BARCLAYS CAPITAL

RESEARCH

Regional financial integration and private sector development

Paper prepared for the ASEAN+3 research group: The role of private sector development in regional economic growth and financial integration

Emerging Markets Research

December 2005

Dominique Dwor-Frécaut
Asian EM Strategist
dominique.dwor-frecaut@barcap.com
+65 6395 3211

www.barcap.com

In this paper we argue that Asian financial integration is to be driven by the private sector, with the role of the public sector consisting of supplying a supportive framework. Past experience has shown that financial integration has not always had the expected benefits in terms of faster growth and lower volatility of output and consumption. We argue that Asian financial integration needs to proceed on two tracks: technical measures to promote a regional financial market and structural policies to reduce the synchronicity of Asian business cycles and to develop a regional surveillance process.

Contents

Policy recommendations

Past experience suggests that to be successful, financial integration has to be private-sector led, with the public sector providing a supportive framework within which the private sector can operate. Asian financial integration would best proceed on two parallel tracks:

1. Development of a regional bond market

This would be achieved through:

- Relaxation of capital controls in countries where the financial sector is strong enough to withstand such a liberalisation
- Prioritisation of areas of necessary convergence in laws and regulations, market practices, and tax regimes. Prioritisation could be driven by the impact of the measures considered on the ease and cost of making cross-border transactions.
- Strengthening of regional infrastructure, which includes:
  - Further development of a regional benchmark
  - The development of a clearing and settlement network
  - The development of a regional investor base.
- Increasing corporate bond issuance. Asia's large and persistent current account surpluses suggest a structural shortage of Asian bonds. This shortage could be remedied through :
  - Reviving investment demand
  - Increasing corporate sector recourse to bond finance
  - Increasing issuance in Asian currencies by non-Asian issuers.

2. Structural economic reforms

These would ensure that increased regional financial integration results in faster growth and lower volatility of output and consumption. Such reforms include:

- Measures to better balance domestic and external demand growth. For instance:
  - FX policies that do not distort the allocation of resources between the tradable and non-tradable sectors.
  - Policies supportive of domestic private sector development, such as policies to lower barriers to market entry or policies supportive of SMEs.
  - A large-scale programme of investment in the non-tradable sector, for instance infrastructure and expansion of services such as health and education. These need not be publicly funded or supplied. Investments in infrastructure and human capital are also needed for countries to make the transition from low to middle-income or from middle to upper-income.
- Measures to establish a regional surveillance process, since financial integration creates a risk that shocks would propagate much more quickly across the region.

As an intermediate step towards full-fledged regional financial integration, a new fund could be set up and managed by countries themselves, rather than by a third party as is the case with ABF 1 and 2. The fund could consider investment in a wider range of securities than ABF 1 and 2, and profits could be used to fund regional initiatives such as giving technical assistance to support regional financial integration or financial sector development.

Executive summary

Success requires better-balanced growth and regional surveillance

In theory, financial integration carries a number of benefits…

In theory, financial integration can raise growth through the augmentation of domestic savings and through a possible positive impact on financial sector development. In addition, under some circumstances, financial integration can help reduce the volatility of output and consumption through investment in foreign assets with returns that have low correlation with national income.

… but it has not always been associated with faster growth…

In practice the impact of financial integration on growth has not been as clear cut as predicted by theory. High income OECD countries tend to be on average more financially integrated than low-income countries (although this does not imply that causality runs from financial integration to growth). The impact of financial integration on growth in low-income countries is more ambiguous. Once other variables are taken into account, there does not seem to be a strong, significant positive impact of financial integration on growth.

These somewhat disappointing results likely reflect two broad factors. First, financial integration may have a different impact on the subject country depending on the channels through which it takes place. Different types of capital inflows have different effects on growth. Second, obtaining benefits from financial integration is likely to require institutions that foster an efficient use of capital, including macroeconomic stability, open trade, well developed and resilient financial sectors and good governance. These are more likely to be present in OECD rather than low-income countries.

… and has at times increased volatility

In practice, the impact of financial integration on income and consumption volatilities has generally been found to be ambiguous. In many instances, the opening of capital accounts has actually resulted in financial and/or balance of payments crises.

But these crises may have reflected domestic weaknesses rather than financial integration per se. In the 1970s and 1980s balance of payments/financial crises affected both industrial and low-income countries. Since the mid-1990s, by contrast, there has not been a major crisis in an OECD country, even though they tend to be more financially integrated than low-income countries, which may reflect the stronger financial sectors of OECD economies.

Emerging market economies are perhaps even more in need of strong financial sectors than OECD countries as financial integration can expose them to large swings in foreign liquidity. In addition, because emerging capital markets are small and illiquid, they tend to be disproportionately influenced by small changes in major capital markets.

Integration to require better absorptive capacity and domestic demand-led growth

For financial integration to translate into faster growth, the process would have to be in synch with measures designed to strengthen countries' absorptive capacity, such as further trade liberalisation and development/strengthening of the financial sector.

In addition, growth in many Asian countries tends to be driven by external rather than domestic demand, which means many seem to share a common exposure to the same type of demand shocks. Hence, regional financial integration may not reduce volatility if countries' business cycles tend to be synchronised. This suggests countries may find it beneficial to support policies that reduce the correlation between regional outputs and financial markets.

Chief among those, in our view, is the need to move to more domestic-driven growth. This would need to include foreign exchange policies that do not distort the allocation of resources between tradable and non-tradable sectors. In addition, domestic private sector development could play an important role.

The process could also be jump-started by large-scale investments in the non-tradable sector: in many countries, the need for better education, health and infrastructure – which is required to move to middle or upper-income status – remains unmet. These expenditures need not be publicly funded or supplied by the public sector. Rather, what may be required is a change in regulatory structure to support greater private sector supply of infrastructure and traditionally public services.

Risk management is an important part of financial integration. With financial integration, risk management will acquire a regional perspective on top of the home dimension. An informal regional economic dialogue and surveillance is already taking place under the auspices of the ASEAN secretariat and of ASEAN+3 meetings. As regional integration progresses, there may be a need to establish a formal regional institution.

Regional financial integration more beneficial than global financial integration

Strong North-South capital flows reflect only the current status quo

Currently there is greater financial integration between ASEAN+3, the US and the EU since global financial centres are found in high-income countries, not emerging markets. In our view this does not constitute evidence, as some have argued, that the development of regional financial markets is too costly relative to its benefits and that it would be more beneficial to let ASEAN+3 integrate with global, rather than regional markets.

Evidence of limits to economies of scale in capital markets development

These arguments are based on the implicit assumption that there are no limits to economies of scale in financial markets. Yet the examples of the US and Europe, where multiple exchanges exist despite limited barriers to financial integration suggest this may not be the case.

Informational asymmetries limit economies of scale in capital markets

In our view, capital markets are not natural monopolies, mainly for two reasons. First, economies of scale are not driven by technological developments alone: connecting stock exchanges involves much more than just physical wiring.

Second, and perhaps more importantly, there is strong evidence that international financial markets are segmented by informational asymmetries: foreign knowledge and understanding of local markets, especially emerging market conditions, is limited. As a result, investors' holdings of foreign assets generally fall far below what would be implied by an optimal portfolio allocation and diversification. Indeed, new research has shown that market sizes and physical distance between markets, rather than rates of return differentials, are the most important determinants of cross-border equity flows between developed countries.

Informational issues are likely to be even more acute in emerging markets where the standards of transparency and governance are not as strong as in developed markets. This likely explains why there are very few instances of emerging market firms that have been able to list directly overseas. Hence a local listing may be a necessary learning process for firms from emerging markets that allows them to prepare for the more difficult requirements of a foreign listing.

The advantages of regional over global financial integration

Due to informational asymmetries integrating with global financial markets is unlikely to be a substitute for the development of domestic financial markets. In addition, global financial integration is not a costless process: successfully integrating with global markets would require countries to improve accounting, auditing, transparency and governance that also need to be improved in order to develop local financial markets.

Regional financial integration, on the other hand, could help countries develop their domestic financial markets through peer pressure and pooling of experience; higher financial sector employment; a lower correlation with the major markets – which would increase the attractiveness of ASEAN+3 assets in international investors' portfolios. Such a focus would also help Asian countries gain more control over factors influencing their markets, but only if financial integration is accompanied by regional policy dialogue and surveillance.

The role of the public and private sectors

Private-sector driven integration has been most successful

Perhaps the most successful example of financial integration leading to market creation – the euromarkets – was entirely private-sector driven. Most interestingly, the euromarket has become a multi-currency fixed income and banking market with a thriving FX market, which shows that monetary integration is not necessary for financial integration.

Although the creation of the Euromarkets was private-sector driven, it took place within the regulatory and policy frameworks of the various countries involved. The development of the euromarkets was not the result of deliberate polices to create a market but rather of laissez-faire and liberal policies on foreign capital flows, financial sector development, FDI and immigration. And of course the fact that the market was developed outside of the countries of origins of the currencies greatly simplified issues such as inconsistent laws, regulations, tax regimes and market practices across countries.

The European experience: Substantial benefits if still a work in progress

By contrast with the development of euromarkets, the development of an EU-wide financial market involves the integration of already existing national markets with their own distinct legal and regulatory systems, market infrastructures and practices and tax systems, with some belonging to the monetary union and some choosing not to participate. EU policymakers have made it clear that the private sector is to drive the integration process.

European financial integration started in the 1980s and is still a work in progress, despite monetary integration. Yet EU economies have already reaped substantial benefits in terms of financial market development. These are not the result of the introduction of the EUR alone: in view of the wide differences in countries' legal and regulatory systems, market infrastructures and practices and tax systems, the expansion of the securities markets in the euro area could not have taken place without the various policy initiatives to reduce cross-border transaction costs.

Comparing Asia's financial integration with the EU's

The task facing Asian policymakers is similar to that faced by the EU in the late 1980s, when financial integration started in earnest. Asia's current economic conditions and policy framework appear less favourable than those that faced the EU, due to greater economic and financial disparities between countries, less intra-regional trade, less capital and labour mobility and a lack of supranational institutions.

As a result the cost of cross-border financial transactions in Asia remains very high. In the case of bond investments, the impediments to cross-border transactions come mainly from regulatory constraints and the lack of development of individual countries' financial markets.

Building blocks for financial integration in Asia

The trade-off between capital account liberalisation and capital market development

Regional financial integration requires dense cross-border transactions and these cannot take place with pervasive capital controls. A relaxation of capital controls in our view is necessary to increase foreign participation, diversify the investor base and create depth, liquidity and scale for Asian financial markets. But this cannot take place unless financial sector have become resilient enough to withstand large swing in foreign capital flows. In addition, the example of the euromarkets in our view shows that financial integration is possible without monetary integration, but requires a very efficient FX market. The emergence of an efficient regional FX market requires substantial reductions in capital controls.

A number of countries have recently started the relaxation of their capital controls by focusing first on the facilitation of foreign investment in their local currency bond market. At this stage of regional financial integration this may be a good compromise between the perception that controls are necessary to ensure stability and the need to liberalise to support financial development. As countries gain confidence with liberalisation, financial sector resiliency improves and regional integration deepens, further relaxation of controls could be considered.

Prioritising regulatory convergence

There is a need to prioritise regulatory convergence, focusing first on the convergence of rules that can have the greatest impact on the ease and cost of cross-border transactions. A number of global standards are already adhered to by many countries in the region and could be used as a basis for regulatory convergence.

Strengthening regional infrastructure

A regional benchmark

The local currency ABF2 has supported the emergence of a regional benchmark, the iBoxx Pan Asia Index, that covers eights local currency bond markets and is quoted in USD on an unhedged basis, as well as of country benchmarks for the eight countries involved. This constitutes a key step in the development of a regional market and the deepening of individual countries' markets, but does not obviate the need for individual countries to maintain liquid benchmark yield curves.

One of the initiatives under consideration to support the development of a regional bond market is the issuance of multi-currency bonds. There is a risk, however, that if multi-currency issuance is carried out at the expense of issuance in local currency that it could further reduce the liquidity of local currency bond markets and distract governments from the need to maintain a liquid benchmark yield curve.

A regional clearing and settlement network

The current clearing and settlement systems in ASEAN+3 do not seem to be a major impediment to cross-border trading. Indeed, rather than a whole new regional infrastructure for clearing and settlements, what seems to be needed is to network existing country infrastructure. At the same time, there will be a need to harmonise clearing and settlement procedures.

A regional ratings process

In view of the role played by informational asymmetries in segmenting capital markets, the development of consistent credit risk assessment across Asia is a crucial element of the regional financial integration process.

So far regional initiatives to support the development of a consistent rating process across Asia have largely consisted of the organisation of forums and seminars. This is a useful first step but continued progress may require the establishment of a regional agency supporting existing local rating agencies. Such an agency could be set up on a cooperative basis by existing local credit agencies to provide a common framework of analysis as well as support services such as training, quality control, or R&D. In view of the limited availability of credit analysis skills, the regional credit agency could initially be set up as a joint venture with one of the big three international rating agencies.

In addition, governments could open, on a reciprocal basis, their market to other Asian countries' rating agencies. Asian ratings agencies would be free to seek business anywhere in Asia provided they met local regulatory requirements and could rate both local and foreign currency debt issues. Indeed, a regional study is currently under way on seeking ways to facilitate cross border acceptance of Asian credit ratings.

A regional investor base

Since the 1997 crisis the investor base for Asian bonds has become more regionalised, although more so in the USD market than in local currency markets. Additional measures to support the emergence of a regional investor base include phase 2 of the ABF2 that will open investments in the Pan Asian Index Fund (PAIF) and in the country funds to institutional and retail investors within and outside the participating countries. In addition, further liberalisation of financial foreign direct investment in banking and fund management could support the emergence of regional financial groups and the strengthening of a regional investor base.

Increasing corporate issuance

Reviving investment demand

Persistent and large current account surpluses suggest bond market development is more constrained by a lack of bond supply than by a lack of bond demand. The emergence of large current account surpluses in Asia in the aftermath of the 1997 crisis largely reflects private investment demand that has remained well below its pre-crisis level. Disappointing private investment in turn may well reflect a lack of structural reforms. Further structural reform that would revive private investment could reduce current account surpluses and increase Asian bond issuance.

Increasing the recourse to bond finance

Countries could also encourage greater reliance on bond finance through a widening of the universe of firms able to access the bond market and through securitisation. Widening the universe of firms able to tap the bond markets would require measures to increase transparency, for instance continuing with the strengthening of accounting and auditing standards.

Strong ABS issuance would require a strong recovery in bank lending as well as the development of supportive legal, regulatory and tax systems. Until recently, in most Asian countries, largely due to slow investment growth, banks have often found it difficult to rebuild their loan books and may have been reluctant to sell those few assets that generate their spread. In a number of Asian countries, loan to deposits ratios have now started to stabilize or even increase but loan growth may have to accelerate further before securitisation becomes a strong source of bond issuance.

Increasing arbitrage issuance

In view of Asia's tradition of high savings, a revival of investment and a greater reliance on bond finance may not be enough to bridge what seems to be a structural gap between demand and supply. What is needed in our view is to bring a steady flow of non-Asian issuers, ie, arbitrage issuers, to Asia.

The markets most likely to attract foreign issuers would have to belong to economies with very strong fundamentals, and markets that offer a large enough range of issue size and maturities with low issuance costs. In the region so far, Hong Kong and Singapore are the only two markets that have attracted foreign issuance on a significant scale. Korea has strong potential, due to the size and development of its bond market and its impressive restoration of strong fundamentals since the crisis and could consider making the required regulatory changes to make its bond market friendlier to potential issuers.

Further suggestions for regional integration

A dual-track process

Regional financial integration in our view requires policy actions on two fronts. On the one hand, technical measures to support the development of a regional financial market. On the other, measures to build a macroeconomic and institutional framework that will enable the region to reap the full benefits of financial integration. So far regional initiatives seem to have focused mainly on the first track and there is a risk that if the second track is not activated, regional financial integration may not bring the expected benefits.

