



Financial Integration in Asia: Overview

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Outline

- Asia's Financial Integration: Overview
- Focus on ASEAN
 - Financial Sector liberalization
 - Capital Account Liberalization (CAL)
- Capital Mobility, Real Convergence and Growth
- Lessons from Europe
- Conclusions



Financial Integration

- Financial integration (FI) refers to financial sector liberalization and capital account integration.
- FI confers benefits if managed well, although it also entails risks.
 - Benefits: improved allocation of saving, investment; better risk sharing; strengthened financial system resilience; higher productivity, growth.
 - Risks: credit booms; amplified shock propagation; higher financial and macro volatility.
- Asia's FI is not as deep as would be suggested by the continent's large supply of savings and close trade integration.
 - FDI-led financial integration, reflecting tight trade links.
 - Structural factors: ongoing development of financial infrastructure, capital markets.
 - Asian and Global Financial Crises (Europe's experience) made Asia very cautious about official financial integration initiatives.



Financial Sector Liberalization (FSL)

- Integration of banking, capital markets, insurance, and other financial services can have large benefits
 - ✓ Financial development boosts inclusion and growth
 - ✓ Helps create stronger financial systems, better able to diversify risks
 - ✓ Goes hand in hand with enhanced financial infrastructure (payments, settlements systems)
- Asia-wide financial markets are hampered by:
 - ✓ Fragmentation created by national regulations and standards (e.g. bank supervision, rating agencies, credit bureaus, and securities commissions)
 - ✓ Lack of mutual recognition and common disclosure requirements



Capital Account Liberalization (CAL)

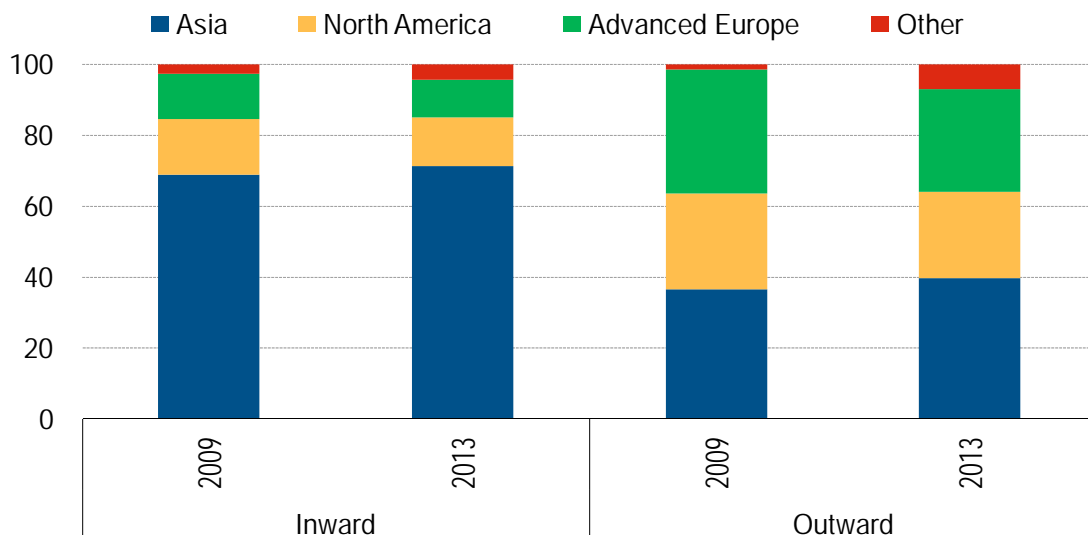
- Wide divergence in financial openness and financial sector development in Asia.
- Asia is becoming more open: although *de jure* restrictions on capital mobility remain, including for example in some low income *and* frontier economies, *de facto*, capital flows, including of residents, are rising.
- Response to AFC/GFC shows divergence:
 - ✓ Some countries (e.g. the ASEAN-4) tightened current account restrictions and export proceeds repatriation.
 - ✓ Frontier countries continue to liberalize (from a low base).



