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ASEAN Capital Market Integration: The Way Forward

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Abstract

The establishment of ASEAN was driven primarily by regional security reasons and further strengthened by their economic cooperation. Although it has been suggested that ASEAN should forge a greater financial integration, there are some reasons to believe that it may not be attainable in the near term, i.e. the segmented nature of ASEAN's financial markets, varied level of financial developments in ASEAN members, and low-level of capital account liberalization. The objective of this paper is to propose what ASEAN should do with regards to the pros and cons of financial integration. Based on the discussion at financial markets development, capital markets, bond markets, and regional financial integration in ASEAN, we have proposed that each ASEAN member country should continue to develop its capital market to promote the efficiency of investment and boost the economic growth.

Keywords: ASEAN, Financial integration, Capital market

1. Introduction

The establishment of ASEAN in 1967 - its first five member states were Thailand, Singapore, Indonesia, Malaysia and Philippines - was driven primarily by regional security reasons. Later, ASEAN attempted to forge economic cooperation as well. Eventually, economic cooperation took the center stage and become the main driver for a closer regional integration. Hence, in 1992 ASEAN initiated ASEAN Free Trade Agreement (AFTA) and followed by the introduction of the ASEAN Investment Area (AIA) in 1995. In the area of finance, the ASEAN Finance Ministers met the first time in 1997 to discuss ASEAN cooperation in finance including enhancing the integration of the region's financial sectors. The establishment of a regional framework for the development of the ASEAN bond market has been on the agenda since 2000 and in 2005 established the FTSE/ASEAN Index, an index designed specifically for the five stock exchanges of five ASEAN members, namely, Indonesia, Malaysia, the Philippines, Singapore and Thailand.

It has been suggested, as a part of the next stage of the ASEAN Economic Community (AEC) development, that ASEAN should forge a greater financial integration, including regional capital markets integration. Regional capital markets integration implies capital moves freely from one member country to another with as little as possible restrictions. Firms (issuers) and investors are free to act across the region and in any member country. Meanwhile, intermediaries (e.g., brokerage firms) are free to act across the region and recognized in every member country. Accordingly, regional investors will have access to a greater range of investment possibilities while firms will access to a larger pool of financial resources. As a further consequence, capital markets integration will lead to increasing competition among the intermediaries in the region as well as among the region's financial centers.

Yet, there are reasons to believe that forging a greater ASEAN-wide capital markets integration may not be attainable in the near term however. Firstly, ASEAN's financial markets, capital markets in particular, are segmented implying resources available to individuals and firms in most member countries come mainly from domestic saving.

Secondly, financial development varies widely among the ASEAN member countries, from an underdeveloped stage at one end of the spectrum to a highly developed at the other end. There are stark differences in the levels of capital market development among the member countries. On the one hand, there are countries whose capital markets are still at an embryonic stage as in the case of Cambodia and Laos or

non existence as in the case Myanmar which yet to establish one. On the other hand, Singapore has one of the world's leading stock exchanges. It should be noted that capital markets play a secondary or complementary role in mobilizing and allocating resources in the ASEAN member countries; the primary role is assumed by the banking sector.

Thirdly, a free flow of capital within the region presupposes all ASEAN countries have adopted an open capital account which removes restrictions to capital mobility across the borders. At the moment not every ASEAN member countries has adopted an open capital account. Capital account liberalization remains a highly contentious issue. Conventional wisdom holds financial liberalization, capital account liberalization in particular, should be among the last to be liberalized. It should be preceded by real sector liberalization, macroeconomic stabilization and establishment of a prudential supervision system. This would allow the country in question to prevent a sudden and massive capital outflow during the reform period.¹

Moreover, some argue that there is no compelling evidence of a large gap between domestic savings on the one hand and domestic investment opportunities on the other hand in developing countries on the other. Developing countries which have relied less on foreign finance, as evidence from their smaller current account deficits or even run current account surpluses, have not grown slower than those more reliant on foreign capital (Prasad et al., 2007).² Meanwhile, Lucas (1990) argues that capital flows from industrial countries where capital-labor ratio is high to developing countries where the ratio is low were much smaller than the level predicted by the neoclassical economic theory. Moreover, as Prasad and Rajan (2008) point out, in recent years, emerging economies have instead been exporting capital, on net, to richer industrial economies. As a result some emerging economies have been accumulating unprecedented amounts of foreign exchange reserves. Finally, a study by Alfaro et al. (2008) shows that foreign direct investment (FDI) does play an important role in contributing to economic growth. However, the study further argues that the positive effect of FDI depends crucially on the level of development of local financial markets. Countries with more developed financial markets tend to benefit more from FDI than less developed ones.

¹ Indonesia is an exception. It adopted capital account in early 1970s, long before it embarked on a comprehensive economic reform which started in the mid 1980s. There are at least two often-mentioned justifications for this move. Firstly, to assure foreign investors that they could repatriate their money any time they wish. Secondly, to begin with, Indonesia did not have a large amount capital, at least not in the beginning of 1970s, to justify the imposition a capital control. Another justification, most likely emerged only much later, stated that an open capital account would force the government to adopt better macroeconomic policies (macroeconomic discipline) to prevent sudden outflows of capital. Needless to say, the 1997 Asian financial crisis, casts a doubt on the validity of this argument.

² As cited in Prasad and Rajan (2008) p. 151.

The foregoing discussion has led some to surmise that there may be a development threshold associated with countries' ability to absorb foreign capital effectively. Kose et al. (2006) for example argue that a country's absorptive capacity depends on a number of factors such as local financial market development, institutional quality, governance quality, macroeconomic policies and trade integration. Above such a threshold financial integration will raise economic (GDP/TFP) growth and lower risks of crises and below it the integration will increase risks of crises but with an indeterminate impact on economic growth.³

The finance literature indicates that financial development---that is, increased provision of financial services with a wider choice of services available to all levels of society---seems to be linked to real development. Yet the exact nature of the link remains unclear. The question about the direction of causation and the exact way by which one variable influences the other are not altogether resolved. One would expect that causation runs both ways. Consider the effect of the real side on finance. It seems natural to assume that a rich financial structure is a general good: wealthier societies will tend to set up more sophisticated financial arrangements. Nowadays even banking has become highly technological. Sophisticated technology is being used in a wide range of banking activities, such as payments and assets transfer, calculation of the pricing of complex financial instrument, processing of data and their application to market transactions, and risk management.

