means that the framework cannot be applied at the same time in every country. Moreover, the more advanced countries within the region will need to provide less developed countries with assistance on financial technology.

Progress toward regional banking integration (defined here as the expansion of banks from ASEAN members into other countries within the region) will enhance the efficiency with which funds are allocated. It will also strengthen the region’s banks, facilitate the development of closer cooperative relationships, and contribute to financial sector stability. However, the facilitation of banking integration will also heighten the systemic risk by deteriorating financial performance of foreign banks operating in ASEAN countries due to their lack of understanding about the local market characteristics in the host country. Other dangers that have been highlighted include increased volatility in capital flows due to speculative cross-border transactions, and dominance of host countries’ markets by foreign banks. That is why the harmonization of prudential regulations and the creation of international risk response systems are so important. Phased liberalization is needed because of the different amounts of time required to strengthen the banking sector in each country.

ASEAN members are negotiating over details of financial services liberalization through the Working Committee on Financial Services Liberalization. Stage 6 of these negotiations has been completed, and the Committee has now entered Stage 7. As far as can be gauged from the progress of these negotiations, ASEAN is moving forward steadily with the liberalization of financial services, including insurance sector.

③ **Capital Account Liberalization**

The regulations that currently govern capital transactions in ASEAN countries can be summed up as follow. First, while some countries, such as Singapore, Cambodia and Indonesia, already have extremely open systems, other ASEAN members still maintain a certain level of regulation. Second, most of these regulations target capital outflows rather than inflows. This situation will need to be reconsidered from the perspective of facilitating regional integration, since it has the potential to limit capital flows among ASEAN countries while facilitating inflows of funds from outside of the region. Third, while most ASEAN members are covered by IMF Article VIII, they still impose restrictions on current account transactions. Fourth, most ASEAN countries restrict the use of their currencies overseas. Fifth, there are few restrictions on inward investment in securities, but there are numerous restrictions on overseas borrowings,
and overseas lending denominated in domestic currencies. Sixth, many ASEAN countries restrict foreign exchange risk hedging by investors. Seventh, some ASEAN countries still levy withholding tax on securities investment.

Progress toward the expansion of investment, trade and business within the ASEAN region is dependent on the liberalization of capital transactions. ASEAN members have completed the task of checking and assessing their restrictions on capital transactions and are now in the process of developing liberalization roadmaps. The Working Committee on Capital Account Liberalization (WC-CAL) has stepped up its monitoring of progress toward liberalization in ASEAN countries and is also discussing policies relating to the risks of liberalization.

### Development of Settlement Systems

Asian Development Bank [2013] contains recommendations relating to trade settlements, money remittances, retail payments and capital market settlements. The goals identified are (1) the improvement of settlement infrastructure, (2) the standardization of settlement systems (settlement technology, market practices, regulations, etc.) to allow efficient cross-border settlements, and (3) studies concerning the linkage of settlement systems within ASEAN. Harmonized settlement systems are likely to play an important role in the AEC, and the Working Committee on Payment and Settlement Systems (WC-PSS) is assessing the current situation and making policy recommendations concerning settlement systems.

The level of settlement systems also varies according to the level of financial systems development. ASEAN countries first need to improve their domestic settlement systems, and then to form links with other countries in the region.

Among the medium-term goals recommended concerning trade settlements are the facilitation of overnight (T+1) settlements of cross-border payments, and settlements in local currencies. Recommendations concerning retail payments include the diversification of the products available (e.g., ATM cards, debit cards, credit cards) and the expansion of services, such as overseas remittances.

In relation to capital market settlements, the Asian Development Bank recommends the adoption of international standards for straight-through processing for both domestic and cross-border settlements, and the expansion of DVP/PVP settlements.

In a related move, the ASEAN+3 countries are working to create a settlement system to support cross-border bond transactions under the Asian Bond Market Initiative (ABMI). Recent progress includes the completion of a reassessment of business feasibility relating to the establishment of a regional settlement intermediary (RSI) by Task Force 4. In addition, discussions are continuing within the newly established Cross-border Settlement Infrastructure Forum, which is based on voluntary participation by member countries. Inui [2014] describes the current status of a settlement system covering 10 ASEAN countries and regions, based on work carried out in the ASEAN+3 Bond Market Forum (ABMF), which is part of the ABMI. Under this system, bond settlements are processed by central securities depositories (CSDs) operated by central banks or securities exchanges in each country. Settlements of funds are processed using real time gross settlement (RTGS) systems provided by central banks, and in many cases settlements are carried out on a delivery versus payment (DVP) basis, which means that bonds and funds are settled at the same time.

Cross-border settlements are also processed through settlement systems in individual countries. However, there are issues in areas other than settlement systems, including restrictions on capital transactions, and systems requiring the qualification of foreign investors. Another problem is the fact that many of the elements that make up settlement systems in individual countries, such as messages and securities numbers, do not comply with international standards.

As previously noted, the priorities now are the standardization of settlement systems in individual countries, and the introduction of STP for cross-border bond transactions and settlements. Progress in these areas would reduce settlement costs and settlement risks. The key question in this context is how cross-border settlements of funds (di-
rect settlements among the currencies of member countries) can be enabled.

The Cross-Border Settlement Infrastructure Forum, which also works collaboratively with the ABMF, has issued a report stating that the most promising regional settlement infrastructure model is not the Asian ICSD or CSD linkage model (settlements of funds using money from commercial banks), which the forum had been considering until now, but rather a CSD-RTGS linkage model based on the linkage of CSDs and central bank fund settlement systems (RTGS) in each country.

5 Development and Integration of Capital Markets

A key goal in the context of ASEAN’s capital market liberalization efforts is capital market integration, which would allow regional issuers to implement issues in any ASEAN country, and regional investors to invest in any country in the region. Another goal is to allow intermediaries to offer their services in any country within the region, subject to approval by the authorities in their home country.

In 2009, the Implementation Plan for ASEAN Capital Markets Integration was adopted. This plan defines specific measures to compensate for the inadequate scale of capital markets in individual ASEAN countries, including the harmonization of market infrastructure with the aim of expanding intraregional cross-border transactions in securities exchanges within the ASEAN region. The main themes of the plan are the creation of an enabling environment (a framework for harmonization and mutual recognition), the creation of market infrastructure (an alliance of ASEAN securities exchanges and a governance structure, the development of new products, the strengthening of bond markets), and the strengthening of the integration process (the alignment of domestic capital market development plans, the reinforcement of structures within ASEAN). Progress on this plan is being driven by the ASEAN Capital Markets Forum (ACMF), which was established in 2004 as a forum for discussion among securities regulatory authorities about capital market development within the ASEAN region.

As listed below, many concrete achievements have resulted from the work of the ACMF.

(a) Expedited Review Framework for Secondary Listings—A mechanism designed to reduce costs and improve efficiency for secondary listings by regional corporations within the securities exchanges of ASEAN countries by simplifying assessing procedure

(b) The ASEAN Corporate Governance Scorecard—Used to assess the corporate governance of listed companies in the ASEAN region

(c) ASEAN and Plus Standards—Uniform disclosure standards developed to improve the efficiency of cross-border securities issues

(d) Work relating to the ASEAN Exchanges, which enabled trading in 210 representative stocks via an electronic network linking seven ASEAN exchanges (Indonesia, Malaysia, the Philippines, Singapore, Thailand, Hanoi, Ho Chi Minh)—The establishment of this structure is being studied by sub-working groups responsible for the four areas of business planning, regulation, market management and technology.

(e) Cross-Recognition of Qualifications on Education and Experience of Market Professionals

(f) ASEAN Framework for Cross-Border Offering of Collective Investment Schemes—Known as the “fund passport” system, this concept will be examined in detail later in this article.

(g) Development of ASEAN stock indices—In 2005, The FTSE ASEAN 180 Index and the FTSE ASEAN 40 Index were developed in collaboration with the FTSE Group of the United Kingdom.

Progress on all of these items has been led by the securities authorities of Malaysia, Singapore and Thailand. When viewed in relation to the Implementation Plan for ASEAN Capital Markets Integration, these items appear to align with the key initiatives relating to a framework for harmonization and mutual recognition, or an alliance
of ASEAN securities exchanges and a governance framework. Items (a) through (c) relate to issues, (d) through (e) to transaction infrastructure, and (f) and (g) to investment.

Obviously there are many differences in the capital market regulations and systems and market infrastructure of ASEAN countries, and it will not be easy to overcome these differences and achieve mutual recognition. Of particular importance are tasks relating to the facilitation of cross-border securities issues, including the harmonization of disclosure standards, definition of securities and rating systems.

Work carried out by the Working Committee on Capital Market Development (WC-CMD) includes ① the creation of the Bond Market Development Scorecard, ② the development of a capacity building program to rectify problems identified using the scorecard, and ③ research on market development issues and policy recommendations to ASEAN members in collaboration with the ACMF.