FDI in Asia is mostly from within the region

Asia: Foreign Direct Investment

(Percent of total foreign direct investment to and from Asia)



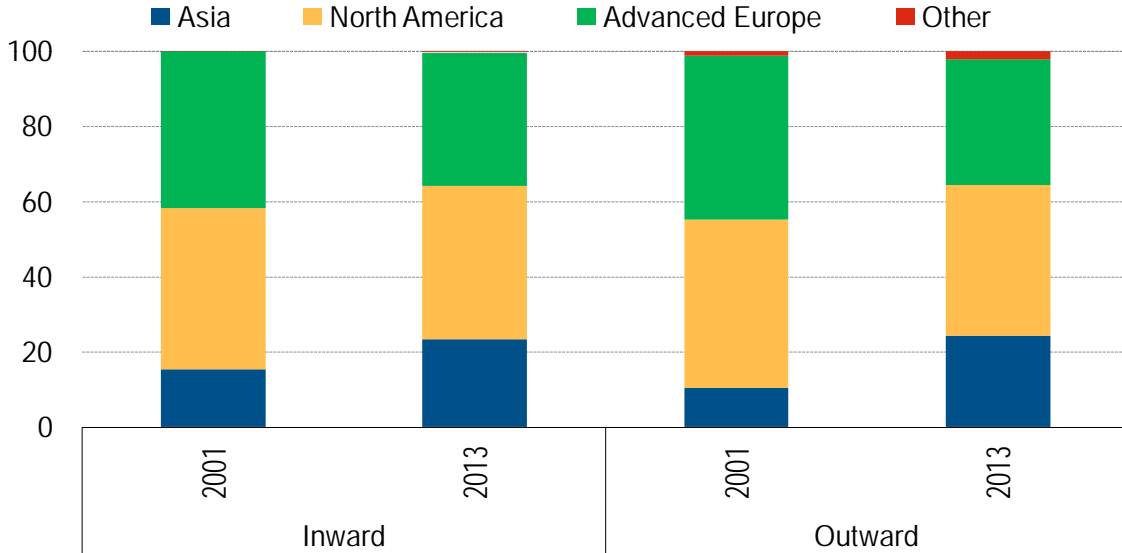
Sources: IMF, Coordinated Direct Investment Survey database; and IMF staff calculations.



Foreign Portfolio Investment in Asia is mostly from outside the region

Asia: Foreign Portfolio Investment

(Percent of total foreign portfolio investment to and from Asia)



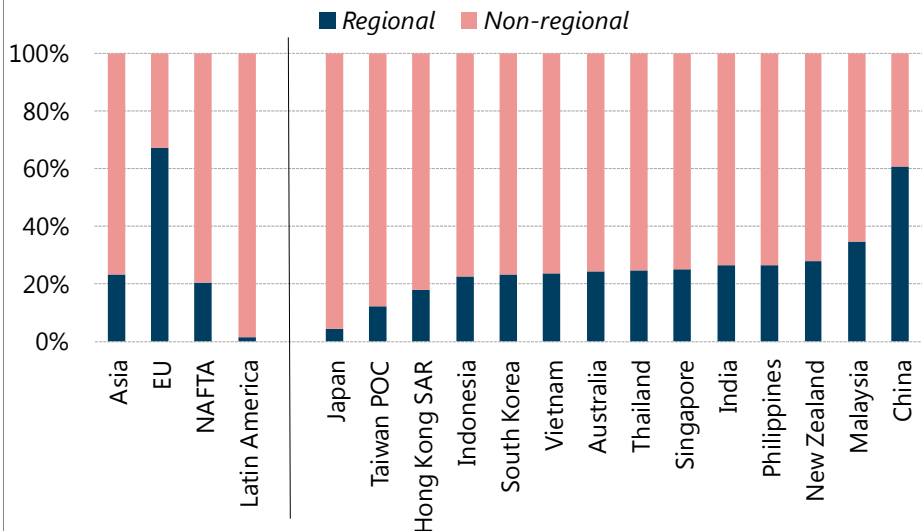
Sources: IMF, Coordinated Portfolio Investment Survey database; and IMF staff calculations.