The limits of networking

Asian financial cooperation has so far proceeded through the development of networks between policymakers, academics and market participants rather than through the establishment of a regional institution. Overall, these networks have, in our view, achieved impressive results.

Yet the networking process has its limits. As financial integration deepens, the issues confronting policymakers are likely to become more complex and coordination between country efforts more demanding. The lack of a regional institution is likely to keep regional financial integration progressing at a very slow pace.

A step towards stronger regional institutions

In the long run, financial integration will require some form of regional institution. In the short term, given countries' reluctance to set up supranational institutions, as an intermediate step another FX reserve pooling arrangement could be considered. This new reserve pooling arrangement would be managed by the participating countries themselves, rather than by third parties as in ABF 1 and 2.

The new arrangement could consider investment in a wider range of securities, for instance in Asian equities, and profits from the fund could be used in regional initiatives such as technical assistance for the development of individual countries' financial markets. Such a set up would promote learning through involvement, networking among Asian policymakers and hopefully become a stepping stone towards the creation of a fully fledged regional financial institution.

Success requires better-balanced growth and regional surveillance

In theory, financial integration carries a number of benefits

"An integrated market is perhaps easiest understood when it concerns goods, and where it refers to a situation where there are no barriers to trade across borders. The same reasoning can also be applied to the wider context of financial markets. Market participants should generally not be discriminated in their access to the market on the basis of their location, and cross-border transactions should be treated equally to domestic ones, notably in terms of rules and costs". [1]

Due to technological innovations, the opening of capital accounts and the liberalisation of financial sectors, financial integration has greatly increased since the 1990s, although the patterns of financial integration have been quite different for OECD and low-income economies. Financial integration has been much more pronounced in OECD economies than in low-income economies, although the latter have also become more financially integrated. In addition, the financial integration of low-income economies has mainly been with high-income countries. At the same time, the increase in North-South capital flows has been concentrated on a relatively small group of low-income economies. The increase in North-South flows has taken place mainly through FDI and portfolios, with bank lending declining and turning negative in the aftermath of the Asian crisis.[2] At the same time, banking FDI in emerging market economies has greatly increased since the early 1990s[3].

The experience of East Asia is consistent with these global trends. An analysis of the financial integration of East Asia shows that post-crisis stock returns have become significantly more influenced by global and to a lesser extent by regional factors than by domestic factors.[4] Over the past year or so foreign participation in local bond markets has increased but has largely come from outside Asia.

There is much more of a consensus on the benefits of trade integration than on those of financial integration.[5] In theory, financial integration has two broad types of benefits: it raises growth and it reduces economic volatility.

Faster economic growth

Financial integration raises growth through channels such as:

- Augmentation of domestic savings: increased availability of capital reduces financing costs to firms;

---

[1] *Jean-Claude Trichet, Integration of the European financial sector, Introductory remarks at the International Banking Event, Frankfurt am Main, 29 June 2004.*
[2] *See Philip Lane and Gian Maria Milesi-Ferretti, "International financial integration", IMF staff papers, Vol. 50 special issue, 2003.*
[3] *See Domanski, Dietrich, Foreign banks in emerging market economies: changing players, changing issues, BIS Quarterly Review, December 2005*
[4] *See Yung-chul Park, "Prospects for Financial Integration and Exchange Rate Policy Cooperation in East Asia", ADB Institute research paper 48, December 2002.*
[5] *For an alternative perspective on the view that there is a generally positive relationship between trade openness and growth see Francisco Rodriguez and Dani Rodrik, "Trade policy and economic growth: a skeptic's guide to the cross national evidence", NBER working paper 7081, April 1999. Rodriguez and Rodrik argue that the relationship between trade policy and growth is "a contingent one, dependent on a host of country and external characteristics".*

- Lower cost of capital through better global allocation of risks: increased risk sharing between foreign and domestic investors helps diversify risk and reduce financing cost;
- Transfers of technology and managerial know-how: FDI can be a conduit for the acquisition and diffusion of technology;
- Stimulation of banking sector development: foreign ownership of banks can support transfer of technological and managerial knowledge and greater competition; [6]
- Stimulation of capital market development: the pooling of individual country market liquidity brings economies of scale that tend to be quite important in financial sector development; in Asia, some countries are experiencing difficulties in developing their bond markets because they cannot get past the critical size that would be needed for the market to take off[7].

Ambiguous impact on economic volatility

In theory, financial integration can also benefit economies through a reduction in the volatility of output and consumption. There is now strong empirical evidence that high output volatility can adversely affect long-term economic growth. Output volatility is particularly disruptive when underdeveloped financial systems do not allow firms and households to smooth disposable income or consumption[8].

The theoretical impact of financial integration on output volatility is ambiguous: if financial integration leads to increased economic specialisation it can increase volatility. While specialisation can increase productivity and growth, without a mechanism for proper risk management it can also increase output volatility, for instance, if a country's exports become highly concentrated in a single sector. On the other hand, financial integration that supports economic diversification can decrease output volatility[9].

The theoretical impact of financial integration on consumption is less ambiguous than that on income. Financial integration should reduce consumption volatility through investments in foreign assets whose returns have a low correlation with national income. In macroeconomic terms, a financially integrated country can spread the adjustment to an adverse shock over a longer period of time and reduce consumption and income volatility by, for example, tapping foreign savings.

Financial integration has not always been associated with faster growth

In practice the impact of financial integration on growth has not been as clear cut as predicted by the theory. OECD countries tend to be on average more financially integrated than low-income countries (although this does not imply that causality runs from financial integration to growth). A study on the benefits of financial integration in the EU has found that with deeper financial integration, the overall level of EU-wide real GDP could increase by more than 1% over a decade or so, and that employment would also benefit. The cost of equity capital was estimated to fall across Europe by about 40

---

[6] See Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and Ayhan Kose, "Effects of financial globalization on developing countries: some empirical evidence", IMF, March 2003.
[7] See B. Eichengreen and P. Luengnaruemitchai, "Why doesn't Asia have bigger bond markets?", mimeo, University of California, Berkeley, February 2004.
[8] For a detailed discussion see Dalia Hakura, "Output Volatility in emerging markets and developing countries," WEO, IMF April 2005.
[9] See Prasad et al. op. cit.

bp, with a further reduction of 10 bp arising from reduced clearance and settlement costs[10].

The impact of financial integration on growth in low-income countries is more ambiguous. China, India, Mauritius and Botswana have achieved high growth with limited capital account liberalisation. Jordan and Peru have maintained low growth despite opening their capital account. Once other variables are taken into account, there does not seem to be a strong, significant positive impact of financial integration on growth[11].

It is also striking that, despite overall greater financial integration after the 1997 crisis, growth rates in Asia have for the most part not recovered to their pre-crisis level. While Asia's high savings rates have not fallen by much post-crisis, investment levels have remained well below their pre-crisis levels and many countries in the region have become net capital exporters. This is somewhat anomalous since one would expect growth rates and hence rates of return on investment in low- or middle-income countries to be higher than that of mature economies. Hence, low- or middle-income countries should be net capital importers rather than exporters.

These somewhat disappointing results likely reflect two broad factors. First, financial integration may have a different impact depending on the channels through which it takes place: different types of capital inflows have a different impact on growth. FDI inflows for instance are more stable and more likely to bring positive technological and managerial spillovers than portfolio inflows[12].

Second, and perhaps more importantly, economists have built a voluminous literature showing the positive impact of financial sector development on growth[13] but financial integration is likely to translate into financial sector development only if certain conditions are met. These include institutions that foster an efficient use of capital, including macroeconomic stability, trade openness, and laws and infrastructure supportive of financial sector development. These are more likely to be present in OECD than in low-income countries. For instance, the lack of vibrancy of private investment in Asia after the 1997 crisis may well reflect a need for deeper structural reforms.

Financial integration has at times increased volatility

In practice, the impact of financial integration on income and consumption volatility has generally been found to be ambiguous. In Asia, economies such as Malaysia and Singapore have pursued a development strategy based on large FDI inflows that has led to a high degree of concentration of exports in the electronics sector and hence is highly exposed to the global electronics cycle. In India by contrast, where FDI inflows have been very limited relative to the size of the country, exports are much more diversified. Interestingly, although Korea's openness to FDI has been much more limited than that of Malaysia or Singapore, Korean exports are also concentrated in the electronics sector[14].

---

[10] London Economics, "Quantification of the macro-economic impact of integration of EU financial markets", London, 2002.
[11] See Prasad et al. op. cit.
[12] For a discussion of the benefits and determinants of FDI see Sonali Jain-Chandra, "Foreign Direct Investment in India: How it can be increased", India selected issue, IMF March 2005.
[13] See for instance Beck, Thorsten and Ross Levine, "Stock markets, banks, and Growth: Panel evidence", NBER working paper 9082, 2002.
[14] For a discussion of output volatilities and relative performance of Malaysia, Singapore and Korea see Dominique Dwor-Frecaut, "Malaysia: new economic strategy calls for more flexible exchange rate", Barclays Capital, 16 February 2005.

In addition, in many instances, the opening of capital accounts has actually resulted in financial and/or balance of payments crises. But these crises may have reflected domestic weaknesses rather than financial integration per se. In the 1970s and 1980s balance of payments/financial crisis affected both industrial and low-income countries. By contrast, since the mid-1990s there has not been a major crisis in an OECD country, even though they tend to be more financially integrated than low-income countries.

During the 1997 crisis, Singapore had a much more open capital account than Korea, but was much less affected. The 1997 crisis is now largely understood to be the consequence of the opening of capital accounts without proper risk management and incentives in the financial sector. There is now a well established consensus that countries should not liberalise their capital account before they have built up strong enough financial sectors.

To benefit fully from financial integration, emerging market economies require financial sectors strong enough to withstand large swings in foreign liquidity. Flows to emerging markets seem to be driven more by push factors (ie, conditions in the OECD markets), than by pull factors (ie, conditions in the recipient countries[15]), which can be destabilising. For instance, in the typical emerging, export-oriented economy, foreign equity inflows tend to be correlated with US equity markets. They are likely to surge when US equity markets perform strongly, which tends to happen when US demand and hence external demand is also strong. As such, foreign liquidity tends to be pro-cyclical.

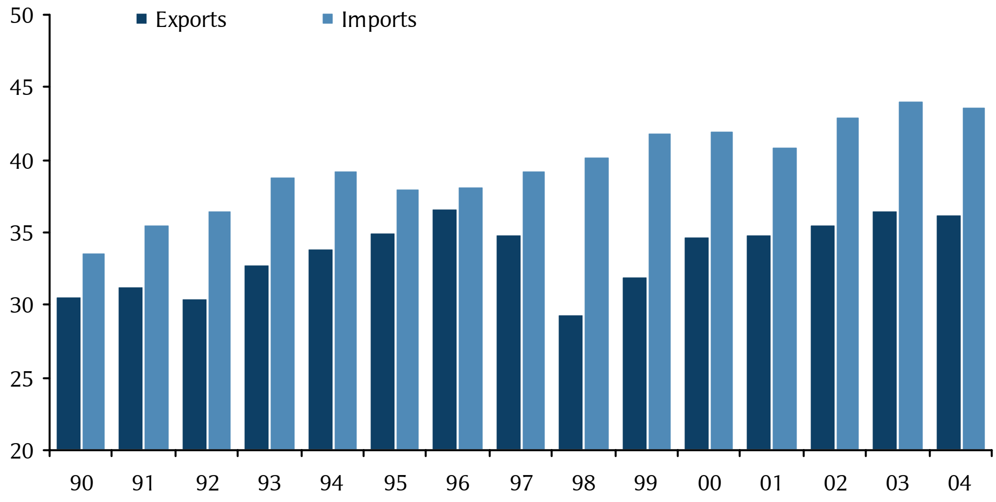
In addition, because emerging capital markets are small and illiquid, they tend to be disproportionately influenced by small changes in major capital markets: for instance, the USD bond market is 300x as large as the SGD bond market. A limited change in US market conditions can have a large impact on emerging markets that does not reflect a change in economic or financial conditions in these countries. Greater financial integration with global markets in the aftermath of the 1997 crisis has resulted in many Asian markets reflecting conditions in the US and EU rather than their own economic fundamentals[16]. In some instances this has complicated policy implementation and macroeconomic management and even increased economic volatility.

Although trade integration is generally considered more beneficial than financial integration, it may not always lead to lower volatility. An analysis of the volatility of output growth in East Asia ex-China shows that volatility has increased after the 1997 crisis and has become much more driven by regional factors, as opposed to country-specific factors prior to the crisis[17]. The relative decrease in individual-country induced volatility post-crisis could reflect better economic policies and stronger financial sectors.

---

[15] See for instance Patrick McGuire, Martijn Schrivers, "Common factors in emerging market spreads", BIS Quarterly Review, December 2003 and Gianluigi Ferrucci, Valerie Herzberg, Farouk Soussa, Ashley Taylor, "Understanding capital flows to emerging market economies", Financial Stability Review, Bank of England, June 2004.
[16] See for instance Dominique Dwor-Frecaut and Philip Nakajima, "Is US monetary policy driving Korean confidence?", Barclays Capital, 15 March 2005.
[17] See Hakura, op. cit.

Figure 1: Intra-regional trade shares remain modest (Share of exports and imports from Asia, % of total)



Source: CEIC; Barclays Capital.

Interestingly, region-induced volatility has increased in relative terms despite an increase in the share of regional trade. This may well reflect the nature of regional trade integration in Asia, which has been largely driven by the integration of East Asian economies along global rather than regional supply chains and the consolidation of China's position as a regional and global manufacturing platform. Hence, the rise in regional trade may not reflect a diversification of sources of external demand but rather a relocation of assembly and manufacturing in China, from various countries in the region. Despite this relocation, final demand for Asian exports still largely comes from OECD countries. Indeed, the greater increase in intra-regional import than export shares since the 97 crisis appears consistent with a pattern of development of intra-regional trade where final demand from within ASEAN+3 has not increased but countries have specialised in the supply of inputs to be assembled in China.

Integration to require better absorptive capacity and domestic demand-led growth

The above discussion suggests that financial integration alone may not be highly beneficial to East Asian economies. To be successful, regional financial integration is likely to require a comprehensive programme of economic reforms.

Stronger absorptive capacity

For financial integration to translate into faster growth, integration would have to proceed in synch with measures designed to strengthen countries' absorptive capacity. Some are already underway; for instance the ASEAN Free Trade Area (AFTA) is under implementation and free trade agreements with China, Japan and Korea are under discussion. A lowering of trade barriers would support better allocation of resources, provided of course that FX policy does not distort the allocation of resources between the tradable and non-tradable sectors.

While Asian economies are, by global standards, highly open, the development of their financial sectors, and their capacity to utilise capital efficiently, is unequal. Financial sector resiliency also appears unequal across countries in the region. This suggests regional financial integration would have to involve initiatives to develop and strengthen individual countries' domestic financial sectors if it is to accelerate growth.

Regional integration can support the development of individual countries' financial sectors through regional experience pooling and peer pressure. Hence, regional financial development and that of individual countries are mutually reinforcing processes.

Domestic demand-led growth

As noted above, in many Asian countries growth tends to be driven by external rather than domestic demand, and in a number of countries exports are highly concentrated in the electronics sector. A common exposure to the same type of shocks suggests Asia could do well under a common monetary policy. However, there are a number of reasons why monetary integration in ASEAN+3 appears a distant prospect: heterogeneity of economic and financial structures, a traditional reluctance to use fiscal policy for counter-cyclical purposes, and most importantly, ASEAN+3 countries do not appear ready for the loss of policy independence that would be required for a move to monetary integration[18].

For the time being, financial integration appears a more realistic prospect than monetary integration. As mentioned earlier, one of the benefits of financial integration is a reduction in consumption volatility through greater international diversification of asset portfolios. In Asia, consumption risk-sharing through capital and credit markets has been found to be significantly lower than in the US or in OECD countries, which suggests significant gains from regional financial integration[19]. But the benefits of portfolio diversification are greatest when rates of returns on portfolio assets have low correlation. Hence, for regional financial integration to be beneficial, regional financial markets would have to hold limited correlation. This suggests that, by contrast with monetary integration, financial integration might work best when country-specific shocks are relatively important.