In addition, the ACMF, WC-CAL, WC-CMD and WC-PSS are continuing their efforts to improve capital market infrastructure.

― Other Activities

Financial integration in ASEAN involves several other processes in addition to the four items outlined above. First, there is the reinforcement of regional surveillance. Organizations monitoring economic and financial conditions in the region include the ASEAN+3 Macroeconomic Research Office (AMRO), which was established by the ASEAN+3 countries. The surveillance and capacity building programs were further strengthened with the creation of the ASEAN Integration Monitoring Office within the ASEAN Secretariat in May 2010.

Second, ASEAN is working to strengthen infrastructure finance. The ASEAN Infrastructure Fund (AIF) was established in 2012 with the aim of strengthening physical connectivity within the region and reducing infrastructure gaps. The first project using the AIF was carried out in Indonesia in 2013, followed by projects in Indonesia, Laos and Vietnam in 2014.

Third, there are initiatives relating to financial inclusion and literacy. Financial literacy initiatives are led by Brunei, which has established a forum for information sharing and other activities. ASEAN countries are also cooperating on financial inclusion initiatives.

2. Financial Systems in ASEAN Countries

(1) Overview of Financial Systems, Strategies for Regional Integration

As discussed in the previous section, the ASEAN countries need to move toward regional financial integration while also reducing the risk of financial crises by responding appropriately to expanding flows of foreign investment. A key priority in this context is the reinforcement of financial and capital markets and financial institutions in individual ASEAN countries. In this section, we will examine financial systems in ASEAN countries from this perspective.

There is considerable variation in the level of development of financial systems in ASEAN countries. Even where the level of development is similar, there are differences in other characteristics, such as market size and financial infrastructure and regulations. For this reason, individual countries have different needs in relation to financial integration, and while some countries want regional integration, others regard links outside of the region as more important.

This means that regional integration will need to be open rather than closed. Moreover, since integration will also cause competition to intensify, it will be necessary to strengthen the competitiveness of financial systems in individual countries, and to reduce development gaps between countries. ASEAN countries need to debate their approach to regional financial integration fully and will need to move forward gradually, while remaining focused on the 2015 and 2020 deadlines.

A comparison of financial assets as percentages of GDP shows that while Malaysia, Singapore and Thailand rank alongside the EU countries, the ra-
When diverse financial systems are integrated, there is no way to ensure that all participants will benefit, and inevitably some will be disadvantaged. Considering this point, a number of priorities will need to be tackled as ASEAN moves toward financial integration. First, it will be necessary to engage in continual debate about ways to reconcile differences in the needs of individual member countries. Second, ASEAN will need to work to reduce differences in development levels, which are partially responsible for differences in the needs of each country. Third, in addition to efforts to enhance the competitiveness of financial and capital markets and financial institutions in member countries, it will also be necessary to improve institutional infrastructure, such as financial regulations. The development of the banking sector in the BCLMV countries, which are still in the early stages of financial development, will be a particular priority in this context. Fourth, the specifics of integration and the ways that integration benefits national interests must be acceptable to member countries. Fifth, there should be a schedule for the achievement of integration. Sixth, regional structures should be created to deal with the risks associated with integration. Seventh, financial authorities should provide leadership for the steady implementation of integration plans.

The most important priority at present appears to be the improvement of financial systems in member countries. Efforts to raise the level of...
In July 2011, Cambodia established a stock exchange with assistance from S. Korea. As of June 30, 2014, there were only two listed companies. Slow progress on the improvement of corporate accounting is seen as a major reason for this.

The fiscal deficit (5-8% of GDP) is financed by aid from international organizations and advanced countries. Government bonds are not issued.

Laos has a chronic fiscal deficit. Only short-term government securities and central bank bonds are issued. In 2013, Laos issued baht-denominated bonds in Thailand.

The fiscal deficit is financed by short-term government securities underwritten by the central bank. The central bank law was amended in July 2013 to limit financing by the central bank. The fiscal deficit is financed by short-term government securities underwritten by the central bank. The central bank law was amended in July 2013 to limit financing by the central bank.

A securities exchange law was enacted in July 2013. Preparations are under way for the establishment of a securities exchange committee and securities companies.

There are stock exchanges in Ho Chi Minh and Hanoi. Investors are mostly individuals. Institutional investors invest in government bonds or central bank bonds.

The central bank law was amended in July 2013 to limit financing by the central bank. The fiscal deficit is financed by short-term government securities underwritten by the central bank.

A securities exchange law was enacted in July 2013. Preparations are under way for the establishment of a securities exchange committee and securities companies.

Table 3 Financial Inclusion of Commercial Banks in ASEAN (2010)

<table>
<thead>
<tr>
<th>Deposit accounts per 1,000 people</th>
<th>Loan accounts per 100,000 people</th>
<th>Bank branches per 100,000 people</th>
<th>ATMs per 100,000 people</th>
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</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>108.0</td>
<td>28.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>504.7</td>
<td>274.8</td>
<td>8.3</td>
</tr>
<tr>
<td>Laos</td>
<td>44.3</td>
<td>4.0</td>
<td>2.6</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1,619.9</td>
<td>284.1</td>
<td>10.5</td>
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<tr>
<td>Philippines</td>
<td>487.8</td>
<td>n.a</td>
<td>7.7</td>
</tr>
<tr>
<td>Singapore</td>
<td>2,134.3</td>
<td>967.7</td>
<td>10.3</td>
</tr>
<tr>
<td>Thailand</td>
<td>1,119.9</td>
<td>237.0</td>
<td>11.2</td>
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<tr>
<td>Vietnam</td>
<td>n.a</td>
<td>n.a</td>
<td>3.3</td>
</tr>
<tr>
<td>Japan</td>
<td>7,169.0</td>
<td>171.0</td>
<td>34.0</td>
</tr>
<tr>
<td>Advanced European countries</td>
<td>2,022.0</td>
<td>701.0</td>
<td>32.0</td>
</tr>
<tr>
<td>U.S.</td>
<td>2,021.9</td>
<td>n.a</td>
<td>36.7</td>
</tr>
</tbody>
</table>

Source: Asian Development Bank Institute [2014], p.144

these systems will enhance the feasibility of ASEAN financial integration. Also, the development of robust financial systems will lead to the creation of structures capable of coping with inflows of capital from outside of the region.

ASEAN is moving toward financial integration not only because of the progress toward integration at the real economic level, but also because of a loss of confidence in capital from outside of the region, which has repeatedly flowed into and out of the region since the Asian financial crisis. After experiencing the crisis, however, Asian countries have dramatically improved their emergency liquidity support systems, in part by accumulating foreign currency reserves. As a result, they were
able to respond appropriately to the sudden decline in liquidity resulting from the 2008 Lehman shock. Efforts to improve financial systems are steadily producing benefits, including the recovery of financial soundness in the banking sector, and the establishment of a position for Asian bonds as a target for investment by investors in advanced countries. These achievements can be seen as evidence of a measurable strengthening of the capacity of ASEAN countries to accommodate capital inflows from outside of the region.

As discussed later in this article, ASEAN countries have a voracious demand for funds, especially for infrastructure development, and will inevitably continue to rely on funds from outside of the region to some extent. The most important priority for ASEAN in this context is to combine the pursuit of financial integration with continuing efforts to strengthen financial systems to ensure that the region can achieve a form of integration that will allow it to remain open and outward-looking.

(2) The Banking Sector

① The State of the Banking Sector

The following analysis examines the financial systems of ASEAN countries by looking first at the banking sector, and then at stock markets and bond markets. We can identify a number of characteristics in the banking sectors of ASEAN countries(2). First, banking reforms implemented since the Asian financial crisis have dramatically improved banks’ financial soundness and earning performance, with the result that banks in ASEAN now compare favorably with banks in advanced countries. Second, because banks had maintained sound management policies, they were affected little by the global financial crisis. In fact, their financial positions have tended to improve continuously since the crisis. Third, there has been no significant change in the relative size and importance of the banking sector within domestic financial systems. ASEAN countries still have financial systems centering on banks, which were seen as a major cause of the Asian financial crisis. Fourth, the size of banks is relatively small by international standards (Fig. 5). For example, banks in ASEAN countries are between one-fiftieth and one-hundredth the size of Japanese megabanks. Fifth, there is a major gap between ASEAN and advanced countries in terms of financial inclusion, including the number of bank branches and bank deposit accounts per unit of population. Sixth, there is considerable variation among ASEAN countries in terms of levels of banking sector development, bank size, and financial inclusion. This situation will be a major impediment to progress toward regional financial integration(3).