Intra-regional inward portfolio investment share in Asia is much lower than in the EU, but higher than in Latin America

Sources of Portfolio Inward Investment

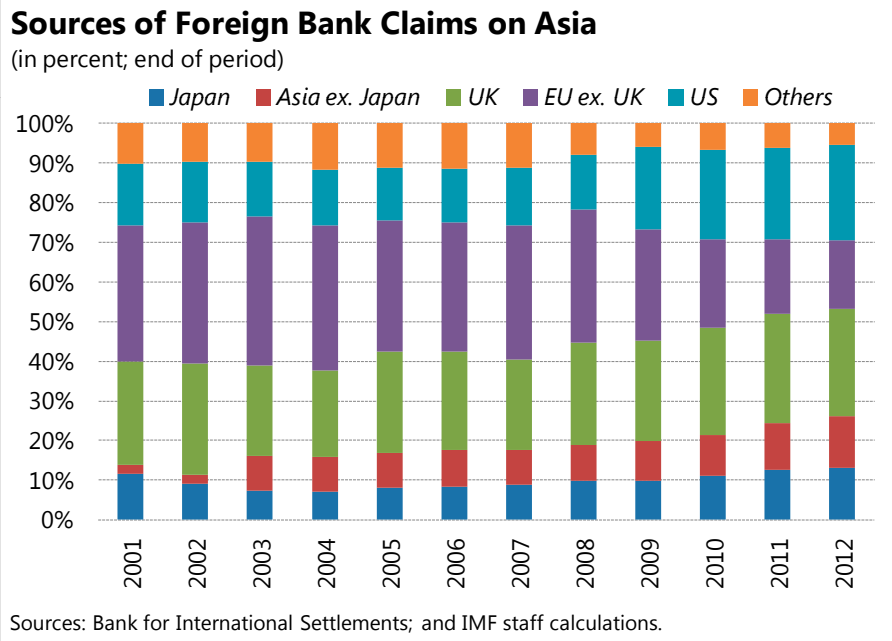
(end of year 2013)



Sources: IMF CPIS database; and IMF staff calculation.



The share of foreign bank claims originating from within Asia is fairly small, albeit increasing



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ASEAN Integration

- ASEAN is a group of 10 very heterogeneous countries, comprising 625 million people and a GDP of \$2.4 trillion.
- ASEAN tariffs are low and there is progress toward more economic and financial integration
- ASEAN Economic Community (AEC) was conceived in 2007; came into effect in Jan 2016
- Freer flow of goods and services and of factors of production would benefit ASEAN economies greatly.



Better Risk Sharing through Financial Integration

Potential Gains from Risk Sharing Among Countries

	Median standard deviation of consumption in individual country	Standard deviation of income in whole group
Asia	3.7	1.7
ASEAN	3.9	3.4
ASEAN+3	3.7	1.8
EU	2.7	1.8
Euro Area	2.4	1.8
Latin America	3.5	1.9

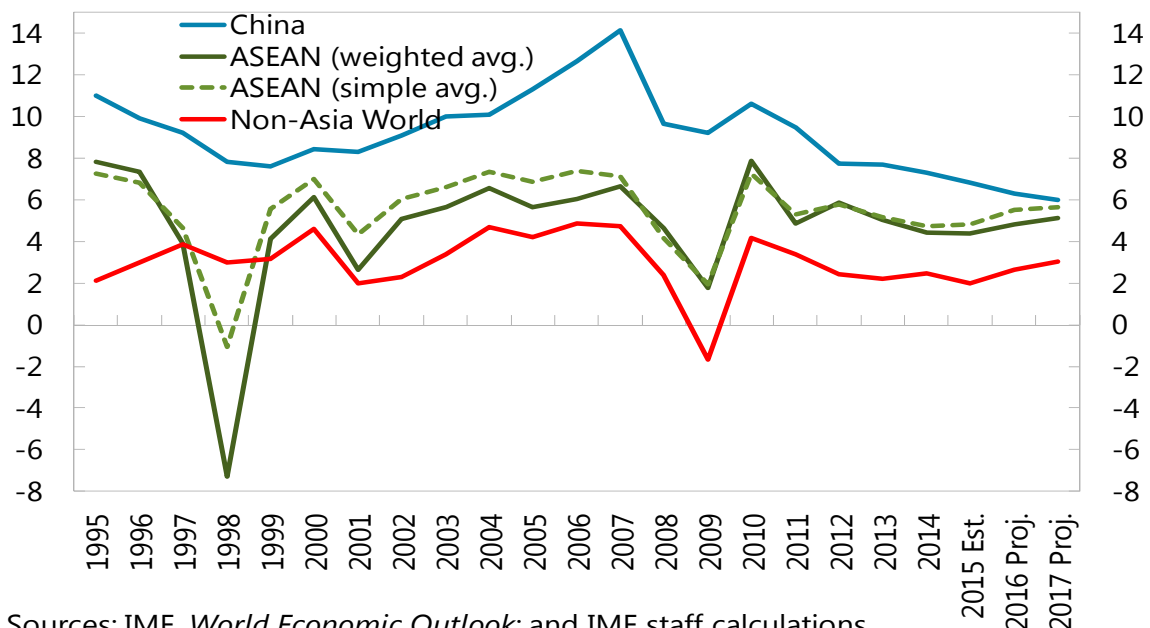
Source: World bank and IMF Staff Calculations.