Figure 2: Contribution of domestic demand to growth has generally not increased since the crisis

	China	HK	Indon	Japan	Korea	Mal	Phil	S'pore	Thai
NEER, 2002-04 (%)	-10.0	-2.0	3.0	-4.0	-3.0	-5.0	-9.0	-6.0	-4.0
REER, 2002-04 (%)	-8.0	-5.0	16.0	1.0	0.0	-6.0	-7.0	-6.0	7.0
Goods and services trade % GDP 92-96	37.2	363.2	52.2	17.1	55.8	174.7	75.7	327.0	84.5
Goods and services trade % GDP 00-04	57.4	302.3	61.8	21.6	75.7	216.3	102.6	370.0	126.2
Dom. demand contrib. % growth 92-96	100.0	132.1	116.5	120.0	111.0	108.3	151.4	81.7	118.5
Dom. demand contrib. % growth 00-04	96.5	75.0	110.9	69.2	74.1	125.0	100.0	36.6	100.0
GDP Growth 1992-96	12.1	5.3	7.9	3.0	7.3	9.6	3.5	9.3	8.1
GDP Growth 2000-04	8.6	4.8	4.6	1.3	5.4	5.2	4.5	4.1	5.1

Source: CEIC, Barclays Capital.

With Asia more likely to move to financial than monetary integration, it may be necessary for countries to deliberately implement measures to reduce output and financial markets' correlation between them. Chief amongst those, in our view, is the need to move to more domestic driven growth. This would need to include foreign exchange policies that do not distort the allocation of resources between the tradable and non-tradable sectors. In addition, domestic private sector development could play an important role: for instance, policies that lower barriers to market entry and support

---

[18] See Eichengreen Barry and Tamim Bayoumi, Is Asia an Optimum Currency Area? Can It Become One? Regional, Global and Historical Perspectives on Asian Monetary Relations, Center for International and development economics research, University of California Berkeley, 1996
[19] Kim, Soyoung, Sunghyun H. Kim and Yunjong Wang, Financial Integration and Consumption Risk Sharing in East Asia, Korea Institute for International Economic Policy (KIEP),December 2003.

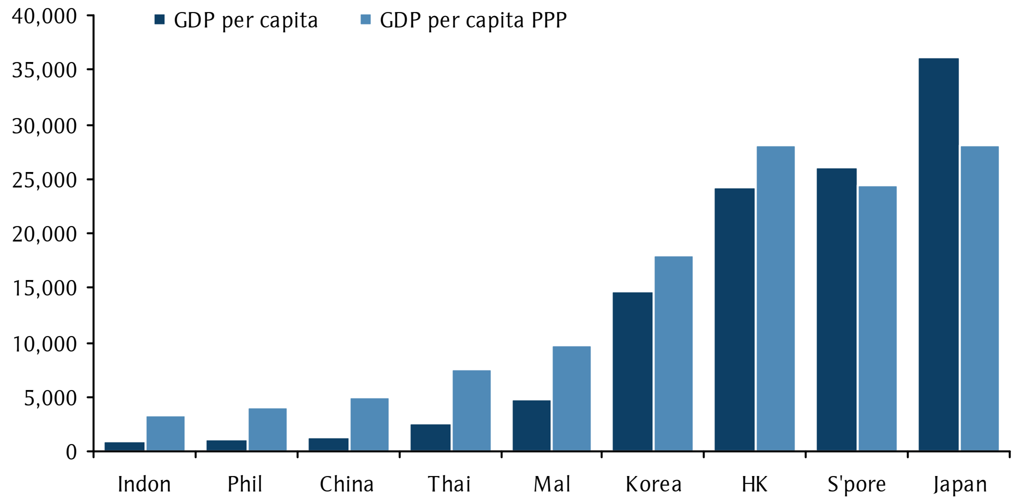
SME development could help diversify the sources of growth. Some of those are already underway: for instance, SME development is one of the regional initiatives launched by the ASEAN secretariat,[20] but there may be more that could be done.

These measures could bring about a gradual rebalancing between domestic demand and external demand-led growth. The process could also be jump-started by large-scale investments in the non-tradable sector: there is much scope in our view to increase domestic demand in East Asia as many countries' needs for better education, health and infrastructure – which are required for migration to middle- or upper-income status – remain unfulfilled. These expenditures need not be publicly funded or supplied by the public sector. Rather, what may be required is a change in regulatory structure to support greater private sector supply of infrastructure and traditionally public services.

Ex-ante, financial integration would be most beneficial with a limited correlation between financial markets. Ex-post, financial integration could increase the risk of propagation of shocks across the region. With financial integration risk management will acquire a regional as well as an individual-country dimension. Hence, economic and financial surveillance will have to acquire a regional dimension.

A regional informal economic dialogue and surveillance is already taking place under the auspices of the ASEAN secretariat and of ASEAN+3 meetings. As regional integration progresses, the scope of this dialogue will need to be extended to include structural issues such as financial sector soundness and development. This may well require the development of a formal regional institution (please see "Some further suggestions for regional financial integration" below).

Figure 3: ASEAN+3 countries have wide differences in income per capita (USD, USD PPP)



Source: IMF; Barclays Capital.

Finally, ASIAN countries have income per capita ranging from USD900 in the Philippines to USD37,000 in Japan. This economic diversity, especially the unequal strength and development of financial sectors, is likely to affect individual countries' abilities to implement reforms and integrate. A strategy for regional financial integration may have to give enough leeway for countries to be able to join the process at a pace that suits their specific economic and financial capabilities.

---

[20] *See ASEAN Policy Blueprint for SME development 2004-2014, ASEAN secretariat, 2003*

Regional financial integration more beneficial than global financial integration

Strong North-South capital flows reflect only the current status quo

Greater financial integration globally has translated in to larger North-South capital flows than South-South flows. This is hardly surprising since financial centres tend to be in high-income countries, not in emerging market economies. While regional financial centres in Asia are emerging, they are still considerably smaller than the likes of London or New York.

As such, it is not surprising that correlation of rates of returns between ASEAN+3 and US and EU markets are stronger than correlations within ASEAN+3. Nor is it surprising that financial flows between ASEAN+3 and major markets are greater than financial flows within ASEAN. Neither is it surprising that, under these circumstances, the opening of capital accounts in the aftermath of the 1997 crisis has increased financial linkages with EUR and US markets more than financial linkages within ASEAN+3[21].

Some have relied on this current status quo to argue that policies such as the development of regional financial markets are too costly relative to their benefits: "The cost of developing the legal, regulatory and informational infrastructures could be very high and hence may not justify the development of capital markets in small economies which are not likely to obtain scale economies and hence efficiency[22]". Therefore, some have concluded, it would be more beneficial to let ASEAN+3 integrate with global, rather than regional markets.

Indeed, an empirical study of foreign listings in OECD and low-income countries has found a positive and significant relationship between funds raised abroad and GDP per capita. The authors infer from these results that as income per capita rises, the biggest and strongest local corporates will list abroad and domestic market liquidity will decrease, "which will make it more difficult for small exchanges to survive". Countries therefore should not develop full fledged local stock exchanges but create conditions that allow corporations to "issue and trade shares abroad efficiently" and "link or merge their local trading systems with global markets"[23].

Evidence of limits to economies of scale in capital markets development

In our view these conclusions are not supported by empirical evidence. First, there is no evidence that higher foreign listings imply lower domestic market liquidity: OECD countries have higher income per capita, deeper capital markets and a higher share of foreign listings than emerging markets.

Second, this conclusion is based on the assumption that equity markets are natural global monopolies: the logical conclusion from their policy recommendations is that there should be only a few equity markets left in the world. Yet, as the authors

---

[21] See Yung-chul Park, "Prospects for Financial Integration and Exchange Rate Policy Cooperation in East Asia", ADB Institute research paper 48, December 2002.
22 Park, Yung-chul and Kee-hong Bae, "Financial liberalisation and economic integration in East Asia", PECC Finance Forum conference, August 2002.
[23] Stijn Claessens, Daniela Klingebiel and Sergio Schmukler, "Explaining the migration of stocks from exchanges in emerging economies to international centers", CEPR working paper 3301, 2002.

themselves note: “there were close to 200 stock exchanges in the US at the start of the 20th century, but there are only about half a dozen today. Surprisingly, stock exchanges in emerging economies have not yet participated in this trend.” One could even argue that, if economies of scale are as important as the authors argue, half a dozen stock exchanges seems a high number for an economy such as the US where there is virtually no impediment to integration of domestic financial markets. Interestingly, following the recent decisions to merge the Chicago-based Archipelago exchange and the NYSE and the purchase of Instinet by NASDAQ, investors have been building up the trading capabilities of the Philadelphia and Boston exchanges[24], which suggest consolidation of equity markets in the US still has a way to go.

Next to the US, the region of the world where few obstacles stand in the way of financial integration is probably Europe, which over the past few decades has been through full liberalisation of capital accounts, opening of financial sectors and the creation of a monetary union. Yet, consolidation of financial markets has been relatively limited: the stock exchanges of Paris, Amsterdam and Brussels have merged to form Euronext, those of Stockholm, Oslo, Copenhagen and Helsinki have formed NOREX, and the Swiss SOFFEX has merged with Deutsche Terminborse to become EUREX, Europe’s biggest derivatives market. However, repeated attempts to merge the London Stock Exchange, the largest in Europe, with other markets have failed. The latest, a takeover offer from the Frankfurt Stock Exchange failed because shareholders on both sides did not feel a merger would enhance the value of the exchanges. Rather than consolidation into a single, mega-exchange, there seems to have been a differentiation of exchanges, for instance London-based Virt-x is a pan-European exchange dominant only in Swiss SMI index stocks.

Third, attempts to establish markets in various countries with partners using a common technology or to establish multiple access points in various countries have not led to the emergence of a global “mega-market”. For instance, NASDAQ has established NASDAQ Europe, NASDAQ Japan and NASDAQ Canada, but these have not emerged as major markets. While EUREX has access points in Amsterdam, Chicago, New York, Helsinki, London, Madrid, Paris, Hong Kong and Tokyo, it still is not the largest derivatives market in the world[25]. It seems that despite technological innovations and global financial integration, there is simply no clear cut evidence that stock exchanges are natural global, or even regional, monopolies.

Informational asymmetries limit economies of scale in capital markets

A positive correlation between foreign listings and GDP per capita does not in our view lead to the conclusion that countries should not develop their own capital markets. Yet this work highlights an important issue, namely why there are still so many exchanges in the world despite the importance of economies of scale in financial market development.

First, the limits to market expansion are not driven by technological developments alone: connecting stock exchanges involves much more than physical wiring. For instance, London, Frankfurt, Paris, Amsterdam, Zurich, Milan, Madrid and Brussels had agreed to create a common electronic system to access multiple exchanges but subsequently abandoned the project. “Common access systems are generally far more

---

[24] *See Liz Moyer, “A new look for Wall Street”, Forbes, 10 November 2005.*
[25] *According to the BIS, London and New York remain the main global centres for OTC derivatives trading. See “Triennial Central Bank Survey, Foreign Exchange and derivatives market activity in 2004”, BIS, March 2005.*

complex and costly than anticipated when first proposed, in the late 1990s. Few of them have been successfully implemented, indicating that linking a national system to foreign systems is simply not a cheap and easy alternative to systems consolidation. Although order-routing systems operated by companies such as Instinet, ITG and Royalblue have demonstrated that common electronic interfaces can indeed be commercially viable, it would appear that the conflict of interest among exchanges considering inter-linkage has been the primary source of difficulty with this strategy"[26].

Second, and perhaps more importantly, there is strong evidence that international financial markets are segmented by informational asymmetry: foreign knowledge and understanding of local markets, especially emerging market conditions, is limited. Perhaps one of the best documented instances of irrational behaviour on the part of investors is the home market bias: investors' holdings of foreign assets generally fall far below what would be implied by an optimal portfolio allocation and diversification[27]. This apparent irrationality has generated a voluminous amount of explanations but a common theme seems to be information asymmetry[28]. Investors don't have as much information about the determinants of rates of returns on foreign as on domestic securities. The home market bias is likely to be even stronger against emerging markets where accounting standards, reporting requirements and financial market infrastructure are generally not as strong as in OECD markets.

That international financial markets are segmented by information asymmetries is demonstrated by new research showing that markets sizes and physical distance between markets, rather than rates of return differentials, are the most important determinants of cross-border equity flows between developed countries[29]. Gravity equations traditionally show that trade in goods are positively related to the size of the economies involved and negatively related to geographical distance. The authors show that a gravity equation performs equally well in explaining trade in equities. Moreover, they show that for both trade in goods and trade in equities, distance is actually a proxy for information asymmetries.

Indeed, there are very few instances of emerging market firms that have been able to list directly overseas. Most list on local exchanges first: the decision to go public is typically driven by considerations such as securing finance on a large enough scale; lowering the cost of finance; deleveraging; and selling controlling shareholders equity[30]. The decision to list abroad is driven by similar considerations, such as tapping a new investor base, capturing lower costs of capital in foreign markets; and signalling stronger corporate governance since listing requirements tend to be more demanding in OECD than in emerging markets[31]. In other words, firms tend to list abroad once they have outgrown their local market, just as they list on their local exchange once they have outgrown the resources offered by owners' private equity and by banks.

---

26 Benn Steil, "Creating Securities Markets in developing countries: a new approach for the age of automatic trading", International Finance 4:2, 2001.

27 See Kenneth French, James Poterba, "Investor diversification and international equity markets", American Economic Review Vol. 81, May 1991.

28 See for instance Karen Lewis, "Trying to explain home bias in equities and consumption", Journal of Economic Literature 37, 1999.

29 See Helene Rey and Richard Portes, "The determinants of cross-border equity flows", Journal of International Economics, Volume 65, Issue 2, March 2005.

30 Marco Pagano, Fabio Panetta and Luigi Zingales, "Why do companies go public? An empirical analysis", Journal of Finance, Vol. 53, No.1 February 1998.

31 See Claessens, Klingebiel and Schmuckler, op. cit.

Because most firms start small before becoming big, a local exchange is needed if the more successful firms are to access a bigger, foreign exchange[32]. This is especially true since informational and regulatory requirements tend to be stronger in main financial centres than in emerging market exchanges. Thus, a local listing may be a learning process for emerging-market firms that allows them to prepare for the more difficult requirements of a foreign listing. From a market practitioner perspective, the notion that emerging market corporates are going to list abroad without listing locally first simply appears unrealistic.

The advantages of regional over global financial integration

Informational asymmetries are in our view the main justification for supporting regional rather than global financial integration. With these asymmetries, the global financial system is in our view more likely to consist of the juxtaposition of several markets with a geographical spread driven by investors' information set, than of one unique global financial market.

In addition, global financial integration is not a costless process: successfully integrating with global markets would require countries to improve accounting standards, transparency, governance and legal systems that also need to be improved in order to develop local financial markets. In sum, there is no clear advantage in our view from integrating with the global market over developing the domestic market, and there could even be serious adverse consequences if a focus on global financial integration distracted policymakers from the task of developing their domestic financial sector.