An analysis of progress toward regional banking integration in this environment shows that while some banks from Singapore, Malaysia and Thailand (usually the top 1-3 banks in each country) have expanded into a number countries in the region, their overseas activities are less extensive than those of major Western Banks, such as Standard Chartered, Citibank and HSBC (Table 4). Moreover, the majority of ASEAN banks are reluctant to expand into other countries within the region, mainly because of the small scale of their operations and their lack of international competitiveness. Another possible reason is the fact that the domestic financial markets in ASEAN have not yet been fully developed and still offer ample

Fig. 5 Average Sizes of Commercial Banks

Notes: As of the end of 2010 for Brunei and the end of 2009 for other countries. For reference, the total assets of the Sumitomo Mitsui Banking Corporation amounted to ¥135,966.4 billion (approx. $1,359.7 billion) as of March 31, 2014.

Source: Lee and Takagi [2013]
which are ranked second and fourth respectively in the Malaysian banking sector, have reached basic agreement on a merger including Malaysia Building Society Berhad (MBSB), a major non-bank financial institution. The aim of this merger is to gain a competitive advantage in the domestic market, which is not really big enough, and to achieve the scale needed for overseas expansion.

The insurance sector is relatively open to foreign participation, but local insurance companies lack competitiveness, and there have been few cases of overseas expansion (Table 5). Most of the companies that have gained shares of ASEAN markets are insurance companies from advanced countries, and there has been little progress toward integration within the region.

Table 4 Presence of Banks in ASEAN Countries (End of 2011)

<table>
<thead>
<tr>
<th>Country</th>
<th>HSBC</th>
<th>Standard Chartered</th>
<th>Citibank</th>
<th>SMBC</th>
<th>Mizuho FG</th>
<th>Bank of Tokyo-Mitsubishi UFJ</th>
<th>Mandiri</th>
<th>BCA</th>
<th>BNI</th>
<th>Maybank</th>
<th>Public Bank</th>
<th>CIMB</th>
<th>Metrobank</th>
<th>BDO</th>
<th>BPI</th>
<th>DBS</th>
<th>UOB</th>
<th>OCBC</th>
<th>OCBC Offshore</th>
<th>SCB</th>
<th>Bangkok Bank</th>
<th>B. Ayudhya</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brunei</td>
<td>○</td>
<td>○</td>
<td>○</td>
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<tr>
<td>Cambodia</td>
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<tr>
<td>Indonesia</td>
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</tr>
<tr>
<td>Japan</td>
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<td>○</td>
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<tr>
<td>Malaysia</td>
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<tr>
<td>Philippines</td>
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</tbody>
</table>
| Source: Asian Development Bank Institute [2014], pp.148-149

ASEAN countries also seek to protect their local banks by restricting participation by foreign banks and discriminating against foreign banks in their domestic markets. Restrictions of these types were substantially relaxed after the Asian financial crisis so that foreign capital could be used to drive the bank restructuring and rehabilitation process that followed the crisis. However, there has since been a resurgence of moves to protect and strengthen local banks by limiting participation by foreign banks. In 2012, for example, Indonesia lowered the ceiling for foreign ownership from 99% to 40%. On the other hand, in July 2014, the Philippines announced that it intended to abolish the 60% ceiling on foreign ownership, and Myanmar has finally started to issue business licenses to foreign banks. These examples show how differences in the development stages, financial and capital market development needs and stances of ASEAN countries are reflected in restrictions on participation by foreign banks.

Banks are also starting to restructure in response to environmental changes caused by progress toward regional integration. For example, media reports indicate that the CIMB and RHB, which are ranked second and fourth respectively in the Malaysian banking sector, have reached basic agreement on a merger including Malaysia Building Society Berhad (MBSB), a major non-bank financial institution. The aim of this merger is to gain a competitive advantage in the domestic market, which is not really big enough, and to achieve the scale needed for overseas expansion.

The insurance sector is relatively open to foreign participation, but local insurance companies lack competitiveness, and there have been few cases of overseas expansion (Table 5). Most of the companies that have gained shares of ASEAN markets are insurance companies from advanced countries, and there has been little progress toward integration within the region.

② Outlook for Bank Integration, Priorities for the Banking Sector

Most of the foreign banks that have established operations in ASEAN countries are from outside of the region. While this situation has started to change, the limited scale of local banks means that only a minority of banks are likely to achieve QAB status in the immediate future, and that progress toward integration will therefore be grad-
There is little possibility of comprehensive banking integration as seen in the EU.

However, Asian financial systems center on banks, and bank integration is likely to play a central role in financial integration. The ASEAN Senior Level Committee on Financial Integration (SLC) was formed as a high-level organization for the planning and monitoring of financial integration.

The four core components of the ASEAN Banking Integration Framework (ABIF) are ① harmonization of principles of prudential regulations, ② the creation of the infrastructure required for financial stability (macroprudential policies, crisis management policies, deposit insurance, etc.), ③ the provision of capacity building programs for the BCLMV countries, and ④ the adoption of standards for QABs. Working groups have been formed with responsibility for each of these areas. To minimize the risks associated with integration, it will also be necessary to establish regional-level monitoring and supervisory functions. In addition to the development of closer cooperation among authorities within the region, AMRO and the Chiang Mai Initiative Multilateralization (CMIM), which have been established within the ASEAN+3 framework, are also expected to play a significant role in this area.

Despite extensive debate by the four working groups, the positions of individual ASEAN members still differ. Malaysia, which has a small domestic market but a highly developed financial system, would benefit considerably from integration and is actively promoting the ABIF. Indonesia, however, has a large domestic market, but the competitiveness of its financial institutions appears to be relatively weak, and there is ongoing debate about the relative merits and costs of integration.

Differences in the size of financial markets and development levels of ASEAN member are also reflected in significant variation in the level of prudential regulations and infrastructure supporting financial stability. The original ASEAN members and the BCLMV countries will need to follow a double-track approach that gives priority to capacity building in the latter group. However, it will not be easy to create a roadmap based on this method that will ultimately lead to the integration of the entire region, and there is a strong possibility that funds will be concentrated in particular countries during the integration process.

As is apparent from the preceding analysis, there are still many issues affecting the banking integration process. While it would be possible for banks that are relatively competitive within the region to lead the way in adapting to integration, it will not be possible to achieve integration on a level that will bring real benefits without consideration for those that cannot keep up with competition.

The priorities for the banking sector are summed up in Fig. 6. First, as will be analyzed in detail later in this article, it will be necessary to improve banking services in ways that contribute to economic development, including the promotion of financial inclusion, and an involvement in domestic demand-related business areas. Second, the competitiveness of banks will need to be strengthened. There are many possible strategies to achieve this, including the facilitation of mergers, the improvement of operating efficiency, human resource development, and the development of new business areas. However, banks must also maintain their present level of soundness by avoiding excessive expansion of their activities. Third, to maintain soundness during the integration process, it will be necessary to develop and harmonize banking regulatory and supervisory functions.
systems. Fourth, support for BCMLV countries in the area of financial technology will need to be stepped up in order to reduce disparity among ASEAN members.

(3) Stock Markets

① The State of Stock Markets

ASEAN stock markets have achieved rapid growth over the past 10 years (Table 6). The markets can be broadly divided into four groups. The first group consists of one market in a financial hub (Singapore). Singapore is a financial hub for the whole of Asia, including ASEAN, and in addition to its wide range of financial products and market participants, it also has a large offshore market. Established domestic markets (Malaysia and Thailand) form the second group. These markets have ample domestic issuer and investor bases, and Islamic financial products are a feature of the Malaysian market. The level of over-the-counter trading in financial derivatives is still low in both of these markets. Investment from overseas is affected by certain limitations, including restrictions on capital transactions. The third group consists of still developing domestic markets (Indonesia, the Philippines). While these markets have expanded rapidly, the size of domestic issuer and investor bases is limited. Institutional investors are still at the developing stage. The underdeveloped markets of the BCLMV countries make up the fourth group. These markets are at the initial stage of development, and financial infrastructure and regulatory frameworks are still being developed. The domestic investor base is small, and apart from Brunei and Cambodia, all countries in this group tightly regulate capital transactions.

A variety of capital market reforms have been implemented by ASEAN countries. The Singapore exchange was established in 1999, while the Philippine Stock Exchange became a joint stock corporation in 2001 and was listed in 2003. In Indonesia, the Jakarta and Surabaya Stock Exchanges merged in 2007. Malaysia has gradually eased restrictions on capital transactions, and investment in domestic securities by non-residents has expanded. Thailand announced capital market development plans in 2002 and 2006.

Over the past 10 years, the number of listed companies in all ASEAN countries has increased by 30%. In Indonesia and Malaysia in particular, the trend toward corporate privatization is helping to drive this growth. In the past stock market intermediaries were mostly global banks from ad-
the small size of individual countries regarding economies and financial and capital markets. As the economic growth of China and India began to accelerate in the 2000s, the ASEAN countries realized with alarm that their stock markets would be unable to compete with other markets without further improvements in a number of areas, including secondary market liquidity, transaction costs, product line-ups, and financial technology innovation. This provided the motive to speed up regional integration, which had still not reached a satisfactory level, leading in 2009 to the announcement of the Implementation Plan for ASEAN Capital Markets Integration.