ASEAN: Real GDP Growth

Real GDP Growth

(In percent)



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.



Trade Integration

- Trade has been an engine of growth in the region
- Considerable progress in trade liberalization:
 - Reduction in tariffs and NTTBs (in goods)
 - FDI inflows to ASEAN has been setting records
 - Regional trade agreements under discussion
 - TPP ...12 countries, including 4 ASEAN countries
 - RCEP ...ASEAN+6

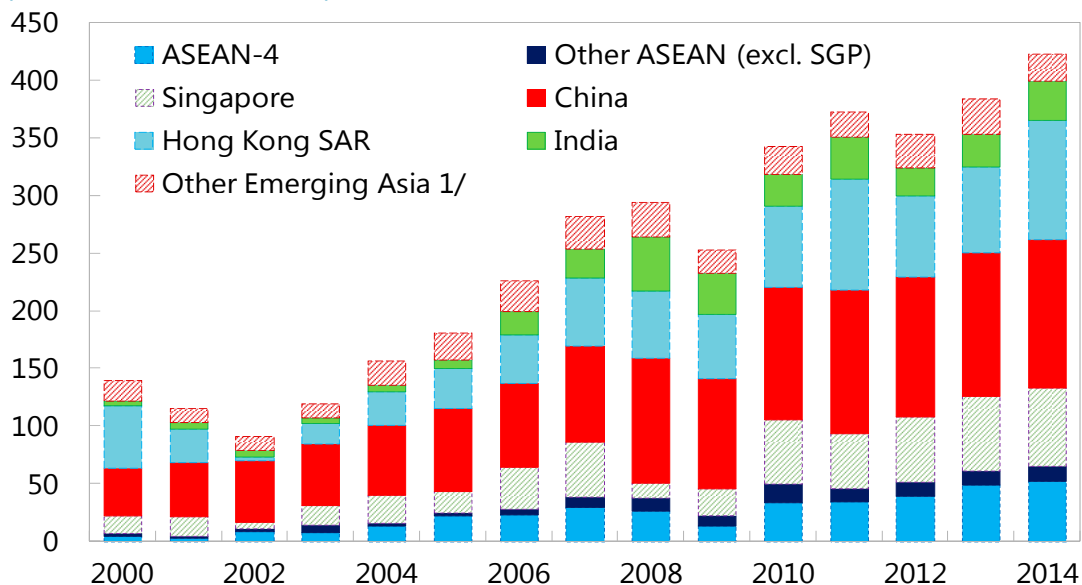
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ASEAN: FDI Inflows

Emerging Asia: FDI inflows, 2000-14

(in billions of U.S. dollars)