Regional financial integration, on the other hand, could help countries develop their domestic financial market in a number of ways:

- Peer pressure and pooling of experiences through regional cooperation, by contrast with global integration where countries are left to their own devices to make the necessary adjustments.
- Job creation: the development of a regional financial market implies that a greater share of low- and high-skills financial sector jobs is likely to move to Asia rather than stay in New York or London, although strong productivity gains in back office functions suggest financial sectors are unlikely to be a source of growing demand for unskilled services jobs.
- Participating in global financial markets from a position of strength: with regional financial integration, markets are likely to acquire greater mass and be less influenced by global markets. This would have two broad types of advantages:
  - A lower correlation between ASEAN+3 and global markets would increase the attractiveness of ASEAN+3 assets in international investors portfolios. For instance, over the past year or so, there has been growing interest among US and European investors in local currency Asian bond markets because of their diversification potential[33].
  - Individual countries could gain more control over factors influencing their markets: currently, changes in conditions in global markets are often driven by policy shifts over which ASEAN+3 have no control. Financial integration would

---

[32] An alternative to listing on a local exchange would be listing on a regional exchange such as Hong Kong or Singapore. See "Asian bourses grow fond of Indian paper", Financial Express, 6 April 2005.
[33] See McCauley, Robert and Guorong Jiang, "Diversifying with Asian local currency bonds", BIS Quarterly Review, September 2004.

likely see an anchor emerge with strong economic fundamentals and a large, well developed financial market. The economic policies of that anchor would affect individual markets in the same way as global markets currently do, but through regional policy dialogue and surveillance countries may be able to gain some control over these policies.

The roles of the public and private sectors

The most successful instance of financial integration has been entirely private-sector driven

Perhaps the most successful example of financial integration leading to market creation, the euromarkets, has been entirely private-sector driven. The euromarkets, ie, markets in financial instruments in currencies outside their country of origins, were started in the 1950s as the US current account deficit increased the supply of USD and regulatory restrictions and tax regulations such as interest equalisation tax in the US, restrictions on US banks foreign lending, reserve requirements, etc., led to the development of a market in bank deposits and loans in USD outside of the US.

A private-sector driven market infrastructure soon emerged:

- LIBOR, the interest rate benchmark, is computed from data supplied by a panel of contributor banks selected by the British Bankers Association; today, LIBOR is fixed for 12 currencies in maturities up to 12 months;
- International clearers Euroclear and Cedel were set up by market participants;
- SWIFT, a network to handle interbank transactions, was founded in 1973 as a non-profit cooperative organisation by 29 banks from 15 countries.

The Euromarkets started as markets for bank deposits and loans, but today include a much wider range of instruments including bonds, commercial paper equities and derivatives. The most important one is the eurobond market, a market for bonds sold outside of the countries of the currencies in which the bonds are denominated. The first eurobonds were eurodollar bonds, which from 1963 to 1973 were issued exclusively in Europe. After the US abolished the interest equalisation tax and restrictions on capital movements out of the country in 1973, dollar bonds could be issued simultaneously in New York and Europe and a true international market emerged.

The euromarkets re-established London as a major financial centre, despite the decline of the UK economy after the Second World War. The euromarkets were then revitalised by the deregulation of the UK financial sector in the 1980s, the Big Bang, and by the arrival of foreign, especially US, financial institutions and the ensuing consolidation of the financial services industry[34]. These days, about 60% of international bonds in the primary market, and 70% in the secondary market worldwide are traded in London.

Most interestingly, the euromarket has become a multi-currency market which shows that monetary integration is not necessary for financial integration (the example of Europe which we discuss below shows that it is not sufficient either). This has been made possible through the development of a thriving FX market: the last BIS survey of

[34] *See Reszat Beate, "How has the European Monetary Integration Process Contributed to Regional Financial Market Integration?", HWWA discussion paper 221, 2003.*

foreign exchange and derivatives markets shows that London is by far the largest FX market in the world[35].

Although the creation of the euromarkets was private-sector driven, it took place within the regulatory and policy frameworks of the various countries involved. It is this framework that allowed the euromarkets to develop so successfully, key factors being:

- The string of US current account deficits of the 1950s, which provided the initial liquidity with which to start the market;
- The US authorities did not oppose private sector trading of USD outside the US, as it was the world reserve currency. The development of an offshore USD market may have been seen as a way of helping to fund US current account deficits;
- Even though the UK in the 1950s had strong foreign exchange controls on GBP transactions, it did not oppose trading in USD out of London;
- Governments, for instance in Japan and continental Europe, did not oppose the internationalisation of their currencies;
- The deregulation of the UK financial sector helped increase the competitiveness of London relative to New York;
- Liberal immigration and FDI policies on the part of the UK helped supply the skills and know-how required for the development of the market.

Hence the development of the euromarkets does not seem to be the result of deliberate polices to create a market but rather of laissez-faire policies on foreign capital flows and of liberal policies on financial sector development, FDI and immigration. And of course the fact that the market was developed outside of the countries of origins of the currencies greatly simplified regulatory issues.

The European experience: Substantial benefits if still a work in progress

By contrast with the development of euromarkets, the development of an EU-wide financial market involves the integration of already existing national markets with their own distinct legal and regulatory systems, market infrastructures and practices and tax systems, with some belonging to the monetary union and some choosing not to participate. At the same time, unlike the euromarkets whose creation really marked one of the initial stages of financial globalisation, financial integration in the EU has benefited from the global trends towards greater financial integration.

EU policymakers have made it clear the private sector is to drive the integration process: “it is the entrepreneurial decisions and business strategies taken by market players who risk their own money that should determine the boundaries of market places. It is for them to define the geographical and material scope of their practices and transactions. Market participants have a better insight into the market, and are more able to judge future developments and consider which opportunities they wish to grasp. It is essential that policy creates a framework in which market participants can operate irrespective of national borders, and achieve the best outcome. This framework should ensure that impediments to integration such as inefficient market infrastructure and protectionist practices are removed. Ideally, it should also act as a catalyst for change[36].”

---

[35] *See “Triennial central bank survey of foreign exchange and derivatives market activity 2004 final results”, BIS, 17 March 2005.*

[36] *Padoa-Schioppa Tommaso, Introductory remarks, Symposium concluding two years of the ECB-CFS research network on “Capital Markets and Financial Integration in Europe” Frankfurt, 11 May 2004.*

Figure 4: The path to European financial integration

Date	Key milestones
1956	Treaty of Rome imposes the same rules for trade in goods and in services, which requires the liberalisation of cross-border and establishment-based trade within the framework of mutual recognition and minimal harmonisation.
Mid-60s	Customs union is implemented.
1985	The Second Banking Co-ordination Directive formalises the principle of mutual recognition and facilitates the provision of banking services across the European Union
1986	Single European Act sets a deadline of 1992 for the completion of the single market, weakens countries' right of veto and extends the power of the European parliament.
Late 1980s/ early 1990s	European countries eliminate capital controls (the UK eliminated them in 1979)
1993	Investment services directive provides easier access to securities markets within the EU
1998	European Council held in Cardiff lifts financial integration to a top political priority, which results in the Financial Services Action Plan (FSAP), containing a large number of concrete steps to reduce or remove impediments to financial integration
1999	Launch of EUR
2000	Lisbon Council sets out the Lisbon agenda that made financial market integration one of the "pillars" of the economic and social agenda, together with macroeconomic, employment and social policy. A deadline of 2003 is set for the implementation of the Risk Capital Action Plan and for those elements of the FSAP relating to securities markets
2004	The Kok Report, a review of the Lisbon agenda prepared by Wim Kok, a former Dutch prime minister, makes clear its frustration with the lack of member states' progress and recommends the creation of an internal market implementation scoreboard, ranking the 25 member states on their progress towards implementation
2005	The Green Paper on financial services policy *(2005-10)* proposes that major goals for this period should be "the consolidation of existing legislation, with few new initiatives" and "ensuring the effective transposition of European rules into national regulation and more rigorous enforcement by supervisory authorities"

Source: Barclays Capital.

The EU has promoted financial integration through a number of policy initiatives (see Figure 4). By 2005, the legislative aspects of the FSAP had been adopted by all countries concerned and countries were turning their efforts towards implementation. Yet, European financial integration to date is still work in progress[37]. Unified markets have emerged only in products where either integration was necessary for monetary union, or the characteristics of the products allowed market participants to overlook the lack of common infrastructure, regulatory and taxation frameworks.

Within the euro area, monetary markets have been integrated to the extent necessary for the implementation of a common monetary policy. On the unsecured money market ie, the interbank deposit market, there is virtually full convergence of interest rates. This has been supported by the development of regional infrastructure: pan-EU reference rates have been developed; a payment system in EUR, TARGET, has been introduced; a Settlement Finality Directive to reduce settlement risk has been introduced.

An integrated European swap market has also emerged after the introduction of the EUR. The high degree of integration reflects the standardisation of products, strong competition and that no settlement of individual securities is required. Interestingly, participants in that market are located as much in London – which does not belong to the monetary union – as in Frankfurt and Paris.

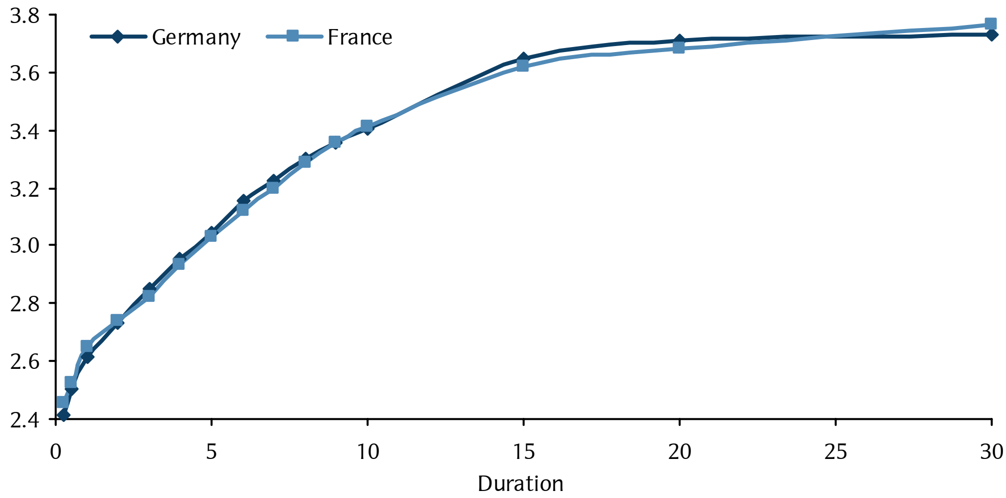
The wholesale banking market in rates products is another example of financial integration following monetary union. As products are standardised, national advantages counts for little and there seems to be strong economies of scale, the elimination of currency risk within the euro area has resulted in the development of euro area-wide products. In the longer run, integration of wholesale banking could have

[37] *See Gjersem Carl, "Financial market integration in the Euro area", OECD Economics department working paper 368, October 2003.*

important consequences for the structure of the banking industry. A two-tier system could emerge with a few large euro area-wide banks and a number of smaller banks servicing retail banking needs in their home markets.

By contrast, integration in the secured money market and in securities markets is lagging due to fragmented infrastructure as well as to differences in regulations, tax regimes and market practices[38]. As a result, cross-border transactions remain much more costly than domestic transactions: a study has found that investors in the EU pay around four times as much for domestic settlement than in the US and that the average for domestic and cross-border settlements in the EU is around eight times higher[39].

Figure 5: Franco-German competition has not resulted in a unified benchmark yield curve (Yield, %)



Source: Bloomberg.

The EUR government bond market is not fully integrated either: there is no EUR government benchmark yield curve; no country is large enough to provide a benchmark across all maturities; and the two largest issuers, France and Germany have been competing for the status of benchmark issuer. German bunds have established the benchmark in 10-year tenors, while the French occupy the yield curve up to 5 years. In addition, the spread between similarly rated French and German curves is often wider than the spread between lower-rated countries, such as Italy and Belgium.

Even though financial integration in the EU is still a work in progress, EU economies have already reaped substantial benefits. Despite the fragmented securities markets, a multi-fold increase in corporate bond issuance has taken place since EUR was introduced. Part of the increase has been due to the financing needs to cover the very high prices of 3G licences and for the wave of M&A associated with the equity market bubble. However, even after the bursting of the equity bubble and the dwindling of M&A activities, EUR corporate issuance is still much higher than it was prior to the adoption of the common currency. In addition, secondary market turnover has increased markedly; the availability of skills in credit analysis has increased markedly;

---

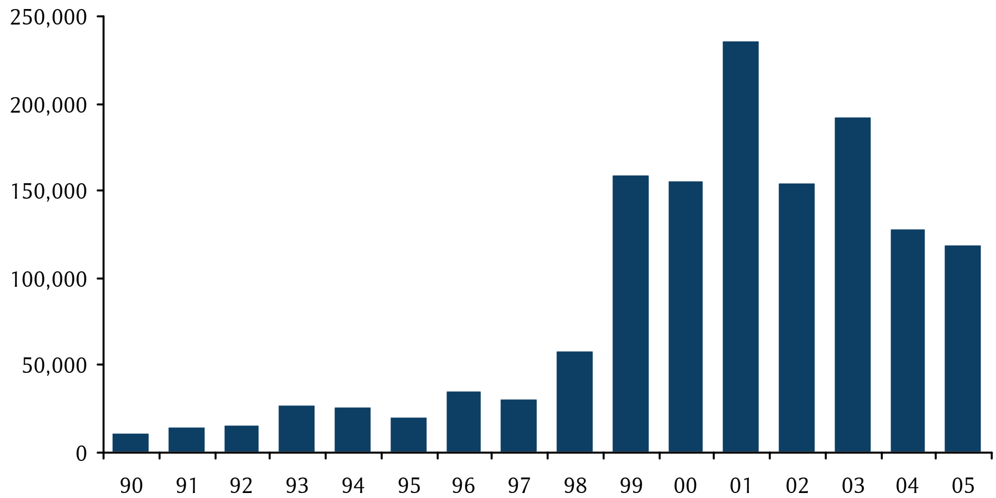
[38] See The Giovannini Group, "The EU repo market: opportunities for Change", Euro paper No 35, European Commission, 1999; "Cross border clearing and settlement arrangements in the European Union", European Commission, 2001; "Second report on EU Clearing and Settlement arrangements", European Commission, April 2003.

[39] Lannoo K. and M. Levin (2001) "The securities settlement industry in the EU: structure, costs and the way forward", CEPS research report 26, 2001.

lower-rated corporate borrowers have gained access to the market; and a European high yield bond market has emerged. Furthermore, issuance costs have declined: underwriting fees fell by an average of about 80 bp due to the greater competition in the investment banking market as a result of the broadening of the investor base[40].

Of course, the introduction of EUR has acted as a catalyst for change. Yet, in view of the wide differences in countries' legal and regulatory systems, market infrastructure and practices and tax systems, the expansion of the securities markets in the euro area could not have taken place without the various policy initiatives to reduce cross-border transaction costs. Indeed, the increase in European corporate issuance started before the introduction of the EUR in 1999. Further progress in EU financial integration will require the continued development of a market infrastructure, further harmonisation of regulatory tax and market practices and a stronger coordination and consultation process.

Figure 6: The euromarket shows the benefits of pooling liquidity (EU corporate issuance, EUR mn)[41]



Source: Barclays Capital.

Comparing Asia's financial integration to the EU's

The task facing Asian policymakers is similar to the one that faced the EU: integration of already established markets with widely different legal, institutional and tax regimes. At the same time, in our view, the relevant comparison is not between Asia and the conditions currently prevailing in the EU since these already reflect 15 years of financial integration, but rather with the conditions prevailing in the EU 15 years ago, when financial integration started in earnest. Overall, Asia's current economic conditions and policy framework appear less favourable than those of the EU in the early 1990s.

---

[40] *Galati and Tsatsaronis, "The Impact of the Euro on Europe's financial markets", BIS working paper 100, July 2001.*

[41] *Legacy currencies before 1999*

Figure 7: Under the current policy framework, Asian financial integration appears more difficult than EU financial integration

	Euro area 1990	Asean+3 2004
Economic variables		
Average country GDP (USD bn)	471	241
Average GDP per capita (USD)	16,800	1300
Regional trade (% of total trade)	64	42
Equity market capitalisation (% of GDP)	48	99
Bond markets capitalisation (% of GDP)	101	48
Policy variables		
Free trade in goods and services	Yes	No
Capital controls	No	Yes
Financial FDI policies	Liberal	Varies across countries, many with restrictions
Immigration controls	No	Yes
Regional institutions	Yes	Several regional initiatives but no supra-national institutions
Common currency	No	No

Source: IMF, WTO, Barclays Capital.