Regional integration would result in improved international competitiveness resulting from the expansion of the investor base and product line-ups, the reinforcement of domestic markets, and the improvement of liquidity. ASEAN would be advanced countries. More recently, however, bank-affiliated securities companies in Malaysia and Singapore have adopted strategies that are clearly designed to promote regional market integration, and they are playing an increasingly important role in the region. In addition, institutional investors, such as pension funds and insurance companies, are expanding in ASEAN countries in response to a conspicuous build-up of savings, improvements in healthcare and pension systems, and other factors. At the same time, there has been an easing of restrictions on investment. There has also been a rapid increase in foreign investment in stocks and government bonds.

② Outlook for Stock Market Integration, Priorities for Stock Markets
As we have already seen, the main reason for economic and financial integration in ASEAN is

<table>
<thead>
<tr>
<th>Table 6 Stock Market Trends</th>
<th>Market Capitalization</th>
<th>Number of Listed Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>463</td>
<td>4,479</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>463</td>
<td>2,654</td>
</tr>
<tr>
<td>India</td>
<td>243</td>
<td>3,479</td>
</tr>
<tr>
<td>Indonesia</td>
<td>30</td>
<td>212</td>
</tr>
<tr>
<td>South Korea</td>
<td>216</td>
<td>1,123</td>
</tr>
<tr>
<td>Malaysia</td>
<td>123</td>
<td>325</td>
</tr>
<tr>
<td>Philippines</td>
<td>18</td>
<td>103</td>
</tr>
<tr>
<td>Singapore</td>
<td>101</td>
<td>539</td>
</tr>
<tr>
<td>Taiwan</td>
<td>261</td>
<td>664</td>
</tr>
<tr>
<td>Thailand</td>
<td>45</td>
<td>197</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Annual Turnover/Market Capitalization (%)</th>
<th>Value of Shares Issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>83.9</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>39.7</td>
</tr>
<tr>
<td>India</td>
<td>63.2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>41.6</td>
</tr>
<tr>
<td>South Korea</td>
<td>254.4</td>
</tr>
<tr>
<td>Malaysia</td>
<td>24.9</td>
</tr>
<tr>
<td>Philippines</td>
<td>13.6</td>
</tr>
<tr>
<td>Singapore</td>
<td>53.8</td>
</tr>
<tr>
<td>Taiwan</td>
<td>217.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>90.4</td>
</tr>
</tbody>
</table>

Notes 1: The figures for China and India are totals for two exchanges (Shanghai+Shenzhen, Bombay+National).
Notes 2: The figures in ( ) under "Number of Listed Companies" refer to foreign companies. The value of shares issued is the sum of IPOs and supplementary issues.
Source: World Federation of Exchanges
recognized as a single asset class, and the interest of foreign investors could be expected to rise. These changes would in turn lead to accelerated economic growth and the diversification of channels for procuring and investing funds.

Integration would also be expected to bring benefits for market participants. First, the potential benefits for investors include better financial products and services, lower transaction costs thanks to competition among intermediaries, and the diversification of investment targets. Second, lower service provision costs, made possible by economies of scale and scope, and an expanded investor base are among the likely benefits for intermediaries. Third, issuers would benefit from lower securities issuance costs thanks to the harmonization of regulations and other systems. Fourth, regulatory authorities would benefit from the development of appropriate regulations for cross-border transactions as the integration process advanced.

Stock market integration is likely to be strengthened through harmonization and mutual recognition, and through the role of the ASEAN exchanges, which are expected to support integration as market infrastructure. Other key factors will include the development of products that will facilitate cross-border transactions, such as cross-border sales frameworks for collective investment schemes.

Progress toward integration can also be expected to accelerate the development of markets in relatively less developed countries. However, care will be needed to ensure that regional integration does not hinder the market development efforts of individual countries. This is another reason why policy adjustment efforts and the establishment of clearly defined short-, medium- and long-term targets are essential.

The needs of ASEAN members differ according to their specific circumstances, and differences in development levels will also be an issue in relation to stock market integration. There is also variation in legal and regulatory systems. For these reasons, ASEAN should aim for gradual integration through the expansion of cross-border transactions rather than through the creation of a single market. It will also be necessary to take an opt-in approach that allows countries to participate when they are able. The integration process is unlikely to move forward unless each country is confident that they will be able to benefit from integration.

There are several priorities relating to stock markets. First, it will be necessary to expand the investor base. Stock investment is not widespread, so there are few individual investors. Only 9% of Singaporeans invest in stocks, compared with 35% in Hong Kong and 17% in Australia. Individual investors account for 60% of transactions on the South Korean stock exchange, compared with just 20% in Malaysia. The scale of institutional investors is also small in ASEAN countries other than Malaysia and Singapore, and their investment strategies tend to be conservative.

Second, while ASEAN stock markets have achieved a certain level of development, as evidenced by ratios of market capitalization to GDP and other indicators, most are also affected by the problem of low liquidity, which is a source of market instability. One possible solution for this problem would be the expansion of the individual investor base, but more wide-ranging measures should also be considered.

Third, the level of cross-border investment within the ASEAN region remains low (Table 7). High levels of cross-border investment are limited to transactions between specific countries, such as Indonesia and Malaysia. ASEAN members will therefore need to implement a wide range of measures, such as the harmonization of market infrastructure, to expand cross-border investment. Another approach that could be effective would be to educate individual investors about the potential of regional companies as attractive targets for investment.

As outlined earlier in this article, Malaysia, Singapore and Thailand are leading progress toward stock market integration. The smooth transition toward integration among these three countries is significant as a successful model for other ASEAN countries to follow. However, there is a vital need for further home market development to ensure that these other countries can really participate. What is needed specifically is further improvement, liberalization and harmonization in
such areas as capital transaction regulations, tax systems, capital market regulations, product line-ups, and corporate governance.

Fourth, human resource development is a vital priority. There is a shortage of capital market experts in ASEAN countries, and in addition to the development of market infrastructure and regulatory frameworks, the recruitment and training of these specialists will also be extremely important.

(4) Bond Markets

1) The State of Bond Markets

Excessive reliance on borrowing from domestic and foreign banks because of the underdeveloped state of bond markets within the region is seen as one of the triggers of the 1997 financial crisis. Recognition of this problem has led to bond market development efforts by governments in the region, and to regional financial cooperation through the ABMI and other forums. The following is a brief analysis of the characteristics of ASEAN bond markets (6).

First, the Asian market as a whole has expanded significantly since the financial crisis, both in absolute terms and also as a percentage of the world bond market (Table 8). However, the dramatic growth of the Chinese market is responsible for a large share of this expansion, and we need to discount this factor. We also need to be aware of the extremely small size of the market at the starting point.

Second, as with the banking sector and stock markets, the level of market development varies widely among countries in the region. This is apparent from ratios of outstanding bond issues to GDP. Nor is the average ratio for the region particularly high. Financial systems in ASEAN countries are dominated by banks, and compared with stock markets, which have expanded to some extent, bond markets offer the greatest scope for development.

Third, while the development of the government bond and corporate bond markets is in balance to some extent, the development of the corporate bond market involves greater difficulties. The development of the government bond market is a prerequisite for that of the corporate bond market. The corporate bond issuer base is weighted toward certain types of issuers, such as financial institutions, infrastructure-related companies, government-affiliated companies and a few large corporations. Reasons for the lack of growth in corporate bond issues in the past include the stagnation of real investment by corporations, and a tendency to prefer financing from retained earnings or through share issues. In addition, Cambodia, Laos and Myanmar have only just reached the stage at which they will need to start developing their bond markets.

Table 7 Balance of Cross-Border Stock Investment in ASEAN (2010)

<table>
<thead>
<tr>
<th>Source Country</th>
<th>Indonesia</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Total</th>
<th>Total investment balance</th>
<th>Intraregional investment ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>...</td>
<td>766</td>
<td>...</td>
<td>2,877</td>
<td>21</td>
<td>3,664</td>
<td>60,971</td>
<td>6.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>8,613</td>
<td>12</td>
<td>8,625</td>
<td>55,467</td>
<td>15.6</td>
</tr>
<tr>
<td>Philippines</td>
<td>...</td>
<td>28</td>
<td>...</td>
<td>974</td>
<td>2</td>
<td>1,004</td>
<td>17,089</td>
<td>5.9</td>
</tr>
<tr>
<td>Singapore</td>
<td>22</td>
<td>7,196</td>
<td>5</td>
<td>...</td>
<td>585</td>
<td>7,808</td>
<td>132,728</td>
<td>5.9</td>
</tr>
<tr>
<td>Thailand</td>
<td>...</td>
<td>320</td>
<td>...</td>
<td>2,978</td>
<td>...</td>
<td>3,298</td>
<td>55,443</td>
<td>5.9</td>
</tr>
<tr>
<td>Vietnam</td>
<td>...</td>
<td>31</td>
<td>...</td>
<td>395</td>
<td>12</td>
<td>438</td>
<td>2,698</td>
<td>16.2</td>
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<tr>
<td>Total</td>
<td>22</td>
<td>8,341</td>
<td>5</td>
<td>15,837</td>
<td>631</td>
<td>24,836</td>
<td>324,395</td>
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</tr>
<tr>
<td>Intraregional investment ratio (%)</td>
<td>2.3</td>
<td>33.3</td>
<td>24.6</td>
<td>8.2</td>
<td>12.5</td>
<td>11.0</td>
<td>2.1</td>
<td></td>
</tr>
</tbody>
</table>

Notes 1: China and Vietnam are not included among the source countries due to the non-availability of data.
Notes 2: Figures shown at the lower right represent total world securities investment balances.
Source: IMF, Coordinated Portfolio Investment Survey
Sixth, although there has been gradual progress toward regional integration, the level of integration remains low (Table 9). Compared with investors in advanced countries, however, Asian investors generally have a regional bias and invest a high percentage of their assets within the region. In addition, there now appears to be a growing trend toward investment in Asian bonds among Japanese investors. This suggests that Asia, including Japan, can be expected to move further toward regional integration in the area of bond transactions in the future.