But there may be another reason for the line of causation to run from the real to the finance side. Richer societies tend to use more complex technology, so that investment opportunities are more specialized, which in turn leads to greater information gaps between borrowers and lenders. Greater information gaps may dictate the need for more elaborate financial arrangements.⁴ Another way to think of it is that an advanced economy with a set of specialized investment opportunities needs a well-informed financial sector that will channel funds to best users.

The reverse direction of causation from the financial to real side is better understood. A well-developed financial system raises the rate of return to savings in most states of the world and for that reason also induces people to save.⁵ Moreover, in

³ There are only a small number studies about financial integration in Asia and none of them is about capital markets integration.

⁴ This line of reasoning is captured in Obstfeld (1994). He argues that growth depends on the availability of an ever-increasing array of specialized but inherently risky production inputs and that this requires portfolio diversification.

⁵ However, because of income and substitution effects, the effect of a higher return to savings on saving rates is indeterminate.

addition to allowing risk diversification on the part of savers, financial markets facilitate risk diversification for projects that will affect technological change.

2. Financial Markets Development in ASEAN

The 1997 Asian Financial Crisis provided an impetus for further financial reform in some ASEAN member states (AMS) and subsequently also for a greater regional financial cooperation. The crisis revealed the weaknesses of the region's financial sectors. It had devastating impacts on the banking sector in some countries, most notably Indonesia, Thailand, and Korea. At the center of the crisis were currencies mismatches and maturities mismatches throughout the region. A currencies mismatch occurs when residents of a country have assets in the local currency but liabilities in a foreign currency. Such was the case in many economies in Asia at the onset of the crisis. Banks and corporations with liabilities in foreign currencies, most notably dollar, were not adequately hedged against a sudden, large exchange rate change. Worse still, many of them also had large short-term liabilities relative to their assets. So when the region's local currencies experienced large depreciations against the dollar their assets were no longer sufficient to service their liabilities.

It should be noted that, before the crisis, some economies in the region adopted fixed exchange rate or managed-float exchange rate regime. Such an exchange regime provided holders of dollar-denominated liabilities with an implicit guarantee against a sudden and large depreciation of local currencies vis-à-vis the dollar. Hence banks and corporations borrowed in dollars, without adequately insuring themselves against exchange rate volatility. Moreover, they often borrowed short term to meet their long-term investment needs and, therefore, created a double mismatch: currency and maturity mismatches.

At the heart of the 1997 Asian Financial Crisis was the banking sector. The region was, and still is, depended heavily on banks as their primary financial intermediary institution (bank-centered financial system). The severity of the Asian financial crisis prompted governments in the region to undertake the necessary steps to strengthen their financial sector, the banking sector in particular. In addition, they also decided to promote greater financial integration at the regional level. The aim is to reduce financial vulnerabilities as well as to provide conduits for recycling the region's excess savings. One such attempt is a creation of the Asian bond market with help from the Asian Development Bank. In addition to that, the ASEAN Plus Three---that is, the ten ASEAN member countries plus China (including Hong Kong), Japan, and South

Korea---has launched a multilateral currency swap, drawn from a foreign exchange reserves pool currently worth \$240 billion. The swap was initiated in Chiang Mai, Thailand, hence the name Chiang Mai Initiative Multilateral (CMIM). Its main purpose is to allow member countries to manage their short-term liquidity problems.

Another off-shoot of the Asian Financial Crisis is an attempt to develop local bond markets in some Asian countries with a support from the Asian Development Bank (ADB). Prior to the crisis, only a few countries in the region that had developed bond market. The idea is that a well developed local-currency denominated bond market will help the country in question to address the currency and maturity mismatches problem noted earlier. Corporations will be able to issue long-term debts in local currency.

Unlike the Asian Financial Crisis, the 2008 global financial turmoil has had relatively mild impacts on Asian financial sectors. It signifies a number of things. First, it suggests limited exposures of the region's financial institutions to subprime mortgage-related securities. This in turn reflects, in part, the relatively low level of financial deepening or financial development, especially among the region's emerging economies. In the case of Indonesia, for instance, none of the country's banks have significant, if any, presence abroad. In addition, these banks do not undertake significant investment activities---for example, issuing and selling securities in capital markets. Second, it may also suggest an improved soundness of the region's financial institutions, especially in the aftermath of the Asian financial crisis.

Table 1. Financial Intermediation in ASEAN, 2000-2012

Country Name	Domestic credit provided by banking sector (% of GDP)					Market capitalization of listed companies (% of GDP)					Bond market capitalization (% of GDP)					
	2000	2007	2008	2010	2011	2000	2007	2008	2010	2011	2000	2007	2008	2010	2011	2012
Indonesia	61	40	37	37	39	16	49	19	51	46	37	20	16	15	13	13
Malaysia	138	109	111	127	129	125	168	81	166	137	73	82	75	95	95	107
Philippines	58	48	47	49	52	32	69	30	79	74	31	36	35	36	35	39
Singapore	80	70	82	84	94	159	210	108	174	129	48	65	68	69	74	86
Thailand	138	132	131	143	159	24	79	38	87	78	27	55	54	67	68	75
Brunei Darussalam	39	19	9	25	8	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Cambodia	6	13	16	23	24	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Lao PDR	9	7	11	27	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Myanmar	31	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Vietnam	35	96	94	136	121	N/A	28	11	19	15	0	14	16	16	14	18

Sources: World Bank and Asian Bonds Online

Recently, there have been some notable improvements in the region's banking performance: lower nonperforming loans, a higher capital adequacy ratio, and notwithstanding the global financial crisis, a higher return on assets in almost all of the

countries of the region. Meanwhile, there has been a change in the intermediary function of the banking sector, as well. The share of credit going to the corporate sector has fallen in some countries, such as Indonesia, Korea, and Malaysia, while lending to the household sector has increased significantly. In addition, the loan-to-deposit ratio is relatively low in many economies, suggesting that, for whatever reason, banks throughout the region seem to have turned more risk averse in recent years.