As mentioned earlier, cross-border securities trade is well explained by gravity equations showing a positive relation with the size of the countries involved and a negative relation to the distance between countries. Cross-border bank flows have also been found to be well explained by gravity equations[42]. This suggests lower cross-border financial flows within ASEAN+3 than within the euro area as countries' GDP tend to be lower and distances higher on average within ASEAN+3 countries. In addition, regional trade appears lower in Asia than in Europe, which could be another disadvantage of Asia relative to Europe since finance tends to follow trade. However, Asian equity markets are larger relative to GDP than European equity markets 15 years ago (Asian equity markets seem more integrated regionally than Asian bond markets which could reflect equity markets greater depth and liquidity)[43].

The policy settings also appear less favourable to financial integration in Asia than in the EU:

- While there were few impediments to free trade in goods and services within the EU in the early 1990s, there remain significant tariffs and non-tariff barriers within Asia.
- While by the mid-1990s European countries had dismantled their capital controls, these remain substantial across Asian countries, with a few exceptions.
- FDI policies including those for financial FDI were also much more liberal in the EU of the early 1990s than currently in most of Asia[44]. With the adoption of the second banking directive in 1989, the EU implemented an approach to banking FDI based on mutual recognition, home-state control and minimum harmonisation. In ASIAN

[42] *See Eichengreen, Barry and Yung-chul Park, "Why has there been less financial integration in Asia than in Europe", Institute of European Studies. Political Economy of International Finance. Working Paper PEIF-4.*
[43] *See Jeon Jongkyou, Yonghyup Oh and Doo Yong Yang, "Financial market integration in East Asia: Regional or Global?", KIEP working paper 05-02, October 2005.*
[44] *Although the recent difficulties encountered by a Dutch bank in the purchase of an Italian bank show that in practice liberalisation has still some way to go, see, "Dutch courage pays off", The Economist, 15 September 2005.*

countries by contrast, rules on financial FDI and foreign participation in financial sectors vary significantly across countries[45].

- Similarly, while there are few legal obstacles to workers mobility within European countries, immigration policies across Asian countries vary considerably; few countries maintain very liberal regimes but the majority limit immigration.
- While EU countries have a number of supra-national institutions such as the European Commission, the European Parliament and the European Court of Justice, Asia does not have formal supra-national institutions to drive the financial integration process.
- While in the early 1990s the EU was already working in the direction of monetary integration, which subsequently provided strong support to EU financial integration, in Asia monetary integration remains a long-term project.

The limited Asian financial integration is reflected in the difficulty and high costs of executing cross-border transactions. In the case of bond investments, the impediments to cross-border transactions fall into two broad categories[46]:

- Impediments to market participation resulting mainly from regulatory constraints:
  - With the exception of China and Indonesia, most countries allow foreign participation in their local bond market as well as access to the onshore spot FX market to purchase local currency bonds.
  - By contrast, a number of countries restrict purchases of foreign bonds by onshore investors, although the ABF2 could provide a vehicle for cross-border bond transactions (see below).
  - A number of countries maintain withholding taxes, although Thailand and Malaysia have recently announced they would exempt non-resident investors in local currency bonds.
- Impediments to hedging FX and interest rate risk resulting mainly from regulatory constraints and the lack of development of individual financial markets:
  - With the exception of China, all countries have a liquid onshore forward FX market and non-resident access is allowed to hedge bond principal and coupon (although the Philippines forward FX market is illiquid).
  - On the other hand, with the exception of Hong Kong and Korea, countries either do not have a liquid cross-currency swap market (CCS) or do not allow access to foreign investors, even for the purpose of hedging bond investments. Some countries have a non deliverable CCS market but these are generally illiquid.
  - Only Hong Kong, Korea and Singapore have a liquid onshore interest rate swap market (IRS) that is accessible to foreign investors.
  - Only Korea has liquid bond futures markets accessible to foreign investors.

Interestingly, the settlements infrastructure does not seem to constitute an impediment to cross-border transactions. A regional working group on foreign exchange transactions and settlements reported that market participants "were generally satisfied with the

---

[45] See Chua Hak Bin, "FDI in the Financial sector: the experience of ASEAN countries over the last decade," Monetary Authority of Singapore, March 2003 and Domanski 2005 op. cit.
[46] See Dwor-Frecaut Dominique, "The Asian bond market from fragmentation to aggregation", Barclays Capital, September 2003.

efficiency and reliability of local clearing and settlements systems". Further, "the current settlement arrangements were not a significant impediment to the development of a local bond market, although there were areas that could be improved"[47].

Figure 8: Impediments to cross border band transactions in Asia

	China	Hong Kong	Indonesia	Korea	Malaysia	Philippines	Singapore	Thailand
Impediments to market participation								
Non-resident access to local bond market	Not permitted	No restriction	Regulatory approval required	No restriction	No restriction	No restriction	No restriction	No restriction
Resident purchases of foreign bonds	Prior approval required	No restriction	Restricted	No restriction	No restriction for residents without credit facilities	Prior approval required	No restriction	Prior approval required
Non resident access to onshore spot FX market	Limited	No restriction	Allowed to purchase local ccy bond	Allowed to purchase local ccy bond	Allowed to purchase local ccy bond	Allowed to purchase local ccy bond	Allowed to purchase local ccy bond	Allowed to purchase local ccy bond
Withholding tax	None	None	0-20%	0-27.5%	None	20%	None	None
Impediments to hedging								
Onshore FX forward	Up to 12 months	Liquid	Liquid	Liquid	Liquid	Illiquid	Liquid	Liquid
Non-resident access to onshore FX fwd	No	No restriction	Allowed to hedge bond-related risk	Allowed to hedge bond-related risk	Allowed to hedge bond-related risk	Prior approval required	Allowed to hedge bond-related risk	Allowed to hedge bond-related risk
Offshore FX market	NDF liquid	None	NDF liquid	NDF liquid	NDF liquid	NDF liquid	Deliverable forward illiquid	NDF liquid
CCS market	No	Liquid	Illiquid (NDCCS)	Liquid	Illiquid (longer tenor FX forwards)	Illiquid	Illiquid	Illiquid
Non-resident access to CCS market 1/	No	No restriction	No	Allowed to hedge bond-related risk or NDCCS	Allowed to hedge bond-related risk	Prior approval required	Allowed to hedge bond-related risk	NDCCS
Non-resident access to local currency funding	No	No restriction	No	Approval required above KRW1bn	No	No	Allowed to fund purchase of lcy bond	FX swap only
IRS market	No	Liquid	Illiquid	Liquid	liquid	Very illiquid	Liquid	Liquid
Non-resident access to IRS market	No	No restriction	No	Allowed to hedge bond-related risk or NDIRS	Allowed to hedge bond-related risk	Prior approval required	No restriction	No (NDIRS only)
Bond futures	No	Illiquid	No	3 yr liquid	Illiquid	No	Illiquid	No

Source: IMF, Barclays Capital.

In the next section, we provide suggestions on how the policy framework could be modified to support faster Asian financial integration.

[47] *"Foreign Exchange transactions and settlements issues, Progress report", Asia Bond Market initiative, Working Group 3, April 2005.*

Some building blocks for private sector-led Asian financial integration

Because the development of a regional bond market is currently the main focus of Asian policy makers, in this section we focus on measures that could support greater integration of bond markets across Asia.

The trade-off between capital account liberalisation and capital market development

Regional financial integration requires cross-border transactions, transactions that cannot take place in the face of pervasive capital controls. In our view, a relaxation of capital controls is necessary to diversify the investor base and create depth, liquidity and scale in Asian financial markets. In addition, we believe the example of the euromarkets shows that financial integration is possible without monetary integration – but it requires an efficient FX market. And the emergence of an efficient regional FX market also requires a substantial relaxation of capital controls.

A regional FX market

Prior to the 1997 crisis, regional FX markets had emerged in Hong Kong and Singapore. Since the crisis, these markets have disappeared, largely as a result of the policies of currency controls imposed by many Asian countries as a result of the crisis. For instance, Thailand has imposed per-counterparty ceilings on credit to non-residents without underlying transactions. Indonesia has a number of restrictions on swaps between domestic banks and non-residents. Malaysia has very tight limits on MYR credit facilities for non-residents. The Philippines requires central bank authorisation for the supply of PHP to the offshore market. Singapore maintains a number of restrictions that prevent the internationalisation of the SGD, eg, the obligation to swap the proceeds of SGD borrowings upon drawdown.

In view of the importance of economies of scale for the development of financial markets, individual, country-specific FX markets may not be able to reach the critical mass required to provide low-cost transactions to investors. To lower the cost of foreign exchange transactions, Asian countries may need to relax capital controls so as to allow the re-emergence of regional FX markets. Asian central banks themselves seem to have acknowledged this trade-off: according to an EMEAP[48] discussion paper "One of the benefits [of internationalisation] is that financial transactions concentrate at specific offshore centers, and these centers gain the advantages in terms of liquidity, and the variety of both financial products and participants available"[49].

Greater foreign participation

Regulation is the key to developing the bond market

Because of the relatively small scale of Asian financial markets, greater foreign participation is necessary for the market to develop. But greater foreign participation is unlikely without the liberalisation of capital flows. In the words of Mr Lee Hsien Loong, Prime Minister of Singapore:

---

[48] Executive Meeting of East Asia-Pacific central banks, a cooperative organization of central banks and monetary authorities from Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore and Thailand.
[49] Kenichiro Watanabe, Hiroshi Akama and Jun Mifune, "The effectiveness of Capital Controls and Monitoring: The Case of Non-internationalization of Emerging Market Currencies," EMEAP discussion paper, January 2002.

> "There is a trade-off between tightening up the capital account, and developing the bond markets. Measures to restrict offshore foreign currency trading have been effective, in so far as reducing or eliminating offshore markets is concerned. But these safeguards come at a cost – they also hinder the development of capital markets, especially the bond markets. Size and liquidity are essential attributes for a market to attract international interest. Already in size and liquidity, we clearly lag behind our counterparts in the West. If Asian markets are fragmented and unable to grow, they risk being ignored by global investors"[50].

Many of the regulations that prevent the development of a regional bond market may no longer be needed now that Asian economies have rebuilt their resiliency. As stressed by Mr Lee:

> "In the immediate aftermath of the Asian crisis, countries that have suffered at the hands of the markets are understandably disinclined to err on the side of fewer restrictions, especially as the benefits from bond market development are unlikely to be large given structural problems in the economy. However, over time as the Asian countries make progress in restructuring their economies and strengthening their institutions, they will reassess the balance of risks, and perhaps modify some of these restrictions"[51].

Asian countries could take bold steps towards liberalising their markets

Singapore has demonstrated that with sound macroeconomic fundamentals, strong financial supervision, prudential regulation and careful sequencing of policy changes, capital account liberalisation need not threaten economic stability. In this regard, the ASEAN plan envisaging a six-stage process for the liberalisation of capital flows by 2020 appears timid. There are a number of countries in Asia with bond markets that have developed to the point where they would benefit from more active foreign participation. These countries' fundamentals are generally strong enough to support the liberalisation of capital transactions necessary for increased foreign participation in their bond markets.

Finally, countries that do not feel comfortable with fully fledged capital account liberalisation could consider liberalisation limited to Asian flows and targeted at greater regional participation in their bond markets. For instance, a number of countries have recently granted non-residents access to the cross-currency swap (CCS) and interest rate swap (IRS) markets, but only for hedging bond-related risk (see figure 8). But the full impact of these measures will be felt once these markets acquire enough liquidity: in Thailand and Malaysia for instance the IRS market has only started to offer liquidity for large, two way transactions over the past few months.

At this stage of regional financial integration partial liberalisation may represent a reasonable compromise between the perception that controls are necessary to ensure stability and the need to liberalize to support financial development. As countries gain confidence in liberalisation, as financial sectors resiliency improves and as regional integration deepens, further reductions in controls could be considered.

---

[50] *BIS quarterly review First Quarter 2002.*
[51] *BIS quarterly review First Quarter 2002.*

Prioritizing regulatory convergence

As stressed by Mr Andrew Sheng, the chairman of Hong Kong's Securities and Futures Commission (SFC):

> "Like Europe, we have too many different rules and standards that impede trade in financial services in Asia. Instead, it is so much easier to trade with London and New York than with another financial centre within Asia.
>
> "There is therefore a need for regulatory convergence of standards across Asia to facilitate market integration. Some critics consider that regulatory convergence across the region will take a long time, given the different regulatory regimes, stages of debt market development, and dramatic cultural, historical and currency differences. But I remain convinced that regulatory convergence may not be as difficult or remote as one would imagine.
>
> "Firstly, we can now use international regulatory standards as promulgated by IOSCO, the International Organisation of Securities Commissions. All regional markets are members of IOSCO and subscribe to IOSCO principles of market regulation. Secondly, it is important for regulators to cooperate with each other to create mutually recognised oversight structures that reduce transaction costs. A coordinated and seamless regulatory structure would allow mutually acceptable investment funds issued in one jurisdiction to be sold in another jurisdiction under common regulatory standards"[52].

Indeed, HK's SFC has already taken a number of initiatives to strengthen bilateral cooperation with its counterparts in Thailand, Sri Lanka, Indonesia, India and Japan. In addition, mutual recognition has already been reached between the Hong Kong SFC and the Australian Securities and Investment Commission.

Harmonisation of regulations along the lines of already existing global standards and the development of regional regulatory cooperation seem promising avenues for the advancement of regulatory convergence. Perhaps, the initiatives undertaken by Hong Kong's SFC could be replicated by a wider group of countries within Asia.

In addition, it might be useful to identify other "priority" areas of in terms of regulatory convergence. Their order of importance could be driven by their impact on the costs of private sector cross-border transactions. For instance, harmonisation of bankruptcy laws and the framework for foreclosure appear to be a lower priority than, for instance, the relaxation of capital controls. An efficient regional financial market could function with a set of divergent bankruptcy laws: Countries with relatively less efficient bankruptcy courts would have to pay a higher risk premium. By contrast, capital controls are an impediment to the creation of an efficient regional market.

Strengthening regional infrastructure

A regional benchmark

The Asian Bond Funds (ABF) 1 and 2 have, in our view, played an important role in the development of the regional infrastructure[53]. The local-currency ABF 2 has supported the emergence of a regional benchmark, the iBoxx Pan Asia Index, which covers eights

---

[52] Sheng, Andrew, "A Pan-Asian bond market: how do we get there?", 2nd Annual Asia Pacific Bond Congress, Hong Kong June 2005

[53] For a description of ABF 1 and ABF 2 see Ma Guonan and Eli M. Remolona, "Opening markets through a regional bond fund: lessons from ABF 2", BIS quarterly review, June 2005

local-currency bond markets and is quoted in USD on an un-hedged basis, as well as benchmarks for the eight countries involved – China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand[54]. The indices include sovereign and quasi-sovereign bonds and are constructed through multi-contributor pricing, along the lines of iBoxx indices in developed markets.

The development of a widely accepted regional, local-currency benchmark is a key step in the development of a regional market and the deepening of individual country markets. With a high-quality, widely accepted benchmark, actively managed bond portfolios can be established. These, in turn, would further widen and diversify an investor base, which currently is composed largely of buy-and hold investors. Together with transparent trading systems[55], such a benchmark could increase trading and liquidity. Increased trading and liquidity, in turn, would widen the universe of bonds for which good quality data can be computed. Already Hong Kong, Singapore, Thailand and Malaysia are planning to launch their country funds as ETFs.

The development of regional and country benchmarks does not however obviate the need for individual countries to maintain liquid benchmark yield curves, without which risk cannot be efficiently priced. In most of Asia, the government is the only issuer with the capability to provide such a curve: there is no other issuer with sufficient size or highly rated enough to act as a benchmark.