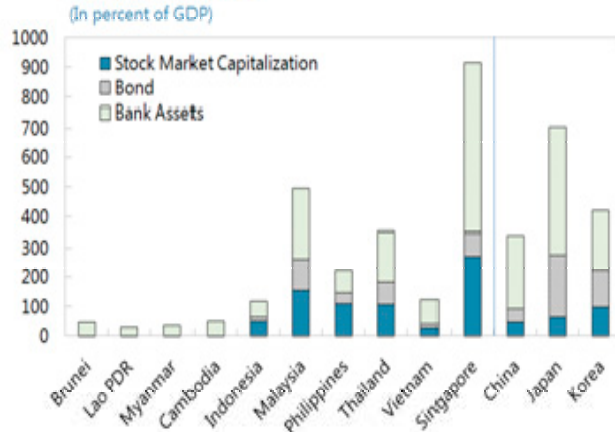
Source: UNCTAD

1/ Other Emerging Asia: Bangladesh, Bhutan, Korea, Macao SAR, Mongolia, Nepal, Sri Lanka, Taiwan PoC, Timor-Leste.



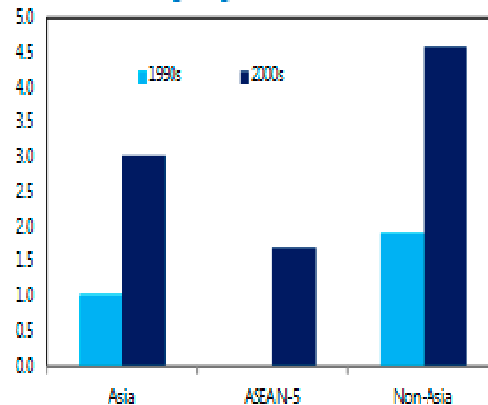
ASEAN: Financial Integration

ASEAN Financial Markets: Total Assets and Composition, 2012
(In percent of GDP)



Sources: EDSS, WEO, and staff calculation.

Bilateral Banking Integration 1/



Source: Duval, Cheng, Oh, Sarraf and Seneviratne (2014).

1/ Calculated as the period median of the median country pairs in each group, expressed in percent of the total external position with the world.

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ASEAN: Financial Integration [1]

- **ASEAN financial systems** are diverse, fragmented and at different levels of development, reflecting countries' overall stage of economic well being.
- **Record FDI into ASEAN:** FDI has been setting new records but foreign ownership restrictions are common, particularly in services.
- **Large potential benefits from FI:** because of economic heterogeneity, the benefits of further financial development and integration in ASEAN would be large.
 - Strengthened FI would help finance investment, including in infrastructure, raise growth, strengthen resilience and promote inclusion.
- **Need to make FI safe:** experience with the AFC and GFC (esp. in the euro area) underscores need for ASEAN FI to be made safe.

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ASEAN: Financial Integration [2]

- **The ASEAN way:** to this end, ASEAN's financial integration strategy has been gradual, based on coalitions of willing, the ASEAN Way.
- **CAL** has also been gradual.
- **Progress** so far:
 - ✓ Openness to inward FDI and growing outward FDI
 - ✓ Local currency bond markets in ASEAN-5
 - ✓ Asian Bond Market Initiative (ABMI)
 - ✓ SGP/MYS/THA stock market linking
 - ✓ ASEAN Infrastructure Fund

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ASEAN: Financial Integration [3]

- **Overcoming fragmentation:** more progress to:
 - harmonize national regulations and standards (e.g. bank supervision, rating agencies, credit bureaus, and securities commissions).
 - develop mutual recognition and common disclosure requirements
- **Frontier ASEAN** has to go beyond bank-centered financial systems and develop financial infrastructure and strengthen their financial regulation and supervision capabilities.
- **Regarding CAL**, while ASEAN is open to inward FDI, there is scope to remove capital account restrictions that still limit options of some ASEAN savers.