Financial development tends to evolve only slowly. Hervé Hannoun identifies four stages of financial deepening.⁶ The first stage is the emergence of banks that are good at dealing with asymmetric information. At this stage, banks play a leading role in mobilizing savings, allocating capital, and providing risk management instruments. The second stage involves stock market development based on an arm's length relationship between companies and investors and, hence, requires companies to publicly disclose their business activities. The next stage involves the development of fixed income markets: bond markets and money markets in which large corporations manage their short-term cash needs. The last stage involves the development of derivatives markets and securitization.

Second, stock markets are increasingly becoming an important source of investment funds through both primary and secondary issues. In general there has been a move toward improving corporate governance in the region's stock markets. This includes protection of minority shareholders and improvement in transparency through disclosure. There are two basic models of regulatory systems: disclosure based and merit based. Hong Kong, Singapore, Malaysia---and to a lesser extent Korea, Indonesia, and Thailand---have adopted the disclosure-based system, whereby the issuers and intermediaries offering securities are required to provide sufficient, accurate, and timely information pertaining to the company's business, finances, prospects, and terms of the securities to allow investors to make informed decisions. Meanwhile, China and the Philippines are still following a merit-based system. Another important development is the demutualization of a number of stock markets in the region, including Hong Kong, Indonesia, Malaysia, the Philippines, and Singapore.

Finally, unlike bank and capital markets, the bond market is relatively new for many of these countries. Its development is prompted by the severity of the crisis. While the primary markets have grown significantly, the growth in some markets has been led by quasi-government issuers or issuers with some form of credit guarantee. Moreover,

⁶ Hervé Hannoun, "Financial Deepening without Financial Excesses," speech, 43rd SEACEN Governors Conference, Jakarta, 2008.

issuers in some markets, such as Malaysia, still concentrate at the high end of the credit quality spectrum. Secondary bond markets have developed even slower than primary markets. Some markets are relatively small and, hence, seem to lack investor diversity. Foreign investors, including global financial intermediaries, have avoided these markets, discouraged by, among other things, withholding taxes and the lack of deep markets for hedging instruments.

3. Capital Markets

Of the region's emerging markets, capital markets in Singapore was among the most active in 2008, as shown by a relatively higher turnover ratio in those markets than in other markets in the region (table 2). Turnover ratio is a measure of market liquidity. The Philippines stock market was one of the least active in the region during the past decade.

Table 2. Stocks Traded, Turnover Ratio (%) in Selected AMS, 2000-2012

	2000	2005	2008	2010	2012
Indonesia	31.5	54.2	71.3	48.1	23.3
Malaysia	44.6	26.9	33.2	27.1	28.6
Philippines	24.1	20.1	22.2	22.6	16.2
Singapore	52.1	40.4	101.6	82.9	43.3
Thailand	52.9	73.9	78.2	104.8	70.4
Vietnam	n/a	24.8	44.8	82.7	13.2

Source: World Bank

Ismail Dalla notes that there has been a general move toward improving corporate governance in East Asian stock markets, including protection of minority shareholders and improvement in transparency through disclosure.⁷ There are two basic models of regulatory systems: disclosure based and merit based. Singapore and Malaysia, and to a lesser extent, Indonesia, and Thailand have adopted the disclosure-based system, whereby issuers and intermediaries offering securities are required to provide sufficient, accurate, and timely information regarding the company's business, finances, prospects, and terms of the securities, to allow investors to make informed decisions. Meanwhile, the Philippines are still following the merit-based system. Another important development is the demutualization of a number of stock markets in the region, including Hong Kong, Indonesia, Malaysia, the Philippines, and Singapore.

⁷. Dalla (2005).

Some studies concerning stock market development focus on a phenomenon known as internationalization. In recent years an increasing number of firms in emerging markets, most notably in Latin America, have turned to international markets, such as New York and London, to raise capital. It seems that most of the firms in question had hitherto been listed in their respective domestic markets. When they turned to international markets they either cross-listed their firms on domestic and international markets or delisted their firms at home. This phenomenon has raised concern because it has an adverse effect on domestic markets. In particular, there has been a reduction in the domestic trading of firms that cross-list, as trading migrates from domestic to international markets. Further, as a corollary, there has been a reduction in the liquidity of the domestic market and, hence, less liquidity for the remaining firms in the domestic market.⁸

Interestingly, most of the migrating firms are from more developed emerging markets, with sound macroeconomic policy, more efficient legal systems, better protection of shareholders (including minority shareholders), and greater openness. Firms in such markets are able attract foreign investors and will turn to international markets if they are certain they will be able to attract these investors.⁹ This has led Stijn Claessens and colleagues to tentatively conclude that large-scale internationalization may make it difficult to sustain fully fledged local stock markets and, as a consequence, may adversely affect medium-sized firms. Medium-sized firms are less likely to go directly overseas but, at the same time, may find it difficult to float their shares in shrinking local market.

It seems from the foregoing discussion that firms use domestic markets as “showrooms” to attract foreign investors’ attention. Without home markets it would be difficult for them to gauge their ability to attract foreign investors. It will be interesting to see how many firms from emerging markets bypass local markets altogether and go directly to international markets to raise capital.

This issue is important for policymakers in ASEAN who have to formulate proper responses to the internationalization phenomenon. The question of whether national financial institutions and markets still matter once domestic agents have access to foreign markets has become very important from a policy perspective.

⁸. Levine and Schumukler (2005).

⁹. Claessens, Klingebiel, and Schumukler (2006).

To answer the above question, Luigi Guiso and colleagues investigate the effect of differences in local financial development within an integrated financial market.¹⁰ They try to answer the question as to whether domestic financial markets become irrelevant in the increasingly integrated financial markets throughout the world. Their finding shows that, even in a fully integrated country like Italy, local financial development still matters. Local financial development, they find, not only enhances the probability that an individual will start his own business but also favors entry, increases competition, and promotes growth of firms. In short, local financial development matters, especially for small firms, even in the absence of restriction on capital movements. It is perhaps one reason that Western European countries, which are highly integrated with the global economy and whose capital markets have declined in importance relative to where they were a century ago, still retain their capital markets.

4. Bond Markets

Unlike bank and capital markets, the bond market is relatively new for many countries in Asia. In the aftermath of the Asian financial crisis, policymakers in the region widely recognized the importance of the bond market in avoiding currency and maturity mismatches in the financial system as well as in providing a reliable source of long-term finance to the corporate sector. In addition, the growth of a country's bond market improves the resilience of its financial system. The bond market's intermediary role becomes critical when banks and capital markets falter or fail. In other words, with a multilayer financial intermediation in place, financial intermediation activities can continue, even if the primary intermediation is in distress.