Because a government benchmark yield curve is a public good, there is a strong case to be made for issuance designed specifically to build up and maintain a liquid benchmark yield curve. This need not affect public finances adversely: Hong Kong, despite having budget surpluses up to FY 00, has developed a 10-year benchmark yield curve created through the issuance of Exchange Fund notes and bills. The proceeds were included in the reserves of the Exchange Fund and have been invested as part of its normal reserve management. Furthermore, in 2005 Indonesia and Malaysia also issued longer-dated maturities to extend their respective benchmark yield curves[56].

One of the initiatives under consideration to support the development of a regional bond market is the issuance of multicurrency bonds[57]. There is a risk that if multicurrency issuance is carried out at the expense of issuance in local currencies, it could further reduce the liquidity of local-currency bond markets and distract governments from the need to maintain a liquid benchmark yield curve. At the same time the European experience with multicurrency issuance suggests only mixed benefits for financial integration[58]. Since Asian financial integration is in its very early stages, it is not clear that multicurrency issuance is the best use of scarce government resources.

---

[54] See" iBoxx ABF bond indices launched", International Index Company, 12 May 2005
[55] In Asia currently, real-time price data is available for USD Asian bonds through broker screens provided by companies such as Cantor Fitzgerald or Garban, which provide similar services in US fixed income markets. By contrast, aside from in Hong Kong and Singapore, broker screens are generally not available in local currency markets, greatly reducing transparency and participation in the market. Screens are available in some countries, but these cannot be used for executing trades and therefore have little practical value.
[56] See Asian Development Bank, Asia Bond Monitor 2005, November 2005
[57] See "Progress report, April 2005 Working Group 1 on Creating new Securitised debt instruments," Asian Development Bank
[58] See Dammers, Clifford and Robert McCauley, "Basket weaving: the Eurobond market experience with currency baskets", Seminar on Global imbalances and Asian financial markets, University of California Berkeley, September 2005.

Figure 9: Government bond market liquidity varies across countries

	China	HK	Indon	Japan	Korea	Mal	Phil	S'pore	Thai
Yield bid/offer spread (bp)	N/A	3	7	2	1	3	20	1	4
Daily trading (USD bn)	1.5	2.9	0.1	212	5.9	0.3	0.3	1.2	0.1
Market cap (USD bn)	331.8	15.5	46.0	6,150.0	185.3	49.2	27.5	43.8	36.6
Market cap (% of GDP)	19.5	9.4	17.5	146.8	26.1	40.6	31.0	40.3	21.9

Source: CEIC, BNM, MAS, HKMA, Barclays Capital.

A regional clearing and settlement network

As mentioned earlier, the current clearing and settlement systems in ASEAN+3 do not seem to be a major impediment to cross-border trading. Indeed, rather than a whole new regional infrastructure for clearing and settlements what seems to be needed is the integration of existing country infrastructure[59].

Figure 10: Settlement procedures vary across countries

Trade settlement	China	HK	Indon	Japan	Korea	Mal	Phil	S'pore	Thai
LC bonds	T+1	T+0/T+1	T+2	T+2	T+1	T+1	T+0	T+1	T+2
FX	T+1	T+2	T+2	T+2	T+2	T+2	T+1	T+2	T+2

Source: Barclays Capital.

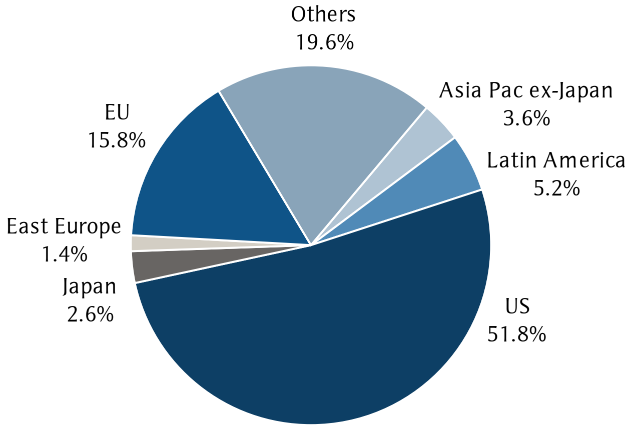
In the long run, there will be a need to harmonize clearing and settlement procedures. Local-currency Asian bonds are processed by clearing houses that typically are located in, but independent from, the central bank and often are owned by the local exchange. To limit settlement risk, most countries work on the basis of Real Time Gross Settlement (RTGS) and Delivery Versus Payment (DVP). Clearing and settlement procedures are generally efficient, though the extent of documentation and the length of the settlement process varies from country to country. Similarly, procedures for settling FX trades vary across countries.

A regional ratings process

In view of the role played by informational asymmetries in segmenting capital markets, the development of consistent credit risk assessment across Asia is a crucial element of the regional financial integration process.

[59] *See Sheng 2005.*

Figure 11: International ratings agencies are focused mainly on the US (S&P ratings universe)



Source: S&P, Barclays Capital.

There are currently a number of inconsistencies in the credit rating process in Asia. In addition to regional sovereigns, the big three international ratings agencies (S&P, Moody's and Fitch) only assign ratings to and a very small subset of Asian corporates and financial institutions that issue on the international markets. In recent years the agencies have also assigned local-currency ratings to sovereign and sometimes even to corporate borrowers. A BIS study revealed a number of inconsistencies in the relationship between foreign- and local-currency ratings used by a single international rating agency, as well striking disagreements between the international rating agencies on the relationship between the two currency ratings[60].

There are also a number of inconsistencies between the local-currency ratings assigned by international ratings agencies and by local ratings agencies. Local rating agencies in each country issue ratings on local-market issuers, which tend to be very different from companies that issue in international markets. Firms that source funding domestically tend to be smaller and have lower creditworthiness than firms that source credit internationally.

Figure 12: Asia has many country-focused ratings agencies

	China	HK	Indon	Japan	Korea	Mal	Phil	S'pore	Thai
No. of local rating agencies	0	0	1	2	3	2	1	0	2

Source: Barclays Capital.

Inconsistencies in ratings need to be ironed out

For investors to take a regional views of bond markets across Asia, they need to feel comfortable with the credit assessment process across countries. This requires that foreign-and local-currency ratings follow a sound, consistent methodology. This may evolve over time, as Asian economies continue to expand regionally, but it could take a significant amount of time. Furthermore, international rating agencies cannot be relied upon to bring about regional convergence since they rate only a very small subset of Asian issuers and have not yet resolved the issue of consistency between foreign- and

[60] *Franck Packer, "Mind the gap: domestic versus foreign currency sovereign ratings", BIS Quarterly Review, September 2003.*

local-currency ratings. An Asian policy initiative is required to develop a truly regional, high-quality rating process.

So far regional initiatives to support the development of a consistent rating process across Asia have largely consisted of forums and seminars[61]. This is a useful first step, but continued progress may require the establishment of a regional agency supplementing existing local rating agencies. It could be set up along the following lines: the regional credit agency would not itself give ratings, but rather provide a common framework of analysis as well as support services such as training, quality control and R&D to Asian ratings agencies. The purpose would not be to impose a detailed methodology from one country to the next, which would be next to impossible in view of differences in accounting systems and financial practices. Rather, the agency's purpose would be to ensure that the probability of default associated with an assigned rating is roughly the same across Asia.

The regional rating agency could operate as a cooperative. It could be owned by local ratings agencies and would charge them for its services. In view of the limited availability of credit analysis skills, the regional agency could initially be set up as a joint venture with one of the big three international rating agencies.

Most Asian countries currently require domestic debt issues to get a rating. Governments could open, on a reciprocal basis, their market to other Asian countries' rating agencies. Asian ratings agencies would be free to seek business anywhere in Asia provided they met local regulatory requirements and could rate both foreign- and local-currency debt issues. Opening the market for credit ratings would have the advantage of allowing ratings providers to be rotated, which could increase the quality and reliability of the ratings. Indeed a regional study is currently under way on seeking ways to facilitate cross-border acceptance of Asian credit ratings[62].

Public intervention needed to kick-start the process, but government meddling could be counterproductive

While public intervention is needed to get the process started, government interference in the actual ratings process would be counterproductive. Governments could best support the Asian rating process by providing seed money for the regional credit agency and by seeking ratings from Asian ratings agencies for all their sovereign and sub-sovereign issues in the local and USD markets. They could also make seeking a regional rating a precondition for private-sector bond issuance on the USD and local markets.

A regional investor base

Since the 1997 crisis, the investor base for Asian bonds has become more regionalised, although more so in the USD market than in local currency markets. An analysis by the BIS of 71 Asian foreign currency bonds issued during 1999-02 shows that Asia's share of the primary market distribution is 46% on average, going from 36% in the case of Singaporean and Korean issuers to 78% for Indonesian issuers[63]. Furthermore, the Asian share of the secondary market distribution is likely to be even larger as a result of the development of cross-currency swap markets that have allowed onshore institutional investors to swap USD bonds into local currency.

---

[61] See "Progress report, April 2005 Working Group 5 on Rating Systems and information dissemination", Asian Development Bank.

[62] See "Progress report April 2005 Working Group 5 on Rating Systems and information dissemination", Asian Development Bank

[63] McCauley, Fung and Gadanecz, "Integrating the finances of East Asia," BIS Quarterly Review, December 2002.

The regional integration of the investor base is limited

The BIS analysis, however, does not provide data on same-nationality share of Asian demand: for instance, onshore asset swappers will tend to buy and swap the USD bonds issued by their own country, rather than other Asian countries. Thus, the BIS study may overestimate the extent of regional financial integration, even in the USD bond market.

More recent data on cross-border flows of securities shows that between 2001 and 2003 East Asia's intraregional cross-border fixed-income flows have remained small around USD40 mn or about 3% of the total cross-border fixed income portfolio flows. East Asia's intraregional equity flows by contrast have increased to USD50 mn from USD35 mn during the period or from 10 to 11% of total cross border equity flows. And during 2002-05, the percentage of syndicated credit facilities ranged by East Asian and Japanese banks rose to 68% of the total from 63% during 1999-02.[64]

Hence regional integration of bond markets seems to be lagging relative to that of equity and loan markets. This is no doubt the result of the regulatory constraints and high transaction costs described above, as well of the relatively less developed state of bond markets across the region. Individual country efforts to develop their own bond markets would go a long way towards increasing cross-border transactions. Additional measures that could support the emergence of a regional investor base include:

- Phase 2 of the ABF 2, which seeks to open investments in the Pan Asian Index fund (PAIF) and in the country funds to institutional and retail investors within and outside the participating countries. So far only USD0.1 bn of private sector money seems to have been invested to the fund in addition to the USD1 bn of seed money provided by EMEAP central banks. Reasons for this low level of private sector participation could include relatively high fees as well as a lack of familiarity on the part of investors with what is in effect a new asset class. More active promotion of the fund and lower fees could support greater private sector participation.
- Liberalisation of financial foreign direct investment:
    - Regional banks – in the aftermath of the 1997 crisis, East Asian countries with the exception of Malaysia have liberalised FDI in the banking sector[65]. This has supported the emergence of non-Japan Asian banks. As mentioned above, East Asian participation in the Asian syndicated loan market tends to be higher than in the equity or bond markets. Hence the emergence of regional banks could play an important role in supporting regional financial integration. In addition, there is some evidence showing that foreign bank entry increases the efficiency of local banks[66]. An initiative to support regional FDI in the banking sector, for instance along the lines of the EU's Second Banking Co-ordination Directive, based on the principle of mutual recognition, could further financial integration.
    - Fund management industry – In many Asian countries, the local fund management industry (provident funds, mutual funds, insurance or life insurance) remains largely closed to new entrants. Creating a truly regional financial space in Asia would require countries to open their fund management markets to one another. This could be done through reciprocal agreements. In the EU, while countries have maintained their individual licensing requirements for institutional investors such as life insurance companies or mutual funds, markets have been

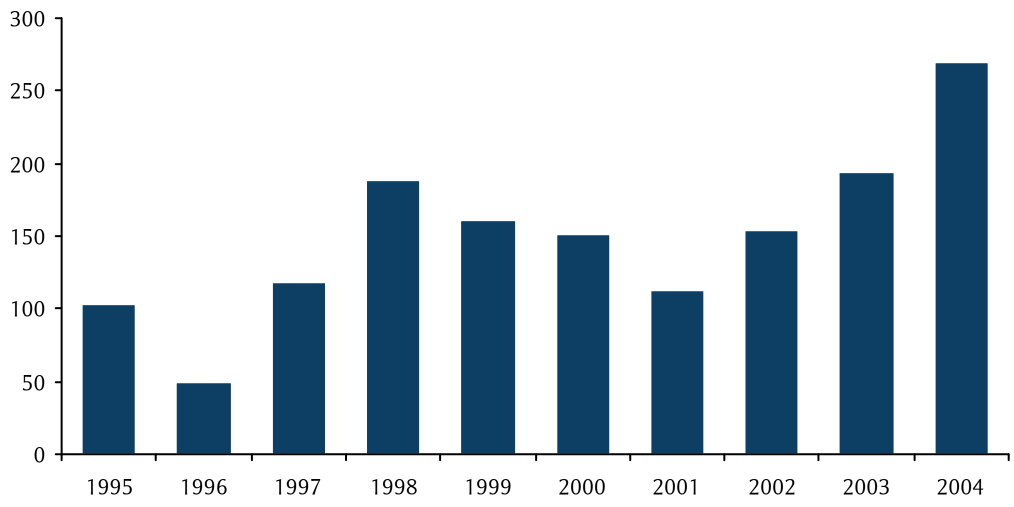
---

[64] *Asia Bond Monitor, November 2005, Asian Development Bank*
[65] *See Chua Hak Bin, "FDI in the Financial sector: the experience of ASEAN countries over the last decade," Monetary Authority of Singapore, March 2003.*
[66] *See Claessens Stijn, Asli Demirguc-Kunt and Harry P. Huizinga, "How does foreign entry affect domestic banking markets?", Journal of banking and finance, 2001.*

completely opened within the EU. Asian countries could also consider opening their fund management industry to non-Asian entrants who would commit to dedicating a minimum share of their investments to Asian bonds.

Increasing corporate issuance

Figure 13: Persistent Asian current account surpluses suggest a structural shortage of Asian bonds (ASEAN+3 current account balance, USD bn)

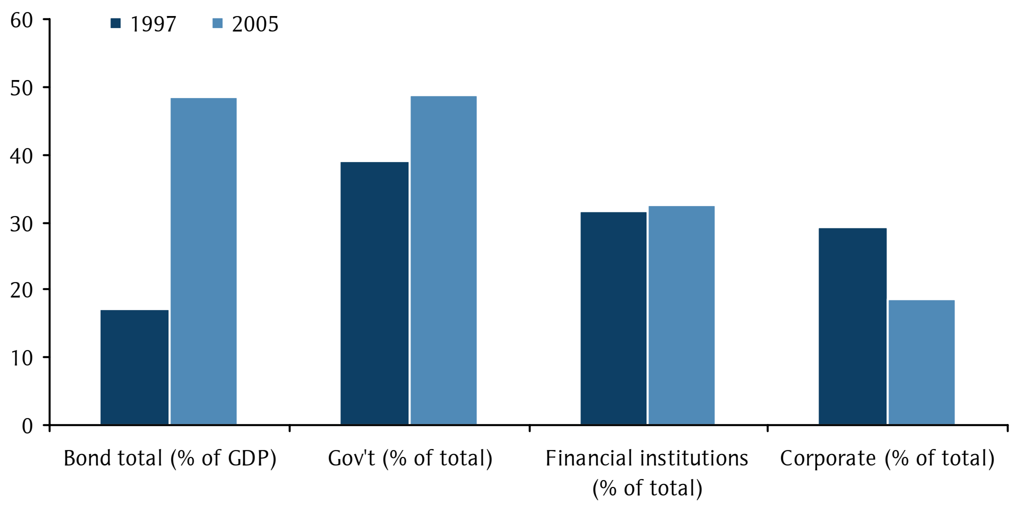


Source: CEIC, Barclays Capital.