Recently there has been an increase in dollar-denominated bond issues by Asian issuers, resulting in part from low interest rates in advanced countries (Fig. 7). Many of these dollar-denominated bonds have low ratings, and some observers have warned that repayment risk could increase. Another factor contributing to the increase in issues is the fact that a variety of issuing structures are available in dollar-denominated bond markets. Asian issuers and investors are rapidly becoming more sophisticated, leading to the diversification of bond issues. One example of this pattern is the growth of covered bond issues in Singapore.

Table 8 Increase in Outstanding Issues in Asian Bond Markets

<table>
<thead>
<tr>
<th></th>
<th>End of 1997</th>
<th>End of 2013</th>
<th>Expansion (Times)</th>
<th>GDP Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Govt. bonds</td>
<td>142.1</td>
<td>4,530</td>
<td>3068</td>
<td>31.9</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>252.1</td>
<td>1,457</td>
<td>1,416</td>
<td>6.8</td>
</tr>
<tr>
<td>Govt. bonds</td>
<td>970.0</td>
<td>1,457</td>
<td>1,416</td>
<td></td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>209.4</td>
<td>1,457</td>
<td>1,416</td>
<td></td>
</tr>
</tbody>
</table>

Notes: GDP ratios as of the end of 2013
Source: BIS data for figures as of the end of 1997, Asian Bonds Online for figures as of the end of 2013

Secondary market liquidity is low. Reasons for this include the fact that many institutional investors in ASEAN are still at the development stage, and the fact that the usual investment style is buy and hold. Another factor is the general lack of development of markets for hedging tools, such as derivatives and repos.

Fourth, bond market development has been approached as a policy priority. Different countries have implemented different policies, and while those policies have resulted in market development, they have not always led to the achievement of the goals adopted when the ABMI was first created, specifically the reduction of borrowing from domestic and foreign banks, and the creation of balanced financial systems.

Fifth, there has been qualitative development of bond markets, in the sense that quantitative expansion has been accompanied by efforts to create robust markets. Some observers have pointed out that bond markets functioned as a “spare tire” by providing those seeking funds with an alternative to international capital markets and domestic banking sectors during the Lehman shock. With the additional impetus provided by global monetary easing and the rapid growth of Asian economies, the importance of these markets as targets for investment from advanced countries has risen dramatically. However, this has had a negative impact by heightening market instability.

Fifth, there has been qualitative development of bond markets, in the sense that quantitative expansion has been accompanied by efforts to create robust markets. Some observers have pointed out that bond markets functioned as a “spare tire” by providing those seeking funds with an alternative to international capital markets and domestic banking sectors during the Lehman shock. With the additional impetus provided by global monetary easing and the rapid growth of Asian economies, the importance of these markets as targets for investment from advanced countries has risen dramatically. However, this has had a negative impact by heightening market instability.

Second, there has been secondary market liquidity is low. Reasons for this include the fact that many institutional investors in ASEAN are still at the development stage, and the fact that the usual investment style is buy and hold. Another factor is the general lack of development of markets for hedging tools, such as derivatives and repos.

Outlook for Bond Market Integration, Priorities for Bond Markets

Initiatives toward ASEAN financial integration currently appear not to include active moves to
integrate bond markets. However, efforts through the ABMI have been based on the view that it would facilitate cross-border transactions. Current efforts are focusing mainly on the facilitation of issues, including cross-border issues, through the establishment of the Credit Guarantee and Investment Facility (CGIF) as a guarantee institution for corporate bond issues within the ASEAN region, the maintenance of the Asian Bonds Online website by the Asian Development Bank to provide information about Asian bond markets, and the efforts to standardize bond issuing rules and to improve and integrate regional settlement systems through the ABMF.

The target as far the standardization of bond issuing rules is concerned is the establishment of the ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF) as a common regional bond issuance program for professional investors. Mutual recognition under this framework will allow greater integration of bond markets for professional investors in each member country. When it was first established, the ABMF was expected to take a top-down approach to the creation of offshore markets in Asia. However, a bottom-up approach was found to be more practical, and this now appears to be the most appropriate strategy. Even so, the achievement of mutual recognition will not be easy. The Joint Statement of the ASEAN+3 Finance Ministers and Central Bank Governors in May 2014 acknowledges the progress of efforts to “clarify commonalities and differences of bond issuing documentation and procedures,” but so far this work does not appear to have resulted in any actual bond issues.

There are several priorities for bond markets. First, it will be necessary to expand the issuer base (Table 10). As with investors, one approach to this task would be to attract overseas issuers. To allow bond issues by small and medium enterprises, it

### Table 9 Balance of Cross-Border Bond Investment in ASEAN (2010)

<table>
<thead>
<tr>
<th>Source Country</th>
<th>Indonesia</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Total balance of inward investment</th>
<th>Intraregional investment ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>...</td>
<td>253</td>
<td>695</td>
<td>8,054</td>
<td>42</td>
<td>9,043</td>
<td>35,735</td>
</tr>
<tr>
<td>Malaysia</td>
<td>12</td>
<td>...</td>
<td>18</td>
<td>6,468</td>
<td>125</td>
<td>6,624</td>
<td>39,662</td>
</tr>
<tr>
<td>Philippines</td>
<td>...</td>
<td>512</td>
<td>...</td>
<td>1,687</td>
<td>46</td>
<td>2,245</td>
<td>25,113</td>
</tr>
<tr>
<td>Singapore</td>
<td>622</td>
<td>1,967</td>
<td>96</td>
<td>...</td>
<td>23</td>
<td>2,707</td>
<td>34,831</td>
</tr>
<tr>
<td>Thailand</td>
<td>165</td>
<td>...</td>
<td>2,280</td>
<td>...</td>
<td>91</td>
<td>2,445</td>
<td>10,186</td>
</tr>
<tr>
<td>Vietnam</td>
<td>...</td>
<td>...</td>
<td>91</td>
<td>...</td>
<td>91</td>
<td>2,633</td>
<td>3.4</td>
</tr>
<tr>
<td>Total</td>
<td>634</td>
<td>2,897</td>
<td>810</td>
<td>18,580</td>
<td>235</td>
<td>23,155</td>
<td>148,159</td>
</tr>
</tbody>
</table>

Notes: The eight Asian countries/regions are Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

Source: Asian Bonds Online

### Fig. 7 Dollar-, Euro- and Yen-Denominated Bond Issues

![Graph showing dollar-, euro- and yen-denominated bond issues](chart)

Notes: The eight Asian countries/regions are Hong Kong, Indonesia, South Korea, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

Source: Asian Bonds Online
would also be necessary to create bond markets for companies with low credit ratings.

Second, the investor base will need to be expanded. There has been some diversification of the investor base, but more needs to be done to improve secondary market liquidity (Table 11). Expectations toward investors should focus on foreign as well as domestic investors. There is a risk that increased participation by foreign investors would lead to market instability. However, with their advanced investment technology and diverse investment styles, there would also be significant benefits. Foreign investment in corporate bonds could also be expected to increase.

Markets would also benefit from diversification of the investment styles of domestic investors. Pension systems should be improved, in part as a way of expanding the institutional investor base.