From this perspective, banks, which are AMS primary intermediation institution, capital markets, and bond markets are considered complementary. Moreover, the availability of alternative channels of financial intermediation will enhance the efficiency of the financial system as whole and, therefore, will promote economic growth and development. Following the crisis, members of the EMEAP (Executives' Meeting of East Asia Pacific Central Banks) launched the Asian Bond Fund (ABF), which aimed at broadening and deepening domestic and regional bond markets.¹¹ In June 2003 the EMEAP launched the first stage of ABF (ABF1), which invests in a basket of dollar-

¹⁰. Guiso, Sapienza, and Zingales (2002).

¹¹. EAMAP members are Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Banko Sentral ng Pilipinas, Monetary Authority of Singapore, and Bank of Thailand.

denominated bonds issued by Asian sovereign issuers in EMEAP economies (except Australia, Japan, and New Zealand). In 2005 EMEAP introduced nine funds: the Pan Asian Bond Index Fund (PAIF) and eight single-market funds, one for each of the following markets: China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand. Whereas PAIF invests in sovereign and quasi-sovereign local currency--denominated bonds issued in all of the eight markets, each of the eight single-market funds invests in sovereign and quasi-sovereign local currency--denominated bonds issued in the local market.¹²

With regard to corporate bonds, primary markets in East Asia have grown significantly. Nevertheless, Jacob Gyntelberg and colleagues note that growth in some markets has been led by quasi-government issuers or issuers with some form of credit guarantee.¹³ One possible explanation is that investors have had little access to information that would enable them to evaluate the credit risks of the issuers. Moreover, issuers in some markets still concentrate at the high end of the credit-quality spectrum. In Malaysia issuers with the equivalent of triple-A ratings account for around 40 percent of the market and issuers with the equivalent of double-A ratings account for another 40 percent. In Korea issuers with the equivalent of triple-A ratings control around 60 percent of the market. Gyntelberg and colleagues argue that it is likely that institutional investors in these markets have internal guidelines to invest only in high-quality securities.

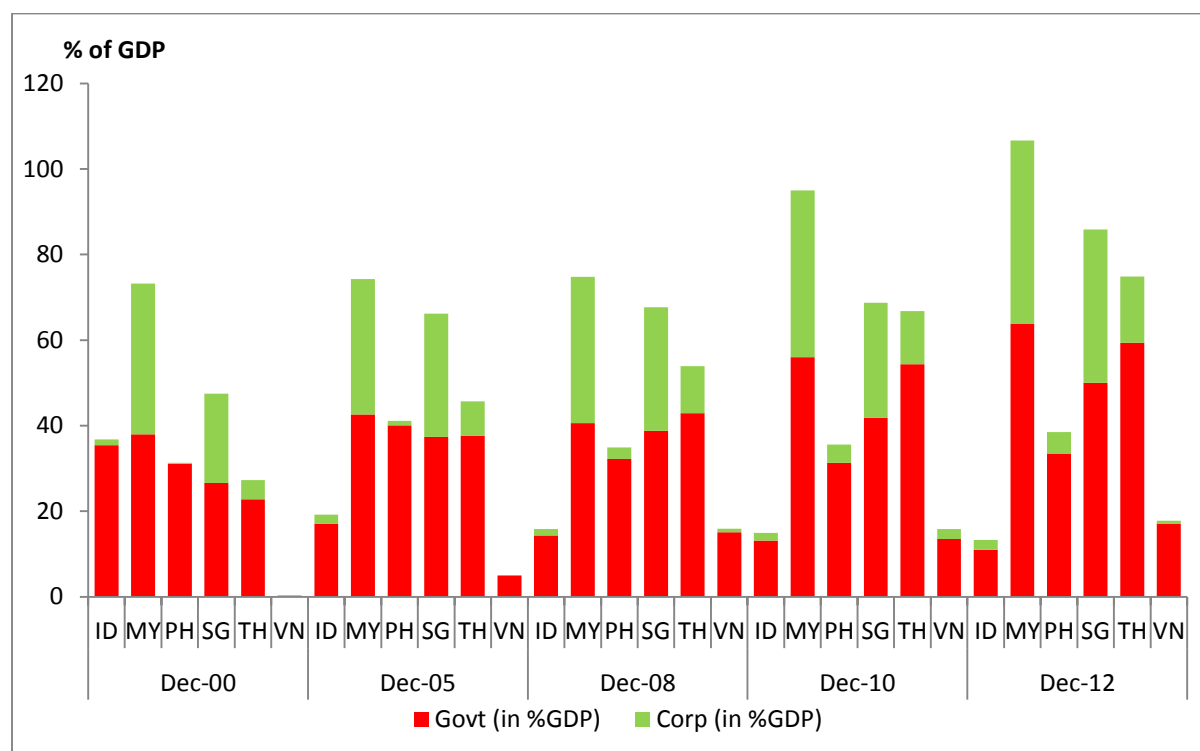
Table 3 depicts market activities in selected AMS bond markets. Most of the region's emerging markets experienced a substantial increase in activities between 2005 and 2007. However, in 2008 some of the markets experienced a decline in activities, presumably because of the global financial turbulence. In terms of issuers, the public sector still dominates in the region's emerging markets. This is consistent with Jonathan Batten and colleagues' observation that foreign borrowers, which have overwhelmingly high-quality credit and comprise sovereigns, supranational, and major financial institutions, enter a market at a later stage of bond market development.¹⁴ Meanwhile, the long-term viability of foreign bond markets appears to be linked to highly liquid foreign exchange and derivatives markets, benchmark issues, and competitive pricing among markets.

¹². Leung (2006).

¹³. Gyntelberg, Ma, and Remolona (2006).

¹⁴. Batten, Hogan, and Szilagyi (2009).