As mentioned earlier, a key impediment to market development is less-than-efficient scale. In Asia, the persistence of large current account deficits in the aftermath of the 1997 crisis suggests that bond market expansion is constrained by lack of supply rather than lack of demand. The current imbalance between demand and supply of bonds could, in our view, could be resolved through three broad strategies: reviving investment demand, increasing recourse to bond finance and increasing arbitrage issuance.

Reviving investment demand

Figure 14: Corporate bond issuance has not really taken off since the 1997 crisis (outstanding local currency Asian bonds)



Source: ADB, Barclays Capital.

As mentioned above, the emergence of large current account surpluses in Asia in the aftermath of the 1997 crisis largely reflects the fact than private investment demand has remained well below its pre-crisis level. While bond market capitalisation in emerging Asia has been risen fourfold during 1997-05, the share of issuance accounted for governments has increased while the share accounted for by corporates has decreased. In many countries, this likely reflects the disappointing performance of private investment in the aftermath of the crisis.

Figure 15: A dearth of issuance reflects the weakness of private investment after the 1997 crisis

	China	HK	Indon	Japan	Korea	Malaysia	Phil's	S'pore	Thai
Private Investment/GDP, 1992-96	40.4	29.3	28.0	27.5	37.6	44.3	23.2	34.1	41.2
Private Investment/GDP, 2000-04	40.0	23.9	19.6	25.0	29.8	28.8	21.6	28.7	20.5
Contribution of Private Investment, 1992-96 (% of GDP growth)	47.9	47.2	44.3	46.7	42.5	66.7	51.4	47.3	45.7
Contribution of Private Investment, 2000-04 (% of GDP growth)	57.0	8.3	21.7	- 7.7	25.9	30.8	20.0	- 4.9	31.4
GDP growth, 1992-96	12.1	5.3	7.9	3.0	7.3	9.6	3.5	9.3	8.1
GDP growth, 2000-04	8.6	4.8	4.6	1.3	5.4	5.2	4.5	4.1	5.1

Source: CEIC, Barclays Capital.

Disappointing growth, private investment and corporate bond issuance may well reflect a lack of structural reforms. The contribution of domestic demand to growth has not increased since the Asian crisis. At the same time, a continued large accumulation of FX reserves suggests countries have not given up on the old export-led growth model, even though this model has largely lost its relevance[67]. Hence, further structural reform that would support domestic-led growth, facilitate market entry and increase financial sector efficiency could also revive private investment, reduce current account surpluses and increase Asian corporate bond issuance.

Increasing the recourse to bond finance

Increasing Asian bond issuance through more dynamic private sector investment is a long-term endeavour. In the mean time, countries could also encourage greater reliance on bond finance through a widening of the universe of firms able to gain financing through the bond market and through securitisation.

In the typical Asian local currency corporate bond market issuers tend to be concentrated in the highest credit ratings or tend to borrow with government guarantees. This may reflect accounting and auditing standards that make it difficult for investors to assess credit risk and hence difficult for lower rated corporates to gain access to the bond market. With family owned conglomerates still a prevalent ownership structure in Asia the incentive to produce extensive public information may not be as strong as in countries where the ownership structure is more diffuse. This suggests a strengthening of accounting and auditing standards could widen the universe of firms able to access the bond market[68].

By contrast, an increase in bond issuance through subsidisation is unlikely to be sustainable. In 2004, JBIC provided credit guarantees for an Asian multinational company to issue THB bonds. As long as credit enhancement is priced at market rates it can help support, in a sustainable way, greater corporate access to the bond market.

[67] See Dwor-Frecaut, Dominique, "Asia: unconventional investment of FX reserves shows limit of FX intervention", Barclays Capital, March 2005.
[68] See Gyntelberg, Jacob, Guonan Ma and Eli M Remolona, Corporate bond markets in Asia, BIS Quarterly Review December2005.

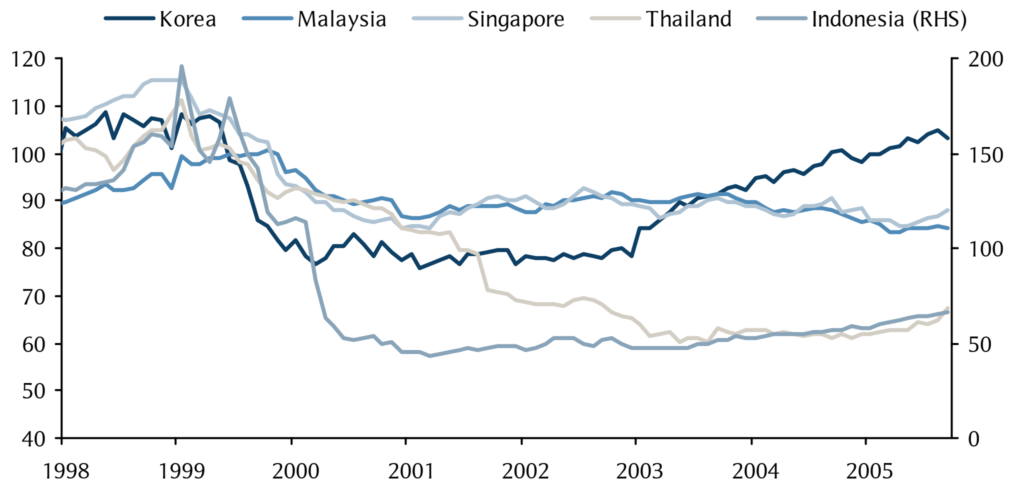
Indeed, one of the topics under discussion under the ABMI (Asian Bond Market Initiative; see below) is the creation of a regional credit guarantee agency[69]. Such an agency could play a useful role in regional financial integration, provided it is self-financing. Perhaps, a government-sponsored, but privately owned, regional credit guarantee agency might work best.

With Asian reliance on bond finance unlikely to increase dramatically over the short run, ABS issuance is viewed by many as a promising source of supply. Strong ABS issuance would, however, require a strong recovery in bank lending, as well as the development of supportive legal, regulatory and tax systems.

Korea used new securitisation laws to recapitalise its banking system

Korea is home to Asia's largest securitisation market outside Japan partly because, as part of its post-1997 crisis reforms, Korea introduced securitisation laws that were used to support the recapitalisation of the banking system. Interestingly, Korea is also the country were the recovery in credit growth since the crisis has been the strongest. In our view, this points out one of the main constraints to the birth of a regional securitisation market – namely, that until recently many Asian banks have found it difficult to rebuild their loan books after the 1997 crisis. Loan to deposit ratios now seem to be slowly rising or stabilizing across Asia but stronger growth may be needed before vibrant securitisation market takes root across the region. And of course, faster investment growth would support this process since it would raise the demand for bank lending.

Figure 16: Loan to deposit ratios are stabilising or increasing



Source: CEIC, Barclays Capital.

In December 2004, the finance ministries of Korea and Japan securitised JPY10bn worth of SME lending from banks in both countries[70]. Initiatives such as this could support the deepening of the markets for securitised debt provided they do not involve a subsidy. However their scale likely will remain constrained by the pace of credit growth and by banks' willingness to sell their loans.

---

[69] *See "April 2005 progress report, Working Group 2 Credit Guarantee and Investment Mechanism", Asian Development Bank*

[70] *See "Progress report, April 2005 Working Group 1 on Creating new Securitised debt instruments", Asian Development Bank*

Increasing arbitrage issuance

In view of Asia's tradition of high savings rate, a revival of investment and a greater reliance on bond finance may not be enough to bridge what seems to be a structural gap between demand and supply. What is needed, in our view, is to bring a steady flow of non-Asian issuers – ie, arbitrage issuers – to Asia.

So far, arbitrage issuance has been limited. Multilateral development institutions such as the World Bank, the ADB and the IFC have issued or are about to issue in CNY, SGD, MYR, HKD, KRW, PHP and THB. However, this issuance is driven by the financing needs of multilateral development institutions and subject to their risk management and currency diversification rules. It appears unlikely, on its own, to bridge the gap between bond supply and demand. To be steady and large enough to have a developmental impact, the flow of arbitrage issuance would have be mainly private-sector based.

A regional initiative currently under consideration seeks to develop standards for Asian bonds, ie, the facilitation of bond issuance by Asian issuers in Asia but outside of their country of origin. This would be a very useful initiative to support regulatory convergence and the development of a regional infrastructure. However, since the issuers targeted by the initiative come from within Asia, on its own the initiative is unlikely to alter the imbalance between bond supply and bond demand very much. To reduce this imbalance, issuers from outside Asia need to be brought in to tap Asia's excess savings.

Hong Kong and Singapore have markets large enough to attract foreign issuance…

Asia can offer attractive markets to potential issuers. The markets most likely to attract foreign issuers would have to belong to economies with very strong fundamentals, and feature markets that offer a large enough range of issue size and maturities with low issuance costs. So far, Hong Kong and Singapore are the only two markets that have attracted foreign issuance on a significant scale. Korea has strong potential, owing to its size, the development of its bond market and the impressive restoration of strong fundamentals after the 1997 crisis.

Figure 17: Foreign issuance could be expanded

	Hong Kong	Korea	Singapore
Sovereign rating	AA-	A	AAA
Corporate bonds outstanding (USD bn)	62	355	22
Foreign issuers (USD bn)	35	0.4	8
Maturity range	Up to 10 years	Up to 10 years	Up to 20 years
Average issue size (USD mn)	100- 150	150-200	250-300

Source: HKMA, MAS, Barclays Capital.

The Hong Kong bond market appears to have made the most progress in attracting foreign issuers. About a third of the outstanding issues in HKD belong to foreign corporates, banks or multilateral institutions. A stable macroeconomic environment, a diversified investor base that includes foreign and retail investors, and a supportive legal and regulatory environment that keeps issuance costs low appear to be the key factors behind Hong Kong's success.

Singapore has seen its volume of foreign issuance increase in recent years, but may not have fully exhausted the potential of the foreign issuer base. In recent years, Singapore has streamlined its financial sector and capital account regulations, but its investor base remains largely focused on real estate and equity. Foreign issuance has increased steadily over the past few years, and is likely to continue to do so with the implementation of economic reforms, which will eventually support the diversification of the investor base and make it easier for arbitrage issuers to tap the local market.

… but need to work on building their reputations

While Hong Kong and Singapore offer state-of-the-art market infrastructure and practices, they are still relative newcomers on the international financial scene. They have not yet earned the reputation enjoyed by major financial centres in OECD countries. Higher foreign issuance on the Hong Kong and Singapore markets could be supported by more proactive marketing policies, for instance, joint road shows by the Hong Kong and Singapore bond markets to educate investors and issuers on the potential of these markets.

Korea has the potential to become the third centre of foreign issuance in Asia

Korea has the largest bond market in Asia ex-China and Japan, but foreign issuance is still very limited largely due to regulatory restrictions. For instance, issuers need to have a legal presence in Korea and the proceeds of the issuance cannot be taken out of the country. With its strong economic fundamental and dynamic bond market, Korea could become the third centre of foreign issuance in Asia, which would also support its government's goal of becoming a financial and logistics hub in northeast Asia. To do so, however, a number of regulatory restrictions would have to be relaxed. Korea could do so without endangering macroeconomic stability, in view of the resilience and efficiency of its economy, after a programme of far-reaching structural reforms in the aftermath of the crisis.

Some further suggestions for regional financial integration

A dual-track process

Regional financial integration in our view requires policy action on two fronts. On the one hand, technical measures to support the development of a regional financial market including, as discussed above, a relaxation of capital controls, regulatory convergence, a regional infrastructure and measures to support stronger bond issuance. On the other hand there is a need to develop a macroeconomic and institutional framework that will enable the region to reap the full benefits of regional financial integration. In our view this includes supporting a move towards better balance between domestic- and foreign-demand-led growth and developing regional surveillance mechanisms.

So far, regional initiatives seem to have focused mainly on the technical aspects of financial integration. There does not seem to be a consensus, for instance, on the need to achieve more balance between domestic-driven and external-led growth. Because these kinds of structural changes likely require an extended period of time to take root, if the necessary policy steps are not initiated soon, there is a risk that integration of financial markets may not bring the expected benefit of lower volatility.

In addition, while mechanisms for regional surveillance have been developed, for instance, through the annual meetings of ASEAN+3 finance ministers, the biannual meetings of ASEAN+3 deputy finance ministers, and through the ASEAN surveillance process, these do not yet have the same impact and credibility as IMF surveillance. This has limited other regional financial cooperation initiatives. For instance, under the Chiang Mai initiative, release of 90% of the funds under bilateral swaps agreements is contingent on countries already having an IMF programme in place. Moving away from IMF to regional conditionality would likely require a stronger Asian surveillance process.

The limited impact of the regional surveillance process seems to be the result of a number of factors including:

- Lack of a permanent secretariat for ASEAN+3, which prevents it from developing the analytical capabilities required for in-depth surveillance;
- The limited geographical reach of ASEAN (which does not include the "+3" and Hong Kong); other policy organisations, such as ASEM and APEC, have wide geographical reach that could dilute their policy effectiveness;
- Lack of dissemination of the results of the regional discussions. While the IMF publishes a Public Information Notice on each article IV consultation and gives countries the option of publishing the review documents themselves, little is known of the outcome of regional surveillance. Indeed, there is limited market awareness of the existence of a regional surveillance process.

The limits of networking

To a large extent, the lack of institutions that could support regional financial integration reflects the nature of Asia's integration process, which essentially is driven by economic and financial considerations, rather than by politics. Initially, regional disappointment at the role played by the IMF and the US in the aftermath of the crisis seems to have been a catalyst. More recently, the memory of the crisis has receded and growing awareness of regional interdependence and global importance, together with a more proactive Chinese stance on regional cooperation, seems to have become the key factor[71].

By contrast, Europe's economic and financial integration has largely been driven by political will: the idea of European political integration has existed for centuries and was firmly established through US foreign policy in the post-World War II years. Indeed, supranational institutions in Europe were built long before financial and monetary integration got under way[72]. For instance, it is not clear that the EU met the criteria for an optimum currency area and in our view, European monetary integration was made possible through political will superseding economic realities.

The lack of an Asian consensus on political integration precludes monetary integration, in our view, since the latter would not be feasible without supranational institutions. Financial integration, by contrast, involves much less loss of policy independence and thus appears feasible without a drive for political integration. Indeed, some have argued that this is one of the reasons why the creation of an Asian bond market has made more headway than the establishment of an Asian monetary fund or a common currency, initiatives proposed by Japan in the aftermath of the 1997 crisis[73].

The lack of supranational institutions in Asia could also reflect a greater faith in market mechanisms among Asian countries than among their European peers. For instance, labour markets are much more flexible in Asia and trade protectionism and social safety nets and government expenditures tend to be much more limited in Asia than in Europe. These differences likely reflect the fact that the social democratic political and economic consensus prevailing in continental Europe is quite different from the consensus prevailing in most Asian countries.

Hence, it is not surprising that Asian financial cooperation has so far proceeded through the development of networks of policy makers, academics and market participants rather than through the establishment of a regional institution. For

---

[71] *See Amyx, Jennifer, "A regional bond market for East Asia? The evolving political dynamics of regional financial cooperation", Pacific Economic Paper 342, Australia national University, 2004.*
[72] *See Bayoumi and Eichengreen 1996.*
[73] *See Amyx, 2004.*

instance, the Chiang Mai initiative has taken the form of a network of bilateral swap agreements rather than a centralised, regional monetary fund. Initiatives for the development of a regional bond market have taken the form of the establishment of regional working groups, with the ASEAN secretariat and the Asian Development Bank playing the role of de facto secretariats[74]. The establishment of the Asian Bond Funds 1 and 2 has taken place through EMEAP, a consortium of central banks involving some ASEAN countries, the "+3" countries, Hong Kong, Australia and New Zealand.

Overall, these networks have, in our view, produced impressive achievements. For instance, while the Chiang Mai initiative remains in our view limited in size and scope, it has allowed Asian policymakers to develop informal regional networks that are stronger than they were before the 1997 crisis. The development of a pan-Asian and country-specific local-currency bond fund and indices represent milestones in the development of regional infrastructure, in our view. The working groups have led countries to relax some of the impediments to cross-border transactions, such as withholding taxes or foreign access to onshore credit and derivative markets. The working groups have also helped to build a consensus on the key issues in the establishment of a regional bond market.