### Table 10 Overview of Current Conditions and Issues in the Corporate Bond Markets of Five ASEAN Countries

<table>
<thead>
<tr>
<th>Market overview, issuers, products</th>
<th>Singapore</th>
<th>Malaysia</th>
<th>Thailand</th>
<th>Philippines</th>
<th>Indonesia</th>
</tr>
</thead>
<tbody>
<tr>
<td>- The bond market has expanded rapidly since 2008. Overseas issuers have also increased their bond issues in Singapore.</td>
<td>- There is limited scope for expansion of the government bond market, but there is room for expansion of the corporate bond market.</td>
<td>- There is scope for further expansion of government bond issues. Corporate bonds are in short supply. There have been little issues by government-affiliated companies.</td>
<td>- Approval for issues takes considerable time.</td>
<td>- The level of market development is similar to that of Malaysia in the late 1990s.</td>
<td>- The level of market development is similar to that of Malaysia in the late 1990s.</td>
</tr>
<tr>
<td>- Products issued are becoming more diverse, including sukuk and yuan-denominated bonds.</td>
<td>- Indonesian and Thailand issuers are issuing bonds in Malaysia.</td>
<td>- The relatively high number of issues with low ratings is a feature of the market.</td>
<td>- The number of issuers is limited, and the size per issue is small.</td>
<td>- Issuer diversification is needed.</td>
<td>- Issuer diversification is needed.</td>
</tr>
<tr>
<td>- Securitization is expected to increase.</td>
<td>- Issues by foreign issuers are restricted.</td>
<td>- Sukuk issues are expected to increase.</td>
<td>- Individual investors are almost non-existent, and institutional investors are not well developed.</td>
<td>- Indonesia is an Islamic country, and although the sukuk market is expected to expand, it is still small at present.</td>
<td>- Indonesia is an Islamic country, and although the sukuk market is expected to expand, it is still small at present.</td>
</tr>
</tbody>
</table>

### Table 11 Investor Mix in Government Bond Markets

<table>
<thead>
<tr>
<th></th>
<th>China</th>
<th>South Korea</th>
<th>Malaysia</th>
<th>Thailand</th>
<th>Philippines</th>
<th>Indonesia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>77.0</td>
<td>18.0</td>
<td>31.9</td>
<td>13.0</td>
<td>31.6</td>
<td>33.7</td>
</tr>
<tr>
<td>Pension funds</td>
<td>-</td>
<td>27.0</td>
<td>32.2</td>
<td>27.0</td>
<td>24.4</td>
<td>4.0</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>5.4</td>
<td>-</td>
<td>5.8</td>
<td>23.0</td>
<td>-</td>
<td>13.0</td>
</tr>
<tr>
<td>Investment trusts, etc.</td>
<td>4.8</td>
<td>21.0</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>4.3</td>
</tr>
<tr>
<td>Foreign investors</td>
<td>10.0</td>
<td>28.3</td>
<td>17.0</td>
<td>-</td>
<td>-</td>
<td>32.5</td>
</tr>
<tr>
<td>Others</td>
<td>12.8</td>
<td>24.0</td>
<td>1.9</td>
<td>20.0</td>
<td>44.0</td>
<td>12.5</td>
</tr>
</tbody>
</table>

Notes 1: Figures as of December 2013 for China, the Philippines and Indonesia, and as of September 2013 for other countries

Notes 2: Some figures are estimates because of differences in the categories used in each country.

Source: Asian Development Bank, Asia Bond Monitor, March 2014
3. The Desirable Ways of Financial System Development

(1) Contribution to Economic Development

① Providing Diversified Financial Services

Reinforcement of domestic financial systems is a prerequisite for progress toward regional financial integration. Another important consideration is the mutually facilitating relationship between the reinforcement of domestic financial systems and domestic economic growth.

One source of insights into the role that financial systems are expected to play in ASEAN countries is Malaysia’s Financial Sector Blueprint, which was released in December 2011. This document identifies future priorities for the financial sector, especially banking. The targets for the period to 2020 cover four areas:

1. A financial sector that best serves the Malaysian economy,
2. Enhancing regional and international financial linkages,
3. Safeguarding the stability of the financial system, and
4. Other key enablers for the development of the financial system.

Recommendations relating to regional financial integration, which falls into the second of these categories, include the reinforcement of regional and international linkages through the gradual opening up of domestic markets to foreign banks,
international cooperation among financial authorities, the development of financial infrastructure to encourage increased cross-border transactions, and an expanded role for the Labuan International Business and Financial Center (IBFC). The Blueprint also calls for efforts to internationalize Islamic finance, including the expansion of market participants, the standardization of documentation, and the enhancement of consideration about regulations and tax systems (Table 13).

The first section of the Blueprint calls for the creation of the financial sector that will best serve the Malaysian economy. The main goal relating to “effective intermediation for a high value-added and high-income economy” is the development of new financial tools—such as infrastructure finance and finance for newly established companies—that will contribute to economic growth. In addition, the Blueprint states that as economic structures change, pension services and business with affluent customers will become increasingly important and banks will need to become more competitive.

In the section calling for the development of deep and dynamic financial markets, the Blueprint emphasizes the importance of improvements to the bond and foreign exchange markets and settlement systems, and the development of a balanced financial system. The Blueprint also calls for financial inclusion for greater shared prosperity and identifies financial inclusion as an important step toward the acceleration of Malaysia’s economic growth and the reduction of income disparity.

While this example relates to Malaysia, the contribution of the financial sector to economic growth is a key factor common to all countries in the region. As far as the banking sector is concerned, since bond issues are limited almost exclusively to large corporations with high credit ratings, there are many areas, such as lending to SMEs and consumers, in which the banking sector must provide appropriate services. Priorities in these areas include the development of credit risk information data bases to facilitate lending, and the enhancement of credit guarantee systems. In the area of consumer services, improved consumer protection and appropriate regulation are needed, in part because of the possibility of excessive lending.

A diverse range of financial services will be needed as economic structures change. Examples include pension-related financial products, services for high-net-worth people, credit for newly established companies, finance for infrastructure projects, microfinance and Islamic finance. The types of services needed will vary according to the way of economic development. The promotion of financial inclusion is also a common priority for ASEAN countries.

Table 13 Balances of Islamic Financial Assets by Region (June 30, 2013)

<table>
<thead>
<tr>
<th></th>
<th>Bank Assets</th>
<th>Sukuk Balance</th>
<th>Islamic Fund Assets</th>
<th>Takaful Insurance Premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>192.3</td>
<td>166.0</td>
<td>24.2</td>
<td>3.5</td>
</tr>
<tr>
<td>GCC</td>
<td>490.3</td>
<td>74.9</td>
<td>30.6</td>
<td>7.6</td>
</tr>
<tr>
<td>Middle East/N. Africa (excl. GCC)</td>
<td>518.3</td>
<td>1.2</td>
<td>0.4</td>
<td>7.1</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>20.6</td>
<td>2.2</td>
<td>1.6</td>
<td>0.2</td>
</tr>
<tr>
<td>Others</td>
<td>62.2</td>
<td>1.0</td>
<td>12.1</td>
<td>0.01</td>
</tr>
<tr>
<td>Total</td>
<td>1,283.7</td>
<td>245.3</td>
<td>68.9</td>
<td>18.3</td>
</tr>
</tbody>
</table>

to seek profit opportunities overseas.

In this way, economic development leads to increases in the scale and complexity of the financial system, and to deepening international integration. This article has emphasized that regional financial integration will not be easy in the existing environment. However, sustained economic development can be expected to increase the likelihood that integration will deepen. This is because the mutually facilitating development of economy and the financial system also helps to drive regional financial integration. This process will heighten the need to liberalize systems that hinder integration, such as restrictions on capital transactions, and build structures, such as financial regulations, to limit risks.

### 3 Issues Relating to Infrastructure Finance and Financial Systems

Infrastructure development is regarded as an important concern for the establishment of the ASEAN Economic Community. Better infrastructure enhances a country’s ability to provide public services, reduces the costs involved in the transportation of people and goods, and strengthens domestic and regional connectivity. This is extremely significant for the formation of production networks and the achievement of economic growth. Goals under the Master Plan on ASEAN Connectivity, which was adopted in 2010, include not only the improvement of physical infrastructure, but also the removal of institutional barriers to distribution and the promotion of human interaction at the social and cultural levels.

Infrastructure development cannot be funded solely from fiscal resources, and the mobilization of private sector funds under public-private partnership (PPP) frameworks is an important priority. However, infrastructure projects involve high initial costs, especially for construction, while the recovery of costs through usage charges and other means takes many years. For this reason, infrastructure development requires not only access to long-term finance, but also accurate assessments of the risks involved in complex projects. Many risk factors can affect infrastructure projects, including governance and political risks. A key is-

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### Table 14 Infrastructure Indices of ASEAN Countries

<table>
<thead>
<tr>
<th>Rank</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>29</td>
</tr>
<tr>
<td>Thailand</td>
<td>47</td>
</tr>
<tr>
<td>Brunei</td>
<td>58</td>
</tr>
<tr>
<td>Indonesia</td>
<td>61</td>
</tr>
<tr>
<td>Vietnam</td>
<td>82</td>
</tr>
<tr>
<td>Laos</td>
<td>84</td>
</tr>
<tr>
<td>Philippines</td>
<td>96</td>
</tr>
<tr>
<td>Cambodia</td>
<td>101</td>
</tr>
<tr>
<td>Myanmar</td>
<td>141</td>
</tr>
</tbody>
</table>

Notes: Based on Global Competitiveness Report (2013-2014), sample: 148 countries, score: 1-7 (the higher the better)

Source: Asian Development Bank Institute [2014], p.167

adequate at present (Table 14). Factors that are expected to drive a rapid increase in the demand for a diverse range of infrastructure include urbanization, the growth of intraregional trade, and growing demand for telecommunications and travel. It will not be easy to meet the demand for infrastructure development funds in this environment. Third, financial systems must be able to keep pace with shifts in the demand for investment and procurement of funds resulting from demographic change. Long-term investment tools will need to be improved, in part because of an anticipated fall in savings rates in countries affected by rapid demographic aging, such as Japan, China and South Korea. Countries with expanding working populations, such as India and Indonesia, will meanwhile need to find sources of finance, not only for infrastructure development, but also to meet demand from both companies and individuals in areas ranging from new businesses to housing. Only by strengthening cross-border financial intermediation systems will it be possible to meet demand in both types of countries.