Table 3. Local Currency Bonds (% of GDP) in Selected AMS, 2000-2012



Source: Asian Bonds Online

Secondary bond markets have developed even slower than primary markets. A number of factors have been identified as possible reasons for the illiquidity of secondary markets. One is that some markets seem to lack investor diversity. In particular, foreign investors, including global financial intermediaries, seem to have avoided those markets. According to Gyntelberg and colleagues, they have been discouraged by, among other things, withholding taxes and the lack of deep markets for hedging instruments. The introduction of ABF2 has helped to address these issues. Meanwhile, John Burger and Francis Warnock argue that bond markets in developing countries tend to be more volatile and exhibit significantly more negative skewness than developed country bond markets, whether returns are hedged or not.¹⁵ These are factors that, according to them, U.S. investors shun. They also argue that improving macroeconomic stability can help mitigate these problems.

¹⁵. Burger and Warnock (2007).

In one study, Barry Eichengreen and Pipat Luengnaruemitchai focus on impediments to bond market development in Asia.¹⁶ In particular, they attempt to identify factors that constrain the growth of the region's bond markets. They argue that one such factor is the size of the economy. Larger economies tend to have bond markets with larger capitalization relative to the size of the economy (GDP) than do smaller ones. Many of the countries in the region have relatively small economies. Other factors that tend to prevent the local bond market from growing are failure of the countries to adhere to international accounting standards, corruption, and low bureaucratic quality. The authors also note that capital control tends to discourage participation in domestic bond markets, which in turn inhibits further development of the bond market in question.

5. Regional Financial Integration

In the aftermath of the 1997/98 financial crisis, countries in the region attempted to promote regional financial integration. One way to promote such integration was to take up the problem of mismatches (maturity and currency) in debtors' balance sheets. To address this issue, regional governments, with assistance from the ADB, created Asian bond markets to foster local currency debt markets. Another course of action was to recycle the region's excess savings within the region; that is, to invest them directly in the region. So far Asians had been sending large amounts of their savings abroad, especially to the United States. The savings would then come back to the region in the form of foreign direct investment and portfolio investment.¹⁷

As noted earlier, the region also established the CMIM under the auspices of the ASEAN Plus Three. The CMIM is a self-managed, reserves-pooling, arrangement governed by a single contractual agreement. The total size of the reserve pool is \$240 billion, to which China, Japan, and Korea contribute 80 percent. The breakdown is as follows: China together with Hong Kong SAR, \$76.8 billion (32 percent); Japan, \$76.8 billion (32 percent); and Korea, \$38.4 billion (16 percent). The ASEAN countries together contribute \$48 billion (20 percent) to the pool.

The purpose of greater regional financial cooperation is twofold: to prevent or, perhaps more accurately, to reduce the likelihood of a systemic financial crisis and, in case of a crisis, to mitigate its impact. With regard to the purpose of the CMIM, there is the desire, in the event of a crisis, to be able to quickly disburse funds with minimal

¹⁶. Eichengreen and Luengnaruemitchai (2004).

¹⁷. See Hannoun, "Financial Deepening."

conditionality. The desire for a quick response is understandable. A failure to promptly respond to a demand from a country that is facing a crisis may end up costing more than if the crisis and contagion were prevented in the first place.

Minimal conditionality poses a dilemma, however. Countries may run into financial problems due to various causes and, therefore, require different approaches. On the one hand, a country with a sound overall economic system may face a dire financial problem because it has been subjected to a large unanticipated external shock. In this situation, it would be unfair to impose strict conditionality. On the other hand, countries' financial problems may be of their own making. The current crisis in Greece is a case in point. The country ran into financial problems because of government economic mismanagement---that is, a budget deficit too high relative to economic output. In such a case, stricter conditionality was deemed necessary.

Strict conditionality has two main purposes. First, it may compel the government in question to undertake the necessary corrective actions to address the root causes of the problem at hand. Second, it minimizes the likelihood of a similar problem reappearing in the future. To achieve this, the CMIM should have a strong, credible, and independent regional surveillance mechanism. For this purpose, the ASEAN Plus Three countries have established the ASEAN Plus Three Macroeconomic Research Office (AMRO) to serve as a regional surveillance unit. AMRO monitor members' economic conditions and convey its findings to the respective governments. The process of regional financial integration essentially implies opening up a country's financial market to players from neighboring economies and, at the same time, allowing local residents to access the financial services available in neighboring economies.

Regional financial integration provides a number of benefits to countries involved. First, a regional market expands the scale and opportunities for financial intermediation. One advantage of a larger market is that, other things equal, it is more cost efficient than a smaller one. Second, a regional market can introduce efficiency in a local market by fostering competition, thus lowering the price of financial products and services. Third, a regional market is more able to cope with idiosyncratic risks by allowing for greater diversification of assets and markets for individual investors.¹⁸

Notwithstanding all the attempts, the regional financial integration process has been advancing only slowly; regional markets remain fragmented. A study by Soyoung Kim and Jang-Wha Lee compares the degrees of real integration and financial

¹⁸. Wakeman-Linn and Wagh (2008).

integration in East Asia using price as well as quantity measures.¹⁹ The idea is that, in fully integrated regional real markets, goods can move freely within the region. More specifically, in fully integrated markets the price should be equalized across countries (law of one price). Also, because of the interdependence through trade, one would expect to observe an increased co-movement of the countries' outputs. Similarly, in fully integrated financial markets, traders can transact financial assets freely within the region. In particular, one would expect to observe the equalization of returns to equivalent financial assets across the region. Meanwhile, better risk sharing resulting from the integration tends to increase the co-movement of consumption across the region.

Kim and Lee find that, on the one hand, real integration has been accelerating, as evidenced by increasing intraregional trade among countries in the region. In particular, they find that real integration based on output linkages increased substantially both regionally and globally following the East Asian financial crisis. On the other hand, regional financial integration clearly lags behind. More specifically, East Asian financial markets are integrated relatively more with global markets than with each other. In another study, Lee utilizes the gravity model to investigate the patterns and determinants of financial integration in East Asia.²⁰ He finds that holding of bilateral assets (equity portfolio and debt securities) are lower in East Asia than in Europe. He attributes this phenomenon to an underdeveloped financial infrastructure, low capital account liberalization, and high exchange rate volatility.