Real Convergence and Growth in ASEAN

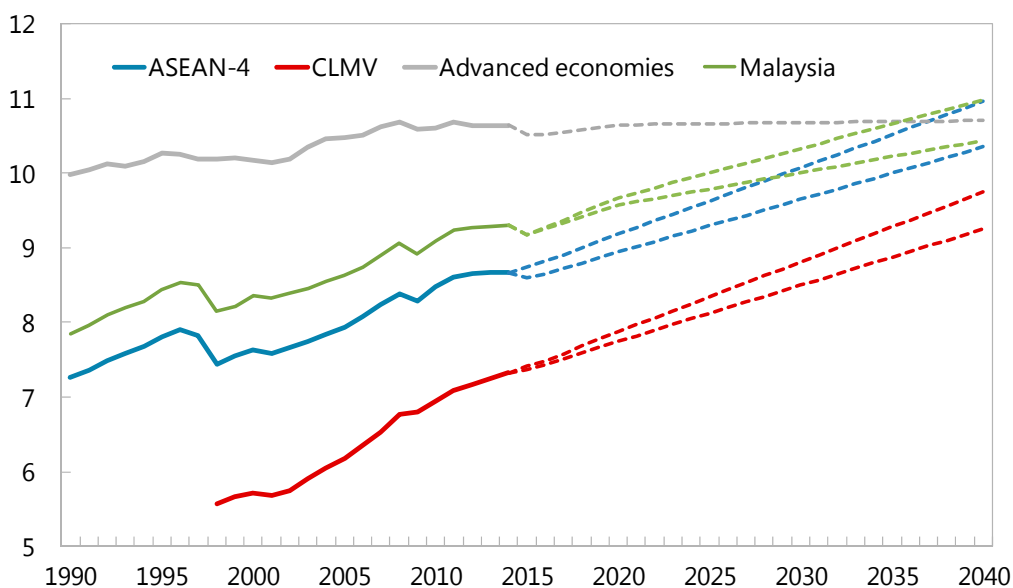
- **ASEAN is diverse** but per capita incomes remain medium or low in many countries, reflecting technology, infrastructure and education gaps. Greater FI can contribute to growth and real convergence. A calculation helps to illustrate the issue.
- **Should ASEAN be a capital importer?** The natural position would be for ASEAN to be a net capital importer:
 - This was the case pre-AFC: CA deficits of 3-6 percent of GDP.
 - ASEAN became net exporter of capital post-AFC: CA surpluses of 2 percent of GDP.
 - Reserve accumulation led to reserves of US\$800 billion although outflows since 2013.



ASEAN: Accelerating Real Convergence

GDP per Capita

(In logs of current U.S. dollars)



Sources: IMF, *World Economic Outlook*; and IMF staff calculations and projections.

Note: Advanced economies includes France, Germany, Italy, Japan, and the UK; ASEAN-4 includes Indonesia, Malaysia, Philippines and Thailand; CLMV includes Cambodia, Lao PDR, Myanmar, and Vietnam.



ASEAN: Current Account Balance

ASEAN countries: Current account balances
(In percent of GDP)

	1990-97 (Avg.)	2000-12 (Avg.)	2013
Indonesia	-2.5	1.8	-3.3
Malaysia	-5.8	12.0	3.8
Philippines	-3.7	2.0	4.0
Singapore	12.4	18.8	18.4
Thailand	-6.2	2.8	-0.7
Brunei	43.4	45.6	39.0
Cambodia	-2.8	-3.8	-8.6
Lao P.D.R.	-6.6	-16.0	-29.5
Myanmar	...	-0.5	-4.9
Vietnam	-6.8	-2.3	6.6

Source: IMF, *WEO*.



ASEAN: Scope of capital inflows

- The answer depends on progress countries make in their institutional and technological environments.
- As these rise, there would be scope for very large capital inflows into ASEAN, leading in the limit to convergence of capital intensities and output per capita—along the path of integration laid out by the AEC agreements.
- We saw this elsewhere production converge, in the real convergence in Europe's periphery, including the CEE.
- But with the large potential benefits from CAL also come considerable risks, as the euro area experience shows.
- OK to gradually open up using best practices



ASEAN: Potential Capital Inflows [2]

Table 2. Potential capital inflows to ASEAN countries
(percent of recipient's pre-inflow GDP) 1/ 2/

A_i/A_J	1	0.9	0.8	0.7
y_i/y_J				
0.1	1739	1484	1242	1015
0.2	863	734	609	489
0.3	565	474	385	294
0.4	407	333	257	174
0.5	305	238	164	77
0.6	227	162	85	-13
0.7	163	95	11	-103
0.8	106	33	-62	-197
0.9	52	-28	-137	-298
1.0	0	-90	-215	-406

1/ Calculations are based on a Cobb-Douglas production function $y_i=A_i k_i^\alpha$, with $\alpha=1/3$.