Basically, if an economy grows, the funds necessary for financing will also expand, leading inevitably to the expansion of the financial system. As an economy matures, simple profit opportunities will decrease, causing financial institutions to become involved in more complex business areas and provide more sophisticated services, and also...
issue with the PPP approach is the level of capacity on the government side. Asia has abundant savings, but the important question is how those savings can be applied to infrastructure development.

Traditionally banks were the main providers of finance for infrastructure projects. However, long-term funds provided by banks are sourced mainly from deposits, especially short-term deposits, and the capacity of banks to expand long-term financing is limited, in part because the level of capital required for long-term financing will increase under Basel III. That is why there is a need for investment by institutional investors with access to long-term funds.

Institutional investors use several methods to invest in infrastructure projects. First, there is investment in unlisted infrastructure funds. A recent estimate places the balance of these funds at around $22 billion. Second, there is investment in bonds rather than equity. Examples include project bond investment funds and project securitization. Bond issues are generally suitable for long-term, large-scale financing. Further expansion of the supply of funds through bond markets will require an increased focus on the improvement of bond markets and the development of institutional investors. Another hurdle that will need to be overcome is the creation of acceptable combinations of risk and yields. Institutional investors will be reluctant to invest in anything other than investment-grade bonds providing yields that are commensurate with risk. One effective approach would be the provision of government subsidies or credit enhancements.

Another way to encourage investment is by improving transparency through the accumulation of data on project costs and returns. Investment in unprecedented areas is not easy, and the accumulation of data—at least concerning future projects—is vital.

The fact that infrastructure investment frequently involves multiple countries is another reason why progress toward regional financial integration is essential. This type of infrastructure development has the potential not only to enhance ASEAN’s international competitiveness, but also to reduce regional disparity.

Other priorities from a financing perspective include support from Japan, China and South Korea for the aforementioned ASEAN Infrastructure Fund, and capacity building to improve government capabilities in relation to PPP projects.

(2) Policies to Facilitate Regional Financial Integration

Facilitation of regional financial integration will require not only the strengthening of markets in individual countries, but also the implementation of measures to promote integration, such as further development of cross-border investment products, modification or harmonization of regulations and systems, and the liberalization of capital transactions (Table 15).

Table 15 Essential Steps for Facilitating Cross-Border Transactions

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Progress on dialog concerning approaches to economic and financial integration within and beyond the region (debate over the costs and benefits of financial integration), reconciliation of differences in national positions and views</td>
</tr>
<tr>
<td>2.</td>
<td>Reduction of differences in bond market development stages through market development in member countries (development of bigger issuers, improvement of credit ratings, improvement of secondary market liquidity, development of risk hedging mechanisms and settlement systems, etc.)</td>
</tr>
<tr>
<td>3.</td>
<td>Expansion of issuer base: The use of securitization and credit guarantees to complement issuer creditworthiness</td>
</tr>
<tr>
<td>4.</td>
<td>Expansion of investor base: Development of regional institutional investors, information distribution and public relations activities for investors</td>
</tr>
<tr>
<td>5.</td>
<td>Product development: Development of cross-border products (securitization products, Asian corporate bond funds, mutual funds, etc.) as catalysts</td>
</tr>
<tr>
<td>6.</td>
<td>Modification and harmonization of systems and market infrastructure (including capital transaction regulations, tax systems, market-related laws and regulations, rating systems and other credit risk data, accounting and auditing standards, and settlement systems)</td>
</tr>
<tr>
<td>7.</td>
<td>Solution of currency-related problems (liberalization of capital account transactions, internationalization of regional currencies)</td>
</tr>
</tbody>
</table>

Source: Compiled by JRI
As mentioned earlier in this article, Singapore, Malaysia and Thailand agreed in October 2013 to establish a similar program as part of their efforts toward ASEAN financial integration. The main driving force for this program was an initiative by Singapore. In the future it may be necessary to reconcile multiple programs. China and Hong Kong are also considering a reciprocal approval system for funds.

The UCITS scheme is also expanding beyond Europe, especially into Asia, and in particular into Singapore and Hong Kong. Asian countries are unable to exert any influence over UCITS, which is a European system. The development of Asian standards would be useful from the perspective of promoting regional financial integration. However, the Fund Passport scheme would require the harmonization and mutual recognition of systems in member countries, and the aims of individual countries would be reflected in the evolution of the system. We need to be aware that the reconciliation of national interests and support for less developed countries as part of the integration process would also be necessary under this system.

4. Key Factors Affecting Progress toward Regional Financial Integration

(1) Europe’s Experience of Financial Integration

① The Evolution of European Financial Integration

In this section we will examine the European experience of financial integration and consider the implications for financial integration in ASEAN. The EC market integration plan implemented between 1985 and 1992 called for free movement of goods, services, capital and labor within the European region. Financial integration initiatives were implemented as part of the process of realizing this plan. Financial integration measures included ① the full liberalization of capital transactions, ② the introduction of a single licensing scheme (mutual recognition of licenses) for finan-
cial institutions and free access to regional stock exchanges for securities companies with stock exchange seats, and a minimal level of harmonization among the financial regulations of member countries.

Efforts to liberalize capital transactions bogged down in the early 1960s, but 1986 saw the beginning of a gradual liberalization process based on EC directives. It was decided that full liberalization would be achieved by July 1990 (1992 for certain countries, such as Spain). Capital flowed into peripheral countries, such as the United Kingdom and Spain, because of the expectation that monetary union would cause interest rates to fall. However, the emergence of doubts about monetary union triggered an outflow of capital, leading in 1992 to the outbreak of the European currency crisis. The currency fluctuation band was widened to 15% in an attempt to resolve the situation, but this showed that the free movement of capital would inevitably be accompanied by currency fluctuations as long as countries retained autonomy over monetary policy.

Another important issue is the harmonization of regulations. Recognizing that the harmonization of laws among member countries would not be easy, the European Commission developed a strategy combining minimal harmonization with mutual recognition, which it presented in its 1985 white paper, Completing the Internal Market. However, even mutual recognition proved to be far from simple, and there was little growth in cross-border transactions. Progress toward the integration of national markets was also impeded by the fact that Europe already had an efficient offshore market in which Eurobonds could be issued cheaply.

With the achievement of monetary union in 1999, Europe began to implement a common monetary policy within the region. This heightened the importance of efforts to integrate short-term financial markets and government bond markets. In May 1999, the European Commission announced the Financial Services Action Plan. The strategic goals identified in this plan were the completion of a single wholesale market, the development of open and secure markets for retail financial services, the implementation of the most advanced prudential regulations and supervision, and action on other issues, such as taxation systems.

There were also developments relating solely to securities markets. In 2001 the Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (the Lamfalussy Report) was completed. This report highlighted problems caused by the complexity of the existing securities-related legislative process in order to promote financial integration, and recommended improvements. These recommendations resulted in the establishment of two regulatory and supervisory organizations: the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR). Known as the Lamfalussy process, this new regulatory and supervisory structure was extended to the banking and insurance sectors in 2002.

However, progress toward the harmonization of regulation and supervision under this system has not been entirely satisfactory. Harmonization has proved to be extremely difficult in the absence of a consensus about the appropriate regulatory and supervisory model. Another problem was the fact that differences in the regulations applied in financial centers, such as the United Kingdom and Luxembourg, were a source of competitiveness.

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Another important issue is the harmonization of regulations. Recognizing that the harmonization of laws among member countries would not be easy, the European Commission developed a strategy combining minimal harmonization with mutual recognition, which it presented in its 1985 white paper, Completing the Internal Market. However, even mutual recognition proved to be far from simple, and there was little growth in cross-border transactions. Progress toward the integration of national markets was also impeded by the fact that Europe already had an efficient offshore market in which Eurobonds could be issued cheaply.

With the achievement of monetary union in 1999, Europe began to implement a common monetary policy within the region. This heightened the importance of efforts to integrate short-term financial markets and government bond markets. In May 1999, the European Commission announced the Financial Services Action Plan. The strategic goals identified in this plan were the completion of a single wholesale market, the development of open and secure markets for retail financial services, the implementation of the most advanced prudential regulations and supervision, and action on other issues, such as taxation systems.