In an earlier study, Barry Eichengreen and Yung Chul Park ask the question as to why there has been less financial integration in Asia than in Europe.²¹ The study focuses on cross-border bank claims, which are available on a bilateral basis. They observe that cross-border bank claims in Europe account for around 33.9 percent of GDP, compared to a mere 3.5 percent in Asia. However, they further note that cross-border bank claims are strongly related to per capita income. The authors therefore conclude that the difference between the two regions in cross-border bank claims is largely the result of their very different levels of economic development as well as differences in factors such as geography and language. The authors also suggest that, since intraregional export as a percentage of GDP are only a third of what they are in

¹⁹. Kim and Lee (2008).

²⁰. Lee (2008).

²¹. Eichengreen and Park (2003).

Europe, Asia needs additional cross-border finance to support further intraregional trade.

Since 2007, the ASEAN vision is to have financial market integration supporting regional economic integration and regional economic growth. An Implementation Plan for an Integrated Capital Market has been agreed in 2009 to enhance market access and liquidity by harmonizing ASEAN members standards prior to converging to global standards, facilitating cross-border trade through mutual recognition regime, developing market infrastructure to support exchange linkages and establishing appropriate safeguards for financial system stability. Given ASEAN Member States' social and economic diversity, the ASEAN chose to follow liberalization through the ASEAN minus X formula to give more flexibility.

6. The Way Forward: Financial Deepening and Competitiveness of Financial Centers in ASEAN

Based on the foregoing discussion, there are a number of steps that ASEAN may want to consider with regard to the proposed ASEAN capital markets integration. Firstly, it is by now clear that each ASEAN member country should continue to develop its capital market as a part of the country's overall financial development irrespective of the integration plan. As noted, while the exact nature of the link remains unclear, it is also obvious that a sound and sophisticated financial system promotes the efficiency of investment and hence economic growth and that a poorly functioning financial system can inhibit economic growth.

It is therefore imperative that Southeast Asian economies continue to deepen their financial sector. As mentioned in the Introduction, capital market development varies widely among the ASEAN member countries. On the one hand, capital markets of Cambodia and Laos, for instance, are still at an embryonic stage while Myanmar is yet to establish one. On the other hand, Singapore has a highly developed stock exchange. Meanwhile, some other markets need to increase their transparency through disclosure by requiring the issuers and intermediaries offering securities to provide sufficient, accurate, and timely information pertaining the company's business, finances, prospects, and terms of securities to allow investors to make informed decisions. The overall objective is to establish well-regulated and competitive capital markets in the region. This requires improvements in the regulatory systems in which the markets operate and

in the provision of information to market participants. It also requires reasonable legal and accounting systems to be in place.

As a corollary, it may be necessary for AMS with more developed capital markets to offer technical assistance to those with less developed ones. Such technical assistance may include development of regulatory frameworks, accounting system and other capital market infrastructure and should be done with the integration plan in mind. With regard to regulatory framework, the proposed capital markets integration requires AMS laws and regulations pertaining capital markets should be harmonized. Prudential regulations are meant to protect investors, ensure that financial markets are fair, transparent and efficient and reduce systemic risks. A strong prudential regulatory environment is the key to a successful financial center. A strong regulatory environment implies the existence an independent and highly motivated regulator whose objective would be to ensure the integrity of the financial market. The existence of independent regulatory bodies are crucial especially in countries where courts are underfinanced, unmotivated, unclear as to how the law applies, unfamiliar with economic issues, or even corrupt (Glaeser et al., 2001). In fact, contrary to popular wisdom, most financial institutions do not want lax regulation largely because their clients need the assurance that the institutions with which they do business are trustworthy.

Similarly AMS should adhere to the same generally accepted accounting principles (GAAP) or accounting standards, preferably international accounting standards that would eventually lead to the adoption of International Financial Reporting Standards (IFRS). There are a number of reasons as to why this is important. Firstly, the issue of how information is disclosed to the market is a crucial matter in ensuring market efficiency. Secondly, in anticipation of increasing cross-listing of firms in a number of the region's stock exchanges require a single, universal set of accounting principles or standards. Finally, the adherence to such a set of standards will reduce the cost of acquiring information and, hence, encouraging investors to engage in different markets in the region at the same time.

As for the capital market infrastructure (see annex for details), AMS should aim at establishing standardized clearing and settlement systems for the integrated regional markets. This implies AMS may want to adopt the same standards for clearing and settlement systems in their respective markets. The importance of an efficient securities clearing and settlement system lies on the safer transfer of ownership of assets against payment. In a study about cross-border securities clearing and settlement in the Europe Union, de Carvalho (2004) points out that the fragmented structure of local securities

depositories has hindered the integration of financial markets in Europe. Such a fragmentation leads to much more expensive and riskier cross-border securities clearance and settlement transactions than if cleared and settled domestically. This reduces the incentive for investors to seek and engage in cross-border investment opportunities.

It should also be noted that neither the plan for a regional capital markets integration nor the fact that capital market development may involve economies of scale diminishes the importance of local capital market development in every AMS. On the contrary, local financial development is crucial to economic development in general, not only because it enhances the probability that an individual will start his own business but also because it favors entry, increases competition, and promotes growth of firms even in the absence of restriction on capital movements (Guiso et al., 2004). Also, the availability of local financial market, local bank in particular, promoted a faster growth for small and medium-size firms, lower the likelihood of firms exit and raise the likelihood of investment (Fafchamps and Schundeln, 2012). It should however be noted that it may take many years before a capital market become sufficiently efficient. For a capital market to become effective in promoting investment, foreign investment in particular, the market needs to reach a certain level of development (Alfaro et al., 2008, Kose et al., 2006 and, Prasad and Rajan, 2008).

Needless to say, some of the region's capital market may never reach the efficiency level noted above. One reason is that not all factors that influence capital market development are subject to external inducement. Market liquidity, for example, is self enforcing for which external stimulus is likely to have only a limited effect and it may take many years before it reaches a self sustaining level if at all.²² Be that as it may, there is nevertheless no a priory way to determine which of the region's market or markets will be in that category.

With regard to local bond market, many of the constraints identified as inhibiting bond market development, such as the relatively small size of the market, are external in nature. But there are factors that tend to discourage participation in domestic markets---such as failure to adhere to international accounting standards, corruption, low bureaucratic quality, and capital control---that the government can remedy. As with the capital market, foreign investors are necessary for further development of the bond market. The governments of the region should address these issues if they hope to

²² A further study may be necessary to determine whether cross-listing of stocks between a less-developed capital market and a more-developed one would increase the liquidity of the former.

develop their bond markets. Emerging markets also tend to be relatively more volatile, and this may be addressed by seeking macroeconomic stability.