Yet the networking process has its limits. As mentioned above, a series of informal discussions among policymakers is no substitute for IMF surveillance. In addition, it may well be that the recent successes were the easiest: for instance, given the abundance of FX reserves in Asia, reserve pooling has limited political cost, especially if the pool is managed by a third party. As financial integration deepens, the issues confronting policymakers are likely to get more complex and coordination between country efforts more demanding. The lack of regional institutions is likely to keep regional financial integration progressing at a very slow pace.

Figure 18: The first revision of country weights in the Asian Bond Fund 2

	Weights		Criteria			
	New weights 1 Oct 05	Previous weights Apr 05	Market size (USD bn)	Turnover ratio %	Credit rating[75]	Market openness
China	11.24	11.28	483	55	A	30
Hong Kong	18.30	17.05	78	623	AA+	100
Indonesia	5.99	6.14	58	102	BB	60
Korea	20.67	21.26	569	610	AA-	60
Malaysia	10.70	10.76	107	136	A+	75
Philippines	4.96	5.19	25	34	BB+	60
Singapore	18.22	18.70	79	534	AAA	100
Thailand	9.92	9.62	67	229	A	70

Source: International Index Company, Barclays Capital.

For instance, at the moment the main instrument for keeping track of countries' progress in the development of their local bond market seems the weighting used in determining each country's allocation in the Asian Bond Fund 2. These weights are determined independently by the company managing the fund according to four factors: the size of the local market, the turnover ratio in that market, the sovereign credit rating, and a market openness factor. The first such review has just been carried

---

[74] See ASEAN+3 bond market initiative, Overview, http://asianbondsonline.adb.org/regional/asean_plus_three_asian_bond_market_initiatives/overview.php
[75] Highest local currency long-term debt rating from Fitch, Moody's and S&P. see International Index Company, iBoxx ABF Index family, Index guide, September 2005.

out, which has seen a slight increase in the weights of Hong Kong and Thailand. While this is a useful and transparent procedure, this is no substitute for a scorecard on country-specific and regional progress in financial sector development and integration.

A step in the direction of stronger regional institutions

In the long run, financial integration will require a regional institution of some kind that is focused on financial surveillance [76]. Current economic reviews, for instance, through the IMF or the OECD are not primarily focused on financial market development. An ASEAN+3-based review focused on individual local-currency bond market performance would be a useful complement. The mandate of this institution could include:

- Promoting convergence of regulatory and legal regimes, taxation and market practice to an efficient regional standard;
- Setting up the institutions required for the provision of basic regional market infrastructure, including a regional credit agency;
- Producing an annual report on progress in regional financial integration and on individual countries' development of their bond markets;
- Promoting the Asian bond market to Asian investors and to arbitrage issuers;
- Serving as a secretariat to regional financial surveillance initiatives.

In the short term, given countries' reluctance to set up supranational institutions, as an intermediate step another FX reserve pooling arrangement could be considered. This new reserve pooling would be managed by the participating countries themselves, rather than by third parties as in the Asian Bond Funds 1 and 2. The fund would be set up as an independent entity and could even be listed, as is the case for the ABF2. Political costs would be limited in view of the abundance of FX reserves in the region – governments would only have to delegate a limited number of staff to manage the fund and commit not to interfere in its management.

There have been a number of proposals for Asian FX reserve pooling, generally to provide balance of payments support to the participating countries or to support exchange rate coordination[77]. We remain doubtful that a monetary arrangement is a realistic prospect in Asia, even in the medium term. In addition, reserve pooling agreements designed to provide balance of payments support could run into the same issues as the CMI, namely the lack of a strong regional surveillance process that would force the disbursement of reserves to be contingent on IMF conditionality and remove much of the regional character.

Hence, a "financial" reserve pooling agreement along the lines of the ABF 1 or 2 might be more practical. The new arrangement could consider investing in a wider range of securities, for instance in Asian equities, and profits from the fund could be used to pay for (at least in part) regional initiatives, such as technical assistance for the development of individual countries financial markets. Such a set up would promote learning by doing and networking among Asian policymakers and hopefully become a steppingstone towards a full-fledged regional financial institution.

---

[76] For instance, Eichengreen has suggested an AFI focused on the strengthening of prudential supervision and regulation and providing BIS-type services to Asian central banks; see Barry Eichengreen, "Hanging together? On monetary and financial cooperation in Asia", unpublished manuscript prepared for the joint World Bank-Japan study of the East Asia region's prospects, 2001.

[77] See for instance Montiel, Peter J., "Reserve Pooling and exchange Rate coordination in East and South East Asia".

References

Amyx, Jennifer, A regional bond market for East Asia? The evolving political dynamics of regional financial cooperation, Pacific Economic Paper 342, Australia national University, 2004

Arner Douglas, Paul Lejot, S. Ghon Rhee, "Impediments to cross-border investments in Asian bonds", PECC general meeting, July 2005.

ASEAN Policy Blueprint for SME development 2004-2014, ASEAN secretariat, 2003.

Asia Bond Market initiative, Working Group 3, Foreign Exchange transactions and settlements issues, Progress report, April 2005, Asian Development Bank.

Asia Bond Market initiative, ABMI road map, May 2005, Asian Development Bank.

Asia Bond Market initiative, Working Group 1 on Creating new Securitised debt instruments, Progress report April 2005, Asian Development Bank.

Asia Bond Market initiative, Working Group 2 Credit Guarantee and Investment mechanism, April 2005 progress report, Asian Development Bank.

Asia Bond Market initiative, Working Group 5 on Rating Systems and information dissemination, Progress report April 2005, Asian Development Bank.

Bank for International Settlements, Triennial central bank survey of foreign exchange and derivatives market activity 2004 final results, 17 March 2005.

Bank for International Settlements, Quarterly review First Quarter 2002.

Battellino, Ric, Recent developments in Asian Bond Markets, Reserve bank of Australia December 2004.

Beck, Thorsten and Ross Levine, Stock markets, banks, and Growth: Panel evidence, NBER working paper 9082, 2002.

Buger, John D. and Francis E. Warnock, Foreign participation in local currency bond markets, May 2005.

Chua Hak Bin, "FDI in the financial sector: the experience of ASEAN countries over the last decade", Monetary Authority of Singapore, March 2003.

Claessens Stijn, Asli Demirguc-Kunt and Harry P. Huizinga, "How does foreign entry affect domestic banking markets?", Journal of banking and finance, 2001

Claessens, Stijn, Daniela Klingebiel and Sergio Schmukler, "Explaining the migration of stocks from exchanges in emerging economies to international centers", CEPR working paper 3301, 2002.

Dammers, Clifford and Robert McCauley, "Basket weaving: the Eurobond market experience with currency baskets", Seminar on Global imbalances and Asian financial markets, University of California Berkeley, September 2005.

Domanski, Dietrich, Foreign banks in emerging market economies: changing players, changing issues, BIS Quarterly Review, December 2005

Dwor-Frecaut, Dominique, "Asia: unconventional investment of FX reserves shows limits of FX intervention", Barclays Capital 11 March 2005.

Dwor-Frecaut, Dominique, "Malaysia: new economic strategy calls for more flexible exchange rate", Barclays Capital 16 February 2005.

Dwor-Frecaut, Dominique, "The Asian Bond Market From fragmentation to aggregation", 12 September 2003.

Dwor-Frecaut, Dominique and Philip Nakajima, "Is US monetary policy driving Korean confidence?", Barclays Capital, 15 March 2005.

Barry Eichengreen, "Hanging together? On monetary and financial cooperation in Asia", unpublished manuscript prepared for the Joint World Bank-Japan Study of the East Asia Region prospects, 2001.

Eichengreen Barry and Tamim Bayoumi, "Is Asia an Optimum Currency Area? Can It Become One?" Regional, Global and Historical Perspectives on Asian Monetary Relations, Center for International and development economics research, University of California Berkeley, 1996.

Eichengreen Barry and P. Luengnaruemitchai, "Why doesn't Asia have bigger bond markets?", mimeo, University of California, Berkeley, February 2004

Eichengreen Barry and Yung-chul Park, "Why has there been less financial integration in Asia than in Europe?", Institute of European Studies. Political Economy of International Finance. Working Paper PEIF-4.

Ferrucci, Gianluigi, Valerie Herzberg, Farouk Soussa, Ashley Taylor, "Understanding capital flows to emerging market economies", Financial Stability review, Bank of England June 2004.

Financial Express, "Asian bourses grow fond of Indian paper", April 6 2005.

French, Kenneth and James Poterba, "Investor diversification and international equity markets", American Economic review Vol. 81, May 1991

Galati and Tsatsaronis, "The Impact of the Euro on Europe's financial markets", BIS working paper 100, July 2001.

Giannetti Mariassunta, Luigi Guiso, Tullio Jappelli, Maria Padula and Marco Pagano, "Financial market integration, corporate financing and economic growth", European Commission economic papers 179, November 2002.

Giovannini group, "The EU repo market: opportunities for Change", Euro paper No 35, European commission, 1999;

Giovannini group, "Cross border clearing and settlement arrangements in the European Union", European Commission, 2001;

Giovannini group, "Second report on EU Clearing and Settlement arrangements", European commission, April 2003

Gonzalz-Paramo, Jose Manuel, "Financial integration and economic growth. Lessons from the European experience", European Central Bank, January 2005

Guonan, Ma and Eli M. Remolona, "Opening markets through a regional bond fund: lessons from ABF2", BIS quarterly review, June 2005

Gyntelberg, Jacob, Guonan Ma and Eli M Remolona, Corporate bond markets in Asia, BIS Quarterly Review December 05

Hakura, Dalia, "Output volatility in emerging markets and developing countries", WEO, IMF April 2005.

Ho, Corrine, Guonan Ma and Robert McCauley, "Trading Asian currencies", BIS quarterly review, March 2005.

International Index company, iBoxx ABF Index family, Index guide, September 2005.

International Index Company, iBoxx ABF bond indices launched , 12 May 2005.

Jeon Jongkyou, Yonghyup Oh and Doo Yong Yang, "Financial market integration in East Asia: Regional or Global?", KIEP working paper 05-02, October 2005.

Jiang, Guorong and Robert McCauley, "Asian local currency bond markets", BIS quarterly review, June 2004.

Kim, Soyoung, Sunghyun H. Kim and Yunjong Wang, "Financial Integration and Consumption Risk Sharing in East Asia", Korea Institute for International Economic Policy (KIEP),December 2003.

Lannoo K. and M. Levin (2001) "The securities settlement industry in the EU: structure, costs and the way forward", CEPS research report 26, 2001)

Lewis, Karen, Trying to explain home bias in equities and consumption, Journal of Economic Literature 37, 1999

Lane, Philip and Gian Maria Milesi-Ferretti, "International financial integration", IMF Staff papers, Vol. 50 special issue, 2003.

London Economics, "Quantification of the macro-economic impact of integration of EU financial markets", London, 2002.

McCauley, Robert and Guorong Jiang, "Diversifying with Asian local currency bonds", BIS Quarterly review, September 2004.

McCauley, Robert, "Capital flows in East Asia since the 1997 crisis", BIS quarterly review, June 2003.

McCauley, San-Sau Fung and Blaise Gadanecz, "Integrating the finances of East Asia", BIS quarterly review, December 2002.

McGuire, Patrick, Martijn Schrivers, "Common factors in emerging market spreads", BIS quarterly review, December 2003.

Moyer, Liz, "A new look for Wall Street", Forbes, 10 November 2005.

Ogawa, Eiji and Takatoshi Ito, "On the desirability of a regional basket currency arrangement", NBER working paper 8002, November 2000.

Packer, Franck, "Mind the gap: domestic versus foreign currency sovereign ratings", BIS Quarterly Review, September 2003.

Park, Yung-chul, "Prospects for Financial Integration and Exchange Rate Policy Cooperation in East Asia", ADB Institute research paper 48, December 2002.

Park, Yung-chul and Kee-hong Bae, "Financial liberalisation and economic integration in East Asia", PECC Finance Forum conference, August 2002.

Park, Yung-chul and Chi-young Song, "East Asia's experiences with the free floating exchanger ate system", FONDAD, December 2001.

Pagano, Pagano, Fabio Panetta and Luigi Zingales, "Why do companies go public? An empirical analysis", Journal of Finance, Vol. 53, no.1 February 1998.

Prasad, Eswar, Kenneth Rogoff, Shang-Jin Wei and Ayhan Kose, "Effects of financial globalisation on developing countries: some empirical evidence", IMF, March 2003.

Reszat Beate, "How has the European Monetary Integration Process Contributed to Regional financial market integration?", HWWA discussion paper 221, 2003.

Rey Helene and Richard Portes, "The determinants of cross-border equity flows", Journal of international economics, Volume 65, issue 2, March 2005.

Rodriguez, Francisco and Dani Rodrik "Trade policy and economic growth: a skeptic's guide to the cross national evidence", NBER working paper 7081, April 1999.

Sheng, Andrew, "A Pan-Asian bond market: how do we get there?", 2nd Annual Asia Pacific Bond Congress, Hong Kong June 2005.

Sonali Jain-Chandra, "Foreign Direct Investment in India: How it can be increased", India selected issue, IMF March 2005.

Steil, Benn, "Creating securities markets in developing countries: a new approach for the age of automatic trading", International Finance 4:2, 2001.

Stevens, Glenn, "Asian financial cooperation", ANU Center for Applied Macroeconomic analysis, 14 October 2005.

Trichet, Jean-Claude, "The integration of the single market for financial services – The Eurosystem perspective", CESR conference on Europe's single market in financial services: under construction or fully integrated, 6 December 2004.

Trichet, Jean-Claude, "Integration of the European financial sector", introductory remarks at the International Banking Event, Frankfurt am Main, 29 June 2004.

Watanabe, Kenichiro, Hiroshi Akama and Jun Mifune, "The effectiveness of Capital controls and Monitoring: The Case of Non-internationalisation of emerging markets currencies", EMEAP discussion paper, January 2002.

Emerging Markets Research

Asia

Desmond Supple
Head of Asian Research
+65 6395 3210
desmond.supple@barcap.com

Nicholas Bibby
Asian EM Strategist
+65 6395 3511
nicholas.bibby@barcap.com

Dominique Dwor-Frécaut
Asian EM Strategist
+65 6395 3211
dominique.dwor-frecaut@barcap.com

Haizhou Huang
Asian EM Strategist
+852 2903 2651
haizhou.huang@barcap.com

Winnie Choi
Asian EM Strategist
+852 2903 2652
winnie.choi@barcap.com

Jon Scoffin
Head of Credit Research, Asia-Pacific
+65 6395 3217
jon.scoffin@barcap.com

Carlos Chan
Credit Strategy
+65 6395 3219
carlos.chan@barcap.com

Philip Nakajima
Interest Rates and FX Strategy
+65 6395 3425
philip.nakajima@barcap.com

Emerging EMEA

Matthew Vogel
Head of Emerging EMEA Strategy
+44 (0)20 7773 2833
matthew.vogel@barcap.com

Jeff Gable
Emerging EMEA Strategist
+44 (0)20 7773 4676
jeff.gable@barcap.com

Leon Myburgh
Africa Strategist
+27 11 772 7222
leon.myburgh@barcap.com

Grace Juhn
Research Analyst
+44 (0)20 777 32031
grace.juhn@barcap.com

Latin America

Philip Suttle
Global Head of Emerging Markets Research
+1 212 412 5564
philip.suttle@barcap.com

José M. Barrionuevo
Head of Latin American Strategy
+1 212 412 3306
jose.barrionuevo@barcap.com

Michael Hood
Latin American Economics
+1 212 412 6734
michael.hood@barcap.com

Gautam Jain
Quantitative Strategy
+1 212 412 5533
gautam.jain@barcap.com

Xun Wang
Analytics
+1 212 412 1370
xun.wang@barcap.com