2/ Inflows for different assumptions about the recipient's TFP in relation to advanced countries.



ASEAN: Moving too cautiously on CAL ?[1]

- **Gradualist approach.** Sometimes, gradualist approaches to CAL such as those pursued in ASEAN are criticized.
- Now ASEAN countries are de facto becoming more open, although most are not as open as other emerging market countries in *de jure* classifications of capital account openness
- Response to AFC/GFC and recent volatility shows divergence:
 - ✓ ASEAN-4 tighten current account restrictions and export proceeds repatriation
 - ✓ Frontier countries continue to liberalize (from a low base)
 - ✓ In response to inflows post-GFC, some ASEAN-4 countries continued to liberalized restrictions on outflows.



ASEAN: Moving too cautiously on CAL? [2]

- A gradual pace of CAL should certainly not be an excuse for inaction. But a measured approach to CAL is warranted:
- As Park and Takagi (2012) and ADB (2013) have emphasized, restrictions related to current account, FDI and capital inflow measures could be removed quickly. ASEAN-5 already open to non-resident purchases of domestic securities (main channel of capital inflows).
- Capital outflow liberalization could also be beneficial:
 - Private outflows relieve appreciation pressure (during UMP)
 - Could enhance recycling of savings within the region
 - But a distinction could be made between institutional and retail investors.



The European Experience

- **Political commitment.** Europe's political commitment to integration was strong. It spelled out objectives and a path to integration, and how each member would benefit. But great diversity of national capabilities.
- **Risks.** Financial integration and liberalization of capital flows, especially monetary integration, raised the volume and volatility of financial flows.
- **Institutions.** Regional institutions for macro-financial surveillance, overseeing of integration and dealing with turbulence were not strong enough.



Lessons from Europe

- A single financial market requires harmonized regulations, a region-wide framework for banking oversight, and a harmonized deposit guarantee scheme.
- Effective cross-border supervision and resolution are key. The set up of regional institutions and legislative process needs to be clarified.
- Need regional frameworks and institutions to identify and monitor systemic risk and manage crises.



Summary

- Asia is a recipient of large FDI inflows, reflecting close trade links, but other dimensions of financial integration lag behind.
- Further financial integration can be beneficial to Asia, by helping to raise capital flows to low and middle income countries in Asia, including ASEAN, and closing education and infrastructure gaps.
- But financial sector liberalization and capital market liberalization need to be accompanied by the development of financial and macroeconomic institutions to manage the attendant rise in risks and vulnerabilities.
- Gradual integration strategies are broadly appropriate, although gradualism should not be an excuse for inaction.



Summary: ASEAN

- Progress is being made on FSL/CAL through regional integration initiatives but more can be done on ABMI, AIF, and stock market linking.
- Continued financial fragmentation is costly; benefits of properly-paced liberalization are clear.
- But recent crises and experience in EU underscore that strong regional institutions need to be set up before financial integration proceeds. Not doing so can be costly.
- ASEAN's gradual integration strategy is broadly appropriate, but gradualism should not be an excuse for inaction.