Secondly, with regard to the proposed ASEAN capital markets integration, there are two possible modes the AMS can take, i.e., top-down approach and bottom-up approach. In the top down approach, the governments take the lead by laying down the necessary steps that the capital markets have to take as well as the timeline to achieve those targets. This is similar to the roadmap to establish a single goods market in ASEAN. That is, the AMS should ensure that they have a common perception early on about how to proceed with the regional capital markets plan: what are the prerequisites as well as necessary steps to achieve the goal. But there are significant differences between achieving a single market for goods and capital markets integration. First, harmonization of AMS domestic rules and regulations pertaining capital market should precede the integration. This includes accounting and financial reporting standards. Second, unlike ASEAN Single Window which is essentially a trade facilitation facility, the establishment of regional securities and settlement infrastructure is prerequisite to financial markets integration and therefore should be in place prior to the integration. Third, because of the nature of the capital market development discussed throughout, it may be difficult to set a timetable for a particular market to join the integration program.

To illustrate the last point, it has been reported that Vietnam's State Securities is considering raising the limit of foreign ownership from 49% of outstanding shares to 51-60% by allowing listed firms to issue non-voting shares. Vietnam has two stock exchanges with about 700 listed companies. Meanwhile the Lao Securities Exchange that opened in January 2011 has only two listed companies, both state-owned, i.e., EDL Generation-Public Co., an electric power company and a bank, Banque Pour Le Commerce Exterieur Lao (BCEL). On the other hand, on the Cambodia Securities Exchange which began operation in April 2012 there is only one firm, i.e., Phnom Penh Water Supply Authority. Finally Myanmar plans to open its stock market in 2015.²³

A number of ASEAN's stock exchanges have taken some steps that may be regarded as a bottom-up approach to the regional capital markets integration. In particular, seven ASEAN stock exchanges one each from Indonesia, Malaysia, the Philippines, Singapore and Thailand and two from Vietnam have collaborated to establish the ASEAN Exchange with an objective to promote greater liquidity in the

²³ "ASEAN's Latecomers Reform Bourses to Attract Cash," downloaded from Nikkei.com file:///D:/Financial%20Development/2013%2004%2024%2011%2024%20-%20ASEAN's%20Latecomers%20Reform%20Bourses%20To%20Attract%20Cash.htm

member exchanges. The members agree to streamline access to and within ASEAN, harmonizing rules and regulations and improving efficiency among member exchanges. So far three of ASEAN Exchange, namely, Bursa Malaysia, Singapore Exchange and the Stock Exchange of Thailand have established a gateway for securities brokers to offers investors easier access to connected the exchanges. The gateway is called ASEAN Trading Link with the main purpose is to make it as easy for investors to trade on other ASEAN stock exchanges as on their own domestic capital market.²⁴

Note that there is no inherent contradiction between the top-down and bottom-up approaches in this respect. In fact they can be viewed as complementary to each other. As noted the members of the ASEAN Exchange attempt to streamline access to and within ASEAN, harmonizing rules and regulations and improving efficiency among member exchanges. But these exactly what the governments are expected to do. The governments need to ensure that the process is inclusive in that it does not discriminate against investors from the non-member exchanges. One way to ensure this is for the members of the ASEAN Exchange to keep the securities regulatory bodies in their respective countries informed of the integration programs and processes.

It is conceivable, however, that the bottom-up process mentioned above may stop short of achieving a full integration of capital markets in the region. Recall that regional capital markets integration needs to satisfy a number of conditions: (i) capital moves freely from one member country to another with as little as possible restrictions; (ii) firms (issuers) and investors are free to act across the region and in any member country; (iii) intermediaries (e.g., brokerage firms) are free to act across the region and recognized in every member country. Accordingly, capital markets integration will lead to increasing competition among the intermediaries in the region as well as among the region's financial centers. But members of one or more of the exchanges may not consider it is in their best interest to have a greater competition among the intermediaries. More specifically, they may see allowing foreign brokerage firms to establish their presence in the domestic exchange as against their best interest. In general, when it comes to capital markets integration, the perceived private benefits by some members of an exchange do not necessarily coincide with social benefits of such integration. And this would be a sufficient reason for governments' involvement in the process. The governments may, for instance, require that the region's capital markets to gradually allowing brokerage firms to establish their presence in each other markets.

²⁴ Source: <http://aseanexchanges.org>

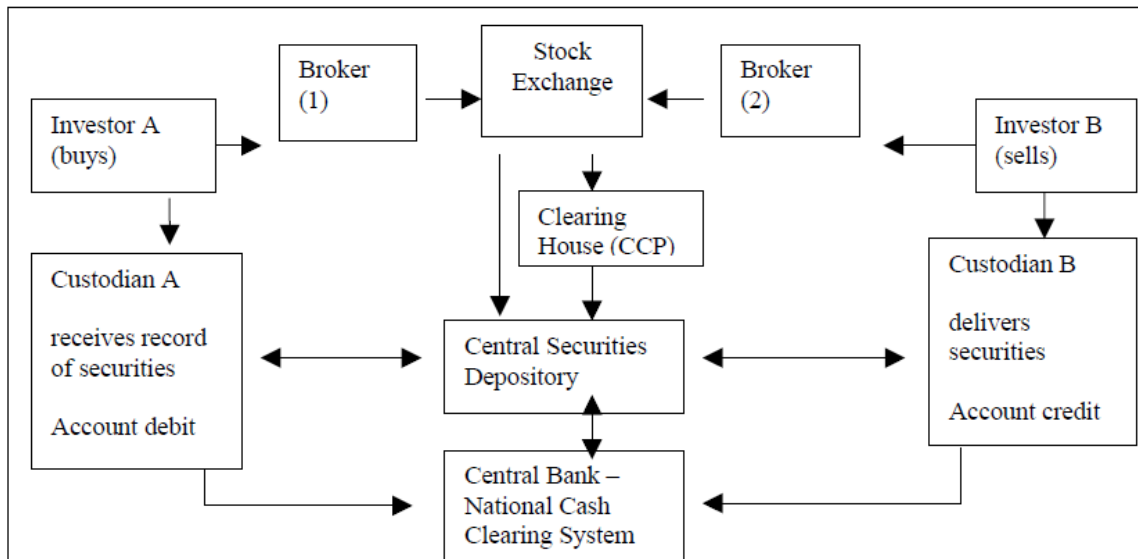
Note also that there is nothing in the discussion thus far against national exchanges to compete with each other. And since arguably capital market development involves economies of scale, it is conceivable one market may become a dominant, regional or even global market, while the rest remain local markets. Nor there is any fundamental reason against the possibility of a merger between two or more of the ASEAN's exchanges or, for that matter, between an ASEAN's exchange and a non-ASEAN's exchange. In each of these issues the governments should make sure that they do not get in the way unless they have reasons to believe that the process in question is flawed.