There were also developments relating solely to securities markets. In 2001 the Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (the Lamfalussy Report) was completed. This report highlighted problems caused by the complexity of the existing securities-related legislative process in order to promote financial integration, and recommended improvements. These recommendations resulted in the establishment of two regulatory and supervisory organizations: the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR). Known as the Lamfalussy process, this new regulatory and supervisory structure was extended to the banking and insurance sectors in 2002.

However, progress toward the harmonization of regulation and supervision under this system has not been entirely satisfactory. Harmonization has proved to be extremely difficult in the absence of a consensus about the appropriate regulatory and supervisory model. Another problem was the fact that differences in the regulations applied in financial centers, such as the United Kingdom and Luxembourg, were a source of competitiveness.

Efforts to facilitate financial integration on a practical level, such as market infrastructure, included programs to extend the effectiveness of monetary policy, strengthen and integrate stock and bond markets, and integrate financial services for companies and individuals. Specific measures included the introduction of the Trans-European Automated Real-time Gross Settlement Express Transfer (TARGET) system, the accelerated integration of short-term financial markets and short-term securities markets, the unification of securities settlements, and the unification of bank account settlements.

These efforts have resulted in steady progress toward financial and capital market integration, including the reduction of yield gaps among markets, increased correlation between rates of return in each sector, and the expansion of cross-border transactions. The gradual harmonization of laws
and regulations has also contributed to growth of cross-border transactions, but the most important factor appears to be the elimination of exchange rate risk as a result of monetary union. However, there are areas in which integration has been relatively slow, such as banking services for individuals.

Europe’s experience shows that the harmonization of financial regulation and supervision is not a simple task. However, there are also areas in which progress toward integration will be relatively easy, such as settlement systems and other market infrastructure. The overall integration process is likely to benefit significantly from increased efforts in these areas.

② The European Crisis

Currency union caused capital to flow into peripheral countries in the region. Consequences for the countries concerned included asset price bubbles, and a loss of international competitiveness due to rising currency values. The subsequent global financial crisis caused the financial positions of European banks to deteriorate, and government fiscal positions were also adversely affected, in part by the cost of rescue measures. Because there had already been a certain amount of progress toward regional financial integration, banks in each country held government bonds issued by various countries in the region. The result was a vicious circle of deteriorating bank finances and worsening fiscal positions.

Lax financial regulation and supervision has been highlighted as one of the causes of the European crisis. While there had been some progress toward the harmonization of financial regulations, bank supervision was still under the control of individual governments. This meant that mechanisms established to cope with crises, such as prudential regulations, deposit insurance systems, bank liquidation systems, and liquidity support structures, were inadequate in the environment created by the expansion of cross-border transactions.

Based on this experience, Volz [2013] emphasizes the need to create regional financial monitoring and supervision organizations in step with progress toward regional financial integration.

(2) Conclusions

① Need for Reconciliation of National Interests and Support for Less Developed Countries

In this final section, we will summarize the key points for regional financial integration. Regional financial integration would lead to an increase in cross-border financial and capital market transactions and would also facilitate the reciprocal use of markets in ASEAN countries. Prerequisites for this include the liberalization of capital transactions, and the harmonization and mutual recognition of regulations, systems, market infrastructure and other elements.

ASEAN financial integration would bring a variety of benefits, including economies of scale, improvements in the quantity and quality of services on offer thanks to the increased competitiveness of the region’s financial systems, support for member countries’ economic development and integration at the real economic level, the reduction of disparities in the economies and financial systems of ASEAN countries, and increased circulation of funds in the region, leading to a reduced reliance on outside funds. Even the relatively less developed ASEAN countries would enjoy significant benefits from integration.

However, ASEAN is characterized by the generally small size of member countries’ financial systems, and by wide disparities between countries in the region. Integration would be driven mainly by private sector economic entities and would lead to escalating competition, and not everyone could be a winner. As far as the integration of labor and goods is concerned, it would be possible to discover factors that would give relatively less developed countries an advantage, such as lower wages and abundant natural resources. However, there would be few such factors in relation to financial integration. This characteristic of financial transactions is responsible for the difficulty of moving forward with regional financial integration. From this perspective, it becomes clear that the reconciliation of national interests and the reduction of
disparities between ASEAN countries will be important priorities. The reduction of disparities will require the reinforcement of financial technology assistance systems for the less developed countries, but this process is likely to take considerable time.

Decisions about whether competition should be encouraged or curbed will need to be made on a case-by-case basis, taking a range of factors into account. A balanced approach is needed.

Contribution to Economic Development as a Criterion for Moves toward Integration

Contribution to economic development is the fundamental purpose of a financial system and should remain a focus during the integration process. Volz [2013] states that the aim of regional banking integration should contribute to regional economic development by giving priority to trade finance and infrastructure finance, and that the emergence of Asian banks as leading international banks is not an essential goal. ASEAN countries also need to be aware that there is a mutually facilitating relationship between regional economic development and financial integration. The most important priority is to discourage the excessive pursuit of profit in ways that do not contribute to the support of real economic activity, and instead to aim for the creation of sound, robust financial systems.

Specifically, the key issues for banks are the types of companies and individuals that should be given loans, and the areas of business on which to focus. The important questions in the case of equity and bond markets are the types of issuers to attract and the types of products to issue.

The overall priority is to allocate funds toward productive purposes. Infrastructure finance is especially important in the current situation. Another key issue is the ability of financial systems to cope with demographic aging, the expansion of the middle class, environmental degradation, the increased frequency of disasters, and other changes.

The Need to Address Risks

Because regional financial integration opens markets up to foreign participation, it also results in increased risk. The prerequisites for the liberalization of capital transactions include sound macro policy management and the improvement of domestic financial systems. The lower the level of economic and financial development, the lower will be the extent to which these prerequisites can be fully met. Integration can bring major benefits for the relatively less developed countries in the region, but these countries also face the greatest risks. The full benefits of integration cannot be realized unless the prerequisites for liberalization are met. This means that the obvious choice is an approach whereby countries participate in integration when they are ready. Full liberalization of capital transactions is not an easy goal for any country.

The creation of crisis preparedness systems also plays a vital role in reducing risks. Related measures include capital flow monitoring, the reinforcement of emergency liquidity support systems, the strengthening of financial regulations and the improvement of financial supervision. These preparations need to be made on a regional basis, which will require the harmonization of regulatory and supervisory systems. ASEAN has no central agency responsible for promoting regional integration, and the integration process is instead based on respect for each country’s autonomy. Given this situation, the resolution of issues such as the harmonization of financial regulations and the establishment of regional financial supervisory organizations will be long-term challenges. ASEAN will need to maintain a balance between progress toward integration and risk management within these limitations.

Asian financial systems have not become the source of a major financial crisis since the 1997 financial crisis. As they move toward regional financial integration, the ASEAN countries will need to maintain the soundness of their financial systems.
Reinforcement of Financial Systems the Most Important Priority

Reinforcement of each country’s financial system will be a prerequisite for progress toward regional integration. This will involve a range of specific priorities. The priorities for banks include the improvement of operating efficiency, the development of new business areas, human resource development, and the facilitation of inter-bank mergers. Among the priorities for stock and bond markets are the expansion of issuer and investor bases, human resource development, the development of financial products, the improvement and harmonization of market infrastructure, systems and regulations, and the improvement of secondary market liquidity. The expansion of the domestic investor base is also important from the viewpoint of coping with capital flows. Growth in the number of cross-border transactions by issuers and investors can be expected to result in accelerated market expansion and development.

The reinforcement of financial systems in ASEAN countries in step with progress toward ASEAN financial integration would contribute to economic development while also helping to reduce risk. Another benefit would be the creation of structures to accommodate funds from outside of the region. This leads to the conclusion that the development of robust financial systems capable of supporting open integration is the most important goal from a long-term perspective.
According to an article about the rapid expansion of investment in Asian bonds in the *Nippon Keizai Shinbun* of July 27, 2014, Japanese investors were net buyers of medium- and long-term bonds issued in Asian countries (especially Singapore and Malaysia) by ¥411.5 billion in the first five months of 2014. This is 70% higher than the total for the same period in 2013. In an article in its August 12, 2014 edition about the shift from government bonds to foreign bonds and infrastructure regarding the asset management of life insurance companies under low interest rate environment, the *Nippon Keizai Shinbun* observed that major life insurance companies had started to expand their investment in bonds and other products issued in emerging countries, including those in Asia, and that some companies had established specialist departments for this purpose.

The main sources for these comments are Date [2011] and Okada [2014a] and [2014b].

In relation to this issue, a senior official of the Philippine central bank commented in February 2014 that the small size of Philippine banks meant that the Philippines was unlikely to benefit from integration in the present environment, and that banks needed to prepare for integration by strengthening their positions in their home markets and improving their risk management systems.

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