ASEAN: Different Stages of Economic and Financial Development

Table 1. ASEAN Countries: Selected Economic Indicators

	Indonesia	Malaysia	Philippines	Singapore	Thailand	Brunei Darussalam	Cambodia	Lao P.D.R.	Myanmar	Vietnam
GDP in 2015 (US\$ billions)	857	296	292	289	393	12	18	13	68	191
Population in 2015 (in millions)	255.5	31.1	102.2	5.5	68.8	0.4	15.5	7.0	51.8	91.7
GDP per capita in 2015 (in US\$)										
Headline	3,354	9,519	2,858	52,218	5,711	27,759	1,140	1,785	1,306	2,088
PPP-basis (2014) 1/	10,033	23,804	6,661	78,958	13,883	73,225	3,109	5,006	5,101	5,370
Poverty in 2012 (percent of population) 1/										
Below US\$2 per day	13.0	0.2	14.1	...	0.6	...	10.3	22.4	...	2.9
Below national poverty line	11.3	1.7	25.2	...	12.6	...	17.7	23.2	...	17.2
Income inequality (Gini coefficient)										
2000	29.7	37.9	46.1	43.4	42.8	n.a.	35.5	32.5	n.a.	37.6
2012 (or latest available year)	38.1	46.2	43.0	41.2	39.4	n.a.	31.8	36.2	n.a.	35.6
Trade openness in 2014 (imports plus exports in goods and services, in billion)										
Total trade	342	398	159	935	497	13	26	14	36	345
Intra-ASEAN merchandise trade	91	119	26	203	100	5	11	7	13	42
FDI inflows during 2010-12 (average, in percent of GDP)										
Total	4.0	6.2	1.1	28.9	6.4	0.6	2.1	2.8	1.1	3.3
From within ASEAN 2/	0.7	1.2	0.3	2.6	1.6	...	1.0	...	0.6	0.6
Portfolio inflows during 2010-12										
Total	2.6	9.5	6.7	9.3	5.0	0.0	0.2	2.4	0.0	0.4
From within ASEAN	0.8	1.6	0.5	1.7	0.6	0.0	0.0	0.2	0.0	-0.2
Private credit in 2014										
Growth (in percent)	13	9	20	7	5	2	31	17	75	14
Private credit (in percent of GDI)	35	130	39	131	115	33	54	41	16	100
Number of banks in 2012 3/	119	27	49	124	30	8	35	32	10	47
Of which: foreign and joint bank	24	19	15	119	14	5	12	21	0	6

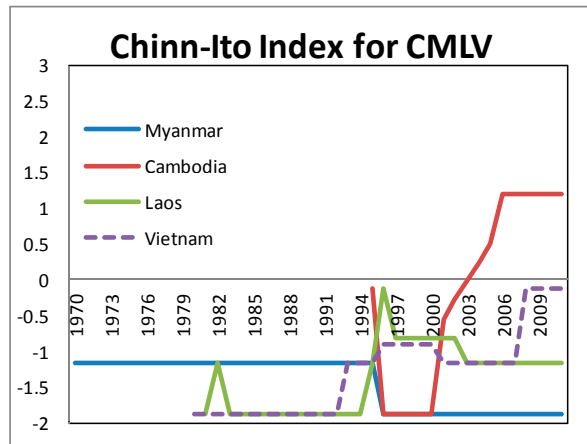
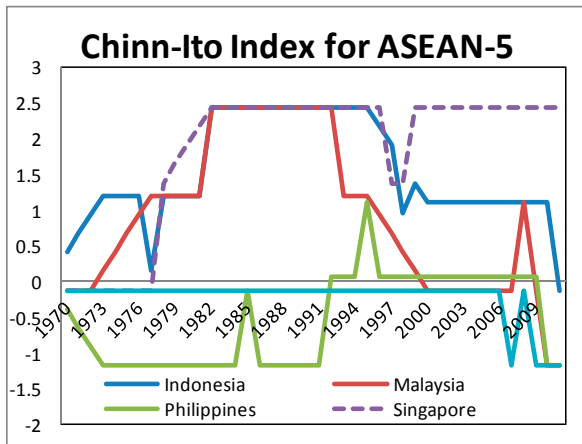
Sources: IMF, *World Economic Outlook*; *Direction of Trade Statistics*; *Coordinated Direct Investment Survey*; *Coordinated Portfolio Investment Survey*; World Bank, *World Development Indicators*; CEIC Data Co.Ltd; country authorities; Bankscope; and IMF staff calculations.

ASEAN: CAL

S'pore: open since 80s (except AFC)

ASEAN-4: only few restrictions on nonresidents buying/selling domestic securities (high de facto openness); some current account and export repatriation restrictions imposed after AFC/GFC

CMLV: financial markets less-developed (low de facto openness; but also low incipient inflows?), little effect of AFC/GFC, openness increasing from low base. Capital account restrictions and export proceeds repatriation remain. Myanmar only recently unified exchange rate



Capital Control Openness Indices (2005)