Annex: Capital Market Infrastructure for Clearing and Settlement

Clearing and Settlement Process for domestic capital market transactions is illustrated in Figure 1 below. The Clearing process is defined as the process of transmitting, reconciling, and in some cases, confirming payment orders or security transfer instructions prior to settlement (CPSS, 2001). Generally, the clearing process attempts to manage risks that may emerge between a trade taking place and being settled. Clearing houses, central securities depositories or international central securities depositories are key players in the clearing process. The Settlement process is an exchange of cash and assets between buyers and sellers to fulfill contractual obligations. For equity trading, settlement process is normally carried out through Central Securities Depository—also known as Securities Settlement system.

The overall clearing and settlement process usually takes place in several working days. A transaction starts with investment firms (investor A buys/investor B sells) instruct orders buying/selling a specified number of shares of a company at a specified price to their respective brokers. Next, brokers send these orders to market (stock exchange). The stock exchange responds by matching buying/selling orders through a process of bids and offers, resulting in prices being determined by market supply and demand. The stock exchange routes back these matching-price result to brokers who in turn, will send to clearing house (if any) and/or to central securities depository. On the other hand, the investment firms inform their custodians that they should expect to receive from/deliver to central securities depository institution. Custodians (usually banks) will match and reconfirm the accounts to which the security and payment would be delivered. This is all done in (T+0) day. On settlement date (usually T+3) day, the brokers will deliver/receive the matching amount of shares/money to settle the trade.

Figure 1. Domestic Trade, Clearing and Settlement



Source: Carvalho (2004)

To sum up, the key players and participants in the capital market are as below:

1. Investors/investment firms: an individual/firm who makes investment. They can be a person, banks, trust fund etc.
2. Brokers. There are different types of brokers in the capital market, notably: broker-dealer (usually a broker-dealer is a company that trades securities for its own account or on behalf of its clients); floor broker (an independent member of an exchange who act as broker for other members and as agent on the floor of the exchange); floor trader (person who trades for his or her own account)
3. Market maker: a firm that quotes both a buy and a sell price in a financial instrument or commodity on a regular and continuous basis.
4. Trader. Like brokers, there are different types of traders. They are stock traders (an individual or organization that buys and sells stocks or other financial instruments in the financial markets); proprietary traders (a company that trades stocks, bonds, currencies, or other financial instruments with the firm's own money so as to make a profit for itself).
5. Analyst - A specialist in the numerical or quantitative techniques of finance. In the investment industry, they are frequently called quants.

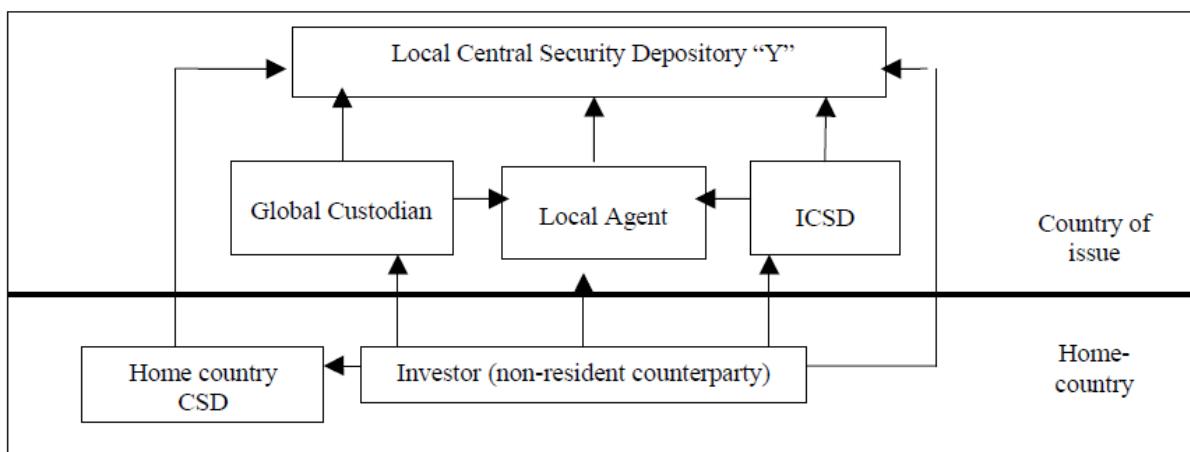
Note that the quality of the physical and human infrastructure such as stock exchanges, trading platforms, payment systems, central securities depositories (CSDs),

certified brokers/traders etc. plays a crucial role in the ability of any market to attract international investors. If risks or costs are high, investors will be deterred, liquidity will be lost, and the market will not develop as rapidly as it could. Both local and international investors must ensure that the market infrastructure operates to international standards in order to attract more capital into market.

Cross-border Clearing and Settlement is defined by Committee on Payment and Settlement System (CPSS) of the Bank of International Settlements (BIS) as trade between counterparties located in different countries (for instance, investor from country X orders to purchase securities/bonds held by investor from country Y) with security settlement being realized in a distinct country of one or both counterparties. Note that securities/bonds traded in this example may or may not be issued in one or both countries X and Y.

Cross-border transaction must be cleared and settled through a number of interactions among different country's settlement systems. Cross-border transaction may go through bilateral links between home country Central Securities Depository institution and country of issue's CSD. Other than that, cross-border transaction may also occur through global custodians who usually have local agents. These local agents have access to a country's CSD. Therefore, international investors used access of local agents to local CSD. Figure 2 illustrate the cross-border transaction below.

Figure 2. Cross-border Settlement



Source: Carvalho (2004)

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